BU/Boston Fed Conference on Macro-Finance Linkages
October 4, 2013
Boston, MA

Discussion of

"Fiscal Consolodations and Bank Balance Sheets"

by Jacopo Cimadomo, Sebastian Hauptmeier, and Tom Zimmerman

Massachusetts Institute of Technology

Jonathan A. Parker

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)

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

- γ_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?

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

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

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

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

- Should we worry about cross-country spillovers?
  - For Euro policy 'yes'; for inference 'yes'; drop λ_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?