

# Discussion of “Liquidity Hoarding and Interbank Market Spreads: The Role of Counterparty Risk” by F. Heider, M. Hoerova & C. Holthausen

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# Discussion of Heider, Hoerova & Holthausen

- neat adaptation of Diamond and Dybvig (1983) to study counterparty risk;

*frictions:*

- .counterparty risk and
  - .asymmetric information
- 
- can generate adverse selection problem (market for lemons);
  - possibility of multiple equilibria;

"The beauty and the simplicity of such a theory are so great that it is easy to forget that it follows not from the actual facts, but from an incomplete hypothesis introduced for the sake of simplicity." J.M. Keynes, 1926

# Discussion of Heider, Hoerova & Holthausen

- important simplifications:
  - banks know distribution of risks in the market;
  - cost of liquidation of asset is exogenous;
  - complete diversification across interbank loans;  
*(once you participate,  
counterparty risk is fully diversified!);*
  - no risk shifting due to limited liability  
(& risk neutrality);
  - banks perfectly competitive;

# Discussion of Heider, Hoerova & Holthausen

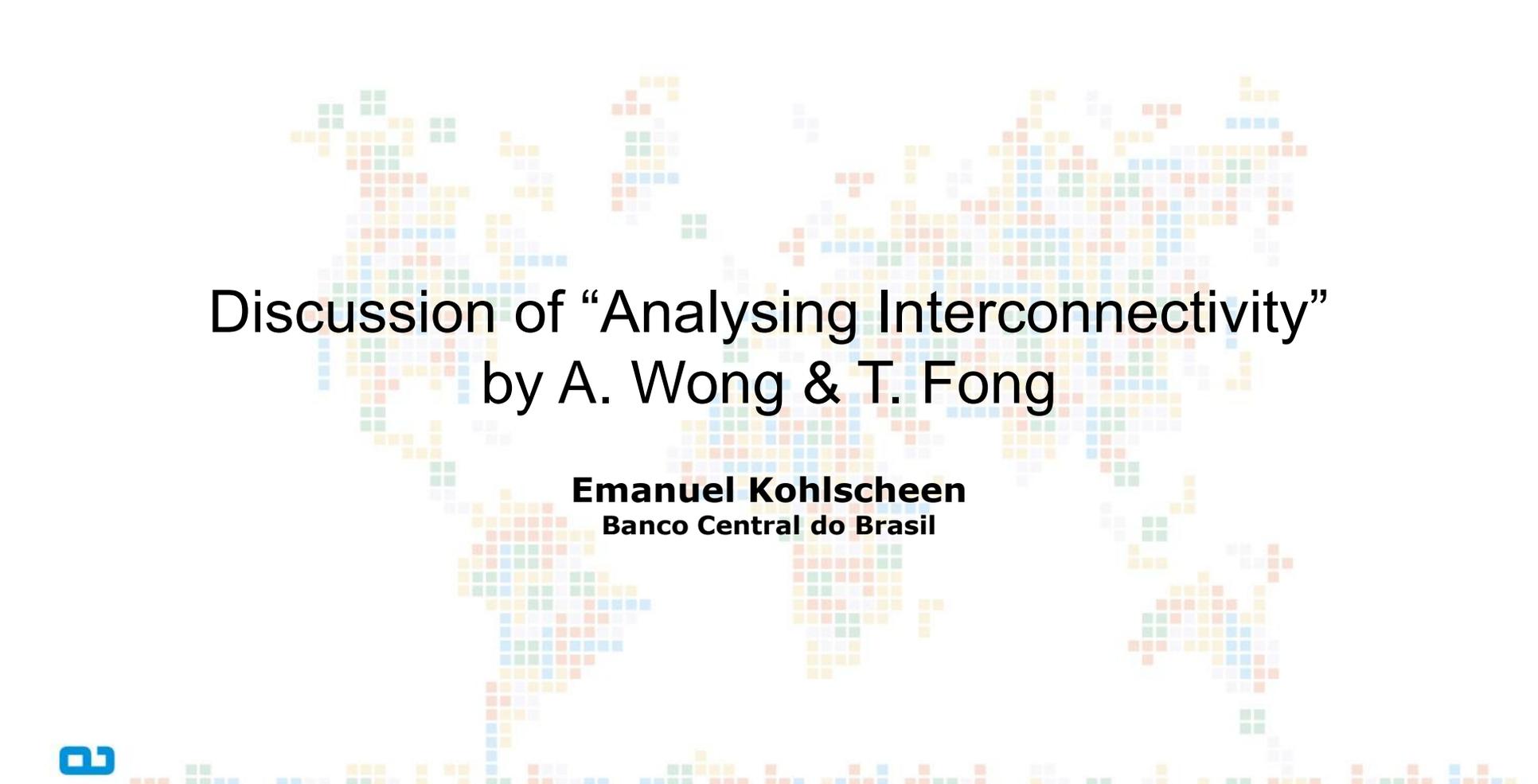
- the model is a case for centralizing bank's liquidity management.

Solution to distortions is elimination of counterparty risk: it is always optimal (and indeed profitable) for monetary authority to intervene!

However,

- .  $(pR > 1 > /s)$
- . "government intervention, voluntary or involuntary, destroys the advantage of a decentralised system, namely peer- monitoring."

(Rochet and Tirole (1996))



Discussion of “Analysing Interconnectivity”  
by A. Wong & T. Fong

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The Financial  
Crisis of 2008

Credit Markets and Effects on  
Developed and Emerging Economies

# Discussion of Wong & Fong

- application of Adrian and Brunnermeier's (2008) CoVaR methodology
  - extension of VaR to measure of systemic risk that captures increase in tail comovement during crises
- “co = conditional, comovement, contagion”;
  - proponents claim that it allows measurement of individual contributions to systemic risk;

# Estimation

$$\Delta X^i = \beta_{0,q}^{i|j} + \beta_{1,q}^{i|j} \Delta X^j + \sum_{k=1}^K \gamma_{k,q}^{i|j} R_k + \varepsilon_q^{i|j}$$

but

- not clear which way causality goes;
- quantile regression: event may not be in our data;

# Estimation in Wong & Fong

$$\Delta X^i = \beta_{0,q}^{i|j} + \beta_{1,q}^{i|j} \Delta X^j + \sum_{k=1}^K \gamma_{k,q}^{i|j} R_k + \varepsilon_q^{i|j}$$

- focus on sovereign CDS spreads  
(except New Zealand and Singapore → corporate)
  - restricted to post October 2004;
  - period of dramatic change in liquidity of the instruments;
- the MSCI world index is a poor proxy for general sovereign risk premium.

# Discussion of Wong & Fong

- most effects are expected, but not all:
  - substantial part of variation explained by country-specific effect (contrary to Longstaff et. al. (2007));
  - collapse of South Korea has same systemic impact as China.
- overall a good piece, but at least some robustness checks would be desirable (other quantiles; crisis sub-sample; alternative estimation methods)
- ***next step: what explains interdependence? Are there real links? (trade, FDI, etc.) Exchange rate regimes? Investor sentiment?***