Review of the International Role of the Euro – Dissecting Foreign Investments in Euro Area Bond Markets During the Sovereign Debt Crisis - Discussion

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Overview

- Motivation – Role of foreign investors in EA bond markets during debt crisis

- Methodology – Standard gravity model of international porftfolio flows

- Main Feature – Rich set of policy issues including impact of falling angels, ECB’s OMT announcement, etc.

Results

- No.1 - Impact of foreign investors on EA financial market fragmentation has been small (2009-2011)
- No. 2 – Against standard prediction in a GM under investment confined to EA stressed countries
- No. 3 - Against standard prediction in a GM, little evidence that foreign investors have engaged in euro-area portfolio rebalancing
- No. 4 – Under investment in stressed euro area countries persist even controlling for changes in sovereign ratings
- No. 5 – Neither US or Japanese investors continued to under invest after July 2012 announcement.

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Some Concerns

- Data - Critical caveat: results confined to long term debt securities only

- Why? – Expect (i) significant share of investment in short term securities and (ii) in times of increasing risk investors shift exposure from long to short term securities

- Model – Not able to disentangle valuation effects of asset price movements from exchange rate effects

- Why? – Typically investors would consider (i) credit risk and (ii) forex risk. Could relative strength of euro contain further sell-off? Avoid original sin problem and double whammy.

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Interpretation and Extension

- Interpretation (1) - Simple survey to gauge going beyond "corner solutions" of investor strategy of (i) portfolio rebalancing and (ii) buy and hold to maturity.
- Interpretation (2) – If at height of crisis yields declined in non-stressed EA countries, then suggests rebalancing within EA was driving the dynamics?
- Extension (1) – In future, if/when we see upgrades, assess whether any asymmetric investor behavior.
- Extension (2) – Some evidence that EA banks sold off assets and reduced positions in Asia and beyond to make up for deteriorating financials at home country. Could this have muted the foreign sell-off?

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Thank you!