Discussion of Banks, Fiscal Policy and the Financial Crisis

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What the paper is about

- Study the link between the banking and the sovereign sector
- In particular
  - analyze macro effects of government support to banks
  - compare these with “conventional” fiscal measures
  - study transmission of sovereign default via the banking sector
- Main results
  - Both government support and sovereign default have strong effects on real variables (with “right” signs)
  - Government support multiplier similar to conventional policy
  - Government support contributed to moderating recession in 2008-09; small impact of bank losses

Methodology

- Use a NK model with banks…
  - lend to impatient HHs; get deposits from patient HHs
  - hold domestic government bonds (and foreign bonds); real costs
  - have a stylized capital requirement
    - Undercapitalization of banks increases the spread on the loan rates…
    - …and, by arbitrage, the entrepreneurs' required return on investment
- Simulate IRFs to 4 different shocks
  - Transfer from the banks to households ("loan-loss shock")
  - Transfer from the government to the banks ("gov't support")
  - Transfer from the bank and the patient households to the government ("sovereign default")
  - Standard fiscal policy shock (gov't purchases)
- Estimate the model for the EA and provide historical decomposition

General overview

- “The” topic at the moment
  - Bank-sovereign nexus at the heart of the current crisis in the euro area: two-way interaction
- The effects of government intervention in the banks has not received much attention from the literature
- …however, the paper has not yet developed its full potential
  - One main comment; other comments for the empirical part

The main comment

- As it is, the sov-banks feedback loop is not yet in the model
  - Ideally, one should model:

    Bank loss → bank capital ↓ → gov't intervenes → fiscal deterioration → gov't (bonds) creditworthiness↓ → Bank loss …
  - As of now, they just model, as independent shocks
    - Bank loss → bank capital ↓
    - gov't intervenes
    - gov't (bonds) creditworthiness ↓ → Bank loss
- Moreover, the three shocks are somehow the same
  - …and similar to a "bank capital shock" (Meh and Moran 2010, Gerali et al 2010, Gertler and Karadi 2011)
- Endogenize some of these features is the challenge of this paper

The main comment (2)

- Endogenize government support
  - For example, follow Gertler and Kiyotaki (HM 2010)

$$\varphi_t = \upsilon_g[(E_t R_{kt+1}^{ih'} - R_{t+1}) - (ER_k^{ih'} - R)]$$

  - In addition, you may include a cost of government intervention (less efficient to manage the banks)
- Endogenize impact of fiscal deterioration on banks' balance sheets
  - Maybe more difficult in your setup…
  - …but you could make the spread on gov't debt a function of debt/GDP → gov't support reduces the value of bonds → banks suffer losses

Other Comments

Things that should be taken into account in the empirical analysis

- Recapitalization (and AP) were only a fraction of government support
  - Guarantees on new liabilities were by far the most important (committed res./GDP: around 17% in UK, DE, FR, as of June 09)…
  - …some evidence that these reduced liquidity risk (BIS 2010)
  - Size of intervention was heterogeneous across EA countries (NL, DE vs IT)
- In the real world, banks were the main source of gov't problems only in some countries (IE, IC); causation inverse in most (GR, IT, PT)
- "Direct holdings" of sov debt is just one channel of sovereign-to-banks nexus
  - Other important channels are liquidity, rating and automatic effects, implicit guarantee (CGFS 2011)

Other Comments (2)

- In hist decomp, authors find small impact of bank losses in 2008-09 recession
  - In EA, the main contribution from the credit channel was not capital reduction but arguably through increased borrowers riskiness and interbank funding problems, which are unmodeled
  - …in addition, the main shock was probably some “confidence effect”, also unmodeled
- Do you really need the international dimension? It seems to me to be an unnecessary complication
- Minor comments
  - How do you justify the operating cost for the bank?
  - How do you interpret the estimate of the parameter φ^x:?

Thank you!