Discussion of

Firm Dynamics and Aggregate Volatility with Endogenously Segemented Credit Markets

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by

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Research Question:

- Does the macroeconomic transmission of aggregate shocks depend on the characteristics of the financial sector?

Answer:

Yes.

Better Research Question:

- How much do bank capital requirements matter in a dynamic general equilibrium model with optimal bond and bank credit contracts, capital, goods and labor markets, and firms heterogeneous by capital and investment return?

Answer:

Quite a lot.

Essential points

- Banks are more efficient than bond market, but more expensive.
  $\longrightarrow$ more bank lending leads to less volatility;
- Firms are borrowing constraint, especially small ones:
  $\longrightarrow$ go to banks and pay spread,
  $\longrightarrow$ suffer most when capital requirements are binding;
- Entrepeneurship is very risky
  $\longrightarrow$ strong need for risk sharing;
- Penalty for repudiation is mild
  $\longrightarrow$ entrepreneurs can still extract surplus.

Issue 1: Closing capital markets

What is the interaction between investors, banks and entrepreneurs?

r is exogenous.

Issue 2: The financing of banks is important

Capital requirements are met for each contract individually.

Not clear where funds come from.

r is exogenous.

No occupational choice.

Issue 3: Choosing bonds or banks

Trade-off: banks are more costly, default penalty is higher, but small firms are more constrained.

Why not diversify?

Difficult extensions

Unsuccessful bond subscriptions converted to loans.

$\longrightarrow$ make capital requirements binding.

$\longrightarrow$ crowd small firms out even more.

Proper penalties for default.