Discussion: Sovereign Risk and Bank Lending: Evidence from 1999 Turkish Earthquake

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Discussion Notes
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The Question

- Do fiscal shocks affect bank lending when sovereign exposure is high?
- Sovereign governments borrow extensively from domestic banks, hence, exposure to sovereign risk is high in domestic banks.
- Recapitalization of weak banks by governments can increase exposure.
- In case of an increase in sovereign risk, banks balance sheets will be adversely affected and lending to private sector may diminish.

Methodology and Data

- Emprical assesement of such an effect is hard due to identification problems.
- The authors present a natural experiment, a shock that increases the sovereign risk exogenously, without effecting bank behaviour per se: 1999 Earthquake in Turkey.
- An original database: Confidential monthly bank balance sheet data.
- Method: Diff-in-diff

Identification issues

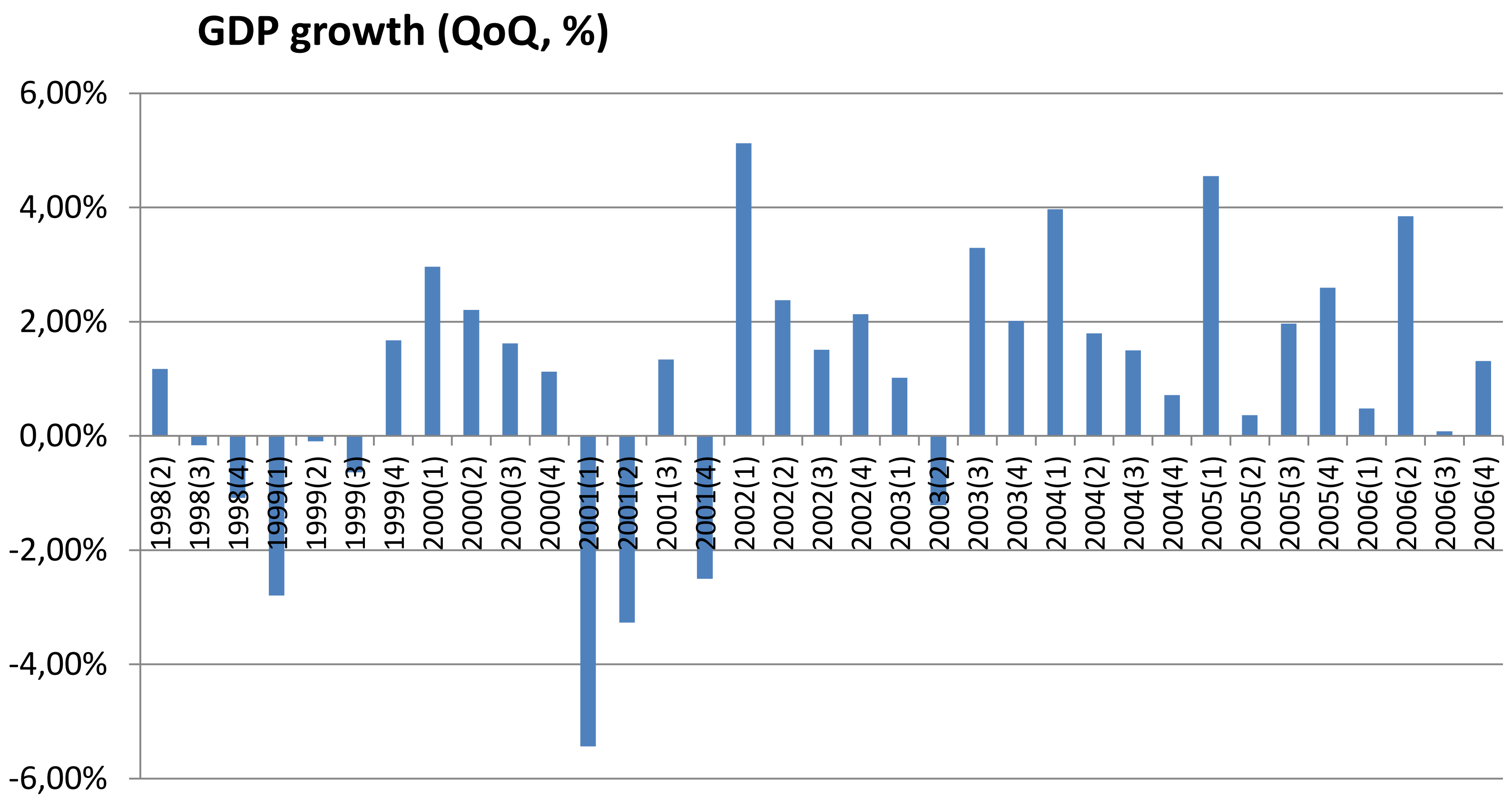
- The authors needs to show that
  - The earthquake has indeed caused a fiscal shock
  - That it is sizable enough on banks balance sheets to create a real effect
  - The banks exposure to earthquake zone businesses is homogenous
  - Demand side effects did not cause the reduction in lending post-earthquake
  - Holdings of gov’t debt does not signal specific bank characteristics (or that at least can be controlled for)

Fiscal shock

- The earthquake was sizable and had considerable effects in Turkey’s risk premium.
- Are there any other similar cases where natural disasters cause fiscal shocks?
  - Indonesia (2004)
  - Any other?
- What about in Turkey?
  - – Placebo tests for period before the earthquake
  - – Asian crisis, Russian crisis, 2001 crisis

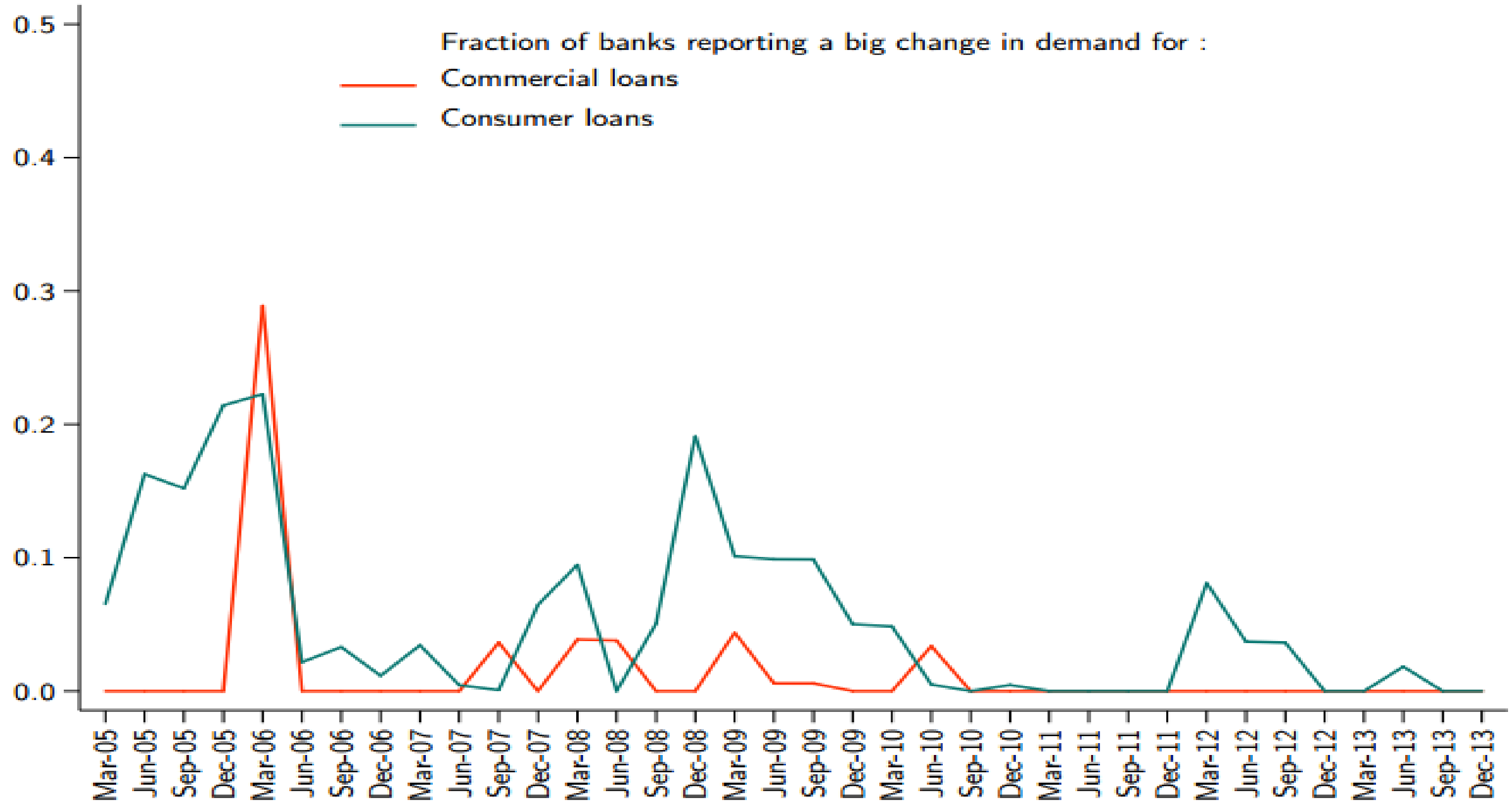
Demand side effects

- Recession pre-earthquake and recovery afterwards.



Demand side effects

- Demand for loans by private sector: How stable is it?
- Regional exposure: Foreign bank exercise.



Crowding out

- Political exposure? Government pressure to purchase bonds? How common, how realistic?

Table IV: Loans to Private Sector and Government-Bond Holdings Before and After EQ

	Government-bond holdings	Loans to Private Sector
April-July 1999 Average	18.7	26.8
August-October 1999 Average	19.0	24.8

Note: Measures are expressed as a ratio to Total Assets (%.

Controlling for bank characteristics

- Determine the determinants of gov’t bond holdings
- Determinants during the earthquake
- Surprise: Higher cash holdings result in higher gov’t bond holding during the EQ
- The authors comment that ‘...supplying government with the needed funds since these are the stronger banks’

Results

- The paper deals with a long list of potential identification issues.
- Concludes that the banks with high gov't exposure decreased private lending after the earthquake more.
- Fiscal distress $\Longleftrightarrow$ financial imbalances, causality here is one way but example specific.