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Euro currency risk and the geography of debt flows to peripheral EMU



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ABSTRACT

The pattern of debt flows to peripheral European Monetary Union members seems puzzling: they are mostly indirect and channeled through the large countries of the EMU. We examine to what extent the introduction of the euro and the elimination of the intra-area currency risk can explain this puzzle. We develop a three-country DSGE framework with endogenous portfolio choice and two currencies. In the equilibrium, the core members of the EMU emerge as the main group of lenders to the peripheral EMU. Outside lenders are pushed out of the periphery debt markets because of currency risk. The model generates a pattern of debt flows consistent with the data despite the absence of any exogenous frictions or market segmentations.

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1. Introduction

Hale and Obstfeld (2016) and Hobza and Zeugner (2014) document an interesting and puzzling empirical fact: since the foundation of the EMU, the financing of peripheral EMU members' trade deficits versus the rest of the world was mostly indirect and intermediated by the large countries of the core EMU.¹ Peripheral EMU debts were held mainly by Germany and France.² In turn, Core EMU debts were largely held by outside investors.

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¹ Peripheral EMU refers to Portugal, Italy, Ireland, Greece, and Spain. Core EMU refers to mainly Germany and France.

It is puzzling why investors outside the euro area are more reluctant to hold periphery bonds, and the core EMU countries hold an overwhelming portion of periphery bonds. Why do outsiders not lend to peripheral EMU directly? Using a stylized model, [Hale and Obstfeld \(2016\)](#) argue that this is because the transaction costs of lending to the peripheral EMU are lower for the core EMU than for the rest of the world. [Coerdacier and Martin \(2009\)](#) find that preferential financial liberalization lowers transaction costs inside the Eurozone (relative to outside the Eurozone) by about 17% for bonds and 10% for stocks. [Kalemli-Ozcan et al. \(2010\)](#) consider three potential candidates to explain financial integration within the EMU: elimination of currency risk, legal harmonization and trade. They find that the elimination of currency risk is the primary explanation for the increasing integration.

In this paper, we theoretically investigate the role of currency risk, and its impact on the geographic pattern of debt flows to the peripheral EMU. We argue that the core EMU has a clear advantage compared to the outside lenders when lending to the peripheral EMU. Core countries share the same currency with the periphery and are not concerned about the currency risk. Due to this advantage, core EMU lenders can push outside lenders out of the periphery bond market.

However, we do not underestimate the importance of other factors that might have caused this market segmentation. [Hale and Obstfeld \(2016\)](#) argue that four main factors contributed to the comparative advantage of the core EMU in lending to the periphery: the decline in (perceived) risks of investing in the peripheral EMU, the decline in transaction costs and the elimination of the currency risk, the European Central Bank's policy of applying an identical collateral haircut to all euro area sovereigns, regardless of their varied credit ratings, and uniform financial regulations within the euro area. Another factor is zero risk weights. The current regulatory framework grants EMU banks a beneficial treatment of credit risk on their sovereign debt exposures by assigning 0% risk weights, essentially exempting sovereign exposure ([Acharya and Steffen, 2015](#)). In addition, the lack of large exposure rule for public debt allows core EMU banks to take on a very large position on peripheral debt. Banks outside the Eurozone, however, do not have that advantage. Information asymmetry might have also contributed to the observed geographic pattern of flows. Information asymmetry refers to the fact that the core EMU lenders know and understand the peripheral EMU borrowers better than outsiders. This is a possibility and can very well be true for private individuals and banks, but to a lesser extent for sovereign bonds.

In our paper, we focus on the role of the currency risk in shaping the direction of the debt flows. We show that in a calibrated three-country DSGE model, with the presence of euro currency risk and no other frictions, the core EMU lenders can hold a large part of the periphery's debt, pushing outsiders out of the peripheral EMU's debt markets. To the best of our knowledge, our paper is the first to analyze the geographic pattern of debt flows using a DSGE portfolio choice approach. [Engel and Matsumoto \(2009\)](#), [Coerdacier and Gourinchas \(2011\)](#) and [Bengui and Nguyen \(2011\)](#) also study optimal portfolio choice in the presence of exchange rate risk. However, the issues they examine are different. [Engel and Matsumoto \(2009\)](#) and [Coerdacier and Gourinchas \(2011\)](#) focus on explaining the equity home bias puzzle. In symmetric two-country setups, they show that not much equity diversification is required when agents can hedge their foreign exchange risk sufficiently. [Bengui and Nguyen \(2011\)](#) examine international debt dollarization in a small open economy setup. Our paper, on the other hand, investigates the pattern of debt flows as an optimal portfolio choice in a three-country setup.

Intuitively, there are two competing channels that influence the portfolio decisions of the core EMU and outside investors. The first channel is called the "currency channel". It refers to the fact that core EMU shares the same currency with the periphery. This currency advantage allows them to absorb the bad shocks to the periphery bonds' returns better than outside investors do. The mechanism works as follows. Consider the core EMU holders and the U.S. holders of the periphery bonds. If the euro depreciates against the U.S. dollar (for instance, because of an increase in the euro money supply), the dollar value of the periphery bond's return declines. This hurts both core EMU and U.S. bond holders. Furthermore, when the non-tradable good prices are sticky, the dollar value of the consumption

² Previous empirical studies such as [Lane and Milesi-Ferretti \(2005\)](#), [Lane \(2006\)](#), [Spiegel \(2009\)](#), [De Santis and Grard \(2009\)](#) and [Haselmann and Herwartz \(2010\)](#) also highlight the euro bias as an explanation to the euro area countries' increasing investments in other euro area countries after the formation of the EMU.

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