Discussion of Capital Inflow Shocks and Convenience Yields

by Ben Zeev, Ben-Ze'ev, Nathan (2025)

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The views expressed here do not necessarily reflect the position of the Bank of England.

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  - Du et al. (2023): OIS-Treasury spread turns negative post GFC as dealers go net-long Treasuries
- This paper: in Israeli government bond market, quantify effect of foreign investor demand on OIS-Sovereign convenience yield + spillovers to other assets using daily, granular data.
  - GIV capital inflow shock significantly raises convenience yields by lowering sovereign yields
  - Mutual funds are counterparties, rebalance towards corporate debt and equity, raising prices
  - Induced wedge between policy (OIS) and sovereign rates harms monetary policy transmission

Comments

1. GIV shock construction
2. Mutual fund rebalancing
3. Smaller points

Comment #1: GIV shock—the exogeneity assumption

- Capital flow GIV by comparing size-weighted flows with (pseudo) equal-weighted flows:

$$GIV_t = \sum_{i=1}^{n} \underbrace{\frac{S_{i,t-1}}{\sum_{i=1}^{n} Q_{i,t-1}}}_{Q_{i,t-1}} \Delta q_{i,t} \quad - \quad \sum_{i=1}^{n} \underbrace{\frac{\tilde{E}_{i,t-1}}{\sum_{i=1}^{n} 1/\sigma^2_{i,t-1}}}_{1/\sigma^2_{i,t-1}} \Delta q_{i,t}$$

- Exogeneity: Partials-out common factors (uncorrelated with size) across foreign investors
  Relevance: Flows by large 'granular' investors, which matter for aggregate, remain

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- Ideal GIV: idiosyncratic shocks to large investors, uncorrelated with market/expectations
  - E.g., fine, legal action, management change, inquiry,... computer failure (see Bippus et al., 2023)

- Risks to GIV: large investors react differently to aggregate shocks (e.g., monetary policy)
  large investors have superior expectations/timing, i.e., reverse causality

Comment #1: GIV shock—the exogeneity assumption

Should we be concerned about exogeneity in this case?

- Small cross-section of firms (18) with very high HH index (0.47)
  - Effectively 1 very large firm ($\sim 68\%$ of market) and maybe 2 medium-sized firms ($\sim 8\%$ of market)

  Can this one large firm experience idiosyncratic shocks, uncorrelated with aggregate shocks, expectations or market, on *each day* of sample (1366 days)?

- GIV *shock*s explain such a high share of variation in convenience yield (40%) and aggregate capital inflows (70%). Is this reasonable for a truly exogenous shock?

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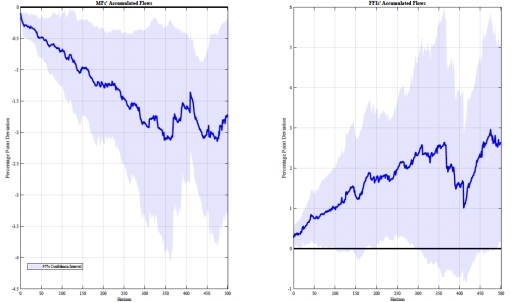
To make the identification more convincing:

1. Restrict to largest GIV moves, more likely to capture abnormal behavior tied to true shocks.
2. Narrative analysis of these large GIV moves–do they seem exogenous. (see Bippus et al., 2023)

Comment #2: Mutual fund rebalancing

- Mutual funds are counterparties to foreign investors' purchases of sovereign bonds in *secondary market*. And rebalance towards corporate debt and equity, raising prices.

Mutual Funds Accomodate in Secondary Market



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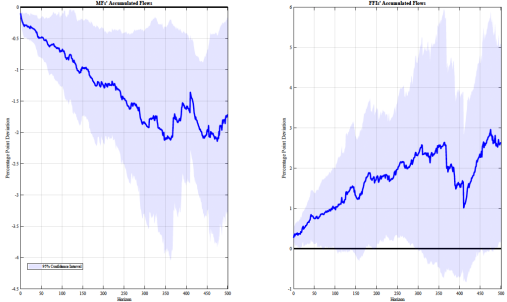
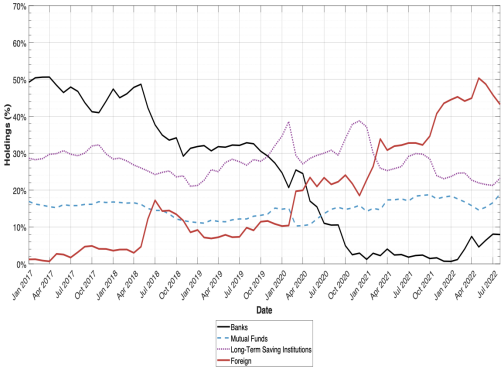


But Positions Flat Overall

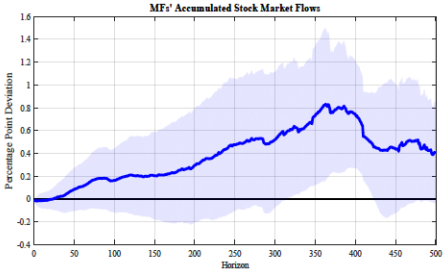


- But, across primary and secondary markets, their positions are flat over sample, so they must being buying government bonds in primary market?

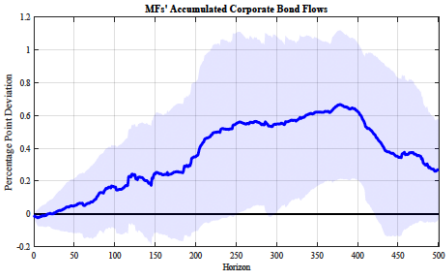
Comment #2: Mutual fund rebalancing

- Is it local banks that accomodate foreign investors' purchases of government bonds?
- Consistent with fact that mutual funds mostly rebalance to risky assets at long horizons.

Mutual Fund Equity Rebalancing



Mutual Fund Corporate Debt Rebalancing



- Suggests that on-impact reaction in risky asset prices may be tied to discounting from lower sovereign yields, as authors mention.

Smaller Comments

1. CIP arbitrage opportunities broke out in 2018, and foreign investors flew into the Israeli government bond market to take advantage, but OIS-Sovereign convenience yield did not rise. It only began to rise in 2020, but CIP deviations were similar to 2018. What was different about post-2020 dynamics to pre-2020 to explain this?
2. Have only 5.5 years of data but are showing impulse responses up to 2 years. Are you running into a problem of some shocks leaving the sample which might explain the rising IRFs over time?
3. Counterparties to foreign investors are selling government bond yields at high price, but the price keeps rising over time, so they in effect are selling at a low price. Why are they selling?

Conclusion

- Very interesting paper quantifying role of (foreign) demand in explaining convenience yield dynamics.

- Going forward, useful to provide more information to help convince readers of exogeneity of GIV—consider large shocks only and do narrative checks—and to clarify the role of local banks and mutual funds in accommodating foreign investors demand across both primary *and* secondary markets.