How diabolic is the sovereign-bank loop? The effects of post-default fiscal policies

CFM-DP2017-05

André Diniz[2] and Bernardo Guimaraes[1,2]

[1]Centre For Macroeconomics and [2]Sao Paulo School of Economics - FGV

In policy discussions about the debt crisis in the Euro area, one key issue has been the deleterious effect of sovereign debt restructuring on bank's balance sheets and, consequently, on the economy as a whole. The mechanism runs as follows: sovereign debt restructuring leads to lower prices for sovereign debt, and thus implies a reduction in the value of banks' assets. This in turn forces banks to deleverage, reducing credit in the economy and leading to a sharp fall in economic activity. In consequence, tax revenues falls.

However, sovereign default is effectively a transfer from debt holders to the government, not a destruction of wealth. Hence, on the one hand, a default episode tightens the constraints on banks and forces them to deleverage, which leads to lower investment and lower output. But on the other hand, it loosens the government's budget constraint -- since, presumably, servicing debt would require higher taxes or less government spending. Therefore, one of the main factors dictating what then happens to the economy is the fiscal response after default.

This paper studies how different fiscal policy responses affect the sovereign-bank loop in a quantitative macroeconomic model with financial frictions where banks hold sovereign bonds. We consider several fiscal policy instruments. We calibrate the model to capture the sovereign-bank loop in the Greek economy following the 2012 Bond Exchange.

Sovereign default forces leveraged-constrained banks to deleverage, which has a negative impact on investment and output. As it turns out, different fiscal policy responses interact with this deleveraging effect in different ways. Debt restructuring in place of higher lump-sum taxation leads to a very persistent but mild output drop. Moreover, restructuring debt instead of cutting government consumption leads to a larger fall in investment and output because the increase in government consumption crowds out investment, which prevents the economy from recovering in the medium run.

However, when distortionary taxation is considered, results are very different. Lower labour taxes (compared to a counterfactual scenario with no debt restructuring and larger taxation needs) raise the marginal productivity of capital and the demand for investment, which more than offsets the losses from financial disruption. Lower consumption taxes also raise the labour supply in the short run, but the stimulus for consumption crowds out investment and hence hurt the economy in the medium run. Lower taxes on banks offset the effect of default and also affect marginal lending decisions, so the effect on investment is positive. Lower taxes on deposits affect the economy in a very similar way by reducing the costs of funds for investment.

We also study how the speed of adjustment to the new situation affects the response of the economy. We find that a more conservative fiscal stance leads to a quicker recovery since government debt crowds out space for capital investment in banks' balance sheets. The bottom line is: how diabolic the post-default sovereign-bank loop is depends to a great extent on the way fiscal policy responds.