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From the financial crisis to the public debt crisis. Some considerations on the Italian Case

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CONTENT

This presentation focuses on some outcomes of the 2007/08 financial crisis.

1. Bailout policy and the opportunistic behavior of banks and financial institutions (moral hazard).

2. Transmission of the crisis from financial to real and public sector.

3. Some consideration on the Italian case.

1. BAILOUT POLICY

The extent and depth of the 2007/08 financial crisis has urged a dramatic policy intervention (**bailout policy**), both in the US and in Europe, to counter bank defaults and avoid a disastrous financial instability.

1. BAILOUT POLICY

The government bailouts of a large number of banks, as well as the interventionist efforts of governments to stabilize economies, have generated a lot of controversy regarding the short and long-term effects of the policy.

1. BAILOUT POLICY

In particular, it is alleged that, by insulating weak financial institutions from the full consequences of a negative outcome, the anticipation of further bailouts may result in a misallocation of resources inspiring risky behavior and leaving the economy more vulnerable to future crises.

1. BAILOUT POLICY EFFECTS

In brief words bailout policies have produced several effects.

1. From one side, they avoided the diffusion of financial market instability and the propagation of a disastrous domino effect on the whole economy. (short term effect)

1. BAILOUT POLICY EFFECTS

2. From the other side, since bailout policies loosen and weaken market discipline, can create incentives for opportunistic behavior (moral hazard) twisting large banks to abandon prudential conducts in favor of excessive risk taking behavior. (short/medium term effect)

1. BAILOUT POLICY EFFECTS

This type of moral hazard is well know as **too big to fail** (TBTF).

The status of TBTF confers an implicit guarantee that allows for opportunistic and risk taking behaviors (more risky credit policies, low liquidity levels and shrinking of capital).

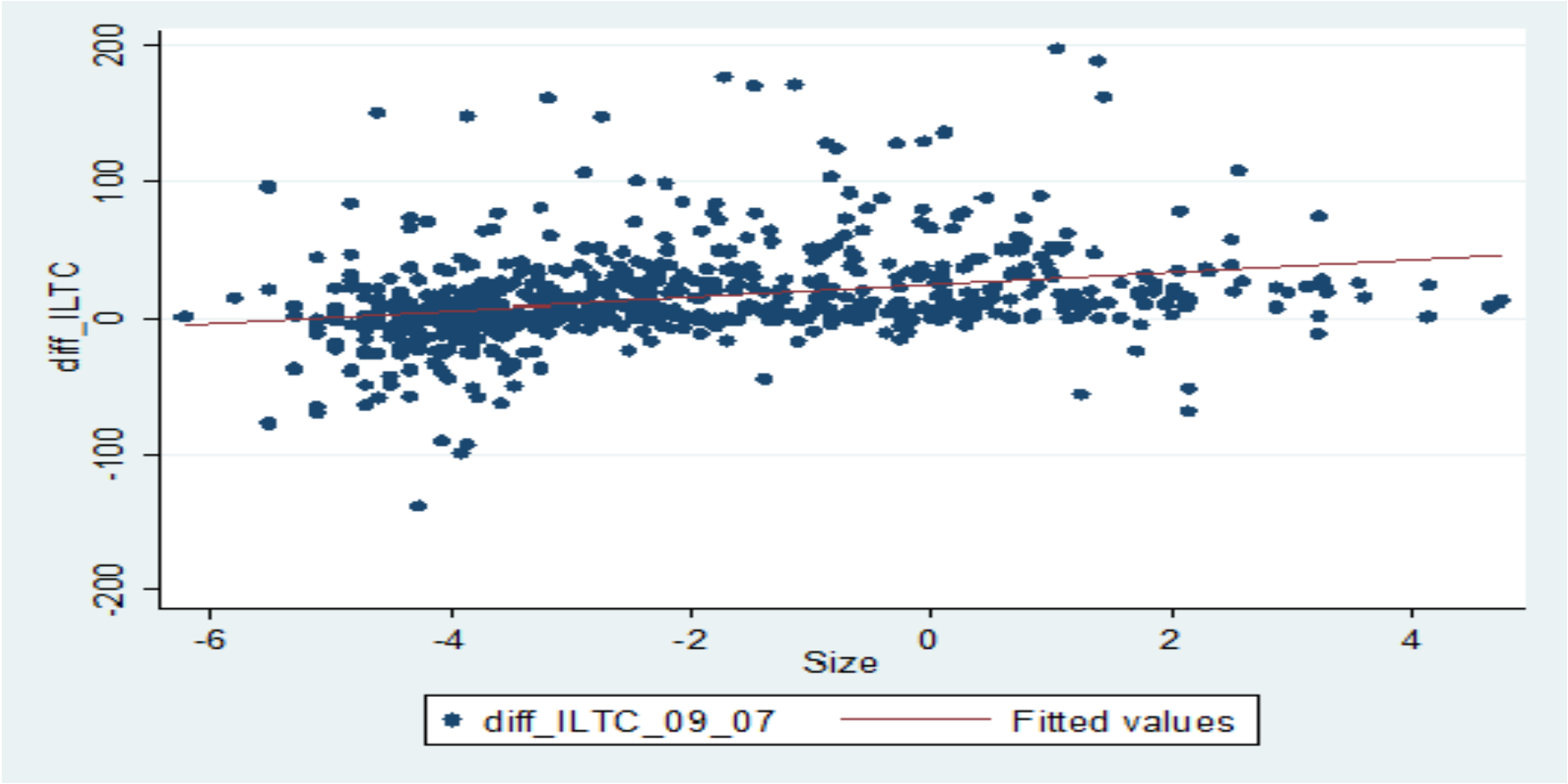
In case of bank default the loss will be paid by tax payer and collectivity.

EMPIRICAL TEST OF TBTF

DATA AND SAMPLE

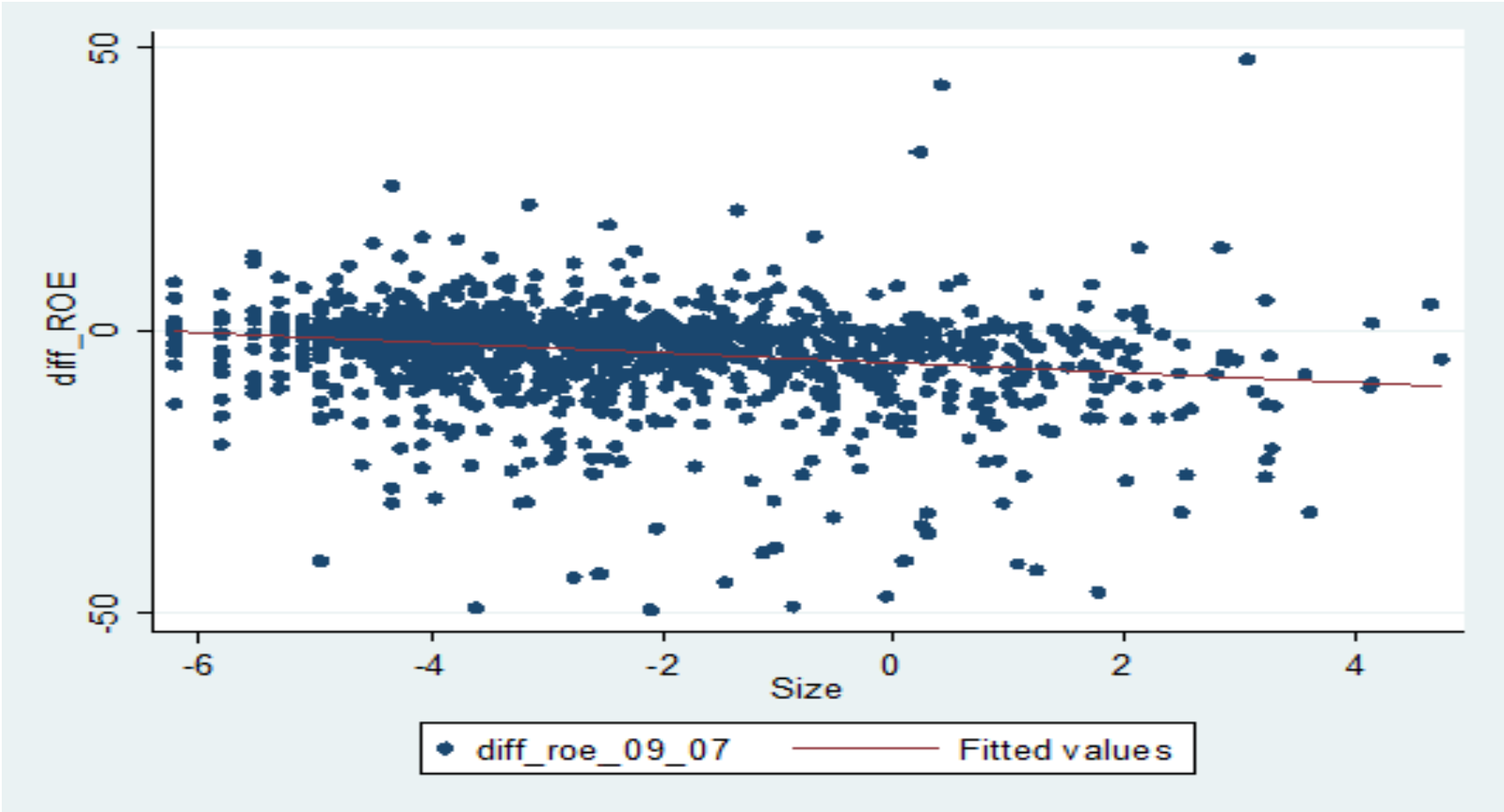
- Database: BankScope, Bureau van Dijk and Fitch/Ibca.
- 16 European countries: (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, UK)
- Number of banks: 1476
- Period of observation: 2007 - 2011
- Bank specialization: commercial banks, cooperative banks, savings banks, real estate and mortgage banks, specialized governmental credit institutions, investment banks, securities firms, and finance company.

Figure 1. RELATION BETWEEN RISK CHANGE OVER THE CRISIS AND BANK SIZE



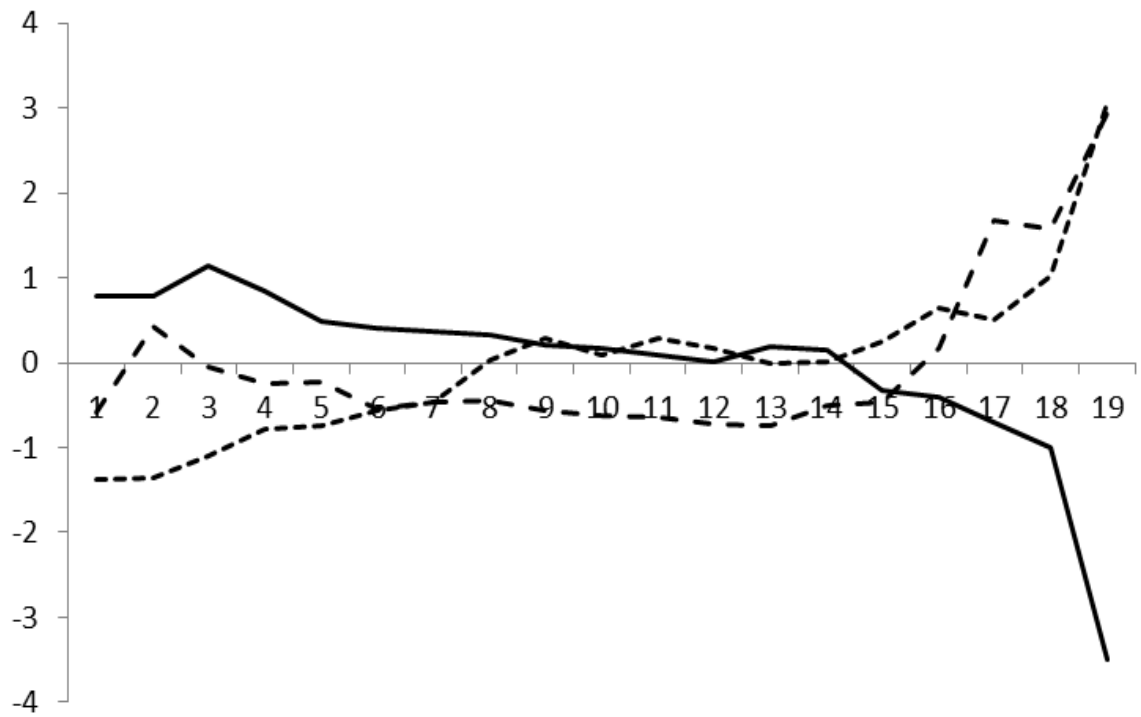
Diff_ILTC (impaired loan/total capital) measures the change in the bank risk over the crisis (2007-09). Size proxies for the dimension of bank i-*th*, and is computed as the log of the total assets at the initial period 2007 scaled, for each bank, for the average bank size in the country of origin.

Figure 2. RELATION BETWEEN ROE CHANGE OVER THE CRISIS AND BANK SIZE



Diff_Roe measures the change in the ROE scores over the crisis (2007-09). Size proxies for the dimension of bank i-*th*, and is computed as the log of the total assets at the initial period 2007 scaled, for each bank, for the average bank size in the country of origin.

Figure 3. TBTF: RESULTS OF SIMULTANEOUS QUANTILE REGRESSIONS



The two dotted lines show the standardized quantile coefficients of the two measures of bank risk ΔILTC (impaired loans/total capital) and ΔLLPTC (loan loss provisions/total capital), over the different bank size (20 quantiles of *Size*). The continuous line refers to the change in the Roe over different bank size (Mattana and Rossi, 2012).

1. BAILOUT POLICY EFFECTS

3. Finally, the extraordinary amount of public funds to counter banks defaults and financial instability, has increased enormously the public deficit and debt of the OECD countries. (medium/long run effect)

De facto these polices have, to some extent, contributed to the second wave of the crisis, well-known as public debt crisis.

1. BAILOUT POLICY EFFECTS

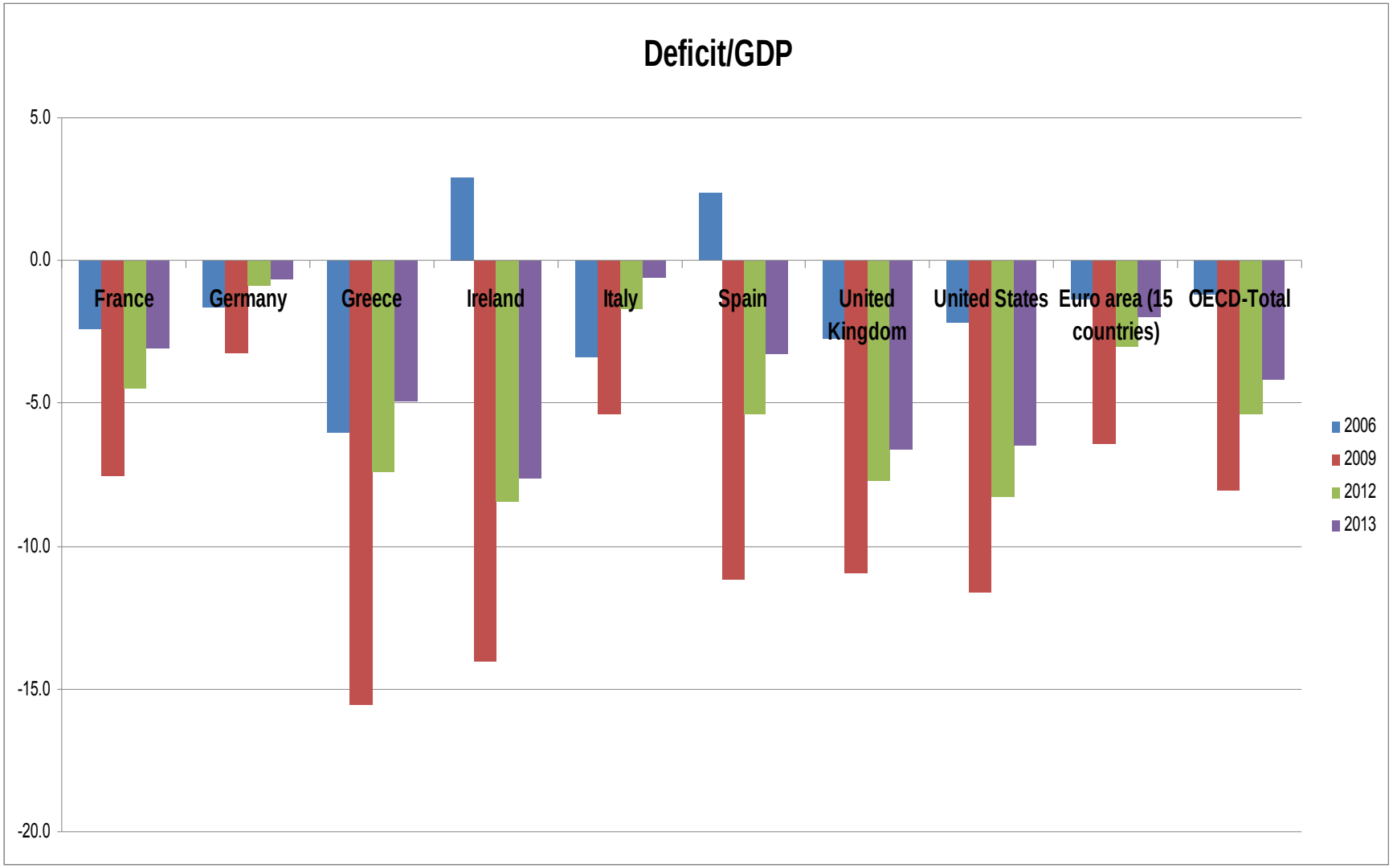
More in details, the first policy interventions - done by the central banks and monetary institutions to support the financial markets - were based on expansionary monetary policy.

As this expansionary monetary policy, turned to be not enough, strong government interventions became necessary (end of 2008).

The effect of these policies can be seen in the amplification of the public deficit (see Graphs 1 and 2).

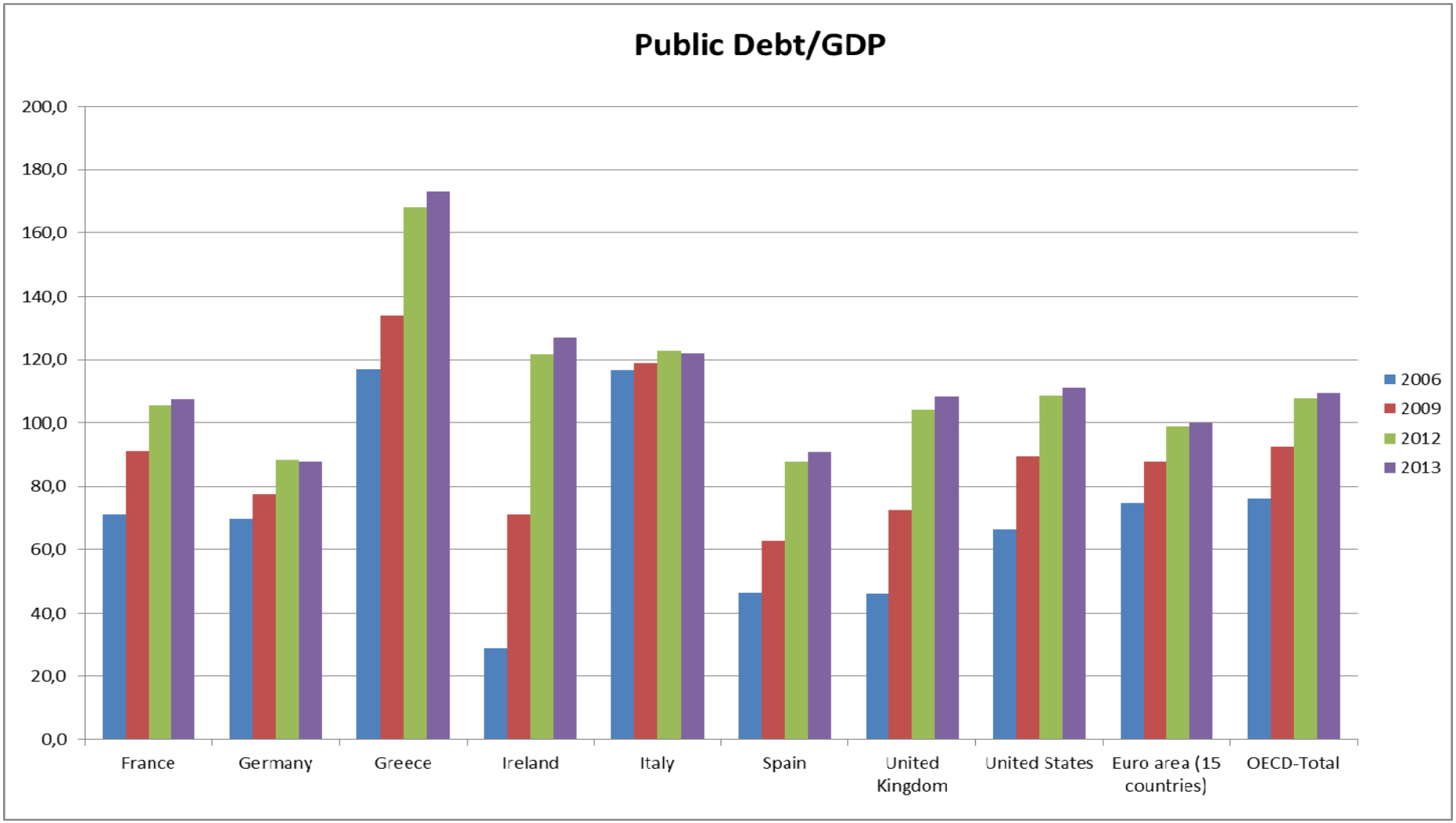
Graph 1. DEFICIT/GDP: SELECTED OECD COUNTRIES

Our elaboration of OECD data.



Graph 2. DEBT/GDP: SELECTED OECD COUNTRIES

Our elaboration of OECD data.



2. TRANSMISSION OF THE CRISIS

The financial crisis, 2007/09, was transmitted to the real sector through these classical transmission mechanisms:

- loss of confidence of banks (crisis of the inter-banking market);
- loss of confidence of household and increased liquidity preference;
- credit crunch, decrease of supply and demand of credit;
- decrease of investment and income;
- increase of unemployment rate;
- decrease in the world demand and exports.

2. PUBLIC DEBT CRISIS

Public debt crisis in Europe started at beginning of 2010.

At that time appeared clear that the Greek Government, in order to satisfy the Maastricht parameters, had manipulated the public accounting data to hide the entity of public debt.

The public deficit and public debt figures had to be revaluated.

2. PUBLIC DEBT CRISIS

Loss of confidence in solvability of the Greek government.

Rating agencies downgraded the Greek public bonds to the level (CCC), April 2010.

The yield differentials (spread) of 10-year government bonds over equivalent German bonds (*Bund*) raised rapidly.

A rescue plan of 110 billion Euros was designed and financed by the European Union and the IMF to avoid the default. The Greek government committed to an extensive austerity program and a fiscal consolidation plan.

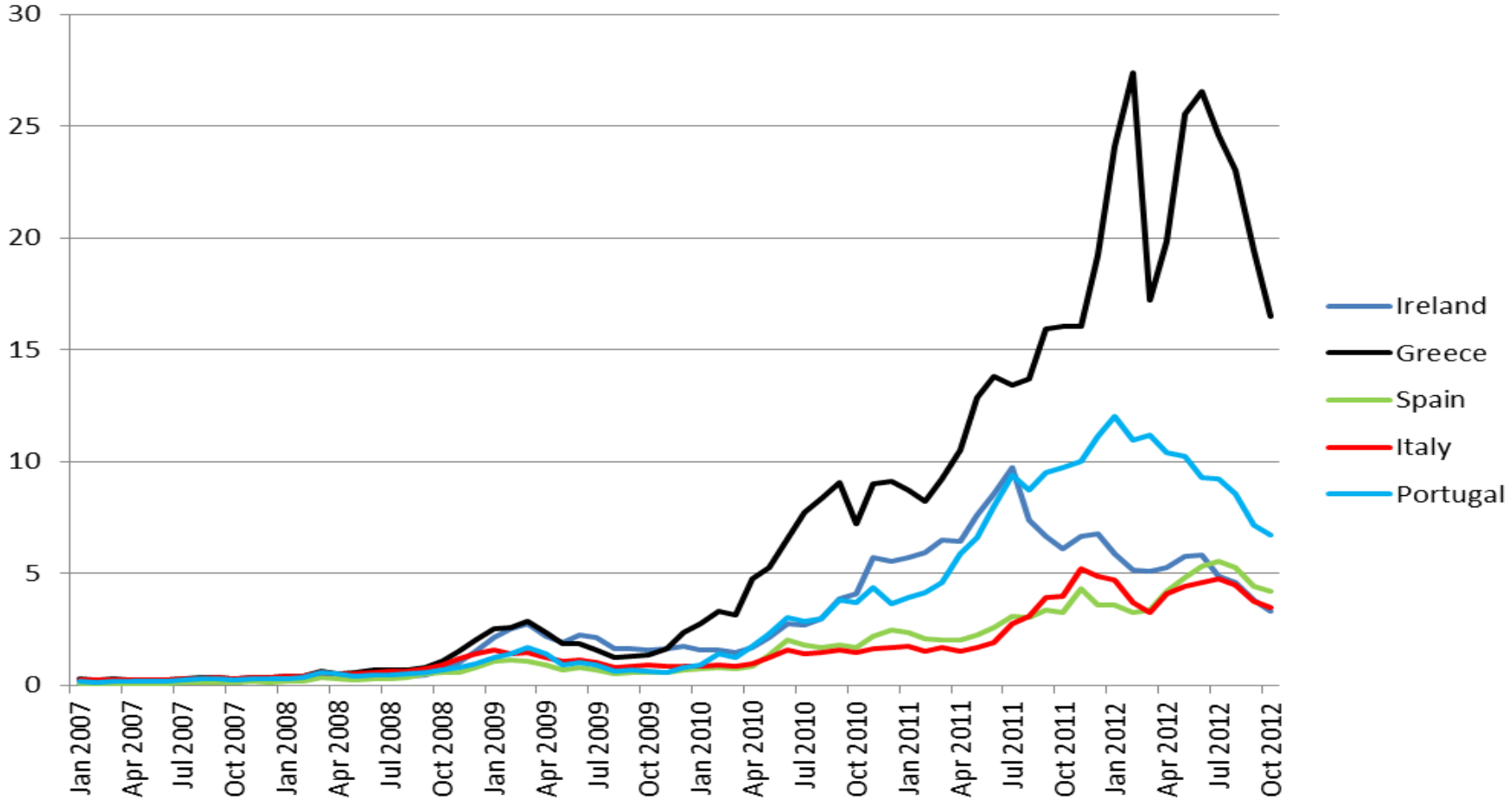
2. PUBLIC DEBT CRISIS

The fiscal crisis and the risk of default of the Greece determined an immediate contagious effect among the Eurozone countries with worse budget deficit, public debt and lower economic growth perspective.

The contagion involved Ireland, Portugal, Spain, and then Italy.

Figure 4. Evolution of the yield differential (spreads) of 10-year government bonds over equivalent German bonds (Bund).

Our elaboration of ECB data.



3. THE ITALIAN CASE

WHY ITALY HAS BEEN UNDER SPECULATIVE ATTACK?

Despite the deficit/GDP ratios (3.6% in 2011, circa 2% in 2012, see Figure 5) Italy has been under speculative attack.

- Big country (accounts for 17% Eurozone GDP) with high debt/GDP ratio (120%).
- Credibility (and timing) of the policy measures to restore market confidence and counter speculation.
- Negative effects of the policy measures on the real growth.

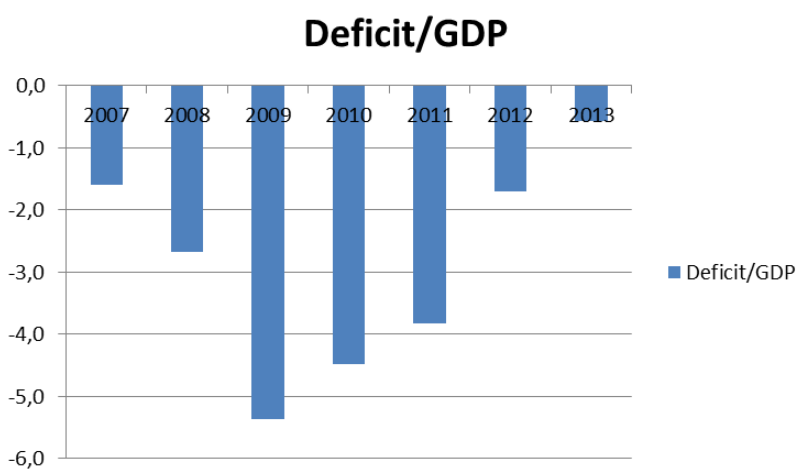
3. THE ITALIAN CASE

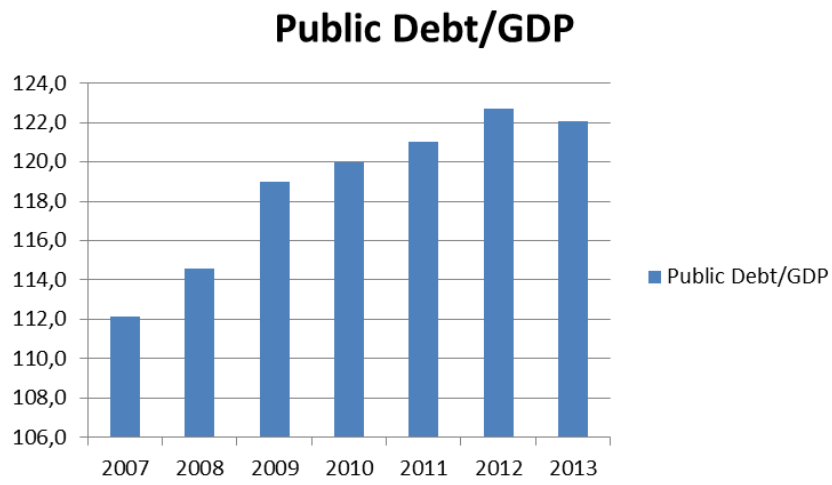
WHY ITALY HAS BEEN UNDER SPECULATIVE ATTACK?

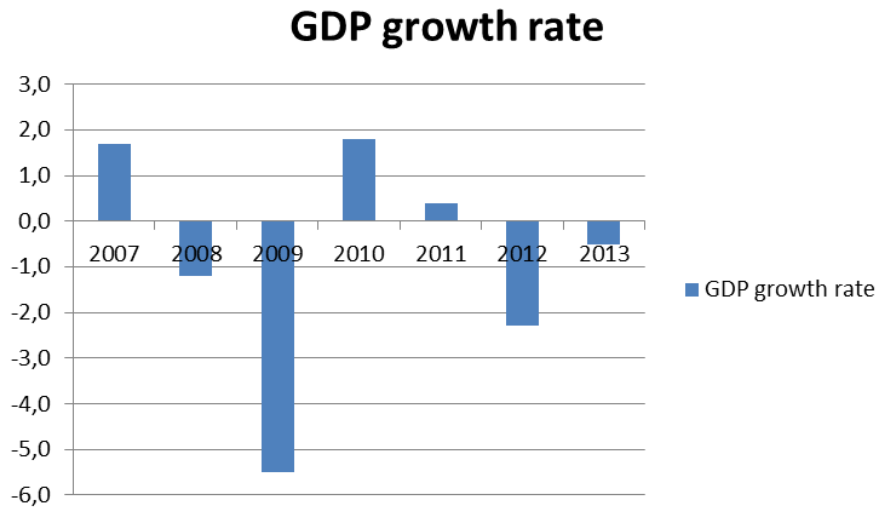
- Increasing unemployment and the negative GDP growth rate (see Figures 5 and 6).
- The simultaneous austerity policy in the European countries has amplified effects on all economies.
- The role of the European institutions in addressing the crisis: lack of European taxation policy and diversity of views on possible actions (ECB, Eurobonds, European firewall, etc.).

Figure 5. Italy: some macroeconomic indicators

Source: our elaboration on OECD data.







3. THE ITALIAN CASE

The Italian government (Monti, 2011) started to implement a severe fiscal consolidation plan (reform of the pension system and labor market, restrictive fiscal policies).

These austerity measures turned to be effective in reducing the risk of default and improving public account disequilibria.

3. THE ITALIAN CASE

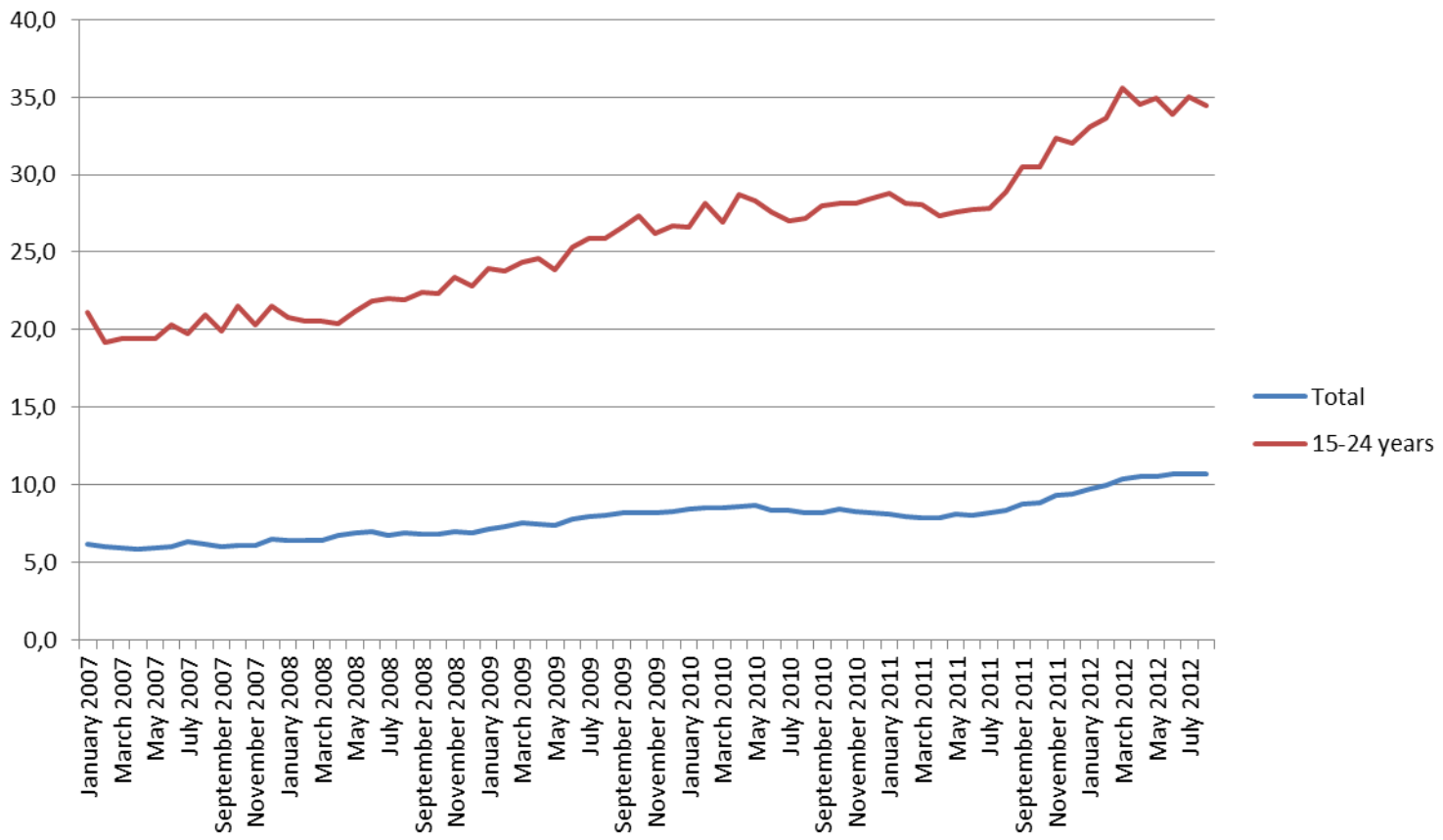
However, they are trigging Italy in a new recession.

- Low level of consumption and domestic absorption.
- Increasing rate of unemployment (see Figure 6), especially for the young-adults (15-24).
- *Credit crunch*, decrease of supply and demand of credit.
- Reduction of households financial wealth (stocks and bonds) and private saving.

3. THE ITALIAN CASE

- Crisis of confidence and risk aversion.
- Increased income inequality.
- Loss of intergenerational and intragenerational equity.

Figure 6. Italian unemployment rates monthly data 2007-2012
Source: Our elaboration of Istat Data.



3. THE ITALIAN CASE

WHICH POLICIES IN A SITUATION OF AUSTERITY AND SHRINKING PUBLIC BUDGETS?

Modernization of the public sector and *bureaucracy*.

Fight against corruption, tax evasion and shadow economy.

Requalifying public expenditure and spending review.

Investing in education and R&D.

3. THE ITALIAN CASE

WHICH POLICIES IN A SITUATION OF AUSTERITY AND SHRINKING PUBLIC BUDGETS?

Interventions for the financial markets shall focus on:

transaction tax (Tobin Tax);

more transparency;

regulating speculation.

3. THE ITALIAN CASE

WHICH POLICIES IN A SITUATION OF AUSTERITY AND SHRINKING PUBLIC BUDGETS?

At industrial level, policy addressed to promote development, throughout this period of financial and ensuing economic and social crisis, shall focus on the greening of economies, which not only is sustainable and ethical, but - within the context of national fiscal stimulus measures - can also boost the economic recovery and stimulate job creation.

A recent report (GreenItaly 2012) has shown that green firms - which promote quality, innovation, eco-efficiency, and environment protection - account for almost 23,6% of total firms in Italy.

3. THE ITALIAN CASE

WHICH POLICIES IN A SITUATION OF AUSTERITY AND SHRINKING PUBLIC BUDGETS?

Firms who have invested in the green technology show:

- an higher propensity to innovate (37,9% versus 18,3% of non-green firms);
- an higher propensity to export (37,4% versus 22,2% of non-green firms);
- a significant propensity to job creation: 38,2% of new total employment comes from green firms.

(Source: GreenItaly 2012)

REFERENCES

GreenItaly Rapporto 2012, L'economia verde sfida la crisi.
http://www.symbola.net/assets/files/Rapporto_GreenItaly_2012_1352307299.pdf

Mattana P. and Rossi S.R.S. (2012), "A test for measuring the too big to fail effect in the European banks over the financial crisis."
Manuscript submitted for publication.

Data sources:
All graphs and figures contained in this presentation are our elaboration on data coming from different sources. More in details:

- data on European banks come from BankScope, Bureau van Dijk and Fitch/Ibca;
- data on Unemployment rates come from the Monthly Time Series on the Labor market indicators ISTAT, Italy, www.istat.it;
- data on Public Deficit, Public Debt and GDP growth rate come from OECD statistics;
- data on long term interest rate come from the ECB statistics.