Discussion of "International Contagion through Leveraged Financial Institutions" by Eric van Wincoop

Scott Davis[1]

Federal Reserve Bank of Dallas

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[1] The views presented here are solely those of the presenter and should not be interperted as representing the views of the Federal Reserve Bank of Dallas or the Federal Reserve System.

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  - Between 2004 and August 2008, the correlation between daily returns of the U.S. and European markets was about 0.5.
  - Since September 2008, the correlation has been about 0.7
  - The 100 day moving average correlation sometimes topped 0.8. (one time was in August 2011)

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- This high correlation of asset prices is hard to square with the low degree of cross-border asset holding that we see in the data.
- One possible explanation is that if assets are held by leveraged financial institutions, then a fall in asset value (from defaults) has a magnified effect on net worth, and thus asset demand.

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    - Institutions start with an endowment of both types of assets, in period 1 they can buy more long-term assets.

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- Reduction in the demand for home and foreign long-term assets in period 1 $\longrightarrow$
- The prices of home and foreign long-term assets fall.

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  - Following an increase in home defaults, foreign institutions have a lower net worth, so demand fewer foreign long-term assets.

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- With a closed-form solution for home and foreign asset prices, the author can take a derivative of the price with respect to defaults to calculate a closed-form solution for the extent of international contagion and find the contribution of individual channels.
- When the parameters in the model are calibrated to match the degree of cross-border asset holding that we observe in the data, the model cannot replicate the extent of international contagion in equity markets that we observed in the recent crisis.

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- The mean or the variance of the pay-off in the second period is unaffected by defaults in the first period
- Defaults affect the asset price simply by affecting net worth and thus demand
    - There is no sort of feedback loop where falling asset prices affect future asset payoffs, leading to falling asset prices.

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- One of the most interesting results from the paper is how the author shows how the contagion and the overall depth of the asset price fall depends on the borrowing constraint.
- When there are no borrowing constraints, contagion is proportional to cross-border asset holding, when there are collateral constraints, contagion is greater.

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- In a pure MM world, the net worth of leveraged institutions should not affect their asset demand in period 1.
- If they could borrow in period 1, their demand in the case with no borrowing constraints should depend on discounted future payoff, and nothing more.

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  - This would essentially look like a liquidity channel and lead to fire sale reactions to asset prices.

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- The country-specific coefficient of relative risk aversion enters into the required rate of return on holding assets
  - It enters into the market risk premium from the CAPM.
- An international coordinated increase in coefficients of risk aversion will push up required rates of return, and thus push down asset prices, internationally.

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  - then an exogenous increase in defaults lowers the expected value of the value of a financial institution's assets, but also the variance.