Discussion of
"Is Banks' Home Bias Good or Bad for Public Debt Sustainability?"
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This Paper

- Banks' **Home Bias** $= \dfrac{\text{Banks' holding of } \textbf{domestic} \text{ sovereign claims}}{\text{Banks' total assets}}$

- How does home bias affect amount, cost & dynamics of sovereign debt?

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- How does home bias affect amount, cost & dynamics of sovereign debt?

- Study 22 advanced economies & 29 emerging economies from 1999 to 2012

- Countries with higher home bias ...
  - ... have lower costs to serve sovereign debt
  - ... have larger amount of sovereign debt
  - ... experience slower fiscal consolidations
  - ... enter in distress with higher amounts of debt

Overview

- Very timely paper
- Speaks to the debate about sovereign debt & risky weights
- Establishes stylized facts that should be addressed by the macro literature
- Very clear and easy to follow

More Details

- Data on banks' holding of domestic sovereign claims & banks' total assets:
  - International Financial Statistics + Arslanalp & Tsuda (2012)
  - Data aggregated at the country level
  - Data from 1999 until 2012, annual frequency
  - 22 advanced economies & 29 emerging economies
- Main regression:

$$r_{i,t} = \beta_1 b_{i,t-1} + \gamma_0 \left(hb_{i,t} - h\bar{b}_t\right) + \gamma_1 \left(hb_{i,t} - h\bar{b}_t\right) \times b_{i,t-1} + \dots$$
$$\dots + \gamma_2 \left(hb_{i,t} - h\bar{b}_t\right) \times VIX_{t-1} + x_{i,t}\delta + \epsilon_{i,t}$$

Regression Design

- There is a clear endogeneity concern
- Government could exert moral suasion to convince national banks to purchase domestic sovereign debt
- Home bias reduces incentives to default $\rightarrow$ countries can increase debt at lower cost Gennaioli et al., 2016; Sosa Padilla, 2016; Thaler, 2016
- Positive & normative implications of banks' home bias depend on the determinants of banks' choice to hold claims on domestic sovereign debt

Regression Design

- Authors instrument banks' home bias with lagged credit-to-GDP ratio & house prices
- Although I appreciate the attempt to minimize endogeneity concerns, I wonder if it is enough to tackle the problem
- I think it would be more convincing to use a Panel SVAR
- Authors could be providing upfront the assumptions required to identify the relationship between banks' home bias and cost/amount of sovereign debt
- Panel SVAR provides a more natural way to control for the dynamics

Regression Design

- A thorough understanding of banks' home bias should focus on determinants of banks' decision to hold claims on domestic sovereign debt
- Government takes as given banks' (individually) optimal choices when issuing debt
- I would opt for bank level data rather than country level data
- Europe: ECB Individual Balance Sheet Indicators on 260 banks (2007:7 - 2015:12)
  - Focusing on EU banks could rule out exchange rate risk as a driver of home bias
- Japan: Credit register & detailed information on balance sheets (1977-2015)
  - Exploit banks' heterogeneous exposure to economic activity across prefectures
  - Use 2011 earthquake as a source of exogenous variation
  - Identify determinants of banks' decision to buy claims on domestic sovereign debt

The Role of Sentiments

- DCC-GARCH derives time-varying correlations between bonds' spreads & VIX
- VIX is interpreted as a proxy of sentiments
- VIX is option-implied expected volatility on the S&P500 index with a horizon of 30 calendar days (22 trading days)
- VIX can be split into a measure of **uncertainty** & a residual $\approx$ **risk aversion**
- Important to take out any role of time-varying uncertainty
  Fernandez-Villaverde et al., 2011; Johri et al., 2015; Seoane, 2016
- Bekaert et al. (2013) provide a methodology to identify the risk aversion component of VIX
- Time varying risk aversion is a slightly different concept from the sentiments of Angeletos and La'O (2013)

Concluding Remarks

- Very interesting paper providing a set of important stylized fact on the relationship between banks' home bias & dynamics of government debt

- These stylized fact should be consider by both researcher & policy makers to discipline the debate on banks' capital regulation & banks' holdings of sovereign debt

- More could be done to identify the determinants of banks' holdings of sovereign debt