THE IMPACT OF BANK LENDING ON CREDIT SUPPLY AND THE REAL ECONOMY

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ABSTRACT

In the context of the ecu crisis, we tend to show that the safety portfolio of banks plays a crucial role within the propagation of monetary shocks across countries. Victimization Italian loan-level information, we tend to show that the shock to the banks' sovereign portfolio caused by Greek bailout was passed on to Italian companies through a credit contraction. This was significantly the case for banks with a lower capital and fewer stable funding. The contraction in credit was similar for each massive and little company; however it solely negatively affected the investment and employment selections of tiny companies. Money intermediaries play a basic role in enhancing economic process, disposition to companies and households and reallocating capital to the highest-value use.

Keywords: Banks, Credit, Financial Fragility, Security Markets, Sovereign Debt, Financial Contagion.

INTRODUCTION

A large fraction of their portfolio consists of securities, real properties, and equity holdings. Whereas there square measure complementarities among these completely different investments, swings within the market value and danger of those assets might cause changes in banks' credit provide, with potential adverse effects on the important economy. This paper studies the role vie by banks' security portfolio on the propagation of international macro-financial shocks to the important economy. we have a tendency to specifically specialised in the role vie by the bank's sovereign bonds-one in all the foremost necessary security category control by money intermediaries-throughout an amount characterized by tensions in international sovereign markets. Specifically, we have a tendency to analyze the credit market dynamics and firms' real economic activity in Italian Republic round the 2010 Greek bailout event. The bailout directly involved Greece and its investors, however it conjointly sparked a widespread turmoil in world money markets, together with the Italian sovereign bond market. We have a tendency to show that Italian money intermediaries with giant exposures to government securities tightened their credit provide when the burst of the Greek sovereign crisis in comparison to less exposed banks, which the credit contraction negatively affected the investment and employment selections of the Italian SME company sector (Albertazzi et al., 2014).

The Greek bailout could be good settings to review the role contend by banks' security portfolios on the transmission of international shocks. First, we tend to are ready to examine the results of financial contagion by that concentrate on one specific shock originating outside of the national borders that wasn't caused by a contemporaneous deterioration in economic fundamentals or political risk. As we tend to tend to debate among the paper, the Greek events radically and unexpectedly changed the possibility perception of presidency bonds issued by

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individual countries in Europe, similarly as European nation. In fact, the sequence of events that culminated into Greece's bailout request was a "*wake-up call*" for investors (Gan, 2007).

We begin by documenting that the turmoil within the sovereign bond market had a negative, causative result on bank disposition because of banks' direct exposure of their security portfolio to the monetary shock. once we compare disposition to an equivalent firm by 2 banks that square measure one variance apart in terms of sovereign exposure, we discover that the additional exposed monetary negotiator reduced its credit provide by 100% additional relative to the less exposed (Petersen & Rajan, 1994). Not solely did the additional exposed banks cut disposition additional intensively, they were conjointly additional doubtless to interrupt current credit relationships or cut credit limits on lines of credit. The paper presents variety of hardiness tests to support the causative interpretation of those results (Baskaya et al., 2017).

Investigating the channels of transmission of the monetary shock to bank disposition activity, we discover that the adjustment in credit provide is larger for poorly capitalized banks and intermediaries relying additional heavily on interbank debt as a supply of funding. This means that the sovereign shock affected disposition as a result of it unexpectedly accumulated the peril of bank assets, forcing monetary intermediaries to regulate their behavior. Sovereign securities, thought-about to be nearly unhazardous before the Greek bailout, started carrying a nontrivial quantity of credit risk when spring 2010 (Adrian et al., 2013).

CONCLUSION

Finally, we document the transmission of the financial shock to the real economy. We find that the Greek bailout - through its effect on banks' lending - negatively affected firms' investment and employment policies. This effect is fully driven by small companies, which cut investments and payroll costs more than other equally exposed large firms. In particular, we estimate that one euro cut in funding to small firms decreased investments by 38 cent and payroll payments by 37 cent. At the same time, we find essentially no effect for larger firms. Importantly, we note that this result is not driven by a differentially credit tightening across large and small firms, but rather by relative inability of smaller businesses to smooth a similar credit shock across different lenders.

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