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Do sovereign-bank inter-linkages affect the net cost of a fiscal stimulus?[1]

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Given the continued adverse macroeconomic fallout across many countries from the financial crisis of 2007/08, it is evident that policy makers are still struggling with the appropriate policy response. In many cases, it would appear that the suite of policy options available are quite limited, given, on the one hand, the expansive stance taken by most monetary authorities and the apparent fiscal constraints imposed by the seismic increases in both public and private debt levels on the other. Consequently, the recent renewed focus on the capacity of fiscal policy to act as an efficient and possibly self-financing, stabilisation tool, in certain exceptional circumstances, is of interest.

In this paper, we illustrate that sovereign-bank inter-linkages can have an impact on the fiscal multiplier. As an example we show how a fiscal stimulus, which returns out-of-work mortgaged households to employment, alleviates the solvency pressures of Irish financial institutions and consequently reduces their estimated future capital requirements. We use an empirical framework consisting of a house price model, a recently developed credit risk model of the Irish mortgage market and the output of a large scale structural model to quantify the savings in future capital requirements of such a stimulus.

In the context of the financial crisis, the Irish economy certainly presents as an exceptional case. The implications both in terms of output and employment have been truly severe with Irish GDP, in 2011, still 9 per cent below its 2007 peak level. Unemployment, which between 2000 and 2007 had averaged just over 4 per cent, now stands at nearly 15 per cent. Many of the pre-crisis vulnerabilities in the economy emanated from an overreliance on property and construction with the residential mortgage market enjoying an unprecedented boom both in terms of continued price increases and the volume of housing units built. Nearly 40 per cent of the current stock of Irish mortgages was issued between 2004 and 2007, when house prices were at their peak. Given the 50 per cent fall (in nominal terms) in house prices since, a significant degree of negative equity is now being experienced by many Irish households. Combined with the rapid

[1] Robert Kelly and Kieran McQuinn (2014), ‘Do sovereign-bank inter-linkages affect the net cost of a fiscal stimulus?’ *International Journal of Central Banking*, Vol. 10, Number 2, pp. 95-128. http://www.ijcb.org/journal/ijcb14q3a3.pdf

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increase in unemployment and a resulting mortgage arrears situation, concerns about significant credit risk in the mortgage books of Irish banks was one of the main reasons for the financial crisis which engulfed the Irish banking sector. The assets and liabilities of the main Irish financial institutions were guaranteed by the Irish exchequer in September 2008.

This impact on the sovereign's fiscal accounts, while of particular interest in the case of Ireland, is also worthy of consideration in other countries where financial institutions are also experiencing significant loan impairment issues.