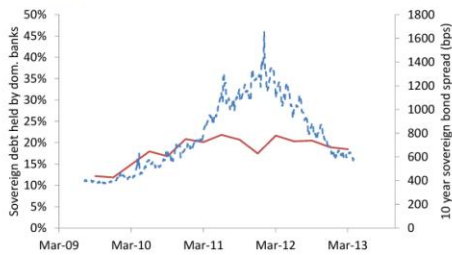


Why Are Banks Not Recapitalized During Crises? A Political Economy Explanation

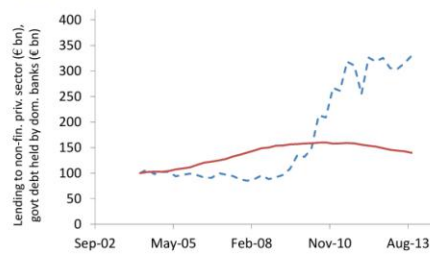
Matteo Crosignani (NYU Stern)

Two Facts About The Periphery: The Portuguese Example

Fact 1. Govt relies more on domestic banks



Fact 2. Banks reduce lending and buy domestic gov bonds



This Paper

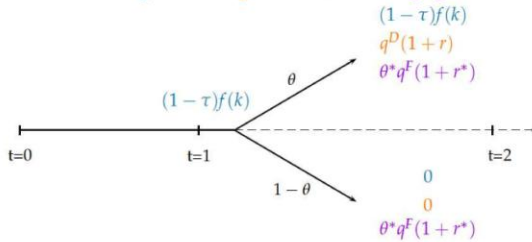
- ▶ **Fact 1.** Highly levered GIIPS banks risk-shift buying domestic gov bonds
 - ▶ Highest payoff in the good state and protected by limited liability in the bad state
- ▶ **Fact 2.** During crises gov bonds become more attractive relative to lending to private sector → crowding-out in private lending
- ▶ **Fact 3.** A myopic government wants undercapitalized domestic banks to boost demand for its debt
 - ▶ Trade-off: more debt capacity vs. distortion in lending (→ lower growth). Govt myopia can trigger a "race to the bottom" among countries in regulation

Model

- ▶ Parsimonious GE model (closed form solutions)
- ▶ Two periods, no discounting, risk neutrality
- ▶ Two symmetrical countries with a gov and a fin. sector

Banks' Investment Opportunity Set

Domestic lending, domestic gov bonds, and foreign gov bonds



Government Debt Capacity

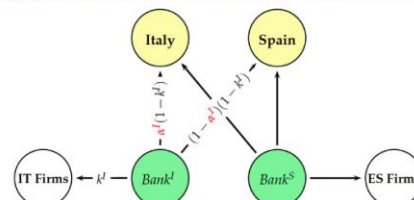
- ▶ Govt issues debt D at $t = 1$ and decides whether to default
 - ▶ Strategic default: immediate cost of default $C(\alpha, k)$
 - ▶ Liquidity default: tax collection too low to repay debtholders
- ⇒ govt debt capacity

$$D = \min \left\{ C(\alpha, k), \frac{\tau \theta f(k)}{1+r} \right\}$$

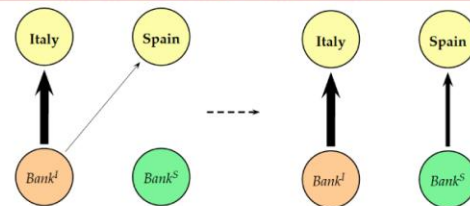
Govt maximizes spending

$$\underbrace{\tau f(k^*(\tau)) + \tau \beta \theta f(k^*(\tau))}_{\text{tax collection}} + \underbrace{D - \beta \theta (1+r) D}_{\text{govt debt}}$$

Benchmark Case: Well Capitalized Banks



Home Bias and Crowding-Out in Lending



Discussion

Alternative Channels:

- ▶ Can be interpreted as a model of moral suasion
 - ▶ Able to rule out regulatory arbitrage and information advantage
- Policy Implications:**
- ▶ Recapitalization weakens the sovereign/domestic banks nexus
 - ▶ Risk weights should have a large exposure component
 - ▶ Banking Union

Empirical Evidence: Home Bias Evolution

