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Fiscal consolidations and bank balance sheets☆

Jacopo Cimadomo [a,*], Sebastian Hauptmeier [b], Tom Zimmermann [c]

[a] *European Central Bank, Fiscal Policies Division, Kaiserstrasse 29, D-60311 Frankfurt am Main, Germany*
[b] *European Commission, Rue de la Loi 170, B-1040 Brussels, Belgium*
[c] *Harvard University, Department of Economics, 1805 Cambridge Street, Cambridge, MA 02138, USA*

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A B S T R A C T

We empirically investigate the effects of fiscal policy on bank balance sheets, focusing on episodes of fiscal consolidation. To this aim, we employ a very large data set of individual banks' balance sheets, combined with a newly compiled data set on fiscal consolidations. We find that standard capital adequacy ratios such as the Tier-1 ratio tend to improve following episodes of fiscal consolidation: for the median bank in our sample, a 1% of GDP fiscal consolidation increases the Tier-1 capital ratio by around 1.5 percentage points over two years. Our results suggest that this improvement results from a portfolio re-balancing from private to public debt securities which reduces the risk-weighted value of assets. In fact, if fiscal adjustment efforts are perceived as structural policy changes that improve the sustainability of public finances and, therefore, reduce credit risk, the banks' demand for government securities should increase relative to other assets.
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* Corresponding author.
E-mail addresses: jacopo.cimadomo@ecb.int (J. Cimadomo), sebastian.hauptmeier@ec.europa.eu (S. Hauptmeier), tzimmerm@fas.harvard.edu (T. Zimmermann).

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1. Introduction

The interdependence between public and bank balance sheets has been a fundamental aspect of the financial and economic crisis which, in some European countries, turned into sovereign debt crises. The strong loosening of fiscal policies as a reaction to the severe economic downturn in 2008/09 coincided with sharp increases in deficit and debt ratios. At the same time, the combination of large fiscal imbalances and low growth potential as well as structural weaknesses in the economy or the financial system led markets to increasingly challenge the sustainability of public finances in some countries. The related abrupt change in the market perception of sovereign risk in turn weakened bank balance sheets and resulted in an adverse feedback loop between sovereign and banking risk (see, e.g., Bank for International Settlement (BIS) (2011).

It is therefore widely agreed that sizable and sustained fiscal adjustments will be necessary to restore sound fiscal positions and ease financial market pressures. Consequently, most industrialized countries have announced medium-term consolidation strategies which would lead to a significant fiscal tightening. In this context, this paper analyzes the effects of fiscal consolidations on banking sector stability.

There is a remarkable lack of work that investigates the channels through which fiscal policy can affect bank balance sheets. The research on the role of the banking sector in dynamic stochastic general equilibrium (DSGE) models is still at a relatively early stage. Angeloni et al. (2011), for example, propose a calibrated DGSE model that includes a banking sector and the government sector. The focus of the paper is on the composition of the fiscal adjustment, and on its consequences for banking stability. It finds that, compared to expenditure based consolidations, labor tax-based policies attain a more rapid debt adjustment and low intertemporal debt costs, but at the expense of higher oscillations in bank leverage and risk. Dib (2010) also presents a DSGE model that includes a banking sector as well as a fiscal sector. The impulse responses of bank balance sheet items to a structural shock to government spending suggest that bank leverage initially increases, but then decreases before it returns to the steady state.

A report published by the Bank for International Settlements (BIS) analyses the impact of sovereign risk on the banking system (see Bank for International Settlement (BIS) (2011)). It highlights the main channels of transmission on banks' funding conditions. The described "asset channel" is closely related to the mechanism this paper aims to identify empirically. Rises in sovereign risk adversely affect banks through losses on their holdings of government papers. As a result of a weakening of the balance sheet, funding of banks becomes more costly. Banks may therefore react to changes in sovereign risk through adjustments on the asset side, i.e. changes in the portfolio composition. By the same token, a fiscal adjustment should trigger more appetite for government securities by banks, as treasuries are perceived to be safer after a fiscal consolidation.

At the same time, banks' perception of sovereign risk should depend on various determinants, notably the contemporaneous state of public finances and the economy as well as expectations regarding future developments. This paper therefore focuses on fiscal policy and analyzes empirically to what extent a tightening in the policy stance affects typical measures for the healthiness of bank balance sheets, notably the Tier-1 capital ratio. We see two channels that establish a link between fiscal policy and banks' balance sheets:

First, a direct channel related to the supply and demand effects on government bond markets. The supply of new government bond issuances will decline in times of a sustained adjustment of budgetary positions. At the same time, ambitious fiscal consolidation efforts may be regarded by investors as a structural policy change which improves long-run fiscal sustainability. A related lower perceived risk of default would increase the demand for government securities relative to other asset classes, thus, counteracting the negative liquidity effect. For US treasury bills Krishnamurthy and Vissing-Jorgensen (2012) show that liquidity and safety constitute important determinants of the demand for government bonds. Which of the two effects prevails theoretically depends on the specific features of the demand and supply curves. Focusing on the banks balance sheet, we would expect to observe an increase in the share of government securities over total assets if the demand effect prevail, and a decrease in such share if the supply effect is stronger.

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