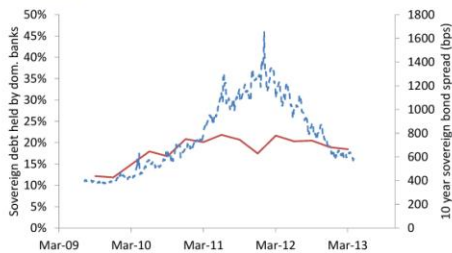# Why Are Banks Not Recapitalized During Crises? A Political Economy Explanation
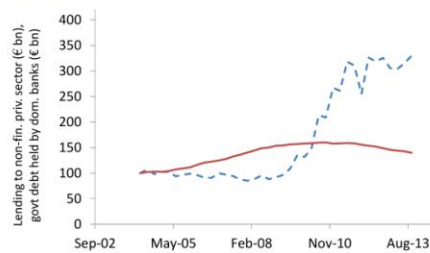
Matteo Crosignani (NYU Stern)

Two Facts About The Periphery: The Portuguese Example

Fact 1. Govt relies more on domestic banks

Fact 2. Banks reduce lending and buy domestic govt bonds

This Paper

- Fact 1. Highly levered GIIPS banks risk-shift buying domestic govt bonds
  - Highest payoff in the good state and protected by limited liability in the bad state
- Fact 2. During crises govt bonds become more attractive relative to lending to private sector $\rightarrow$ 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 ($\rightarrow$ 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 govt and a fin. sector

Banks' Investment Opportunity Set

Domestic lending, domestic govt bonds, and foreign govt bonds
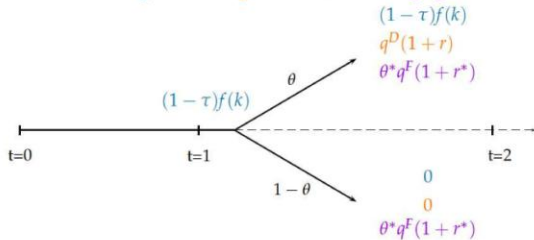
Government Debt Capacity

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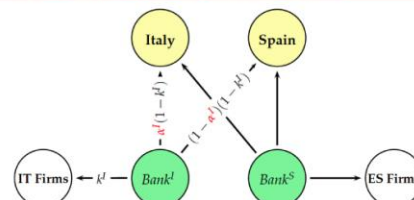 - Liquidity default: tax collection too low to repay debtholders

$\Rightarrow$ govt debt capacity

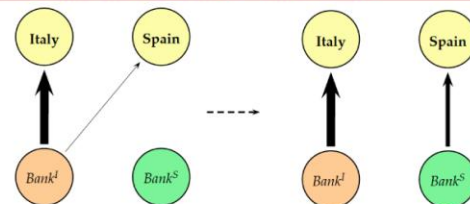$$D = min\left\{ C(\alpha, k), \frac{\tau\theta f(k)}{1+r} \right\}$$

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