

# Bond Flows and Liquidity: Do Foreigners Matter?

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# Summary

- Paper documents a positive relationship in local currency bonds in Mexico between
  - Foreign holdings
  - Liquidity premiums
- Foreign holdings  $\uparrow$  1%, liquidity premium  $\uparrow$  0.7 basis points
  - Foreign market share  $\uparrow$  40% between 2010-2017, liquidity premium  $\uparrow$  0.3%
- COVID-19 shock for causality

# Main Finding

- Liquidity risk identified from market prices of bonds
  - ✗ Current market liquidity
  - ✓ Forward looking liquidity
- Foreign holdings of local currency bonds  $\uparrow \rightarrow$  Forward-looking liquidity premium  $\uparrow$ 
  - **Interpretation:** Risk of sudden reversal is larger with higher foreign participation
  - **Intuition:** Foreigners pay for risk they pose by selling simultaneously going forward

# Comment: Term Structure of Liquidity Premiums

- In JMP on EM bonds:
  - Long-term yields **comove more** than short-term ones after GFC
  - Global financial cycle is **more relevant** for long- than short-term yields
- How liquidity premium behave at different maturities?
  - As maturity increases, are liquidity premiums: flat, raising or declining?
  - Is liquidity premium at shortest maturity related to market liquidity measures?
- In fact, in baseline model sensitivities  $\beta^i$  to  $X_t^{liq}$  differ across securities

## Comment: Data Frequency

- Analysis: Monthly
- Availability: Daily for most variables, especially **foreign participation**
  - ATSM estimation at daily frequency already done in a robustness check (A.4)
  - CPI inflation weakly linked to liquidity premium (Table 6 last column)
  - Removing debt-to-GDP does not alter regression results (Table 6 column (2))
- Sample size: 127 vs 2,741 observations

# Comment: Regression Analysis

- Imperfect multicollinearity
  - Monthly frequency: Might try VIF in full specification as well (i.e. (4) like (2))
- Limited sample size
  - Daily frequency: Exclude CPI inflation and debt-to-GDP
  - Biweekly frequency: Exclude debt-to-GDP
- Interaction term of foreign holdings with ZLB dummy

## Comment: Causality

- COVID-19 shock → Foreign investors pulled out of EM bonds (foreign holdings ↓)
  - Estimation: liquidity premiums ↓
  - Data: liquidity premiums ↑
- Why the breakdown? Explanations:
  - Provided: fear foreign pullback intensifies to finance public deficits in AE
  - Alternative (JMP): credit risk increased, indeed coefficient of CDS rate is negative

## Comment: Technical

- Are results sensitivity to the benchmark bond?
  - $\beta^9 = 1$  key assumption to identify level of  $X_t^{liq}$
  - What if  $\beta^{16} = 1$  is used instead?
- Is there a condition for the benchmark bond?
  - What if initially  $\beta^7 = 1$  but then you want to expand the sample period?
  - End-of-sample **date** < Maturity **date** of benchmark bond?



# Conclusions

- Important topic, relevant paper
- Link between foreign holdings, liquidity premium and financial stability
- Main comments:
  - Liquidity premiums per maturity
  - Daily frequency to increase sample size
  - Role of credit risk after COVID-19