Fragmentation in euro area banks' sovereign portfolios and its impact on international pricing*

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Abstract

Leveraging on a confidential dataset of euro area banks' portfolio holdings of government securities, both domestic and international, I study the determinants of the deviations from covered interest rate parity (CIP), i.e., hedged euro-dollar yield differentials. First, I document stark fragmentation in banks' holdings across different euro area countries. This suggests that country's convenience yield and the characteristics of the banks holding the government bonds matter. Motivated by those facts, I estimate hedged euro-dollar yield differentials for euro area banks and find sizable and heterogeneous CIP deviations, despite their common currency. Decomposing the CIP into a risk-free interest rate differential and a convenience yield differential across currencies shows a convenience for holding dollars, albeit it differs across euro area regions. In a second stage, I link the CIP deviations to three factors: the cumulative asset purchases of government bonds from the ECB asset purchase programmes, bank home bias and regulatory constraints. The last two significantly explain the deviations from arbitrage, confirming the role of fragmented banking systems in affecting the transmission mechanism of a common monetary policy and providing supporting evidence for the emerging theoretical literature linking CIP and banks' balance sheets.

Keywords: heterogeneous portfolios, fragmentation, sovereign bonds, convenience yields, securities data,covered interest rate parity.
JEL codes: F3, G2, G4.

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