Government Guarantees and the Two-Way Feedback between Banking and Sovereign Debt Crises*

Agnese Leonello

European Central Bank, Sonnenmünzstrasse 20, 60314, Frankfurt am Main, Germany

Abstract

This paper studies the effects of government guarantees on the interconnection between banking and sovereign debt crises in a framework where both the banks and the government are fragile and the credibility and feasibility of the guarantees are determined endogenously. The analysis delivers some new results on the role of guarantees in the bank-sovereign nexus. First, guarantees emerge as a key channel linking banks’ and sovereign stability, even in the absence of banks’ holdings of sovereign bonds. Second, depending on the specific characteristics of the economy and the nature of banking crises, an increase in the size of guarantees can be beneficial for the bank-sovereign nexus in that it enhances financial stability without undermining sovereign solvency.

Keywords: bank runs, sovereign default, strategic complementarity, government bond yield.

JEL: G01, G18, H63

1. Introduction

Public guarantees to financial institutions are considered an effective tool for preventing banking crises and mitigating their negative effects. However, they have also been criticized for the large costs they entail for the government providing them and, ultimately, for taxpayers. The recent

*The views expressed here are my own and do not reflect those of the European Central Bank or the Eurosystem. I am grateful to participants at the European Finance Association (EFA) conference in Lugano, the Financial Intermediation Research Society (FIRS) conference in Quebec City, Chicago Financial Institutions Conference, and to seminar participants at the Halle Institute for Economic Research, the University of Vienna, the University of Naples Federico II, University of Aachen, University of Amsterdam, the European Central Bank, the Bank of Italy, the Institute for Advanced Studies, the Dutch Central Bank, the Frankfurt School of Finance and Management, the University of Bonn, and Warwick University. I also wish to thank for their useful comments and suggestions Toni Ahnert, Franklin Allen, Christoph Bertsch, Max Bruche, Elena Carletti, Marco Di Maggio, Itay Goldstein, Florian Heider, Luc Laeven, Simone Manganelli, and Stefano Rossi. All errors are mine.

Email address: agnese.leonello@ecb.europa.eu (Agnese Leonello)
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