Financial volatility, currency diversification and banking stability.

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August 25, 2017

Diversification and banking stability

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The idea that a significant amount of bank assets and liabilities are in foreign currency and can be exploited as a policy instrument.

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The idea that a significant amount of bank assets and liabilities are in foreign currency and can be exploited as a policy instrument.

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- The first is to provide a theoretical model that examines the interactions between asset returns, funding cost and exchange rate in determining banking stability.
    - i.e how does diversification influence banking stability?
- Secondly, the paper estimates a DCC-GARCH that depict dynamics in the US and EU financial markets.

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- Diversification is introduced in two dimensions:
  - Asset diversification.
  - Diversification of liabilities.
- The introduction of diversification leads to a reduction in equity volatility (i.e Banking stability).
- This conclusion is dependent on the variance covariance matrix of assets, liabilities and exchange rate.

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Empirics:

The empirical section uses DCC-GARCH to estimate the variances and correlations between

- Asset returns proxied S&P500 index and Eurostox50
- Funding cost
- The exchange rate

Comment: Model is appropriate

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Theoretical Considerations:

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- In terms of model considerations an interesting literature to look at is Tasca & Battiston (2011).
- Intuition behind some of the model results can be explored into more details.

- One of the most important results in the paper is the derivation of:
  - The efficient share of asset diversification ψ
  - The efficient share of liabilities diversification λ
- $\hat{\psi}$ and $\hat{\lambda}$ are both functions of the variance covariance matrix and the leverage ratio.

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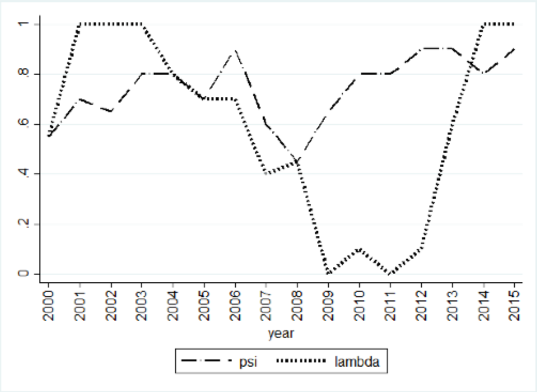
Efficient Diversification



Compare this to the actual empirical measures of ψ and λ

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Conclusion

- The paper tackled an important issue that has not received much attention from policy makers.
- The theoretical model is simple and easily comprehensible.
- What specifically is the policy prescription from the paper?
- How is diversification related to bank capital and banking profitability?