Monetary uncertainty and default
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Contribution

- The DSGE model with banking sector and endogenous default choice for banks and firms
- The effects of monetary uncertainty shocks on aggregate economy and default rates

Model

- DSGE model with three sectors: households, firms and banks
- Cash-in-advance (CIA) constraint for households
- Working capital constraint for firms (firms need borrow from banks to finance wage bills)
- Banks and firms experience disutility from defaulting (Shubik and Wilson, 1977; Dubey, Geanakoplos and Shubik, 2005). Endogenous repayment choice.
- 3 shocks: productivity shock, monetary shock and monetary uncertainty shock

Results

The effects of monetary uncertainty shock:

- households deposit more for precautionary reasons and work more
- investment and capital of firms decrease
- output falls (after short increase due to higher labour supply)
- default rate of firms climbs
- ... while that of banks drops

Comment 1: Identification of monetary policy shocks

- Money supply is fully exogenous in the model:

$$\ln m_t = \rho_m \ln m_{t-1} + (1 - \rho_m) \ln \bar{m} + \chi \sigma_{m,t} \epsilon_{m,t}$$

$$\epsilon_{m,t} \sim i.i.d. N(0,1)$$

- In practice, monetary aggregates respond endogenously to non-policy variables and shocks.

- Identification of monetary policy shocks (Bernanke and Mihov, 1998; Romer and Romer 2004).

- Estimates of monetary uncertainty shocks may be affected too. Multivariate GARCH?
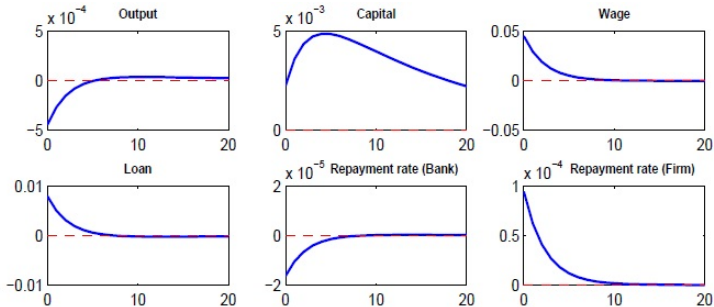
Comment 2: Dynamic responses to monetary shocks

No liquidity effect (interest rates rise in response to expansionary monetary shock)!?
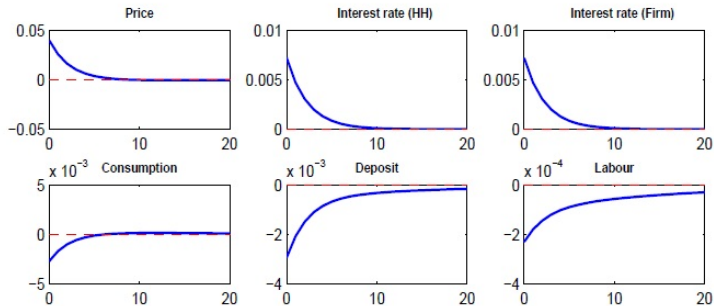
Comment 2: Dynamic responses to monetary shocks

Rising bank default rate in response to more liquidity in banking system!?

Comment 3: Ad hoc nature of default costs

- Default costs are introduced as a (dis)utility term in bank and firm problems.
- Easy to compute.
- No microfoundations.
- The models with limited commitment and *actual* equilibrium defaults (Hopenhayn and Werning, 2008).