

Bank foreign currency hedging and the impact on covered interest parity: an Emerging Market perspective

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Introduction

- Grateful for the opportunity to revisit the topic of CIP
- Deviations from CIP captured attention, particularly since GFC
- Stream of papers
 - BIS (Avdjiev et al., 2017; Borio et al., 2018), IMF (Cerruti et al., 2019; Hong et al. 2019), Du et al. (2018), others
- Evidence
 - Persistent deviations of CIP, even for liquid developed countries
- This paper
 - Deviations for panel of EMs
 - Case of Mexico (another liquid market)
 - Nice data from Mexico on bank positions
 - Actual foreign hedging rather than estimates
 - Global banks vs. commercial banking system

Questions this paper tries to address

1. Whether resident bank hedging widens CIP deviations
 - Yes
2. Evidence of arbitrage constraints
 - Mixed
3. Whether foreign counterparties can offset the bank effect
 - Yes
4. Whether resident bank hedging (net of foreign hedging) has an effect
 - Yes
5. Whether the results are driven the foreign subsidiaries of global banks
 - Yes

Terminology

- Deviations from CIP

$$b = (1 + r_{t,m}^*) - ((1 + r_{t,m})S_t/F_{t,m})$$

- Negative basis: U.S. dollar rate lower than the synthetic dollar rate

$$(1 + r_{t,m}^*) < ((1 + r_{t,m})S_t/F_{t,m})$$

- Relate this measure to resident bank hedging needs
 - FX assets minus liabilities

Interpretation

- How bank pressure could work to generate deviation from CIP

$$(1 + r_{0,m}^*) = ((1 + r_{0,m})S_t/F_{0,m})$$

- At $t=1$: FX assets at $m >$ FX liabilities at m

$$(1 + r_{1,m}^*) < ((1 + r_{1,m})S_1/F_{1,m})$$

- Other intermediaries can play countercyclical role
 - Institutional investors and foreign investors large in EM, Mexico
 - Does larger hedging demand from banks really move the market?
- Why do banks remain with unhedged positions, even after accounting for derivatives?
 - They could undo the mismatch, changing lending/deposit rates

Empirical analysis

- Correlation vs. causality
 - Negative basis can be explained by assets minus liabilities
 - But CIP deviations could also explain larger assets minus liabilities
- Identification
 - Exogenous, actual demand pressure to observe causality, not estimation through assets-liabilities
- Maturity matching?
 - FX hedging if maturity is also matched across all components
 - Can this explain significance in results across maturities?
- Significance
 - Low statistical power for Mexico, 53 obs., monthly data 2013-2017
 - More power for panel, but less innovative and smaller effects
- Statistical and economic significance of the point estimates results

Suggestions

- Rather lengthy paper
 - 50 pages, with text at space and a half, and 22 tables/figures
 - Narrative unnecessarily long at times
- Personally, I would ...
 - Shorten it, make sure to avoid redundancies
 - Focus it much more
 - Add details to avoid confusion
 - Add more analyses where needed
- Think about contribution to the literature
 - Explain more explicitly what this adds relative to existing papers
 - Explain how new data can uncover factors not tested earlier
 - Build on it to show more power: statistical, economic, identification
- Link flow closely to main question asked at the beginning

Final thoughts

- Literature might move to different directions
- Importance of different factors in determining deviations in CIP
 - Micro data
 - Identification
 - This paper a nice role on this effort, more analysis like this welcome
- General equilibrium effects: “So what?” question
 - Higher FX hedging demand from global banks can increase the cost of hedging for all, but they also have benefits: net effect?
 - Do banks really have a spillover on other actors?
- Policy response
 - Role for the central bank and supervisory agencies
 - Take other side of the risk
 - Regulate financial intermediaries to reduce exposure

Thank you!