SONOMA: Small Open Economy for Macrofinance
Croce, Jahan-Parvar, and Rosen

Discussion – MFA – August 2020

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This Paper

Modern International Macrofinance Model

- Why a quantitative small open economy model
  - Policy analysis: ask the Italian!
  - Firm credit frictions (Jermann-Quadrini) interacted with external (international) financing ...
  - ... sprinkled with RBC shocks and LRR shocks.
- No exchange rates
  - Focus on Eurozone countries (Greece, Italy, Portugal, Spain)

Take-away

- Robust enough for policy analysis (small scale DSGE) ...
- New results
  - Firm credit frictions are dampened in small economy model (through)
  - External financing shocks matter: they are financial shocks

This Discussion

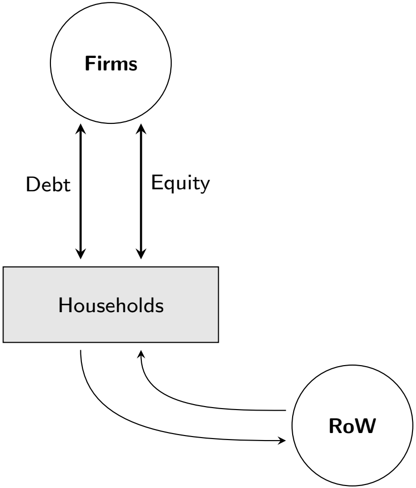
A lot to cover ...

- Present framework and insist on crucial new mechanisms
- Discuss some of the implications

Plan

1. Framework: Open Economy with Macrofinance

2. Discussion: a Model of the Eurozone

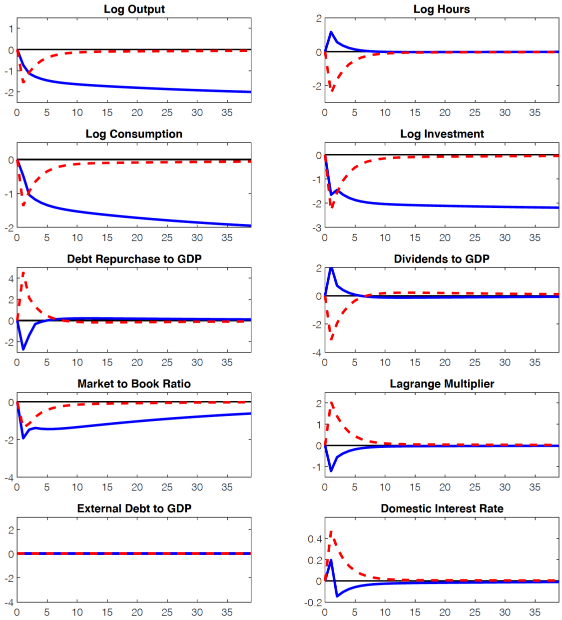

Firms
Debt
Equity
Households
RoW

Basic Mechanisms

Firms face financing constraints

- Bad financing shock: increase in discount rate
- Standard IRF response

Basic Mechanisms

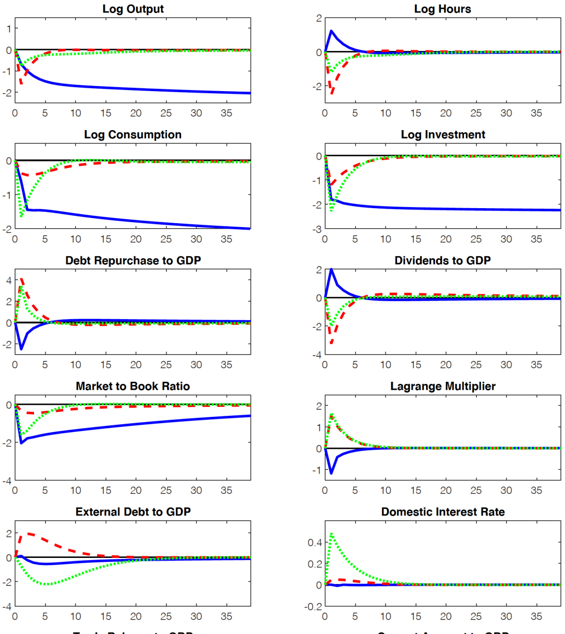


Basic Mechanisms

Insight from the open economy model

- New margin of adjustment: households funding source through external markets
- Dampened adjustment to financing friction:
- Substitution from internal to external funding

Basic Mechanisms



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Response to a shock to external financing

Change in External Financing

- Exogenous shock of external financing
  - Is it the *bund* that increases or the spread that rises?
  - Local spreads are tied to local economics conditions
    - e.g. internal financing constraints, leverage
- What exactly is this shock?

Why this matters?

- Endogeneity of local credit conditions and external funding
  - *Twin Crisis*
  - When banking sector is most fragile that capital flows outwards
- Here both sources of financing are substitute, not "complements"
- Room for considering these jointly in the model?
- Important if we want to consider monetary policy

Response to a shock to external financing

Other Responses

- Exports fall to reequilibrate current account balances
  - Labor falls: do we see in practice hours falling or wage falling
    - Mundell metaphor of the tail wagging the dog with fixed exchange rates
  - Do we see gross exports or gross imports falling? This matters for firm adjustment
    - No notion of import in the model
- Important if we want to consider fiscal policy

State Dependence

Non linear response

- Role of external financing is independent of financial situation
  - Stream of positive shocks: high debt accumulation and leverage
- Withdrawing external funding can be very costly
  - Rapid deleveraging
- Less costly in a low leverage economy:
- Importance of the link between financing conditions in domestic and RoW

Other Comments

Granularity

- Focus on one country
  - More granular data
    - Amadeus has balance sheet data
  - Estimate the real substitution from internal to external funding
- Important if we want to consider Eurozone coordinated policies

Final Thoughts

Very interesting Paper!

Take away

- New approach to bring together two literature and answer big policy questions
- Interesting mechanism between local firm financing and outside international funding

Maybe later

- Role of exchange rates (Mundell)