Financial volatility, currency diversification and banking stability.

Author: Justine Pedrono

Discussant: Maxwell Tuuli

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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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  - Asset diversification.
  - Diversification of liabilities.

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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 Eurostoxx50
- Funding cost
- The exchange rate

Comment: Model is appropriate
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Theoretical Considerations:

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- Intuition behind some of the model results can be explored into more details.
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Efficient Diversification

- One of the most important results in the paper is the derivation of:
  - The efficient share of asset diversification $\psi$
  - The efficient share of liabilities diversification $\lambda$

- $\hat{\psi}$ 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 $\psi$ and $\lambda$
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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?