

Discussion of “Long Run Inflation and Financial Panics”

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Focus of the paper

Research question: What are the effects of long-run (or *trend*) inflation on financial instability (in the form of *bank runs*)

Contribution to the literature:

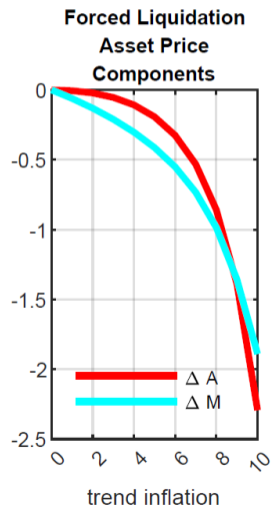
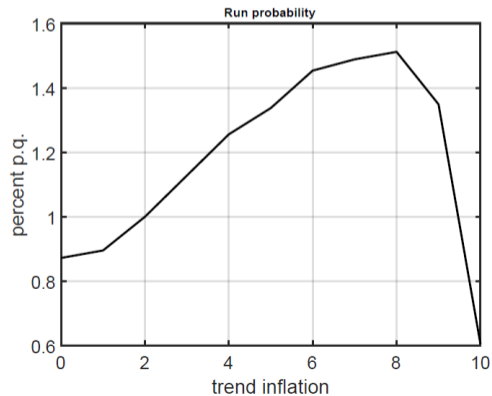
- ▶ Going further than short-run financial stability risk and short term deviations from inflation targets
- ▶ Going further than investigating the effects of long-run inflation on the macroeconomy

Methodology: New Keynesian DSGE model where system-wide bank runs can arise endogenously to compare the probability of having a bank run for economies that only differ in terms of trend inflation

Findings of the paper

- ▶ The probability of having a bank run is hump-shaped in trend inflation, driven by the magnitude of **asset price declines**
- ▶ **Mechanism:** the stronger the decline in asset prices, the larger the deterioration of banks' balance sheets → larger likelihood of bank run
- ▶ Two opposing forces drive the **link between trend inflation and the decline of assets prices**
 - Higher trend inflation → monopolistic markup ↑ (because firms become more forward looking) → expected rental rate of capital ↓ → earnings on assets ↓
 - Higher trend inflation → income and consumption ↓ → marginal utility of consumption ↓ → comparative disadvantage (marginal value in terms of non-goods of inefficiency) of non-banks in issuing credit ↓ → smaller decline in asset prices

Findings of the paper



General assessment

- ▶ Nice and very topical paper! Especially in light of inflation that might be more persistent than anticipated
- ▶ Important findings on link between high trend inflation and financial instability: hump shaped
- ▶ Clear language and well-explained mechanisms, not too technical
- ▶ Need for clarification on 3 fronts (**main comments**):
 1. How do certain assumptions impact the results?
 2. Can you empirically validate your results?
 3. What are the policy implications of your findings?

Comment 1: assumptions

Strong (?) assumption 1: “deposits are uninsured”

- ▶ Quick check for the largest euro area banks: on average only 35% of deposits is uninsured
- ▶ Drechsler et al., 2023: “... *the run risk only applies to the portion of the deposit franchise that comes from uninsured deposits*” → Would be good to get an idea of how changing this assumption would affect your results
- ▶ In general, it might be important to position your paper w.r.t. this paper, e.g. “*The key insight is that a run equilibrium only emerges at high interest rates*”

Comment 1: assumptions

Strong (?) assumption 2: “banks are completely unregulated”

- ▶ Capital regulation → effect on bank leverage?
- ▶ Liquidity regulation (LCR, NSFR) → effect on liquidation price?

Ikeda, 2024: analyzes the impact of leverage and liquidity regulation on bank runs

Comment 2: empirical validity

Calibration:

- ▶ effect of inclusion of GFC and L4L period in calibration? Robustness to inclusion/exclusion of certain periods?
- ▶ are the results sensitive to the 'ad hoc' calibration of the sunspot probability of financial crises?

Validation:

- ▶ do you see that historical episodes of high trend inflation are linked to a larger occurrence of bank runs?
- ▶ do you have empirical evidence for the statement that with higher trend inflation a larger fraction of credit is intermediated by non-banks?

Comment 3: policy implications

- ▶ For now limited attention in the paper given to policy implications: *"If the rate of price increase turns out to be that high for a prolonged period of time, certain macroprudential measures might be warranted in order to increase the resilience of the banking sector"*
- ▶ Drechsler et al., 2023 argue for a rate-cyclical optimal capital buffer, could there be a rationale for an capital buffer depending on the level of the trend inflation?
- ▶ Ikeda, 2024 calculates the optimal joint leverage and liquidity requirements

Bibliography

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