Term Premia in Emerging Markets

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This version: July 22, 2019

Abstract

The sovereign debt of advanced economies is generally considered free of default risk, which is key in the estimation of their term premia. The risk-free assumption, however, is not appropriate for the sovereign debt of emerging market economies. I use yield curves adjusted for credit risk in order to adequately estimate the term premia of 15 emerging markets. I find that the main component for the 10-year yield of emerging markets is the expected future path of the short-term interest rate, while for advanced economies the main component is the term premium. I also find that both global and domestic factors are important drivers of the term premia in emerging markets.

Keywords: Synthetic yield curves, term premium, affine term structure models.

JEL Classification: E43, F34, G12, G15, H63.

1 Introduction

Different countries have different default risks for debt issued in their local currencies. Since the debt issued by the U.S. is generally considered free of default risk, it can be used as a benchmark to assess the debt of other countries. I exploit this idea to construct risk-free yield curves for several countries, which I then use to estimate the term premia embedded in them.

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In theory, the yield of a *risk-free* zero-coupon bond can be decomposed into the average short-term interest rates expected over the life of the bond plus a term premium for holding it. The term premium is the compensation investors require for bearing the risk that the short-term interest rate does not evolve as they expect. If long-term bonds lose value when the marginal utility of investors is high as is the case during recessions or in episodes in which inflation is high, those bonds would be seen as risky investments so investors will require a compensation for holding them; in those cases, they would demand a positive term premium. On the contrary, if long-term bonds gain value in those situations, then they will be seen as a hedge and investors will be willing to receive less than what is expected for the short-term rate, which translates into a negative term premium.

Estimation of the term premium is an important task in macroeconomics and asset pricing. For instance, term premia estimates have been used to assess the effectiveness of some of the unconventional monetary policy tools used by central banks in advanced economies in response to the Great Recession (Kuttner, 2018). In addition to providing valuable information to analyze the transmission of monetary policy, term premia estimates have also been used to study the macroeconomic determinants of bond risk premia (Wright, 2011), which may differ for advanced and emerging economies. However, the literature has mainly focused on estimating the term premia for advanced economies. Although there are some estimates for emerging markets,[1] none of them corrects for credit risk.[2] This paper fills that void.

The findings reported below show that the main component for the 10-year yield of emerging markets is the expected future path of the short-term interest rate, while for advanced economies the main component is the term premium. The term premia

[1]See, for example, De Pooter, Robitaille, Walker, and Zdinak (2013), and Blake, Rule, and Rummel (2015).

[2]Credit risk here is defined broadly including, for example, (selective) default risk, currency convertibility risk, regulation risk, capital controls, jurisdiction risk and, if any, liquidity risk. Therefore, when investors require compensation for any of these risks, it is considered that they demand a premium for credit risk even if the country does not default per se. Notwithstanding this, historically emerging markets have indeed defaulted in debt issued in local currency, some examples include El Salvador (2017), Ecuador (2008), Argentina (2001), Russia (1998); in 1999 after an earthquake, Turkey retroactively taxed its debt.

in emerging markets for the 10-year maturity is around 175 basis points on average, compared to an average of around 200 basis points for small open advanced economies. The results also show that both global and domestic factors are important drivers of the term premia in emerging markets. The U.S. term premium is a key common factor, while domestic inflation and unemployment are important local drivers of the dynamics of the term premia. An increase in those variables is associated with an increase in the term premia. The exchange rate is also related and its effect is in line with the risk-taking channel of exchange rates found by Hofmann, Shim, and Shin (2017); according to which a currency appreciation is associated with easier financial conditions and compressed sovereign bond spreads.

Affine term structure models are the standard tool to estimate the term premium. A key assumption in those models is that the yields used are free of default risk. Although it is a reasonable assumption for the sovereign debt of advanced countries, the debt of emerging markets include a premium for credit risk even for bonds issued in local currency (LC) as has been shown by Du and Schreger (2016a). Therefore, a direct application of term structure models to the sovereign yields of emerging markets would give biased estimates of the term premium. I construct synthetic yield curves using financial derivatives to 'adjust' for credit risk. This is important since bonds denominated in LC have become an important source of funds for emerging markets in recent years, in contrast to foreign currency (FC)-denominated bonds (Du and Schreger, 2016b). Recent studies have used synthetic instruments in other contexts but, to the best of my knowledge, this is the first attempt to estimate affine term structure models using synthetic yield curves.

To construct the synthetic yield curves, I follow the methodology developed in a series of papers by Du and Schreger (2016a), Du, Im, and Schreger (2018a) and Du, Im, and Schreger (2018b). Today an investor can lock in a risk-free investment in LC by first exchanging LC for U.S. dollars (USD), investing those USD in U.S. Treasuries and then entering into a forward contract in which the investor agrees to sell USD for LC in the future. Once the payoff (in USD) from the Treasuries is realized, the investor exchanges USD back into LC at the exchange rate agreed in the forward contract. While those papers use the synthetic LC yield curves as an intermediate step to analyze the deviations from covered interest parity, I focus on the synthetic curves themselves and rely on their 'risk-free' property to estimate the term premium. This allows me to decompose the nominal LC yield curves into three parts: the expected future path of the short-term interest rate, the term premium and the LC credit spread (the difference between the nominal and synthetic curves). Arguably, this characterization of the components of nominal yield curves will enhance the analysis of monetary policy in emerging markets.

This paper is related to different branches of the literature in international macroeconomics and finance. First, it makes use of synthetic LC yield curves which was pioneered by Du and Schreger (2016a) for emerging markets to analyze the LC credit spread as a measure of credit risk in LC debt, and later used by Du et al. (2018a) for advanced economies to study the convenience yield of U.S. Treasuries. Second, it makes an international comparison of term premia estimates for emerging markets, contributing to the work done by Wright (2011) for advanced economies.

On the effects of U.S. monetary policy shocks on the yields of emerging markets, this paper is related to the results in Gilchrist, Yue, and Zakrajšek (2018) by studying not only the effects on the yield curve but on its components. Hofmann et al. (2017) already study the link between the U.S. monetary policy, the exchange rate and LC credit spreads.

Finally, this paper contributes to the large literature on term structure models by pioneering the use of synthetic yield curves in the analysis.

The rest of the paper is structured as follows. The next section explains how to construct both nominal and synthetic yield curves. Section 3 explains the affine term structure model that will be estimated. Section 4 describes the estimation procedure and the data sources. Section 5 reports the estimated term premia and presents some stylized facts, while section 6 studies their cyclical properties. The last section concludes.

2 Construction of LC Yield Curves

Although the focus of this paper is on the synthetic yield curve, the nominal yield curve is also of interest.[3] A byproduct of decomposing the synthetic yield curve into the expectation for the future short-term interest rate and a term premium, is to decompose the nominal yield curve into three parts, the third component being the deviation from covered interest rate parity (CIP) -which in the case of emerging markets is the LC credit spread-. In addition, the nominal yield curve is used to compare the estimated term premium obtained from it to the one obtained from the synthetic yield curve. This section explains how to construct both curves.

2.1 Construction of Synthetic Yield Curves

The key idea to construct the synthetic LC yield curves is to swap the U.S. yield curve into LC using the forward premium for the respective maturity (see Du, Im, and Schreger, 2018b).

For maturities of less than one year, the forward premium can be calculated as the difference between the forward and the spot exchange rates. Outright forwards, however, become illiquid for longer periods. Therefore, for maturities greater than one year, the forward premium can be calculated using cross-currency swaps (CCS).[4] Although, the fixed-for-fixed CCS rates are rarely observed in the market directly, they can be constructed using cross-currency basis swaps and interest rate swaps. The idea is to swap fixed payments in LC into floating rate USD-cash flows using cross-currency basis swaps (referenced to the USD London interbank offered rate), and then swapping those floating-rate cash flows into fixed USD-cash flows using interest rate swaps. CCS are usually collateralized instruments and so the bilateral counterparty risk in CCS is small.

Let $y_{t,n}^{US}$ denote the zero-coupon yield for the n-period U.S. Treasury bond at time t, and $\rho_{t,n}$ the n-period forward premium from the USD to the LC at time t. Then the

[3]Below the synthetic yield curve is denoted by $\widetilde{y}_{t,n}^{LC}$ and the nominal yield curve is denoted by $y_{t,n}^{LC}$.

[4]CCS are used instead of credit default swaps (CDS) for two reasons: the definition of default in CDS is not always straightforward and, more importantly, defaults on LC bonds are not considered trigger events of CDS contracts.

zero-coupon synthetic LC yield for the n-period bond at time t, $\widetilde{y}_{t,n}^{LC}$, is defined as

$$\widetilde{y}_{t,n}^{LC} = y_{t,n}^{US} + \rho_{t,n}. \tag{1}$$

Note that $\widetilde{y}_{t,n}^{LC}$ is the borrowing rate paid by a hypothetical risk-free issuer in LC, it is the n-period synthetic LC risk-free funding rate. Note that the resulting synthetic yield curve $\widetilde{y}_{t,n}^{LC}$ does not require knowledge of the nominal yield curve, $y_{t,n}^{LC}$.[5]

According to the CIP condition, the nominal (direct) and the synthetic (indirect) LC interest rates should be equalized. In particular, a sovereign issuer of an emerging market should be able to borrow directly or indirectly (synthetically) in LC at the same yield. However, Du, Tepper, and Verdelhan (2018c) show that there are persistent and systematic deviations from CIP. In fact, Du and Schreger (2016a) and Du et al. (2018a) study these deviations for emerging markets and advanced economies, respectively. In particular, the spread between the two yields ($y_{t,n}^{LC} - \widetilde{y}_{t,n}^{LC}$) is what Du and Schreger (2016a) define as the LC credit spread for emerging markets, and what Du et al. (2018a) called the convenience yield for advanced countries.

2.2 Construction of Nominal Yield Curves

I use Bloomberg Fair Value (BFV) curves to estimate the nominal yield curve, $y_{t,n}^{LC}$. BFV curves are par yield curves provided by Bloomberg on a daily basis for different maturities. To obtain the implied zero-coupon curves, the yields are converted into discount factors, which are then used to estimate the parameters of the Nelson-Siegel-Svensson model.[6]

Nelson and Siegel (1987) assume that the instantaneous forward rate n years ahead, $f_{t,n}$, is a continuous function that depends on four parameters:

$$f_{t,n} = \beta_0 + \beta_1 \exp\left(-n/\tau_1\right) + \beta_2 \left(n/\tau_1\right) \exp\left(-n/\tau_1\right). \tag{2}$$

The behavior at long and short maturities is determined by the parameters β_0 and β_1, respectively, while β_2 and τ_1 determine the magnitude, direction and position of the

[5] Note that $\rho_{t,n} = 0$ for the USD and, thus, $\widetilde{y}_{t,n}^{US} = y_{t,n}^{US}$.

[6] As a robustness check, I estimate the nominal yield curves from actual prices for some of the countries in the sample. These estimated yield curves follow those reported by Bloomberg closely.

yield curve's "hump".

Svensson (1994) extends the Nelson-Siegel approach by considering a second hump to capture the convexity of bonds at longer maturities. This is achieved at the expense of introducing two more parameters in the functional form of the instantaneous forward rate:

$$f_{t,n} = \beta_0 + \beta_1 \exp\left(-n/\tau_1\right) + \beta_2 \left(n/\tau_1\right) \exp\left(-n/\tau_1\right) + \beta_3 \left(n/\tau_2\right) \exp\left(-n/\tau_2\right). \qquad (3)$$

The continuously compounded zero-coupon yield curve implied by the Svensson model is obtained by integrating the instantaneous forward rate in equation (3), and is given as follows:[7]

$$\begin{aligned} y_{t,n} = \beta_0 + \beta_1 \left(\frac{1-\exp\left(-n/\tau_1\right)}{n/\tau_1}\right) &+ \beta_2 \left(\frac{1-\exp\left(-n/\tau_1\right)}{n/\tau_1} - \exp\left(-n/\tau_1\right)\right) \\ &+ \beta_3 \left(\frac{1-\exp\left(-n/\tau_2\right)}{n/\tau_2} - \exp\left(-n/\tau_2\right)\right). \end{aligned} \qquad (4)$$

The parameters in the Svensson model are estimated by minimizing the sum of squared deviations between the log prices obtained from the reported BFV yields $y_{t,n}^{LC}$ and the log prices implied by equation (4) weighted by the inverse of the duration for each period. Using log price deviations weighted by duration is approximately equal to fitting yields but is faster because the latter requires numerically finding the root to a nonlinear equation (see Gürkaynak, Sack, and Wright, 2007).

3 Affine Term Structure Model

Discrete-time affine term structure models with an exponentially affine pricing kernel are commonly used in the literature to estimate the dynamics of the nominal yield curve mainly for advanced economies (see Wright, 2011). In this paper, however, I use an affine term structure model to estimate the dynamics of the synthetic yield curve. The advantage of this approach is that it allows to decompose the *nominal* yield curve into three parts: the expected future short-term interest rate, a term premium and the LC

[7] The continuously compounded zero-coupon yield curve implied by the Nelson-Siegel model is obtained by setting β_3 equal to zero in equation (4).

credit spread.

3.1 Model

Let $P_{t,n}$ be the price at time t of a zero-coupon risk-free bond with maturity n, then the continuously compounded yield on that bond is $y_{t,n} = -\ln P_{t,n}/n$. Thus, the one-period continuously compounded risk-free rate is $r_t = -\ln P_{t,1}$.

The no-arbitrage assumption implies that there exists a stochastic discount factor (SDF), M_{t+1}, such that today's price equals the expectation of tomorrow's discounted price:

$$P_{t,n} = \mathrm{E}_t \left[M_{t+1} P_{t+1,n-1} \right]. \tag{5}$$

Since the price at maturity of a zero-coupon bond is 1, recursive substitution of equation (5) implies that today's price equals the expectation of the product of SDFs over the life of the bond, $P_{t,n} = \mathrm{E}_t \left[\Pi_{j=1}^{n} M_{t+j} \right]$.

A $\mathrm{K} \times 1$ vector of state variables X_t is assumed to drive the dynamics of the one-period interest rate r_t, the $\mathrm{K} \times 1$ market price of risk λ_t and the logarithm of the SDF in an affine form as follows:

$$r_t = \delta_0 + \delta_1' X_t \tag{6}$$

$$\lambda_t = \lambda_0 + \lambda_1 X_t \tag{7}$$

$$M_{t+1} = \exp\left(-r_t - \frac{1}{2} \lambda_t' \lambda_t - \lambda_t' \nu_{t+1} \right) \tag{8}$$

where ν_{t+1} is $i.i.d.$ $\mathrm{N}\left(0, I_{\mathrm{K}}\right)$.

Assume that the dynamics of the vector of state variables X_t evolve under the physical measure ($\mathbb{P}$) according to the following vector autoregression (VAR):

$$X_{t+1} = \mu + \Phi X_t + \Sigma \nu_{t+1}. \tag{9}$$

The SDF in equation (8) and the law of motion of the vector of state variables in equation (9) can be formalized separately or jointly; see Gürkaynak and Wright (2012) for a review of the literature.

The following parameters:

$$\mu^* = \mu - \Sigma\lambda_0$$

$$\Phi^* = \Phi - \Sigma\lambda_1$$

govern the dynamics of the vector of state variables under the risk-neutral or pricing measure ($\mathbb{Q}$):

$$X_{t+1} = \mu^* + \Phi^* X_t + \Sigma\nu_{t+1}. \tag{10}$$

The log price and the continuously compounded yield of a risk-free zero-coupon bond in this model are then affine functions of the state variables X_t:

$$P_{t,n} = \exp\left(A_n + B_n X_t\right)$$

$$y_{t,n} = -\frac{A_n}{n} - \frac{B_n}{n} X_t. \tag{11}$$

where the scalar $A_n = A(\delta_0, \delta_1, \mu^*, \Phi^*, \Sigma)$ and the $1 \times$ K vector $B_n = B(\delta_1, \Phi^*)$. These coefficients can be computed recursively combining the no-arbitrage condition and the functional form for bond prices as follows:

$$A_{n+1} = -\delta_0 + A_n + B_n'\mu^* + \frac{1}{2}B_n'\Sigma\Sigma' B_n, \quad A_0 = 0$$

$$B_{n+1} = -\delta_1 + \Phi^{*\prime} B_n, \quad B_0 = 0$$

The term premium for maturity n at time t, $tp_{t,n}$, can then be estimated as the difference between the yields obtained under the $\mathbb{Q}$ measure and the yields obtained under the $\mathbb{P}$ measure:

$$tp_{t,n} = y_{t,n}^{\mathbb{Q}} - y_{t,n}^{\mathbb{P}}. \tag{12}$$

Note that a key assumption behind this model is that the yield $y_{t,n}$ is risk-free. Du and Schreger (2016a) find that the LC credit spread is statistically different from zero and, thus, that the nominal yield $y_{t,n}^{LC}$ for emerging markets is not risk-free. Therefore, I focus on the synthetic yield $\widetilde{y}_{t,n}^{LC}$ because it aligns better with the risk-free assumption.

3.2 Identification Problem

In principle, the only input needed to estimate the parameters of the affine term structure model are zero-coupon bond yields. This is enough to estimate (μ^*, Φ^*), the pricing coefficients under the $\mathbb{Q}$ measure in equation (10). However, they are not enough to identify (μ, Φ), the parameters under the $\mathbb{P}$ measure in equation (9), which are necessary to estimate the term premium as indicated in equation (12).

This identification problem is due to the high persistence of bond yields, which results in small sample bias as has been highlighted by Kim and Orphanides (2012) and Guimarães (2014). Accordingly, the dynamics of the state vector will tend to mean-revert too quickly, overestimating the stability of the expected path of the short-term interest rate. In that situation, much of the variability in yields will be attributed to fluctuations in the term premium.

Different solutions have been proposed to address this identification problem, including restrictions on parameters, bias-corrected estimators and using survey forecasts of professional forecasters. Guimarães (2014) compares the three approaches and concludes that the use of surveys is an effective solution to obtain a robust decompositions of the yield curve.

Therefore, there are two ways in which the information from surveys can be used in this context. First, to obtain a model-free estimate of the term premium as the difference between the long-term interest rate and the expected future short-term interest rate over the horizon of the survey; this estimate serves as a robustness check. Second, to supplement the information from bond yields in the estimation of affine term structure models.[8]

4 Methodology

This section describes both the estimation method and the data sources employed in the estimation of the model presented in section 3.1.

[8] In a future draft, I will therefore supplement the affine term structure model with survey data on the expected long-term policy rate for each country.

4.1 Estimation

Affine term structure models can be estimated by maximum likelihood. Traditionally, the convergence to the global optimum of that method has been subject to computational challenges and multiple local optima. In light of this, Joslin, Singleton, and Zhu (2011) (hence JSZ) propose a normalization that improves the convergence to the global optimum of the likelihood function.

The model's likelihood function is the product of the $\mathbb{P}$ and $\mathbb{Q}$ likelihood functions. The JSZ normalization allows for the near separation of both likelihood functions and reduces the dimension of the parameter space from $(\delta_0, \delta_1, \mu^*, \Phi^*, \Sigma)$ to $(r^{\mathbb{Q}}_{\infty}, \lambda^{\mathbb{Q}}, \Sigma)$, where $r^{\mathbb{Q}}_{\infty}$ is the long-run short-term interest rate under $\mathbb{Q}$, $\lambda^{\mathbb{Q}}$ is a $\mathrm{K} \times 1$ vector of ordered eigenvalues of Φ^*, and Σ is a lower triangular matrix with positive diagonal elements.

The JSZ normalization allows a two-stage estimation of the model presented in section 3.1. First, the $\mathbb{P}$ parameters are estimated by OLS of the VAR in equation (9), using the estimated K principal components of the synthetic yield curve $\widetilde{y}^{LC}_{t,n}$. This provides initial values for the maximum likelihood estimation of the matrix Σ. Then, taking $\hat{\mu}$ and $\hat{\Phi}$ as given, the $\mathbb{Q}$ parameters can be estimated by maximum likelihood.

4.2 Data

The macroeconomic and financial variables used in section 6 are downloaded from Bloomberg. Here I describe the data sources for the construction of the yield curves and for the surveys of professional forecasters.

4.2.1 Yield Curve Data

I use end-of-month data for the following 15 emerging markets (EMs):[9] Brazil (BRL), Colombia (COP), Hungary (HUF), Indonesia (IDR), Israel (ILS), Korea (KRW), Malaysia (MYR), Mexico (MXN), Peru (PEN), Philippines (PHP), Poland (PLN), Russia (RUB), South Africa (ZAR), Thailand (THB) and Turkey (TRY).

[9] The currency identifier for each country is shown in parenthesis.

In order to establish a set of stylized facts for emerging markets, the results are compared against those obtained for 10 advanced countries (AEs): Australia (AUD), Canada (CAD), Denmark (DKK), Germany (EUR), Japan (JPY), Norway (NOK), New Zealand (NZD), Sweden (SEK), Switzerland (CHF) and the United Kingdom (GBP). These countries are sometimes split into two groups to assess whether the type of advanced country matters. The first group (G-3) is comprised by Germany, Japan and the United Kingdom. The second group (A-SOE) comprises the rest of the countries. Note that the latter is basically a group of advanced small open economies, which arguably are more directly comparable to emerging markets.

As explained in section 2.1, the U.S. yield curve and the forward premium for different maturities are needed to construct the LC synthetic yield curves. Data for the U.S. zero-coupon yield curve is obtained from the database developed by Gürkaynak, Sack, and Wright (2007) (hence GSW). Although the GSW dataset goes back to 1961, the main issue for the construction of the synthetic yield curves is the information needed to calculate the forward premium.

As mentioned before, for periods less than one year, the forward premium is calculated using forward exchange rates, while for longer periods it is calculated from CCS rates. The maturities of less than one year considered in the analysis are 3, 6 and 9 months; that is, I use the forwards and the spot exchange rate to compute the forward premium for those maturities. To construct the CCS rates, I use each available maturity starting from year one. The maximum maturity available varies per country but there is data covering at least up to ten years for all but it can go as far as 30 years for some countries.[10]

The forwards used to construct the forward premiums (for less than one year) for Korea, Philippines and Thailand are obtained from Datastream. For all the other countries, the data to construct the forward premiums (using forwards and CCS curves) is obtained from Bloomberg.[11]

[10] After 10 years, the periodicity decreases to every five years. Then, when they are available, the maturities beyond 10 years are reported for 15, 20, 25 and up to 30 years.

[11] A spreadsheet with the Datastream and Bloomberg tickers used in the construction of the forward premiums and in the estimation of the nominal yield curves is available upon request. The file consolidates and expands (with tenors and tickers) equivalent files kindly posted online in Wenxin Du and Jesse Schreger's websites.

The model presented in section 3.1 is estimated for each country separately. Therefore, the starting dates vary (between January 2000 and November 2006) but the end date is the same for all countries (January 2019). Although data for advanced countries is available earlier, their initial dates are set at January 2000. Note that there are at least 10 years of data for all emerging markets, which is a reasonable time period for the estimation of affine term structure models.

4.2.2 Survey Data

As mentioned in section 3.2, long-horizon forecasts for the policy rate of emerging markets can be used to obtain model-free estimates of the term premium and to supplement bond yields in the estimation of affine term structure models.

Although Consensus Economics provides long-horizon forecasts for consumer inflation and real GDP growth, it does not provide those forecasts for policy rates. In order to approximate the policy rate expectations embedded in those survey responses, I use the following model for the policy rate of each emerging market

$$r_t = \beta_0 + \beta_r r_{t-1} + \beta_\pi \pi_t + \beta_y g_t + \epsilon_t, \tag{13}$$

where r_t is the policy rate, π_t is the year-on-year consumer inflation and g_t is the year-on-year real GDP growth. β_r is a smoothing parameter that improves the fit of the model to the data. The information for r_t is obtained from the policy rate statistics of the Bank for International Settlements, while the data for consumer inflation and real GDP growth is downloaded from Bloomberg.

To obtain the implied expectations of the policy rate, I estimate the regression in equation (13) using quarterly data and assume that the parameter estimates apply to the long-horizon survey forecasts for inflation and real GDP growth from Consensus Economics. I do this for all emerging markets in the sample except for Israel and South Africa due to data availability.

The expectations of the policy rate obtained in this way can then be used for the two goals described in the first paragraph of this section. In particular, the term premium using surveys will be obtained as:[12]

$$tp_{t,n}^{survey} = y_{t,n} - \left(\frac{\hat{\beta}_0}{1-\hat{\beta}_r} + \frac{\hat{\beta}_\pi}{1-\hat{\beta}_r} \pi_t^{survey} + \frac{\hat{\beta}_y}{1-\hat{\beta}_r} y_t^{survey} \right). \qquad (14)$$

Since the surveys used from Consensus Economics are long-term forecasts ten years ahead, $n = 10$ in equation (14).

5 Empirical Results

The aim of this paper is to decompose the synthetic yield curves of emerging markets, which in turn provides a decomposition of their nominal yield curves. I use two benchmarks to assess the relevance of the results. First, I compare the estimated term premia for emerging markets to those of advanced economies. Second, I compare the term premia obtained from both nominal and synthetic yield curves[13] to assess the benefit of using synthetic curves.

5.1 Estimated Synthetic Yield Curves

An affine term structure model is estimated for each country using the JSZ normalization and the two-stage procedure described in section 4.1. The VAR model in equation (9) is estimated using the first three principal components (PCs) of the synthetic yield curves. Consistent with the empirical evidence that uses nominal yield curves,[14] on average more than 99% of the variation in synthetic yields is explained by those three factors for all emerging markets.

Table 1 summarizes the fit of the models. The table shows the average root mean square fitting error in annualized percentage points of nominal and synthetic yields for emerging markets and advanced economies.[15] As can be seen, the fit of the model for

[12] Note that under stationarity, $\mathrm{E}(r_t) = \mathrm{E}(r_{t-1})$.

[13] In each case, assuming that the curve used is risk-free.

[14] Litterman and Scheinkman (1991) first report this and refer to those PCs as level, slope and curvature.

[15] For each country, the root mean square fitting error is calculated as the square root of the average (across months and maturities) squared difference between the observed yields and the fitted yields from the estimated affine term structure model.

	Nominal	Synthetic
EM	0.15	0.48
AE	0.13	0.08

Table 1: Fit of Affine Term Structure Models.

the nominal curves of both groups of countries is similar. The fit for the synthetic curves of advanced countries slightly improves relative to the fit for their nominal curves, while that for emerging markets declines. It is worth mentioning that the latter is driven mainly by two countries, Brazil and Indonesia, whose root mean square fitting error is slightly above 2%.[16] This requires further inspection of the synthetic yield curves of these two countries.[17]

5.2 Nominal Yield Curve Decomposition

Once the affine term structure model is estimated for each country, I can compute the term premia for each maturity (as explained in section 3.1) and, in turn, decompose both the synthetic as well as the nominal yield curves.[18] In particular, the synthetic yield curve is decomposed into the expectation of the future short-term interest rate and a term premium. In addition to those two, the third element in the decomposition of the nominal yield curve is the deviation from CIP.

Table 2 shows the simple average across countries of the decomposition of the 10-year yields.[19] Several patterns emerge from the table. The values for the deviations from CIP (CIP Dev) are in line with the results reported by Du and Schreger (2016a) and Du et al. (2018a) referred to as the LC credit spread (LCCS) for emerging markets and the convenience yield for advanced countries, respectively. Note that the estimated term premium is higher on average than the CIP dev for the three groups of countries; it

[16] Although not as high, the root mean square fitting error for Peru and Philippines is also above average at around 0.64 and 0.54, respectively.

[17] In some special cases, outliers may need to be dropped in some periods to be able to fit the curve for the rest of the points.

[18] Although term premia estimates are calculated for all maturities, only the 10-year maturity is reported in what follows for the sake of brevity.

[19] The numbers in the table do not add up exactly for two reasons: (1) the term premium is obtained using equation (12), that is it uses the fitted synthetic yield curve, while the table reports the observed synthetic yield curve for the column ‘Synthetic’, and (2) the sample period for the yield curves might differ slightly to that of the CIP deviations.

	Nominal	Synthetic	Expected	Term Premium	CIP Dev
EM	7.10	6.11	4.29	1.74	0.85
A-SOE	3.48	3.52	1.54	1.97	-0.23
G-3	2.41	2.13	0.52	1.60	0.15

Table 2: 10-Year Yield Decomposition (%).

is almost 90 basis points higher for emerging markets, almost 150 basis points higher for Germany, Japan and the United Kingdom and more than 200 basis points for the advanced small open economies. Thus, the term premium plays a relatively bigger role than CIP deviations in the dynamics of sovereign bond yields.

While the main component of the nominal yield curve of emerging markets is the expectation of the future short-term interest rate, for advanced countries the main component is the term premium. That is, the term premium plays a relatively bigger role in the dynamics of the sovereign bond yields of advanced countries than those of emerging markets.

Finally, note that for the subset of small open economies it is cheaper to borrow directly in their own currency (since CIP Dev is negative), unlike what is seen for emerging markets.

5.3 Term Premia: Nominal or Synthetic Yield Curve?

Affine term structure models are usually estimated using nominal yield curves on the assumption that they are free of default risk. Du et al. (2018c) show that deviations from covered interest parity are non-negligible. Therefore, there is a wedge between the nominal ($y_{t,n}^{LC}$) and synthetic ($\widetilde{y}_{t,n}^{LC}$) yield curves given by the LCCS in the case of emerging markets and by the convenience yield in the case of advanced economies. Does this wedge bias the estimation of term premia? Equivalently, does it matter which curve is used to estimate the term premia? We can answer these questions by fitting the model described in section 3.1 to both curves and compare the estimates.

Table 3 show the average term premia across groups of countries obtained by using the nominal and the synthetic yield curves. For advanced countries, the difference between

	Nominal	Synthetic
EM	2.17	1.74
A-SOE	2.03	1.97
G-3	1.70	1.60

Table 3: 10-Year Term Premium Comparison (%).

the two is less than or equal to 10 basis points on average, while for emerging markets is more than 40 basis points. To assess whether the term premium estimates from the two curves are statistically different from each other, I perform a t-test for the equality of means (with unequal variances) between them for each country. The null of equal means is rejected at the 5% significance level for all emerging markets except Hungary and Malaysia. However, the null is only rejected for four advanced economies (Australia, Denmark, Japan and New Zealand). This shows that there are gains by using synthetic yield curves to account for credit risk when estimating the term premia, especially for emerging markets.

The evidence in tables 2 and 3 shows that, although sometimes used interchangeably, the terms 'risk premium' and 'term premium' are not the same thing, at least not for emerging markets, since *both* the term premium and the LC credit spread play an important role in the dynamics of the risk premium in the bond yields of emerging economies.

5.4 Stylized Facts of EM Term Premia

I use the U.S. term premium as a benchmark to compare the behavior of the term premia in emerging markets. Two frequently cited estimates of the U.S. term premium are Kim and Wright (2005) (hence KW) and Adrian, Crump, and Moench (2013). Analysis of the estimates of the U.S. term premium shows that: (1) it is time-varying; (2) it has declined over time; (3) its sign changed from positive to negative in recent years; and (4) increases during periods of uncertainty and vice versa. Common explanations for the decline in the U.S. term premium include an increased demand of U.S. assets by global investors, and the effects of the the large-scale asset purchases conducted by the the Federal Reserve in response to the Great Recession. Regarding the change in the sign of the term premium, Campbell, Sunderam, and Viceira (2017) argue that it is explained by a flip in the sign of the correlation between stocks and bonds; when investors changed their perception of bonds as hedges of stock investments, the correlation between the two assets turns negative which drives down the term premium. Finally, the U.S. term premium increased around the onset of the Great Recession (September 2008), the taper tantrum (June 2013), and the 2016 U.S. presidential election (November 2016), while it declined after the first unexpected announcement of the quantitative easing program by the Fed (March 2009) -which was seen as helping to reduce some of the uncertainty at the time-.

The 10-year term premia estimates for emerging markets are plotted in Figure 1. It is worth highlighting some regularities observed in the figure: (1) term premia in emerging markets are time-varying; (2) the estimates are sensible, i.e. they fluctuate between -1% and $+6\%$; (3) there appears to be co-movement in the term premia of some countries; (4) they behave similar to the U.S. term premium around key dates; (5) there is a slight downward trend in the term premia of some countries; (6) the term premia in emerging markets can be negative during some periods, but not to the level seen for the U.S.

Special cases include that of Brazil whose term premium turn negative around the Great Recession and that of Russia whose term premium declined considerably. These cases might be reflecting local conditions and deserve further analysis. Consider, for example, the case of Turkey towards the end of the sample, where relevant events in 2018[20] translated into a higher term premium.

In addition to Brazil, Russia and Turkey, the term premia of most Asian countries has been in negative territory for some period of time. Moreover, with the exception of Brazil and South Africa, the term premia of emerging markets being negative is a phenomenon observed after the Great Recession.

For comparison purposes, Figure 2 shows the 10-year term premia estimates for advanced economies using synthetic yield curves. A clear downward trend is observed for all countries. This is consistent with the empirical evidence that uses nominal yield curves;

[20]On June 24, 2018, Recep Tayyip Erdogan won the presidential election. On October 2, 2018, the journalist Jamal Khashoggi disappeared after he visited the consulate of Saudi Arabia in Istanbul.

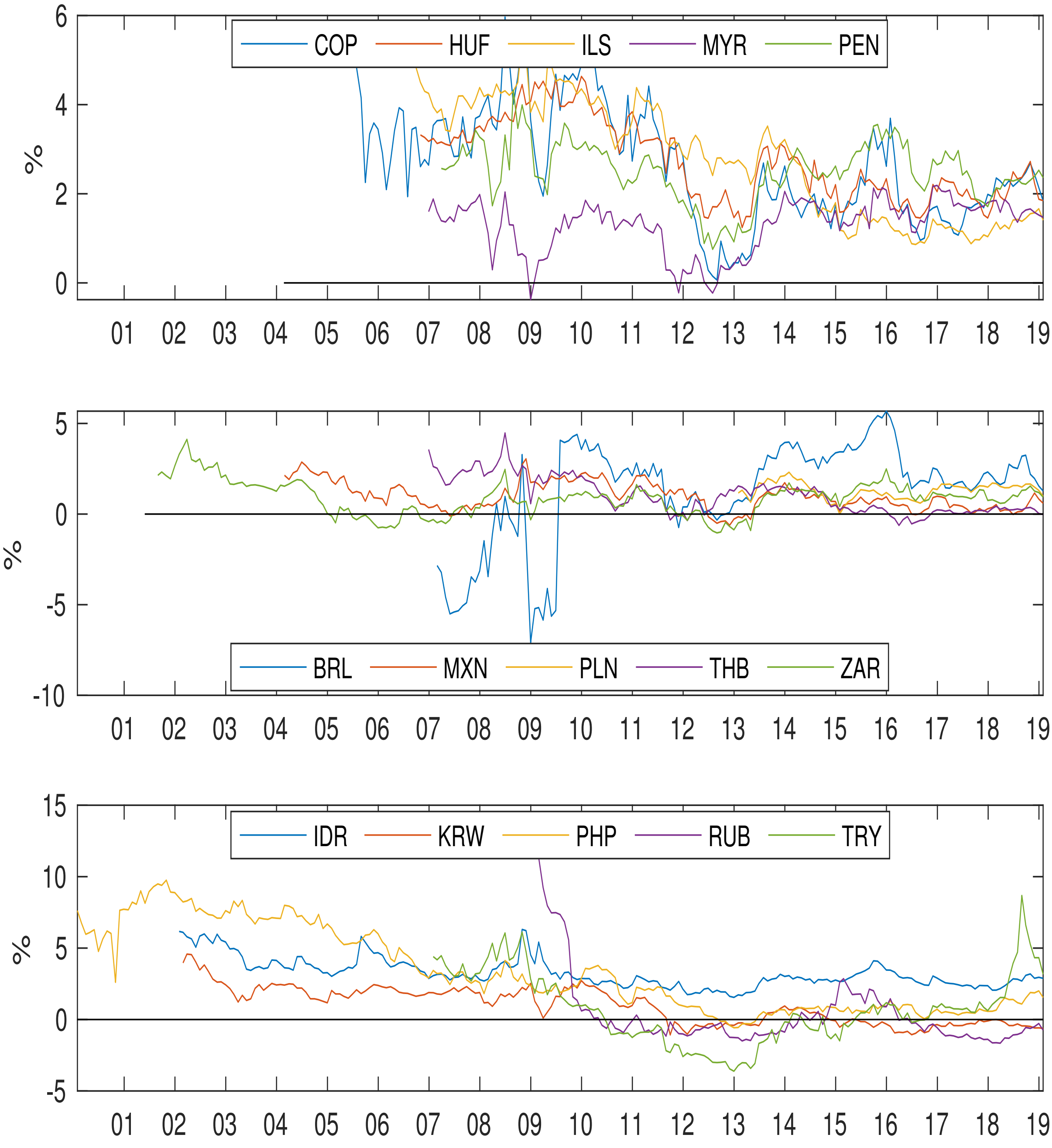

Figure 1: Estimated 10-Year Term Premia: Emerging Markets.

Wright (2011) shows a declining trend in term premia for most of these countries going back to the 1990s and argues that it reflects a reduction in inflation uncertainty.

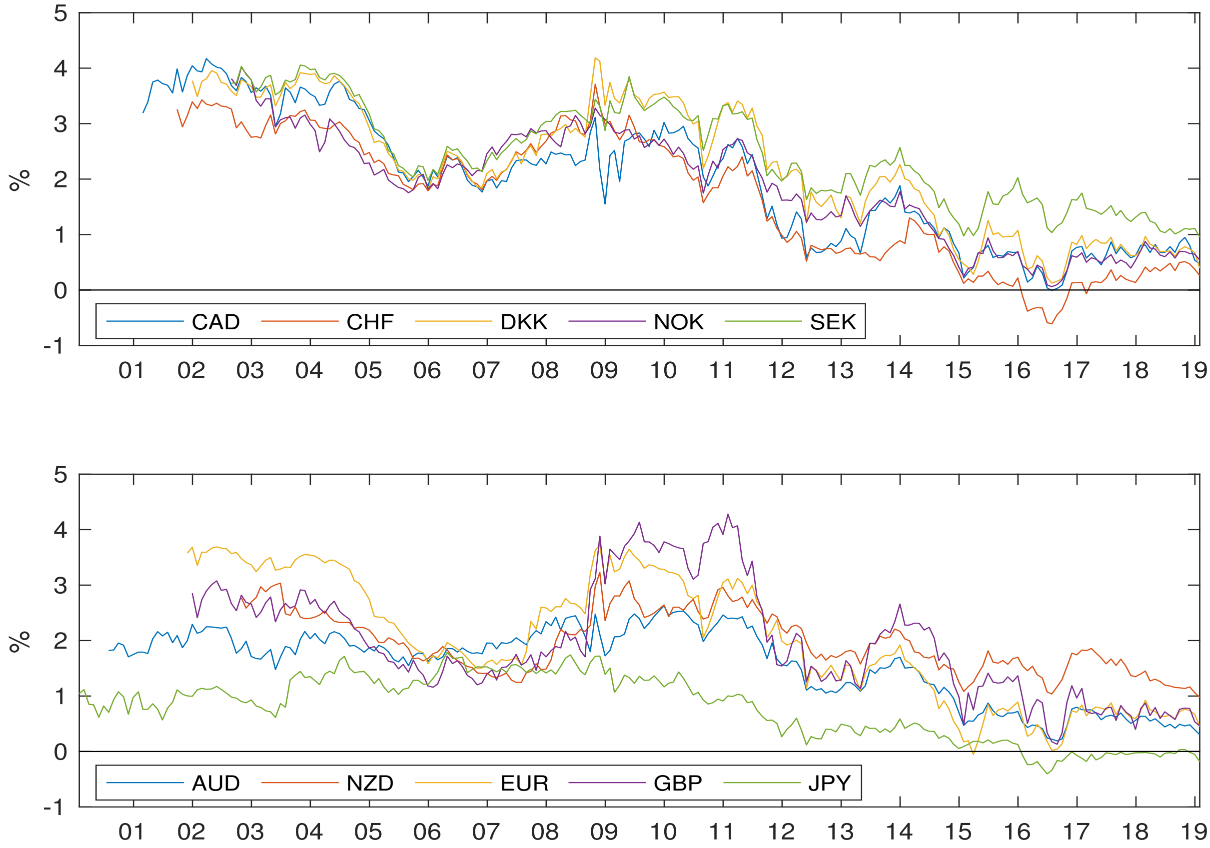

Figure 2: Estimated 10-Year Term Premia: Advanced Economies.

Note that although the term premia of most advanced countries seem to reflect a common factor, that of Japan behaves differently probably reflecting the fact that Japan was at the zero lower bound before the other countries.

According to KW, the 10-year term premium estimate for the U.S. has been negative for most of the time since mid-2011, fluctuating between -1% and 0. Of the advanced countries considered, only Switzerland and Japan have experienced more than one month with a negative term premium, compared to several emerging markets, mainly Korea, Russia and Turkey. In particular, before the taper tantrum there was a tendency of declining term premia for emerging markets, which for some countries actually turned out negative.

	Dec-2006
EM	81.01
AE	98.07

Table 4: Total Variation Explained by First 3 PCs (%): 10-Year Term Premium.

5.4.1 Term Structure of Term Premia

In addition to comparing the term premia across countries, one can also compare them across maturities per country. In general, the term premium increases with maturity. As one would expect, when long-term bonds are seen as riskier than short-term bonds, investors would require a higher compensation for holding long-term bonds. This pattern, however, is not universal as can be seen in Figure 4 in the Appendix, which shows two examples of this, namely Korea and Mexico. Therefore, the exceptions for the general pattern are observed in both emerging and advanced countries since the KW estimates also show that after the Great Recession, the 1-year U.S. term premium has been above the 5- and 10-year term premia at some points.

5.4.2 Common Factors in Term Premia

To see whether there are common factors influencing the term premia in emerging markets, Table 4 shows the proportion of the total variation in the 10-year term premia explained by their first three PCs. To consider all countries, the starting date is December 2006. The first three PCs explain more than 80% of the variation in the term premia of emerging markets and more than 98% for advanced countries. This evidence highlights the importance of considering global factors as drivers of the term premia. But at the same time, the evidence for emerging markets shows that both domestic and common factors seem to be at play as drivers of their term premia.

5.4.3 Survey-Based Term Premia

As already mentioned, one way to check the term premia estimates obtained from affine term structure models is to use survey data since long-term surveys of professional forecasters can be used to obtain a model-free estimate of the long-term term premium. Using this approach, the term premium is calculated as the difference between the long-term interest rate and the survey-expectation of the future short-term interest rate over the same horizon. Since the long-term expectations of the policy rate for emerging markets are not provided by Consensus Economics, they are approximated as explained in section 4.2.2. As it is also explained in that section, given the persistence of bond yields, surveys can also provide information to help in the identification of the term premium. It is important to acknowledge, however, that surveys might not represent the market expectations or the expectations of the marginal investor.

Figure 3 displays the 10-year (long-term) term premium estimated in this way for most of the emerging markets considered in Figure 1.

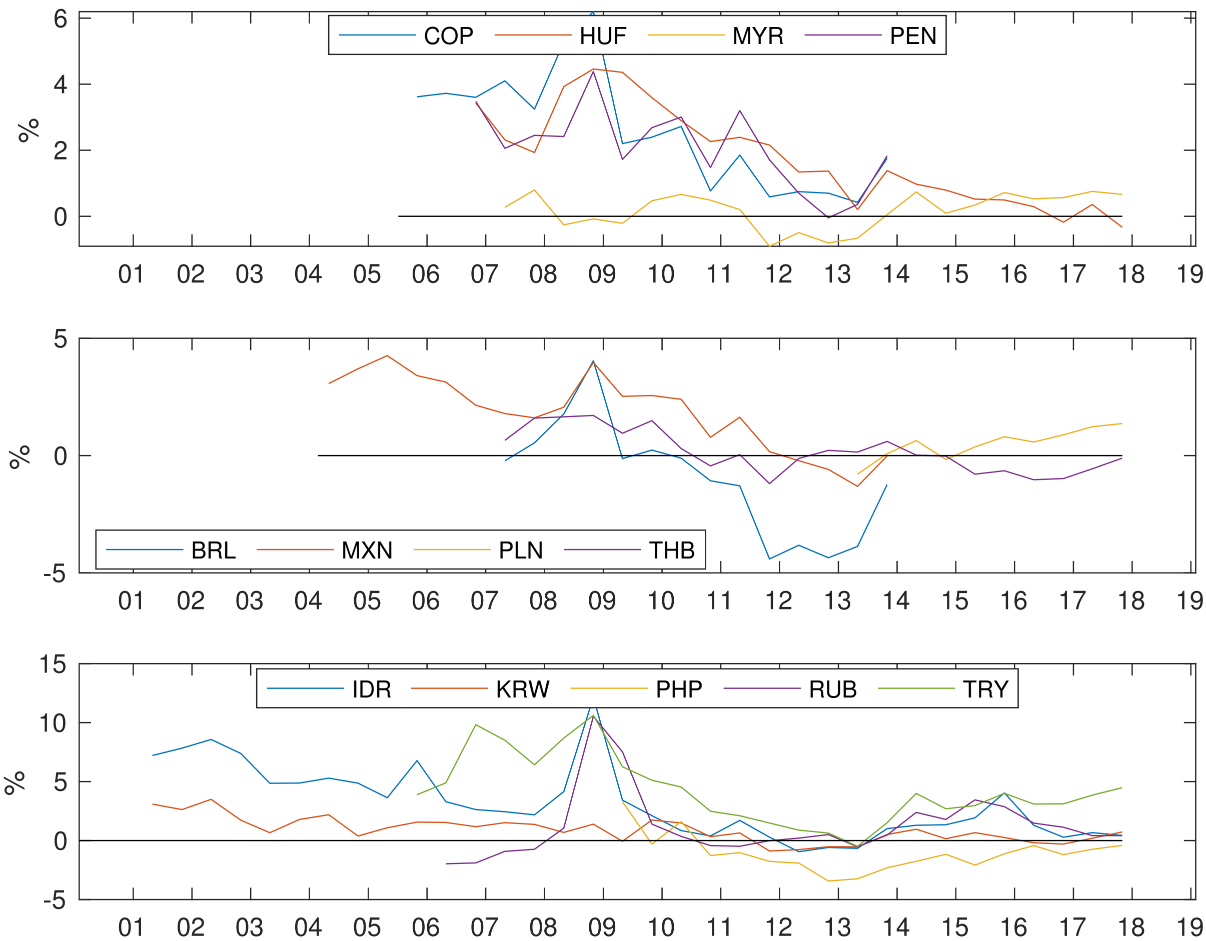

Figure 3: Survey-Based 10-Year Term Premium Estimates.

With the exception of Brazil during 2012-13, the term premia estimated using survey data are in line with the model-based term premia. In fact, the average correlation

	TP-USTP	TP-CIP Dev	⊥TP-CIP Dev
EM	0.60	-0.28	-0.13
A-SOE	0.80	-0.01	-0.20
G-3	0.71	-0.29	-0.22

Table 5: Correlations of 10-Year Term Premia: U.S TP and LCCS.

between the two is 80.4%.[21] This is reassuring and supports the idea of supplementing the term structure model with survey data to better pin down the term premia in emerging markets, which will in turn provide a more robust decomposition of the nominal yield curve. This will be done in future versions of this paper.

6 Cyclical Properties of the Term Premia

Since this is the first time that term premia is estimated using synthetic yield curves, I first present their correlation with variables commonly associated with risk and uncertainty before proceeding to a more formal analysis.

6.1 Relationship with Risk and Uncertainty Measures

To see how the term premia co-moves with variables associated with risk and uncertainty, they are compared against the 10-year U.S. term premium from KW, the LC credit spread from Du and Schreger (2016a) or the convenience yield from Du et al. (2018a), and the economic policy uncertainty (EPU) index proposed by Baker, Bloom, and Davis (2016). The first variable is an indicator of global financial conditions, while the second is an indicator of credit risk for emerging markets or the convenience yield for advanced economies. The EPU index is based on the frequency of articles in local newspapers containing key words such as 'economy', 'uncertainty' and 'central bank'; however, it is only available for 5 of the emerging markets in the sample. Tables 5 and 6 show these correlations.

The term premia in emerging markets is related to the U.S. term premium but not as

[21] Even for the term premia calculated using the nominal yield curve, the correlation with the survey-based term premia is equal to 85%.

	BRL	COP	KRW	MXN	RUB
TP-EPU	0.14	0.46	-0.32	0.40	-0.22
$\perp$TP-EPU	0.11	0.28	-0.31	0.20	-0.09

Table 6: Correlations of 10-Year Term Premia: EPU Index.

tightly linked as those for advanced countries. To assess the relationship of the country-specific component of the term premia with the other two variables, I regress the term premium of each country on the U.S. term premium and use the residuals as the 'idiosyncratic' term premium (i.e. the part of a country's term premium orthogonal to the U.S. term premium).

The correlation of the term premia with the deviations from CIP is negative. Du and Schreger (2016a) show that the LC credit spread has a low reaction to global variables. This provides a possible explanation for the negative relationship between the term premia and the LC credit spread, since the former seems to react to global factors as is formally tested in the next section. The last column of table 5 shows that once the term premia in emerging markets is purged from the effect of the U.S. term premium, the relationship is still negative but the magnitude declines. The opposite is observed for advanced small open economies but remember that for them the deviations from CIP reflect a convenience yield.

The term premia for Latin American countries show a positive correlation with the EPU index; the correlation for Korea and Russia, however, is negative. The relationship might be related to the fact that after the Great Recession, the term premia for both countries has been negative during a considerable period as shown in figure 1. This can be verified if the EPU index for countries with a similar situation (like Turkey) becomes available. Although the magnitude declines, the sign of the relationship with the idiosyncratic component of the term premia holds suggesting a role for domestic drivers of the term premia.

6.2 Drivers of Term Premia

To study the cyclical properties of term premia in emerging markets formally, I run panel data regressions with a variety of macroeconomic and financial variables as explanatory variables. The macroeconomic variables considered have a monthly frequency; for the financial variables considered (which are available daily) end-of-month values are used.

The panel data regressions have the form

$$tp_{it} = \alpha_i + \beta' z_{it} + u_{it}. \tag{15}$$

where tp_{it} denotes the model-based 10-year term premium of country i in month t, z_{it} is a vector of regressors and α_i denotes country fixed effects. The regressors include global and domestic variables as suggested by the evidence presented in tables 4-6. This is a first step towards understanding the drivers of term premia and, therefore, it is important to acknowledge the potential econometric problems such as endogeneity as well as the effects of the persistence of the variables considered.

The global financial variables include the Cboe's volatility index (VIX), the federal funds rate, the S&P 500 index and the oil price. The VIX and the federal funds rate have been used in the global financial cycle literature (see Rey, 2013) to study the effects of common factors on capital flows. The VIX is usually used as a measure of risk aversion and economic uncertainty and the fed funds rate is a measure of the monetary policy stance in the U.S. Given the sudden spikes in the VIX, it is common to use the $\ln(VIX)$ instead of the VIX directly. For the U.S. monetary policy, the variable used is the effective federal funds rate calculated by the New York Fed.

The domestic variables include inflation, the unemployment rate and industrial production to capture macroeconomic effects. In addition, the exchange rate (LC per USD) and the local stock market index are used as measures of local financial conditions.

Monthly returns, calculated as the log difference of the series, are used for the stock market indexes, the oil price and the exchange rate.

Table 7 reports different specifications of the model in equation (15). The first model in the table focuses mainly on global variables, while the second one focuses on domestic

	(1)	(2)	(3)	(4)	(5)
log(Vix)	0.18		0.65***	0.14	
	(0.41)		(0.21)	(0.17)	
FFR	0.08		0.22**	0.12	
	(0.11)		(0.10)	(0.10)	
USTP10	1.55***			1.22***	
	(0.28)			(0.16)	
Return S\&P	-0.01		0.00		
	(0.01)		(0.01)		
Return Oil	-0.00		0.00		
	(0.00)		(0.00)		
INF		0.26***	0.22***	0.21***	0.222***
		(0.05)	(0.05)	(0.05)	(0.0400)
UNE		0.22***	0.21***	0.13**	0.137**
		(0.07)	(0.06)	(0.05)	(0.0583)
IP		-0.02	-0.02	-0.02*	-0.0193**
		(0.01)	(0.01)	(0.01)	(0.00792)
Return FX		0.02**	0.02*	0.02*	0.0199*
		(0.01)	(0.01)	(0.01)	(0.0103)
Return Stocks		0.00	0.00	0.00	0.000373
		(0.01)	(0.01)	(0.01)	(0.00751)
Constant	1.04	-1.40*	-3.18***	-0.84	1.235*
	(1.27)	(0.67)	(0.93)	(0.76)	(0.636)
Observations	2,406	1,969	1,969	1,969	1,969
R-squared	0.29	0.27	0.34	0.49	0.547
Number of Countries	15	15	15	15	15
Country FE	Yes	Yes	Yes	Yes	Yes
Time FE	No	No	No	No	Yes

Robust standard errors in parentheses; *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Table 7: Panel Data Regressions. Dep. Variable: EM 10-Year Term Premium (%).

variables. These two models already shed some light on the driving forces behind the term premia in emerging markets. However, the models with the most explanatory power include both global and domestic variables.

The main global factor is the U.S. term premium, and the two main domestic factors are inflation and unemployment. Holding the other factors constant, an increase in any of these three variables increases the term premia in emerging markets. Note that external conditions have a relevant impact on domestic bond markets since the greatest effect comes from the U.S. term premium. This is in line with the literature studying the global financial cycle that focuses on capital flows. However, the channel does not seem to be through the VIX nor even through the monetary policy of the U.S. directly via the federal funds rate but through the U.S. term premia. Both the VIX and the federal funds rate appear to have a positive effect on the term premia in emerging markets but the effect disappears once the U.S. term premium is included in the regressions. An increase in the U.S. term premium translates into a more than proportional increase in the term premium of emerging markets.

The effect of the domestic variables is in line with what has been found for advanced countries using nominal yield curves. Investors demand a higher term premium during recessions, when the unemployment rate increases. This provides evidence of a countercyclical behavior of the term premia in emerging markets. Moreover, the positive effect of inflation on the term premia conforms with the idea that inflation erodes the value of nominal bonds and so in periods of rising inflation investors demand a higher term premium. The effect of both variables is broadly similar across models.

The exchange rate also seems to be playing a role; a depreciation of the local currency is associated with an increase in the term premium. This seems counterintuitive from the perspective of the standard trade-channel effect since emerging markets are usually commodity exporters. However, it is in line with the risk-taking channel of exchange rates found by Hofmann et al. (2017), according to which currency appreciation is associated with easier financial conditions and compressed sovereign bond spreads.

Finally, the effects of the domestic variables remains once one controls for time fixed effects. The effects of those variables remain broadly similar across the different specifications.

7 Conclusions

This paper estimates the term premia for 15 emerging markets using synthetic yield curves. The LC credits spread accounts for the difference between the nominal and the synthetic yield curve. By accounting for credit risk, this paper avoids violating the risk-free assumption underlying affine term structure models.

Exploiting the flexibility of these models, I decompose the synthetic yield curve into an expectation for the future short-term interest rate and a term premium, which in turn allows to decompose the nominal yield curve into three components (the third one being the LC credit spread).

The evidence presented in this paper shows that the main component for the 10-year yield of emerging markets is the expected future path of the short-term interest rate, while for advanced economies the main component is the term premium. The term premia in emerging markets for the 10-year maturity is around 175 basis points on average, higher than the average of the LC credit spread of 85 basis points. The results are compared to those obtained from surveys of professional forecasters and from advanced countries to establish a set of stylized facts. It is shown that the benefits of using synthetic yield curves are greater for emerging markets than for advanced economies, which implies that the terms 'risk premium' and 'term premium' should not be used interchangeably, at least for emerging markets. The analysis also shows that the phenomenon of a negative term premium is not limited to advanced countries.

The analysis shows that both global and domestic factors are important drivers of the term premia in emerging markets. The U.S. term premium is a key common factor having a more than proportional effect on their term premia. The evidence also shows a countercyclical behavior of the term premia as well as a positive relationship with inflation, in line with the idea that it erodes the value of nominal bonds.

The work presented in this paper can be extended in several directions and I will continue working on them. First, as already indicated, the information from survey data can aid in mitigating the identification problem in affine term structure models, which translates into more robust estimates of the term premia. As a consequence, the decomposition of the nominal yield curve will also be more robust so that it can provide useful information for the analysis of monetary policy in emerging markets.

Different models can also be used to assess different characteristics of the data from the synthetic curves. A model that explicitly considers the joint behavior of nominal and real interest rates can allow to further decompose both nominal and synthetic yield curves into the expectation of the future real interest rate and the real term premium. The model can also be supplemented not only with survey data but also with macroeconomic information. Other extensions include models with jumps in yields, which might be applicable to a couple of emerging markets (those with a poor fit mentioned in section 5). Given the reaction to common factors, multi-country term structure models might be relevant. To further study the phenomenon of negative term premiums, quadratic term structure models with joint dynamics for stocks and bonds might be useful.

Finally, minor improvements can also be included like extending the comparison with advanced economies for the analysis shown in section 6. In particular, analyzing the relationship between the EPU index for those advanced countries for which it is available (Australia, Canada, Germany, Japan, UK and Sweden) to compare it with what is reported for emerging markets, as well as contrasting the results from the panel regressions to advanced countries. More generally, the panel regression analysis can be applied to the other components of the nominal yield curve, namely the expectation part and the LC credit spread. This will provide a broader picture of the relative importance of global and domestic factors on local bond markets.

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Appendix

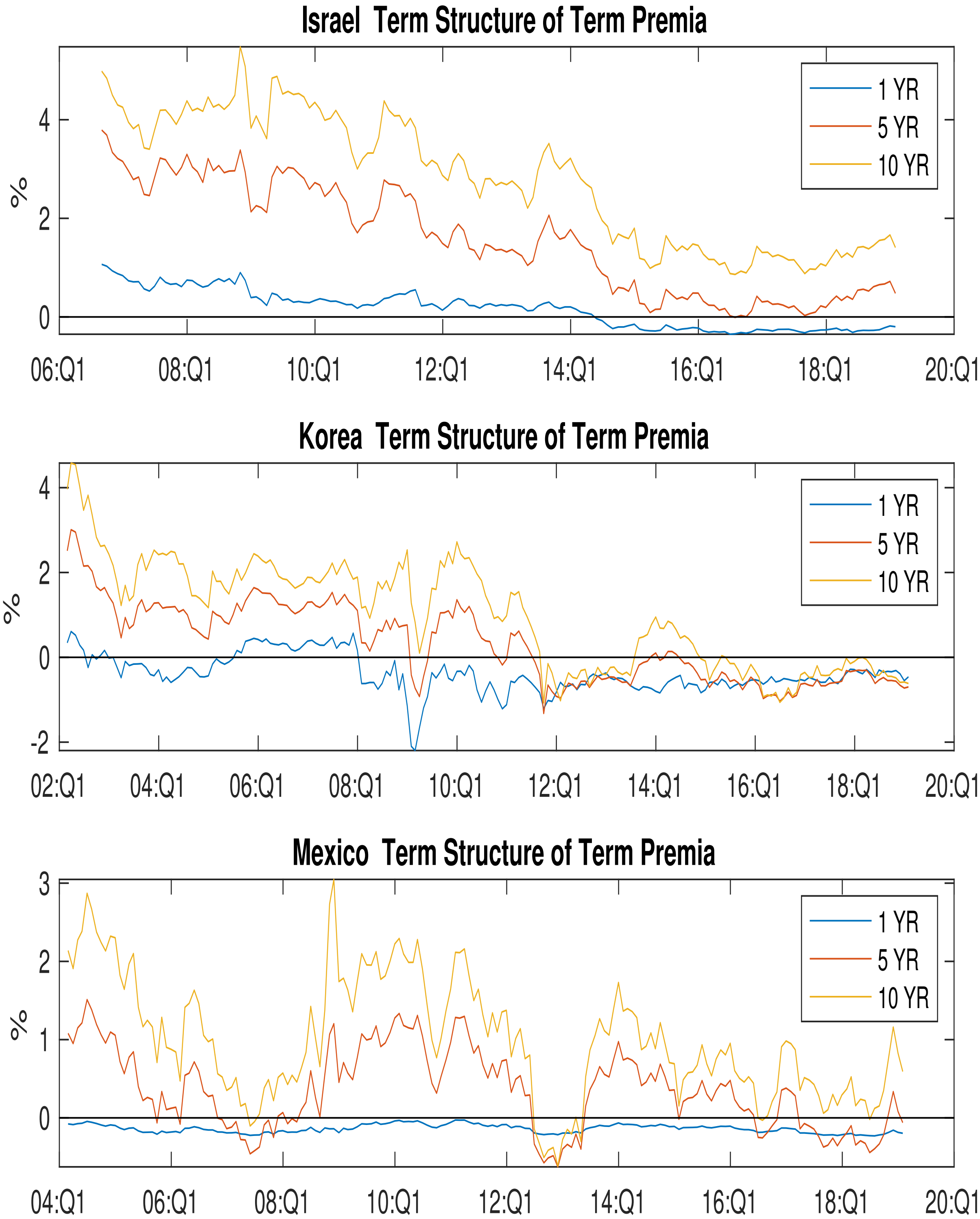

Figure 4: Estimated Term Premia for Different Maturities.