Diabolic Loop
between
Sovereign & Banking Risk

Markus K. Brunnermeier
Princeton University

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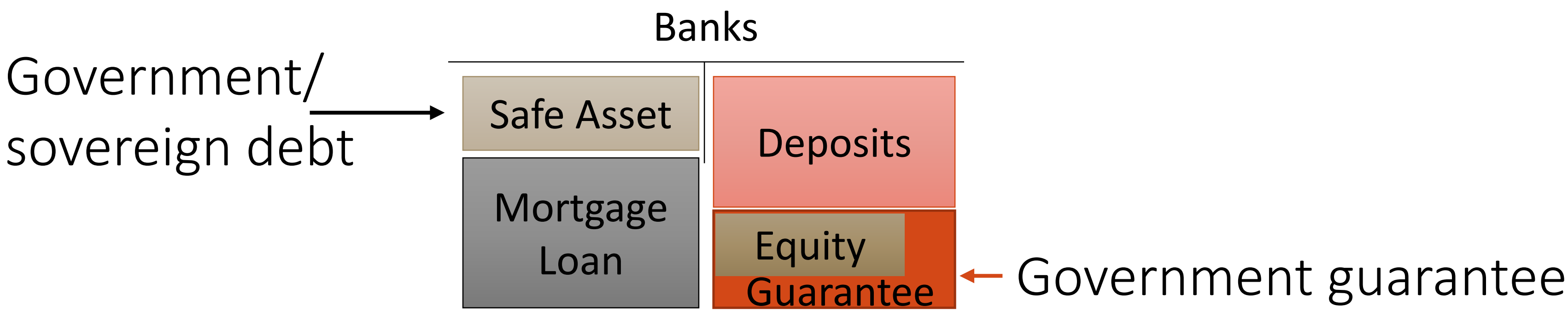
How do these concepts hang together?

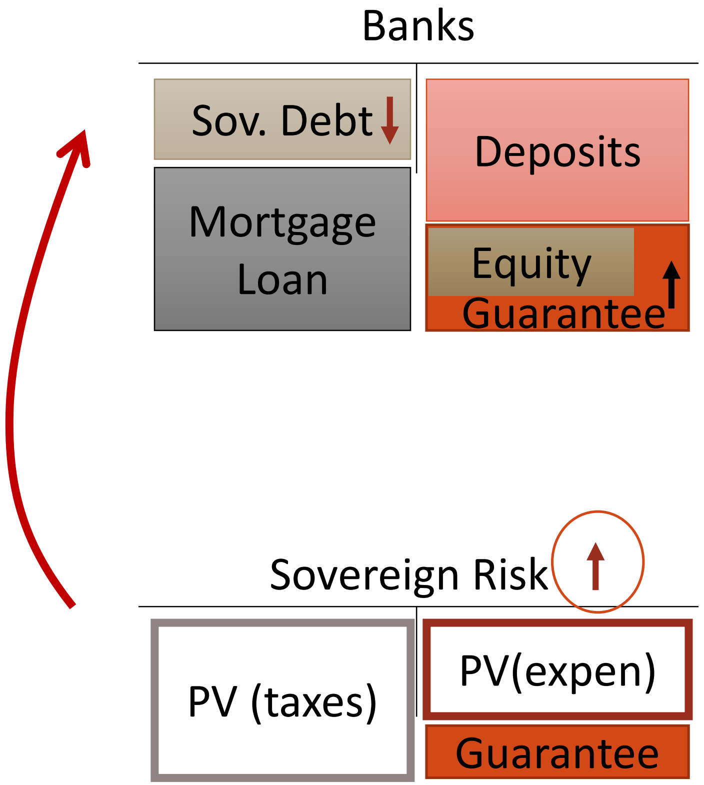
- Diabolic-Loop (Doom loop)
  - Sovereign-banking-nexus
- Financial repression
- Financial dominance
- Liquidity risk nexus
- Safe assets
  - Flight to safety
  - Cross border flight

Diabolic loop: Gov. on both sides



Diabolic loop

- Direct nexus



Diabolic loop

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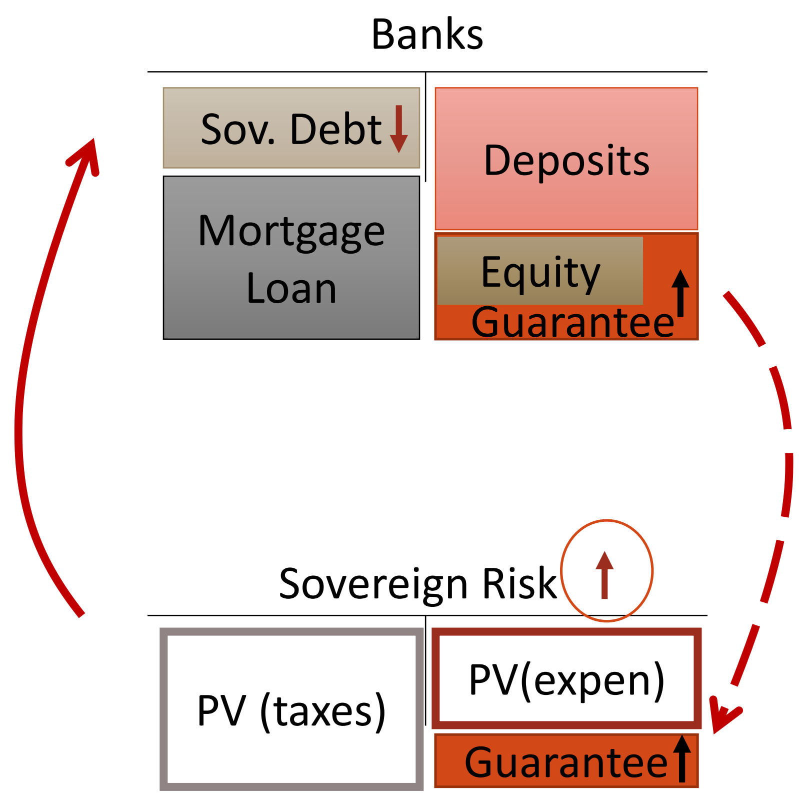
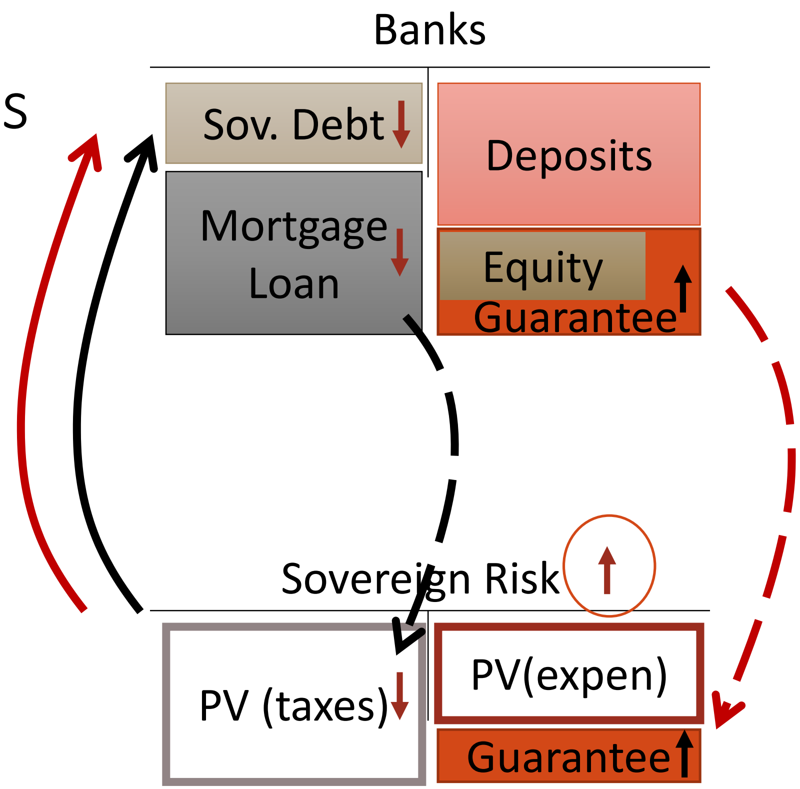


Diabolic loop

- Direct nexus
- Indirect nexus



Diabolic loop

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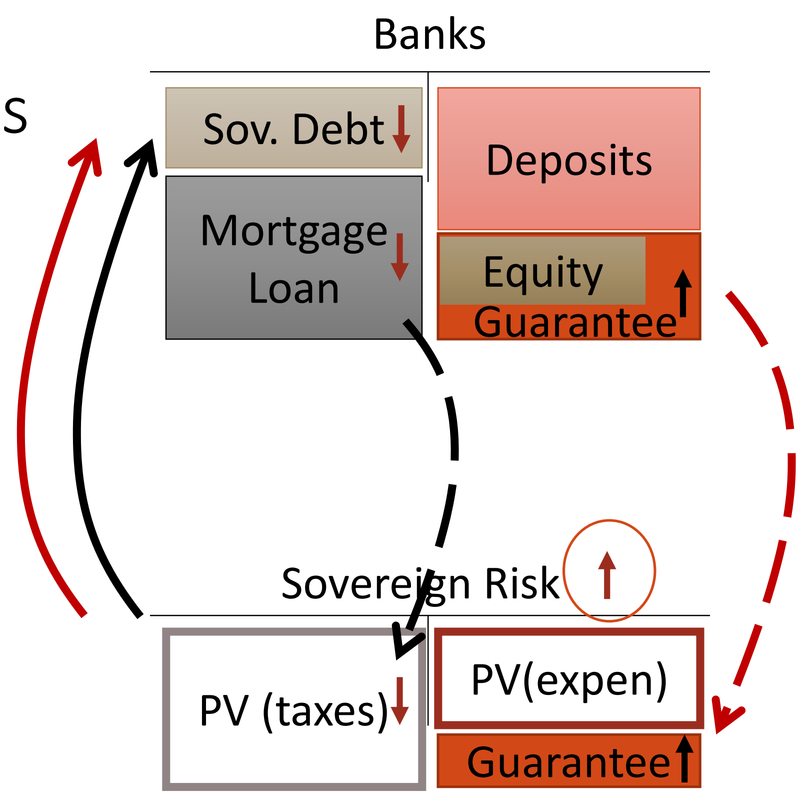
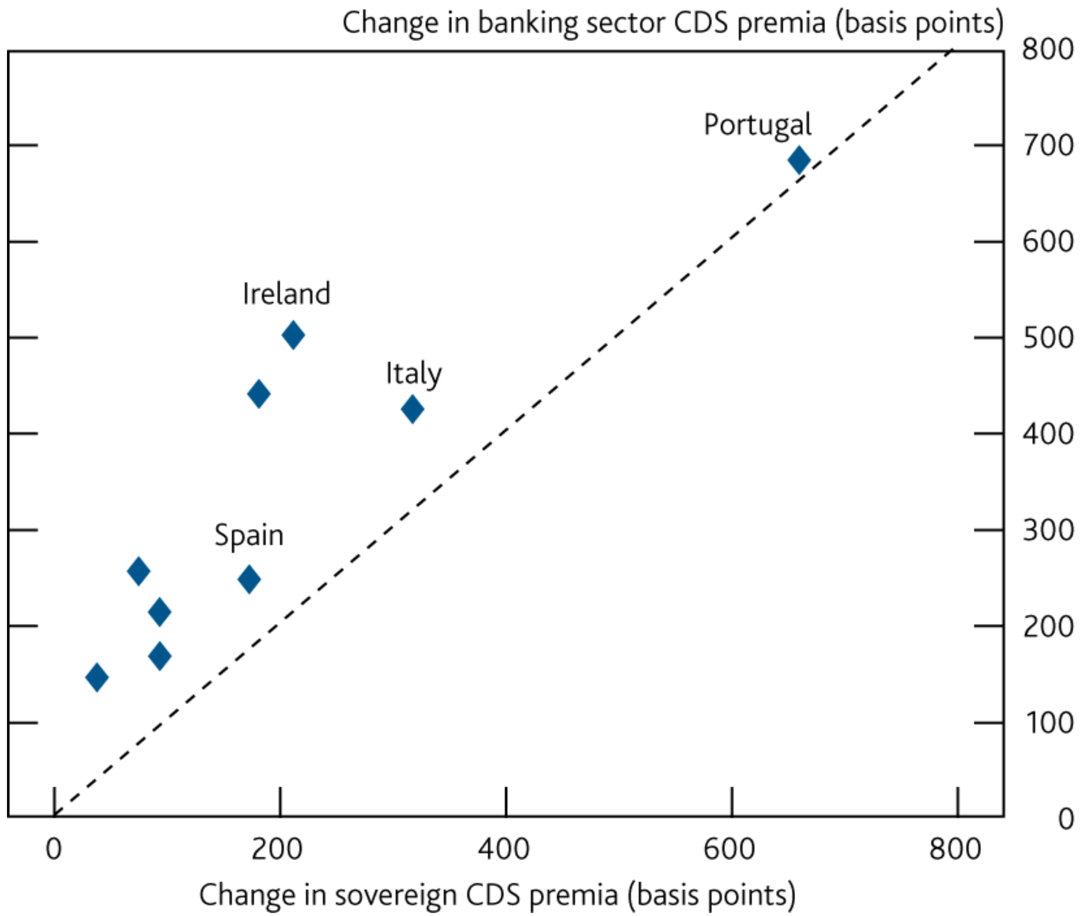


- Trigger: Banking crisis (Ireland, Spain)
  Sovereign crisis (Portugal, Greece)

Link between banking & sovereign CDS

- Banking CDS spread and sovereign CDS spread



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- Twin crisis – High correlation
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- Crisis is much worse (if it can't avoided)

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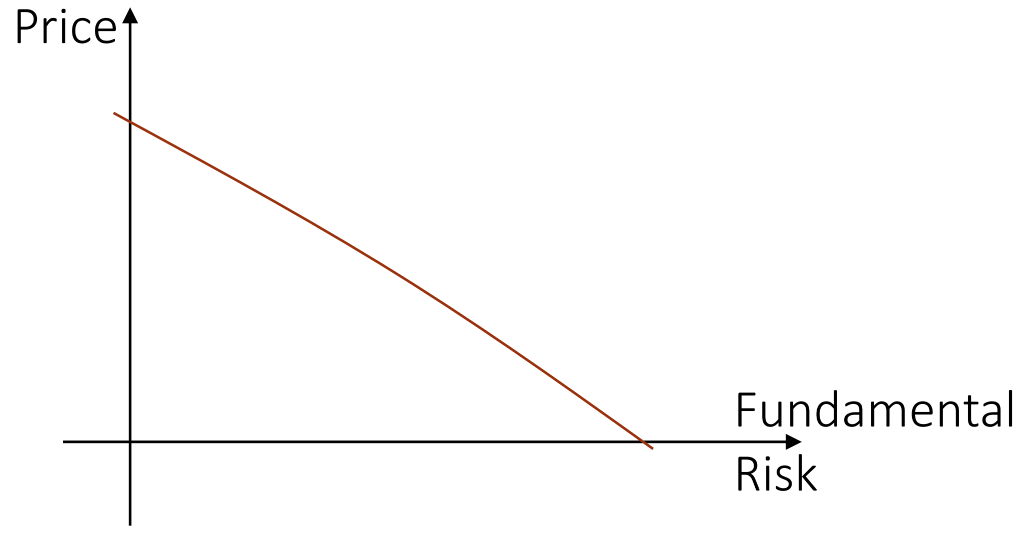

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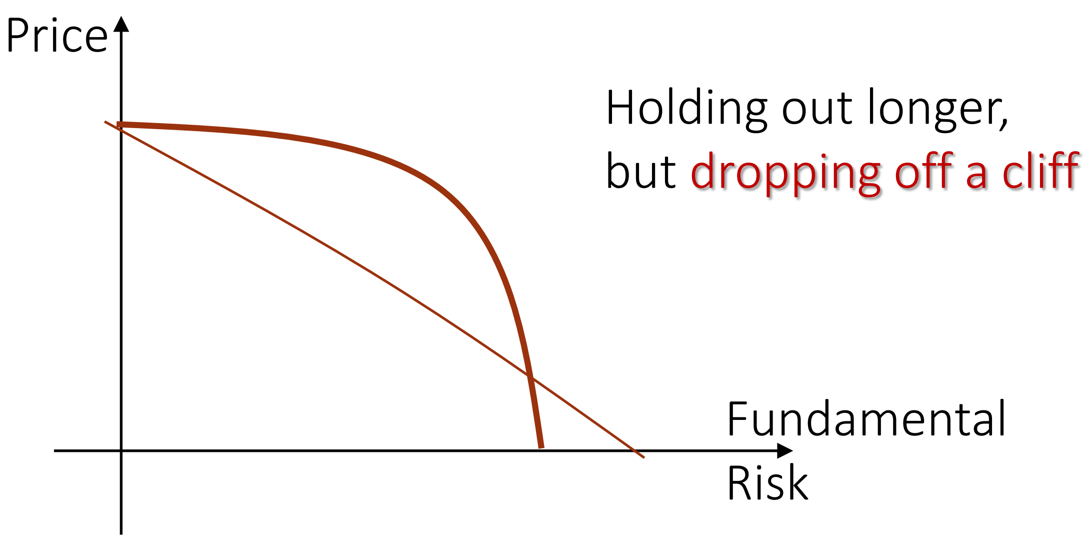

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Risk bearing capacity	Equity	Fiscal space • Δtax capacity • Commitment/reputation

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Intention	Lower Equity ↓ Obtain gov. guarantee FINANCIAL DOMINANCE ⟷	Push safe asset onto banks Cheap gov. funding FINANCIAL REPRESSION
Liquidity risk		

Who insures whose liquidity risk?

- Why should government issue long-term bonds?

- Two views - dual role of
  default-free long term gov. bond (no credit risk)

1. Banks insure governments against rollover risk
   - .. But what if banks are undercapitalized? ⇒**"Empty" insurance**
2. Government insures banks
   - "The I Theory of Money" – redistributive monetary policy
   - Cut short-term interest rate – buy bonds through OMO
     - Value of long-term bond rises
     - "stealth recapitalization" of distressed sector

Cross-border implications

- "Nationalization" of sovereign debt holdings
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- Country without a "safe asset"
  - Option 1: buy foreign safe asset

    large cross-border capital flows

  - Option 2: bet on own sovereign debt

- Solution: European safe asset
  - Without joint liability (ESBies)

Maturity implications

- In times of crisis government can dilute long-term debt
- Issuance of becomes more short-term
- Term spread widens

In sum

- Diabolic-Loop (Doom loop)
  - Sovereign-banking-nexus
- Financial repression ↔ Financial dominance
  - Extracting cheap funding/guarantees
- Default risk nexus (mutual guarantee)
- Liquidity risk nexus
- Safe assets
  - Flight to safety
  - Cross border flight

Further points/facts:

- Banks' holding of sovereign debt (see ESRB Sovereign risk report)
  - Before 1990s: 35%-40%
  - Prior crisis: 5%-10%
  - Crisis: domestic banks stepped in
- Type of crisis
  - Specie
  - Foreign $
  - Domestic crisis is typically solved by means of inflation
- Regulation
  - Capital/liquidity requirements won't bite
  - Large exposure limits have bite (better diversification)
  - ESBies – but how to deal with Sweden, Czech republic
- Basel does not require zero risk weight
- Is QE an opportunity to get sovereign debt of bank's balance sh
- CB as primarily source of liquidity (vastly expanded balance sheet)