Discussion of "A Preferred Habitat Model of Term Premia, Exchange Rates and Monetary Policy Spillovers" by Pierre-Olivier Gourinchas, Walker Ray, Dimitri Vayanos

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Fourth Biennial Conference, Warsaw
Sep 22, 2022

The views expressed are those of the discussant, not necessarily those of the Bank of Canada.

Overview

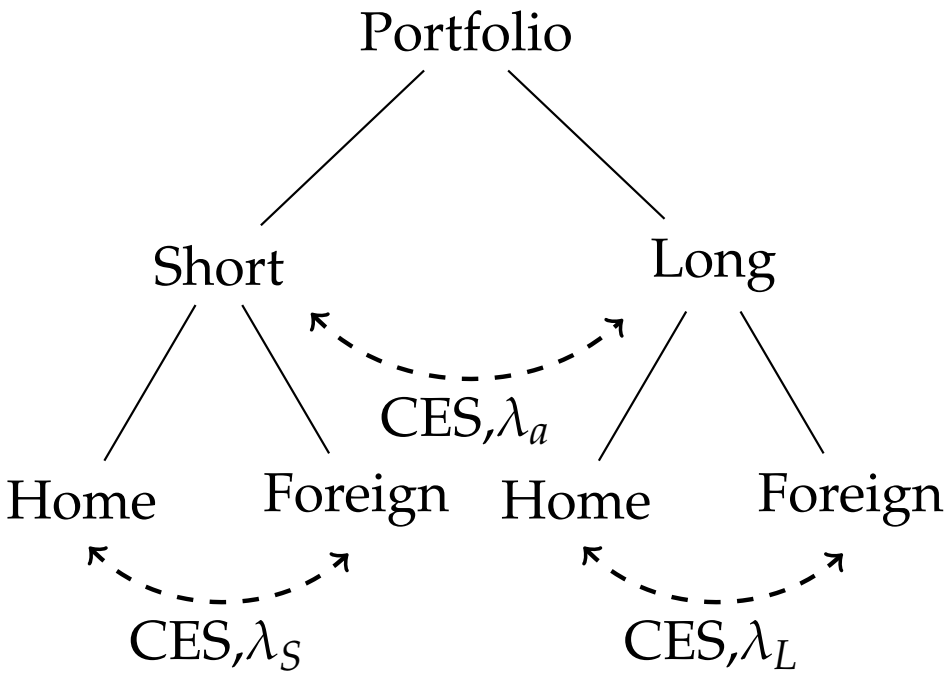
- Well-written paper addressing some of the key challenges that open economies face. Enjoyed reading it.
  - QE had significant spillovers on FX rates as well as foreign yields. US QE, for instance, lowered both term premium and risk premium on Canadian assets, increased equity and house prices (Kabaca and Tuzcuoglu, 2022).
- This paper offers an international portfolio balance model to explain FX rates and the term premia together. The model features ”new” ways of introducing portfolio balance effects.
  - Three types of investors: Currency traders, bond investors, and global arbitrageurs.
  - Segmentation achieved via separate currency traders and bond investors who express preferences over a bond of specific country and maturity.
  - Arbitrageurs have access to both markets. But there are limits to arbitrage because of their risk aversion.

Overview

- Following easier monetary conditions at home, arbitrageurs increase not only their foreign currency positions but also foreign bond holdings since they generate a hedge against the risk that foreign short rate drops and foreign currency depreciates.
  - Unconventional policy is stronger in reducing foreign yields partly because of a positive correlation in short rates across countries.

Alpanda and Kabaca (2020): CES utility over assets

- Same question, very similar conclusions in terms of spillovers on FX rate and term premia. A more traditional macro method to introduce portfolio balancing effects.
- Portfolio preference term in HH utility function in a two-country New-Keynesian model.



- Finite values for the elasticity parameters ensure deviations from EH as well as UIP arbitrage conditions.

Alpanda and Kabaca (2020): CES utility over assets

Imperfect substitution between ST and LT portfolios allow us to write down two distinct modified UIP conditions:

Short-term UIP:

$$R_t - R_t^* = Ed_{t+1} + \frac{1}{\lambda_S} f(b_{s,t}/b_{s,t}^*)$$

Long-term UIP:

$$(R_t + T_t) - (R_t^* + T_t^*) = Ed_{t+1} + \frac{1}{\lambda_L} f(b_{L,t}/b_{L,t}^*)$$

Note that T_t approaches to T_t^* as λ_S and λ_L approaches ∞.

Estimation of the model results in higher substitution between home-foreign bonds, (λ_S and λ_L), than short-long portfolios, (λ_a). This generates term premium spillovers following a QE policy at home.

- Conventional policy does not trigger a substantial change in neither domestic nor foreign term premium because of very mild changes in government bond supplies.

Contribution of this paper

- Key difference: Portfolio balancing effects are partly endogenized via mean-variance optimization by arbitrageurs. Investors look to hedging options against currency and short-rate risk.
- The paper should discuss in terms of what we gain going from old-fashion way to the new one. A comparison could be useful. Insights from Ray (2019)?
  - Especially if this is the way we should go in terms of modelling int'l financial environment in larger open-economy macro DSGE models, the reader should be convinced that the cost is worth.
- Clearly, the "risk" component is something to be highlighted relative to the old-fashioned way. Also, the model has implications on foreign yields even under conventional policy
  - Any evidence of foreign yields spillovers (for hedging purposes) following a rate cut across countries where short rates do not comove?

Exogenous short rates

- QE might induce changes in short rate expectations.
- On the one hand, investors might now expect with more certainty that policy rates will be at zero for a while
- On the other hand, if QE is expansionary, this should lower the length of ZLB thereby increasing policy rate expectations after some X period.
- Depending on the net impact, FX rate response could be amplified or mitigated.

Short-rate correlation, EMEs, SOEs

- Somewhat overemphasis of short-rate correlation (albeit not key for the main findings). Does this hold over QE periods anyways?
  - ECB and Canada hiked around 2010-2011. Policy rate expectations increased in Canada following US QE.
- Correlation btw AE-EME short-rates much lower. Does this mean the model generates lower spillovers for EMEs?
  - Search for yields rather than investors trying to hedge short-rate risk here?
- SOE implications of the model? Especially on the FX rate front.