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**THE QUALITY OF PUBLIC FINANCE AND THE FINANCIAL  
SOUNDNESS OF BANKS IN THE EU COUNTRIES****Abstract:**

The recent international crisis, and in particular the public debt crisis, reiterated the belief that the government sector and the financial and banking sector are deeply connected, therefore the level and composition of budgetary aggregates influencing the dynamics of banking activity. Against this background, our paper aims at empirically assessing the impact of public finance variables, in particular of general government deficit and public debt, on the soundness of the EU banking sectors, measured by the bank Z-score and the ratio of non-performing loans. The analysis is conducted for aggregated data at the level of the banking sectors of EU countries, coming from the datasets of the World Bank (Global Financial Development Database, World Development Indicators, Worldwide Governance Indicators) and the European Commission (Eurostat), and spans over 15 years (2000-2014). In addition to public finance indicators, several other macroeconomic and institutional variables that could affect banking sector's health and financial stability are included into our model, as control variables. Overall, our empirical analysis confirms that government sector's decisions, reflected in the quality of a country's public finance, are important not only for ensuring fiscal sustainability but also for banking sector's and overall financial stability.

**Keywords:**

banks, Z-score, non-performing loans, general government deficit, public debt, financial stability

**JEL Classification:** G21, G28, E44