Comments to On the Interest Channel and the Global Financial Cycle for EME by Ramos-Francia, Garcia-Verdu and Sanchez-Martinez

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What the paper does

- This work analyzes the effect of domestic (inflation) and external factors (VIX) on the term structure of nominal interest rates for a set of 8 emerging market economies with IT and different degrees of exchange rate flexibility, financial openness and use of MaPP.
- Use of affine interest model based on arbitrage conditions to separate the risk neutral short term interest rate from the term premium and calculate the effect of both factors on the latter.
- The results show that an increase in VIX, in general, rises the term premium, whereas for most countries there is no significant impact on the risk neutral interest rate.
- Regarding inflation, higher inflation increase expectations on future short term interest rates, and thus increase the risk neutral interest rate.

Comments

- Very interesting and insightful paper!
- VIX as a measure of the Global Financial Cycle (GFC)
  - GFC is defined as the co-movement between capital flows, credit growth and asset prices. Is VIX a sufficient indicator of this co-movement for EME?
  - Should we consider other variables to complement VIX as a measure of access of EM to foreign financing, such as monetary policy rates in AEs?
  - Main determinant of GFC is monetary policy in the center country (Rey 2018); indirect measures through common dynamic factors extracted from capital flows (Cerutti et al 2017)

Comments

- Results show high heterogeneity in the response of the interest rate and term premium to VIX shocks.
  - One interpretation is that it could respond to differences in the structure of the monetary and Mapp policy framework and the degree of financial integration of each country.
  - Could formalize the analysis of the determinants of the elasticity of the interest rate / term premium to VIX shocks.

Comments

- Model identification
  - Identification issues given short sample (2004-2010 as start date) and few observables, which could affect the stability of the parameter estimation.
  - The model relies on the arbitrage condition. How strong is this for EM with low level of capital market development?
  - Simpler strategy could consider a factor model to separate between common and idiosyncratic factors within yields of different maturity. Then use common factor to analyze its co-movement with VIX.
  - What are the underlying shocks behind the increase in inflation and VIX? Especially important when analyzing the joint shock.