Discussion of

“Fiscal Consolidations and Bank Balance Sheets”

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Outline

1. Summary
2. Theoretical channels
3. Interpretation of results
4. Implications for the conduct of fiscal policy/banking regulation?
1. Summary

• Data on banks and countries
  
  – 15 years, 17 countries, most banks (300,000 obs)

\[
y_{ij,t} = \sum_{s=1}^{j} \alpha_s y_{ij,t-s} + \sum_{s=0}^{p} \gamma_s F C_{i,t-s} + \sum_{s=0}^{l} \beta_s X_{t-s} + \mu_j + \lambda_t + \epsilon_{ij,t}
\]

• \( \gamma_0 \): FC during year \( t \) leads to 8% higher end of year T1CR or about 1% higher T1CR at the median bank

• The end of the following year cumulative: 12% and 1.5%
1. Summary

• Heterogeneity in treatment effect
  – Under-examined in paper
  – Larger banks and more profitable banks respond less
    • But have higher average T1CRs
• Most of the effect is on the denominator of the T1CR
  – But point estimates have both equity and risk-weighted assets increasing
  – And function form does not allow comparison
2. Theoretical channels

What are the central ways that a fiscal consolidation in a country would affect banks T1CR?

\[
\text{Equity value: e.g. Common stock plus reserves}
\]

\[
\text{T1CR} = \frac{\text{Sum of risk-weighted assets}}{\text{Equity value: e.g. Common stock plus reserves}}
\]
Fiscal Consolidation

Government Debt
- Decrease default risk
- Increased payouts

Recession
- Increased loan default
- Increased risk premia

Bank Balance Sheet
- Passive increase in value of govt bonds
  - no change denominator of Tier 1 capital ratio T1CR (zero risk weight)
- Active portfolio trade: buying more govt debt
  - increases T1CR
- Foregone or reduced lending
  - increases T1CR
- Revaluation/reset risk weights
  - decreased risk increases T1CR
- Change in funding costs (risk of a run)
  - leading to balance sheet adjustment

Jonathan A. Parker, October 2013
BU/Boston Fed Conference on Macro-Finance Linkages
3. Interpretation of results

\[ y_{ij,t} = \sum_{s=1}^{j} \alpha_{s} y_{ij,t-s} + \sum_{s=0}^{p} \gamma_{s} FC_{i,t-s} + \sum_{s=0}^{l} \beta_{s} X_{t-s} + \mu_{j} + \lambda_{t} + \epsilon_{ij,t} \]

- Between Natural Experiment and VAR inference
  - Includes debt/GDP and output gap at \( t \)
  - Measured effect of FC is mixed with effects through debt and gap
  - But not looking at VAR innovation in system
  - Dynamics: cumulative effects need VAR thinking
3. Interpretation of results

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- Should we worry about cross-country spillovers?
  - For Euro policy ‘yes’; for inference ‘yes’; drop \( \lambda_{t} \)?

- **Lots** of austerity -- a few countries is in austerity more than half the time
  - Does the effect measure the effect of the economy that the FC is also responding to?
4. Is this channel a good thing?

The authors evidence is suggestive that banks invest in government debt rather than loans in and following fiscal contractions.

• Good: banks become safer in fiscal contractions
• Bad: banks stop lending
  – Because there are no good loans to be made
  – Or because they are taking losses and reclassifying loans and are constrained
• Big question: how nonlinear is the effect in T1CR?