



# Policy measures in the deleveraging process: A macroprudential evaluation

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## Abstract

This paper evaluates post-crisis effects of deleveraging policy in Slovenia. Reductions in banks' credits to nonfinancial sectors were driven by increased collateralization, credit rationing, and a neglect of cash flow performance of banking clients. These jeopardized the normal deleveraging of companies with positive cash flows, and rolling over credits, which stifled economic growth. Erroneous sequencing, timing, and calibration of measures steering the deleveraging process generated these processes. Optimal deleveraging process demands that the Central Bank also focus on the stability of the financial system. This task should be a constitutional part of the third macro policy pillar, namely macroprudential policy.

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## 1. Introduction

In many developed countries much focus has been placed on fiscal consolidation policies due to excessive budget deficits resulting from the eruption of the crisis. However, the latest study conducted by [Blanchard and Leigh \(2013\)](#) shows that the introduction of fiscal consolidations

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resulted in even lower economic growth than foreseen. They explain this fact by stating that “actual fiscal multipliers have been larger than forecasters assumed” (p. 19). This implicitly calls into question the effectiveness of the austerity programs imposed and requires further thought in relation to the optimal mix of economic policies in the post-crisis period. Along the same procyclical argument, the reasonableness of straining microprudential policy implemented almost systematically by the EU banking regulators in the post-crisis period could be called into question. Its effects could be, like those of fiscal austerity measures, only procyclical and, because of its prolonging credit crunch effects, harmful not only for recovery but also for macro financial stability. Hence, it could not be unexpected that a new (third) pillar of macroeconomic policy, macroprudential policy, has been emanating from rethinking macroeconomic policy after the crisis, which would have financial resilience as well as output objectives.<sup>1</sup>

The above mentioned is particularly topical in countries that were affected by the so-called balance sheet crisis. Slovenia is a good example of such an affected country. The existence of the mechanism, which (through financial accelerator) endogenously amplified and propagated the process of companies’ debt accumulation triggered by external funds inflow in the pre-crisis period in Slovenia, is already well documented.<sup>2</sup> The sudden stop of financial inflows and the collapse of external real demand reverted booming growth to a spiraling downturn in the post-crisis period; from seven percent growth in the pre-crisis year of 2007, the economy faced more than an eight percent fall in growth in 2009. This was followed by near stagnation in the 2010–2012 period.

In this paper we investigate channels through which a lack of appropriate macroprudential policy aggravated economic performances. Cash flow migration and illiquidity contagion of companies from different sectors of the economy and from different sized groups are studied to detect the main factors and policy drawbacks influencing economic performance in the post-crisis period.

We built our research on [Miller and Stiglitz \(2010\)](#) and [Krishnamurthy \(2010\)](#) theoretical models of illiquidity provision after the bubbles collapsed.<sup>3</sup> As asset prices fall, and thus corresponding items in balance sheets fall, firms would not only have problems in repaying debt service, but would also be forced to accelerate repaying debt (deleveraging). Fire sales would be the only way out of the liquidity squeeze. But, fire sales add to the downward pressure on asset prices (nominal value of collateral), which would accelerate deleveraging even more, and highly leveraged borrowers would become insolvent very easily.

To study the deleveraging process after the crisis eruption (financial inflows “sudden stop”) in the economy, we added two additional elements to these theoretical models: intercompany credit (debt) and external agent (policy makers – banking regulator) intervention in steering the deleveraging process. If the model also includes companies that produce raw materials, intercompany credit (debt) is an additional type of (debt) financing that amplifies the model boom and bust phase performances (asset prices, volume of credit) of companies (especially small businesses). The opportunity cost (economic activity, employment, loss of net worth) of deleveraging could, therefore, depend on the sequencing of debt redemption. The main reason for this is different repudiation risk protection; for banks (deep pocket investors in the Miller–Stiglitz model) it is credit collateral and the threat of raw material non-supply for intercompany debt (forced credits). The external agent (policy maker) could steer the deleveraging process if able to influence liquidity supply and/or size of repudiation risk protection measures. Its interventions could considerably

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<sup>1</sup> See [Blanchard et al. \(2013\)](#) and [Haldane \(2013\)](#).

<sup>2</sup> See [Bole et al. \(2012\)](#).

<sup>3</sup> On earlier version of these models, see also [Minsky \(1986\)](#), [Kiyotaki and Moore \(1997\)](#).

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