

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

Discussion of

“Fiscal Consolidations 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?

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

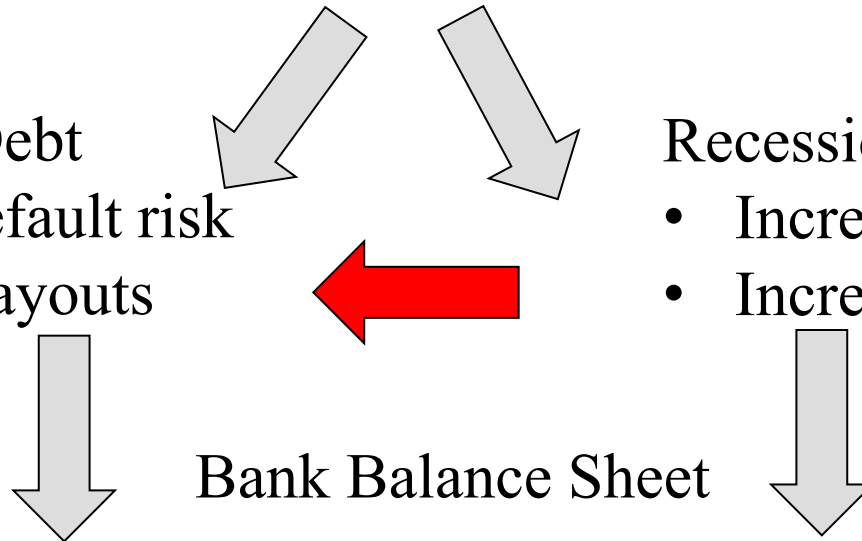
Fiscal Consolidation

Government Debt

- Decrease default risk
- Increased payouts

Recession

- Increased loan default
- Increased risk premia



- 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?

