Discussion of:
Nexus Between Financial and
Sovereign Credit Risks:
Theory and Evidence
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Three Papers and Three Points

1. “Sovereign debt, government myopia, and the financial sector” RFS (2013) with Raghuram Rajan


Sovereign debt, government myopia, and the financial sector

• Sovereigns are too willing to repay sovereign debt
  – Fear of exclusion for international capital markets
  – Cost of default for the financial sector
  – *Short-termist* governments ‘kicking the can down the road’

• Predictions on debt dynamics, likelihood of default, distortionary tax policies based on simple comparative statics of the model
A Pyrrhic Victory? - Bank Bailouts and Sovereign Credit Risk

- Twin crises of banking sector and sovereign debt through bailouts:
  - Post bailout sovereign CDS spreads co-move with bank CDS spreads
  - Transmission channel through bank holdings of sovereign bonds
The Greatest Carry Trade Ever?
Understanding Eurozone Bank Risks

• What is the carry?
  – ‘Sell’ German bunds and buy GIPSI debt
  – A bet on convergence of EZ member bond prices
  – Limits of arbitrage and funding risk
  – Examples: Dexia & Bank of Cyprus

• Was there regulatory arbitrage?
Myopia & Pyrrhic Victory -- Comments

- Basic Theoretical Points seem right
- Models are designed mainly to yield empirical predictions based on simple comparative statics
- Welfare and Financial Regulation Analysis?
- There could be other mechanisms at play?
Carry Trade -- Comments

- Is it a Carry Trade?
- Was there regulatory arbitrage?
- What are the main arguments and evidence?
  - carry trade is concentrated in undercapitalized banks
  - non-GIPSI banks also hold a lot of periphery debt
  - “behavior is bank specific and does not extend to hedge funds, non-European banks, or non-financial firms”
Carry Trade -- Comments

- Multi-factor model:

\[ R_{i,t} = \beta_{0,i} + \beta_{GIPSI,i} \times R_{GIPSI,t} + \beta_{Germany,i} \times R_{Germany,t} + \beta_{m,i} \times R_{m,t} + \varepsilon_{i,t} \]

- Bank stock returns sensitive to peripheral bond returns

- Coefficient is higher if bank holds more peripheral bonds
Carry Trade -- Comments
Carry Trade -- Questions

- Are differences in the factor loadings across banks driven by decline in wholesale funding or by non-performing loans?
- If so, can we still describe this as a ‘carry trade’?
- What is the benchmark sovereign debt portfolio for a bank that is not engaging in a speculative carry trade?
- What role did ECB liquidity provision play?
Bolton and Jeanne (2011)

• Data from the European Stress test of 2010.
Bolton and Jeanne (2011)

Data from the European Stress test of 2010
Role of ECB Liquidity?

National Central Bank Target balances vis-à-vis the Eurosystem

Source: Compilation by the Ifo Institute
Summing up

- EZ sovereign debt and banking crises closely intertwined
- Will the banking union sever that link?
- Is the worst behind us?