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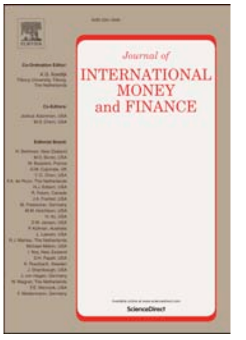

Fiscal Consolidations and Bank Balance Sheets

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Abstract

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. 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, reduces credit risk, the banks' demand for government securities should increases relative to other assets.

JEL Classification: E62, G11 G21, H30.

Keywords: Fiscal consolidations, bank balance sheets, portfolio re-balancing, banking stability.

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 a sovereign debt crisis in mid-2010. 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 soveregin 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).

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