Comments on "Financial globalisation and monetary independence"

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This paper addresses some important issues. There are few central bankers or monetary economists around the world who are disinterested in the traction of monetary policy, and all would pay close attention if traction were to be lost. And there are papers suggesting that we are indeed losing traction. Helene Rey's 2013 Jackson Hole paper has argued that the pre-Great Financial Crisis (GFC) view that countries face a trilemma of policy choices between monetary policy independence, exchange rate stability and interdependence of financial markets has collapsed to a dilemma since monetary policy independence is no longer a feasible option. Much of this debate is connected with the observations of other papers that highlight the convergence of long-term interest rates (Turner (2013, 2014)), the pro-cyclical movement of exchange rates (Bruno and Shin (2015b)) and the compelling evidence that phases of global cross-border banking liquidity ((Schularick and Taylor (2012) and Bruno and Shin (2015a)) tie together advanced economies (AEs) and emerging market economies (EMEs). Rey's view is that there is a global credit cycle through which the risk-taking channel of monetary policy is driven by loose US policy (both through low short-term rates and the use of QE that lowers long-term rates). The risk appetite of investors rises as the risk premium falls, amplifying the credit cycle externally. This implies that a flexible exchange rate does not insulate the domestic economy from external shocks, reducing the trilemma to a dilemma.[2] According to Borio and Zhu (2012), and Ahmed and Zlate (2014), risk appetite is the linchpin in the transmission process, linking countries through portfolio flows. Moreover, leverage and bank-to-bank credit play key roles in propagating capital flows to EMEs (Bruno and Shin (2015a)).

There are, however, detractors from this view. Aizenman et al (2015) argue that it is necessary to control for trade linkages, financial development and gross national debt as those factors imply a greater baseline sensitivity of peripheral to centre countries. This being the case, we may overstate the loss of monetary independence, which may always have been constrained by trade, finance and debt linkages. Aizenman et al (2015) seem to be more tentative about drawing strong conclusions from greater monetary interdependence or loss of traction. But, at a minimum, it appears that we should control for the baseline sensitivity of these links between peripheral and centre countries.

I would like to address three main points with respect to this paper. First, I summarise the insights of the paper itself – the advantages of this particular decomposition exercise. Second, I consider other decompositions and ask whether

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[2] Miyajima, Mohanty and Yetman (2014) use a model with an open economy user cost of capital concept to explore these channels. They find that the exchange rate moves countercyclically after an external shock. An exchange rate appreciation can induce looser domestic monetary policy, easing credit conditions. It can affect the balance sheet of firms, allowing them to borrow more domestically and internationally.

we have focused on the right one. This is a matter of the choice of fundamentals used to decompose the term premium. Finally, I consider what these tell us about financial conditions more generally and how else can they be modelled.

The paper offers important insights into the definition of terms. It differentiates between monetary autonomy, monetary dependence and financial contagion. It is also about distinguishing monetary dependence from financial contagion, and distinguishing changes due to risk appetite from those resulting from fundamentals. The authors do a fine job of removing the parts of the long-term bond yield related to expected monetary policy to focus on the term premium. The common component in the residuals determines the extent of monetary policy dependence. The paper shows that co-movements in the residuals have different dynamics compared with "off-the-shelf" measures of global risk such as the VIX index of US stock market volatility. EMEs are shown to be less exposed than AEs to global contagion (contrary to popular opinion), and the sensitivity of EMEs to global risk did not increase after the GFC (again contrary to popular opinion). The extent of co-movements from the decompositions in this paper differ from the co-movements apparent from long-term bond yields. But this is not entirely surprising since expectations of future short-term rates, and the fundamentals driving the term premium, have been removed before the co-movement of residuals is considered. Under this decomposition, monetary policy does not appear to be losing as much traction as some might have feared – we can all breathe more easily.

So what should we conclude? Either EMEs are more independent or they are affected by the global credit channel. We are not able to determine which of these two elements is true from the correlations of residuals. Potentially these results reveal that EMEs are more idiosyncratic than AEs. This may be due to the relatively large shocks they experience and the low correlation between those shocks across countries. The decompositions used here focus on shocks that are proportionally large for the EMEs concerned, but may not be large in an absolute sense, and are most likely to be much smaller than the shocks affecting AEs. Nevertheless, being relatively large, they may appear to give EMEs greater independence due to the dissimilarity of the residuals from the decomposition. Further exploration of the differences between EMEs – as opposed to their independence from global shocks – could be revealing. Could certain characteristics determine the extent to which EMEs' policy responses converge at points of stress? An analysis of the response of Asia-Pacific currencies to the US dollar around the time of the 2013 "taper tantrum" suggests that EMEs with more liquid currencies are more exposed to global volatility risk (Levich and Packer (2015)).

The conclusions are of course dependent on the type of decomposition that has been implemented. This raises several questions: How can we be sure about the reliability of the decomposition? How do we determine the "correct" fundamentals? Should we allow for announcements and news? How does the decomposition relate to financial conditions more generally?

This decomposition exercise would be more convincing if the authors could establish the "usefulness", quality of signal and robustness of their carefully extracted residual series. What makes this decomposition useful, high quality and robust for monetary policymakers? How much has to be taken on trust in the exclusion of fundamentals? Can we verify that the process has been conducted for maximum benefit?

A critical issue in extracting the residuals is the definition of fundamentals. In the paper, this is based on principal components (most significant common factors). We need to be convinced that the use of local yield curve and forward rate information and global information (such as yields on core country assets, lags of unexpected returns and the VIX index) is sufficient to control for fundamentals. We also need to be sure that by using this particular decomposition exercise we do not get results that are at variance with decompositions based on other fundamentals. For example, if we control for market depth and liquidity, bond characteristics (term to maturity, duration, amounts outstanding and coupon) and expected default frequency (along the lines suggested by Gilchrist and Zakrajsek (2012), and Bleaney et al (2016)), can we draw similar conclusions from the co-movement of residuals from this decomposition? We might also consider the use of a broader range of macroeconomic and financial factors, following Faust et al (2013), who used 15 macro and 110 financial variables. Term structure decompositions are to some degree model-specific, but the findings would be more robust if the co-movements between residuals under a range of alternative definitions of fundamentals were similar.

What about announcements and news? Monetary policy in AEs has been conducted unconventionally through announcements as much as through changes to policy instruments. There is considerable evidence that monetary policy announcements lead to changes in the term premium component of bond yields, as reported by Giannone et al (2011) and Altavilla et al (2014). We might also ask whether news has an impact on long-term yields and term premia. Brazys and Martens (2015) find that economic news can explain 20% of the total daily variation in US Treasury returns. Moreover, they indicate that some news items have temporary effects (manufacturing surveys and retail sales) while others have permanent effects (GDP advance/preliminary announcements). This suggest that we should first examine whether measures of fundamentals should be supplemented with news, and then allow for the possibility that some of these effects could be temporary and others more permanent.

Finally, how do the empirical results of the paper relate to financial conditions more generally? Financial condition indices have come back into favour as the recent paper by Hatzius et al (2010) illustrates. If there is a signal from the residuals, can this be related to EME financial conditions? Or is it related to real economic activity? The results from corporate bond markets in Gilchrist and Zakrajsek (2012), and Bleaney et al (2016) show that, for the US and European economies, the residuals from a decomposed bond spread index offer a useful forewarning of downturns in real activity. Could the same be true of the decomposition of sovereign bond yields? If so, could it be used to anticipate recessions due to changes in global risk appetite? Is any forward-looking information contained in the residuals or is it essentially contemporaneous?

This is a well-executed and insightful paper. I enjoyed reading it. It makes its main point very clearly: we are not losing traction. Further investigation would help in convincing the reader that the results are robust and that important variables have not been left out. It may also extend the usefulness of the decomposition to other uses such as monetary policy responses to changes in risk appetite.

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