Government Debt and Banking Fragility: The Spreading of Strategic Uncertainty*

Russell Cooper† Kalin Nikolov‡

August 5, 2013

Abstract

This paper studies the interaction of government debt and interbank markets. Both markets are known to be fragile: excessively responsive to fundamentals and prone to strategic uncertainty. The goal is to understand the channels that link these markets and to evaluate policy measures for their stability.

1 Introduction

> We must break the vicious cycle of banks hurting sovereigns and sovereigns hurting banks. This works both ways. Making banks stronger, including by restoring adequate capital levels, stops banks from hurting sovereigns through higher debt or contingent liabilities. And restoring confidence in sovereign debt helps banks, which are important holders of such debt and typically benefit from explicit or implicit guarantees from sovereigns. (Christine Lagarde, April 17, 2012)

Following the Greek sovereign debt write-down in 2011, the four largest Greek banks made losses of more than 28 billion euros (or 13% of GDP).[1] This was enough to wipe out almost all of their combined equity capital. In 2010, the Irish government ran an unprecedented peace-time of deficit,

*We are grateful to seminar participants at the Federal Reserve Bank of Kansas City for helpful comments and questions.

†Department of Economics, Pennsylvania State University, USA, email: russellcoop@gmail.com

‡Research Department, European Central Bank, Kaiserstrasse 29, Frankfurt-am-Main, email: kalin.nikolov@ecb.int

[1] National Bank of Greece, Alpha Bank, Pireus and Eurobank.