Discussion of “Bank foreign currency hedging and the impact on covered interest parity: an Emerging Market perspective”
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*These slides and associated remarks represent only my opinions, not necessarily those of the Board of Governors or the Federal Reserve System.

Summary

- **Question**: Do banks' hedging demand affect cover interest parity (CIP) deviations in emerging markets?
- **Methodology**:
  - Panel regressions for 10 EMEs using hedging needs calculated based on the BIS international banking statistics.
  - Case study focused on Mexico using supervisory information on hedging positions.
- **Results**:
  - Hedging needs and positions are correlated with CIP deviations in the panel and Mexican-focused tests.
  - The hedging positions of global banks in Mexico explain most of the results for the case study.

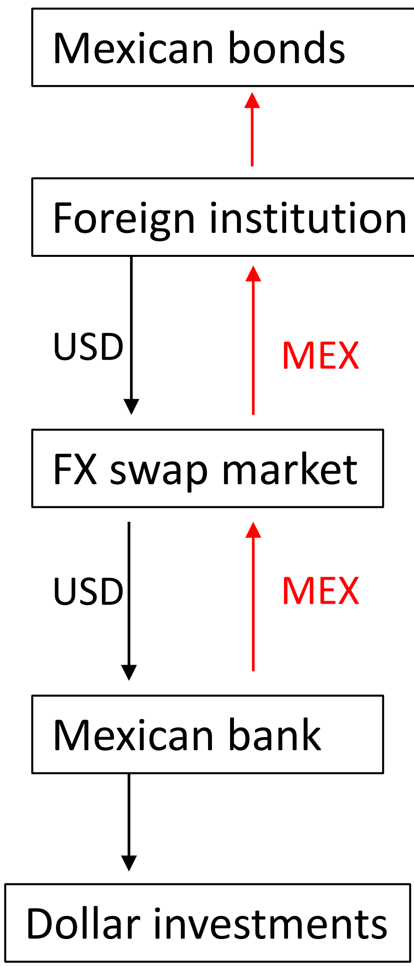
Where does this paper fit?

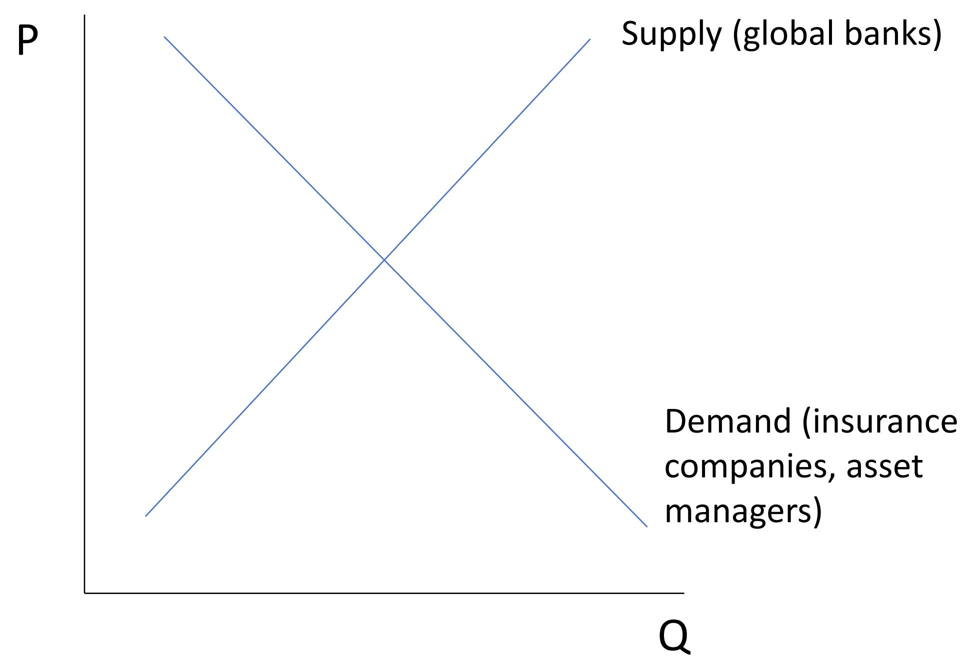
- Portfolio balance effects: Quantity driven explanations to asset prices (e.g., Gabaix and Maggiori, 2015; Greenwood, Hanson, Stein, and Sunderam, 2020).

- Supply factors and CIP deviations: Ivashina, Scharfstein and Stein (2015), Du, Tepper, and Verdelhan (2018)

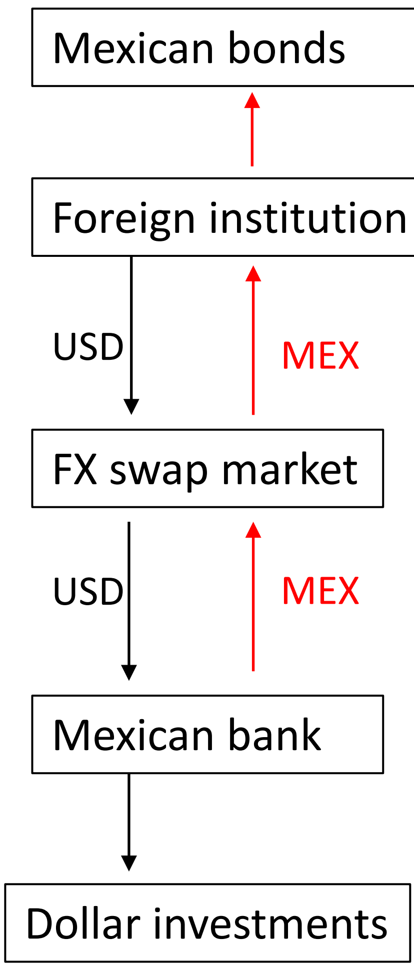
- Demand factors and CIP deviations: Liao and Zhang (2020) – relation between net external imbalances and spot and forward exchange rates

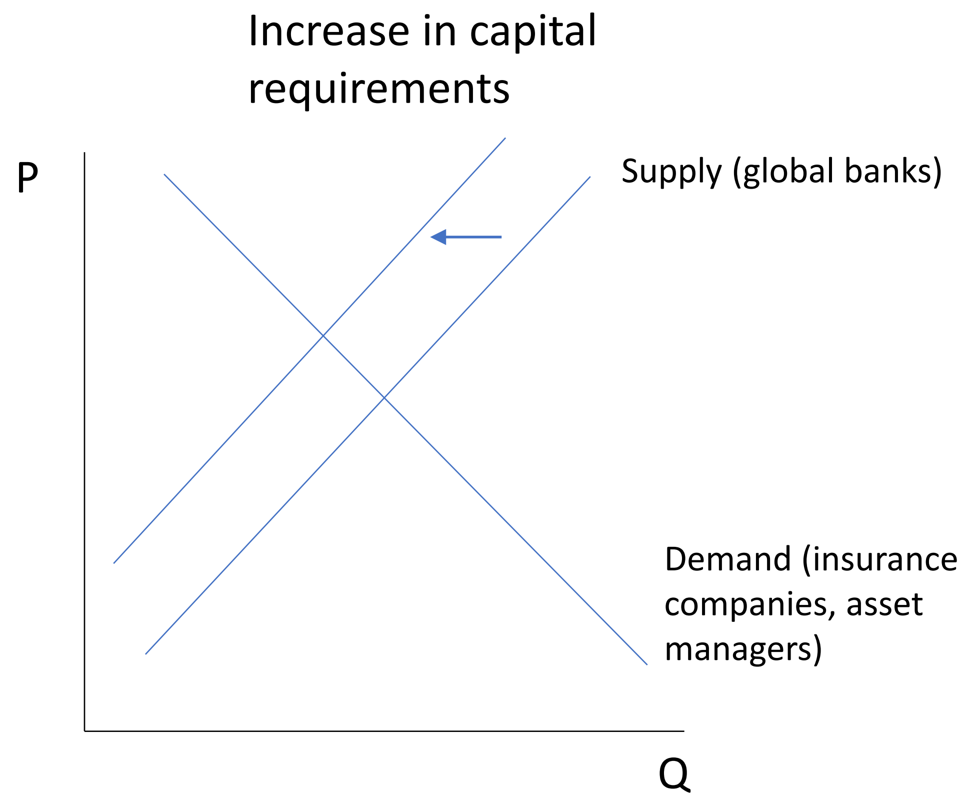
The FX swap market



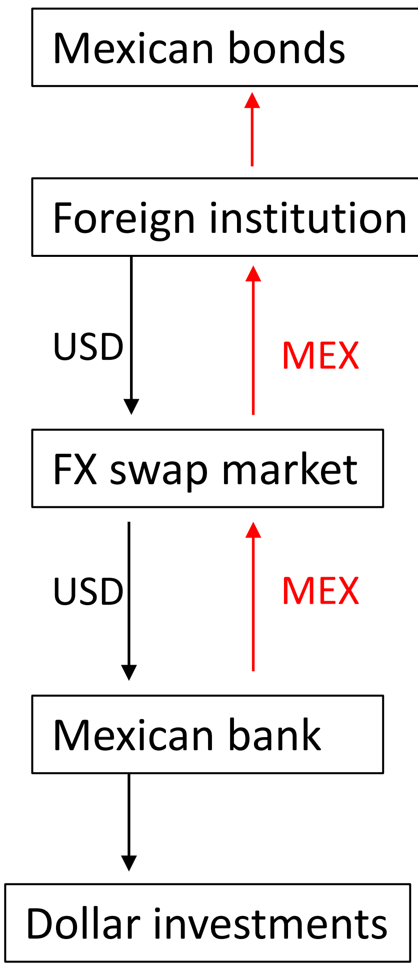


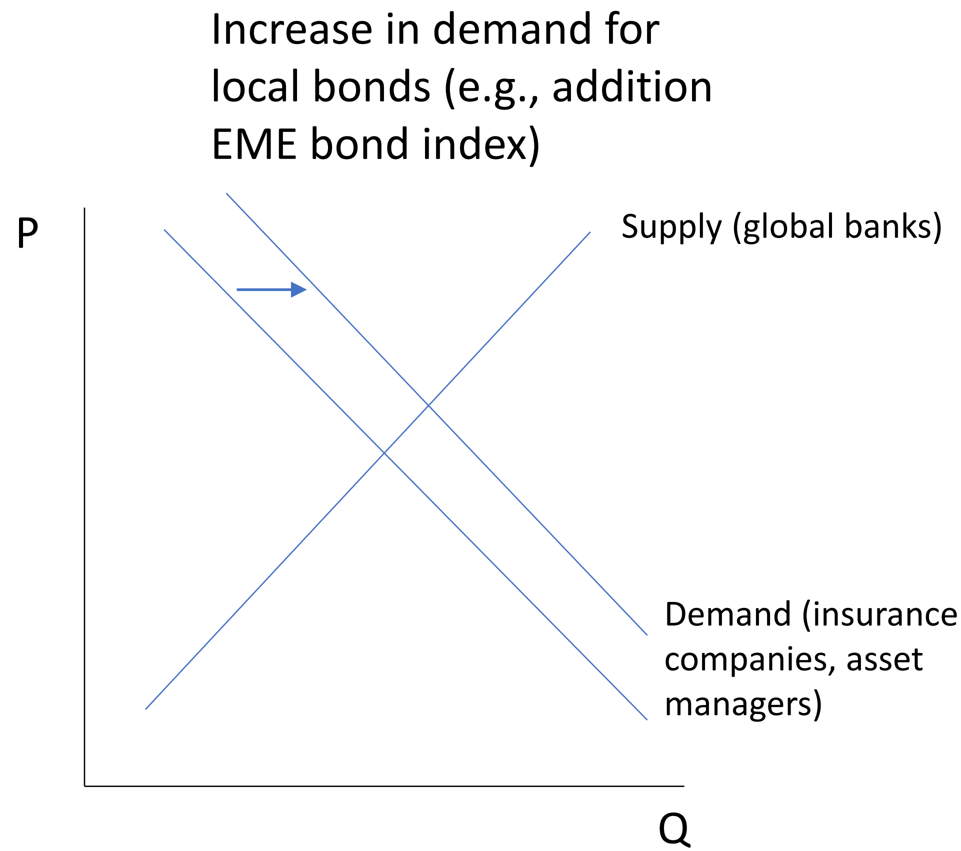
The FX swap market





The FX swap market





Comments (1)

- Differentiate equilibrium outcomes in FX markets from shifts in the supply and demand for FX hedging.

- What are the motivations for Mexican banks to hold foreign-currency assets? Are they supplying hedging in the FX market or are they demanding hedging to invest in foreign-currency denominated assets?

- Provide more information on the role of global banks in Mexico. Are they providing hedging to others or doing something else?

Comments (2)

- Having a supply and demand framework (Koijen and Yogo, 2020), one can determine clearer supply and demand shifters that can serve as instruments. For example, assume Mexican banks supply hedging and foreign investors demand that hedging.
  - On the demand side, can U.S. corporate yields act as an instrument for the demand for Mexican bonds (or rebalancing of Mexican bonds in a global index)?
  - On the supply side, changes in regulations that may have affected Mexican banks' supply of hedging.

Comments (3)

- Following the same framework, the panel estimations could be enhanced.
  - Exploit importance of local bond markets for international investors (Williams, 2018; Pandolfi and Williams, 2019)
  - If global banks providing hedging to EME banks, capture their capacity to provide that hedging (e.g., He, Kelly, Manela, 2017)

- How much of the result from the Mexican monetary policy shock is driven by liftoff in the United States? Can this be identified?

Minor comments

- The introduction should highlight the results of the paper and its contributions earlier. Currently, the findings of the paper are discussed largely after page 6.

- Streamline the paper. Focus on the main tests and move the rest to the online appendix.

- Not necessary to create a subsection 4.2.1.

Final thoughts

- Very nice paper, looking forward to reading the next draft.

- Thank you!