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FINANCE

IÉSEG SCHOOL OF MANAGEMENT

EMPOWERING CHANGEMAKERS FOR A BETTER SOCIETY

'BANKRUPTCY CODES AND RISK SHARING OF CURRENCY UNIONS'

XUAN WANG – VU AMSTERDAM

ABSTRACT

Since the Eurozone Crisis of 2010-12, a critical debate on the viability of a currency union has focused on the role of a fiscal union in adjusting for country heterogeneity. However, a fully-fledged fiscal union may not be politically feasible. This paper develops a two-country general equilibrium model to examine the benefits of the bankruptcy code of a capital markets union - in the absence of a fiscal union - as an alternative mechanism to improve the financial stability and welfare of a currency union. When the banking sector cannot fully enforce loan repayment, I show that a lenient bankruptcy code in the cross-border capital markets union removes the pecuniary externality of banking insolvency, so it leads to a Pareto improvement within the currency union. Moreover, the absence of floating nominal exchange rates removes a mechanism to neutralise domestic credit risks; I show that softening the bankruptcy code can recoup the lost benefits of floating nominal exchange rates. The model provides the financial stability and welfare implications of bankruptcy within a capital markets union in the Eurozone.

Keywords: Equilibrium default, bankruptcy code, fiscal union, capital markets union, financial stability, bank credit and inside money, price-level and exchange rate determinacy, liquidity-intermediary asset pricing

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