

# Term Premia and Credit Risk in Emerging Markets: The Role of U.S. Monetary Policy <sup>†</sup>

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## Abstract

This paper documents the channels through which U.S. monetary policy impacts the sovereign bond yields of emerging markets. Traditional decompositions of sovereign yields are not suitable for emerging markets because they rely on a default-free assumption. Instead, I decompose the yields of 15 emerging markets into average expected future short-term interest rates, a term premium and compensation for credit risk. I use this decomposition to analyze the transmission channels of U.S. monetary policy surprises identified with intraday data. I find that the response of emerging market yields to target, forward guidance and asset purchase surprises is economically significant, yet delayed over days. In addition, unanticipated U.S. monetary policy decisions lead to a reassessment of policy rate expectations and a repricing of interest and credit risks in emerging markets. Finally, U.S. unconventional monetary policies limit the monetary autonomy of emerging markets along their yield curves.

*Keywords:* Credit risk, term premium, synthetic yields, emerging markets, affine term structure models, monetary policy spillovers.

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

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# 1 Introduction

U.S. monetary policy has worldwide consequences, yet the channels through which it affects the sovereign bond yields of emerging markets are not well understood. Since sovereign yields are the benchmark to price other domestic assets, the ability of emerging markets to mitigate any undesired impact from U.S. monetary policy relies on understanding those channels. Decomposing the yields and analyzing how the components respond is a sensible approach, but traditional two-part decompositions are not suitable for the yields of emerging markets because they are assumed to be free of credit risk.

The main contribution of this paper is to empirically quantify the transmission channels of U.S. monetary policy to the sovereign yields of emerging markets. To achieve this, the paper first proposes a novel three-part decomposition of the yields that accounts for credit risk, and then asks how U.S. monetary policy transmits to those components.

Investors holding local currency bonds of emerging markets bear two major risks. One is the risk of not receiving the promised payments. Although emerging markets have increasingly borrowed in local currency over the last two decades (IMF-WB, 2020), they remain prone to default (Reinhart and Rogoff, 2011; Jeanneret et al., 2014; Beers et al., 2020).<sup>1</sup> The other is the risk that inflation erodes the real value of bond payments. The compensation for this risk is the standard term premium. Thus, compensation for credit risk addresses the risk of not receiving the promised payments, whereas the term premium compensates investors for bearing interest rate risk.

To account for credit risk, I construct default-free yields in local currency by essentially swapping the U.S. yield curve into a local currency one using cross-currency swaps. Those synthetic yields can be seen as the borrowing rates paid by a hypothetical local currency bond issuer with no credit risk,<sup>2</sup> and so traditional decompositions can be applied to them. I use a standard affine term structure model augmented with survey data to

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<sup>1</sup>Before 2000, several emerging markets issued bonds at short maturities and in foreign currency. Nowadays, they mostly issue bonds with longer maturities and in local currency. There have been more than 30 default episodes in LC since 1996 Jeanneret et al. (2014); examples include Barbados (2018), Jamaica (2013, 2010), Nicaragua (2008, 2003), Argentina (2001), Turkey (1999) and Russia (1998).

<sup>2</sup>Under this approach, the U.S. yield curve serves as a default-free benchmark for other countries. Although Augustin et al. (2019) argue that U.S. sovereign default risk is not zero, it is not volatile enough to affect the results for emerging markets.

obtain robust decompositions of the synthetic yields.<sup>3</sup> Such yields have been widely used to study deviations from covered interest rate parity (CIP) but, instead of concentrating on the CIP deviations, I focus on the synthetic yields themselves.<sup>4</sup> To the best of my knowledge, this is the first application of affine term structure models to synthetic yields.

This paper decomposes the nominal (or actual) yields of 15 emerging markets from 2000 to 2019 into three parts. The first two components come from the decomposition of synthetic yields, namely an average expected future short rate and a term premium. The third component is the spread between the nominal and the synthetic yields, which captures the compensation for credit risk in the local currency debt of emerging markets (Du and Schreger, 2016).<sup>5</sup> This decomposition gives reasonable estimates for the components. Across emerging markets, average expected short rates, the term premium and the credit risk compensation in the 10-year nominal yield represent on average 4.2, 2.2 and 0.9%, respectively. Although credit risk is an important component, the literature on term structures of emerging market yields has not examined it systematically.<sup>6</sup> By explicitly accounting for credit risk, the second component is a genuine term premium. I show that this term premium compensates investors for bearing inflation uncertainty, consistent with the evidence for advanced economies (Wright, 2011) and with inflation in emerging markets being more volatile than in advanced economies (Ha et al., 2019).

The characterization of the transmission channels of U.S. monetary policy needs both the three-part yield decomposition and the identification of unanticipated policy decisions by the Fed. I distinguish between target, forward guidance and asset purchase surprises following the literature (Gürkaynak et al., 2005; Swanson, 2018). These monetary policy

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<sup>3</sup>Guimarães (2014) shows that affine term structure models augmented with survey data provide robust decompositions of the U.S. and U.K. (nominal) yield curves.

<sup>4</sup>Du et al. (2018b) show that persistent and systematic deviations from CIP reflect a higher regulatory burden for financial intermediaries. Du et al. (2018a) argue that CIP deviations reflect a convenience yield in advanced economies, whereas Du and Schreger (2016) show that they capture a local currency credit spread for emerging markets, which is used by Hofmann et al. (2019) to explain the link between currency appreciations and the compression of the sovereign yield spreads of emerging markets.

<sup>5</sup>Credit risk here is broadly defined including, for example, (selective) default risk, currency convertibility risk, regulation risk, capital controls, and jurisdiction risk, so compensation for any of these risks is considered as compensation for credit risk even if the country does not default per se.

<sup>6</sup>The analysis of sovereign credit risk traditionally focuses on bonds denominated in foreign currency. For instance, Hilscher and Nosbusch (2010) report the relevance of domestic factors to explain sovereign credit risk, while Longstaff et al. (2011) document the importance of global factors. Bostanci and Yilmaz (2020) study the connectedness of the network of sovereign credit default swaps.

surprises are identified using intraday data around Fed’s monetary policy announcements. This is by now a well-established strategy to overcome endogeneity concerns because it isolates the surprise component of monetary policy decisions.

Three main findings summarize the transmission channels of U.S. monetary policy surprises to emerging market yields. First, the responses to target, forward guidance and asset purchase surprises are economically significant but sluggish, and amplify over the month following the surprise. This delayed response is consistent with the evidence for the U.S. and other advanced economies, which Brooks et al. (2019) attribute to a portfolio rebalancing channel and slow-moving capital. Moreover, the effects of asset purchase surprises last longer in emerging market yields than in U.S. yields. Portfolio rebalancing involving emerging market bonds following asset purchases is thus slower.

Second, monetary policy surprises spill over to all yield components, so that unanticipated Fed policy decisions give rise to a reassessment of policy rate expectations and a repricing of risks in emerging markets. Investors expect monetary authorities in those countries to eventually follow the Fed’s monetary stance rather than counteract it, given that average expected future short rates decline following target, forward guidance and asset purchase easing surprises. In addition, Fed’s unconventional monetary policies aimed at reducing the U.S. term premium, namely forward guidance and asset purchases, ultimately also decrease the term premia in emerging markets. Lastly, long-term credit risk compensation increases following target and forward guidance easing surprises. Loose financial conditions abroad trigger a ‘reach for yield’ behavior among investors (Hausman and Wongswan, 2011) that can incentivize more borrowing in emerging markets by sovereigns in local currency (Bigio et al., 2018) and by corporates in foreign currency<sup>7</sup>. In either case, the price of default risk (not necessarily the risk itself) increases. This effect can be seen as the fiscal implications in emerging markets of Fed’s monetary policies, something that has not been discussed so far in the literature.

Third, since the global financial crisis, U.S. monetary policy has spilled over to emerging markets through a yield curve channel. I show that among emerging markets long-

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<sup>7</sup>Du and Schreger (2017) show that higher reliance on foreign currency borrowing by corporates increases sovereign default risk in emerging markets.

term yields are more interconnected than short-term ones, so the global financial cycle is more relevant for the long end of their curves; equivalently, their monetary autonomy is stronger at the front end of their yield curves (Obstfeld, 2015). U.S. unconventional monetary policies aimed at influencing long-term yields thus limit the monetary autonomy of emerging markets along their yield curves. The effects transmit, in particular, through the expected future short rate as argued by Kalemli-Özcan (2019) as well as via the term premium as suggested by Turner (2014) and Kolasa and Wesolowski (2020). Global risks hit emerging markets even when borrowing in local currency (Carstens and Shin, 2019).

A growing literature analyzes the spillover effects of U.S. monetary policy to the local currency sovereign bond yields of emerging markets. Hausman and Wongswan (2011) report significant spillovers, while Bowman et al. (2015) compare the effects of conventional and unconventional monetary policies. The present paper is nonetheless more closely related to the work of Curcuro et al. (2018), Adrian et al. (2019) and Albagli et al. (2019), who decompose the yields to analyze the transmission channels of such spillovers, but it differs in a number of dimensions. Most importantly, this paper explicitly accounts for the credit risk embedded in emerging market yields, and analyzes the effects of different types of monetary policy surprises identified with intraday data.<sup>8</sup>

The rest of the paper proceeds as follows. Section 2 explains how to construct the local currency yield curves. Section 3 presents the affine term structure model used to decompose the yields. Section 4 assesses the yield decompositions. Section 5 analyzes the U.S. monetary policy spillovers to emerging market yields. The last section concludes.

## 2 Local Currency Yield Curves

This section explains how to construct the nominal and synthetic local currency (LC) yield curves of emerging markets, and explains that the spread between the two is a model-free measure of the compensation for credit risk. In the next section, the *synthetic* yield curve will be decomposed into average expected future short-term interest rates and

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<sup>8</sup>Rogers et al. (2014) and Rogers et al. (2018) analyze the spillovers on bond yields using surprises identified with intraday data but they focus on advanced economies. Gilchrist et al. (2019) study the effects for advanced and emerging countries but for debt denominated in foreign currency.

a term premium. The three components of the *nominal* yield curve will then be used to characterize the response of emerging market yields to U.S. monetary policy.

## 2.1 Construction of Synthetic Yield Curves

The main idea to construct the synthetic LC yield curves is to use the U.S. yield curve as the benchmark for all other countries and to swap it into LC by adding a foreign exchange forward premium at each maturity. The forward premium compensates investors for the expected depreciation of the currency. In this paper the exchange rate is expressed in LC per U.S. dollar (USD), so a currency depreciates when the exchange rate increases. This approach assumes frictionless financial markets; in particular, it assumes that (i) unconstrained arbitrageurs have access to U.S. and LC bonds, (ii) the derivatives contracts used to construct the forward premium have no counterparty risk, and (iii) U.S. yields are free of default risk.<sup>9</sup> Du and Schreger (2016) show that this is a useful benchmark to quantify credit risk in the LC debt of emerging markets.

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

$$\tilde{y}_{t,n}^{LC} = y_{t,n}^{US} + \rho_{t,n}. \quad (1)$$

in which  $y_{t,n}^{US}$  denotes the zero-coupon yield for an  $n$ -period U.S. Treasury security at time  $t$ , and  $\rho_{t,n}$  is the  $n$ -period forward premium from USD to LC at time  $t$ . The calculation of the forward premium depends on the maturity. For maturities shorter than one year, the forward premium is calculated as the annualized difference between the forward and the spot exchange rates. For maturities equal or larger than one year, the forward premium is calculated using cross-currency swaps because outright forwards are less liquid. Since fixed-for-fixed cross-currency swap rates are rarely observed in the market directly, they are constructed using cross-currency basis swaps and interest rate swaps. The idea is to exchange cash flows in the two currencies, USD and LC. Start by swapping fixed payments in LC into floating-rate cash flows in USD using cross-currency basis swaps (referenced to the Libor—London interbank offered rate—in USD), which are then swapped into

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<sup>9</sup>Augustin et al. (2019) argue that U.S. sovereign default risk is not zero. Nevertheless, it is not volatile enough to affect the results in this paper.

fixed-rate cash flows in USD using interest rate swaps. Both types of swaps are liquid, marked to market and collateralized instruments, so the bilateral counterparty risk in cross-currency swaps is small.

Since the construction of synthetic yields relies on the U.S. yield curve and currency derivatives, it does not require information about the nominal yields.<sup>10</sup> By contrast, the nominal zero-coupon yield,  $y_{t,n}^{LC}$ , is constructed directly from quotes of LC bonds actually traded in the market.

According to the CIP condition, the nominal (direct) and the synthetic (indirect) LC interest rates should be equal. Essentially, CIP implies that an issuer should be able to borrow directly or indirectly (synthetically) in LC at the same yield. Du et al. (2018b) show, however, that there are persistent and systematic deviations from CIP. Indeed, the spread between the nominal and synthetic yields ( $y_{t,n}^{LC} - \tilde{y}_{t,n}^{LC}$ ) measures CIP deviations in sovereign yields. For advanced economies, Du et al. (2018a) argue that CIP deviations measure the difference in the convenience yield of U.S. Treasuries relative to that of the sovereign bonds of other advanced economies. By contrast, Du and Schreger (2016) point out that CIP deviations have a different interpretation for emerging markets.

The nominal-synthetic spread is a model-free measure of the compensation for credit risk in the LC yields of emerging markets. Whereas the nominal yields of advanced economies are usually considered free of credit risk, the nominal yields of emerging markets include a credit risk compensation given the possibility of default (Du and Schreger, 2016, 2017). Since credit risk in the components of the synthetic yields (equation (1)) is small, a synthetic yield can be seen as the borrowing rate paid by a hypothetical issuer in LC with no credit risk.

Du and Schreger (2016) show that the nominal-synthetic spread is highly correlated with the rates of credit default swaps (CDS)—financial derivatives aimed to protect investors against default by a bond issuer. However, the nominal-synthetic spread adequately measures credit risk on LC debt, whereas CDS are suitable for studying the sovereign risk in bonds denominated in foreign currency (see, for example, Longstaff

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<sup>10</sup>Since there is no forward premium for the USD relative to the USD,  $\tilde{y}_{t,n}^{US} = y_{t,n}^{US}$ .

et al., 2011). Indeed, according to the International Swaps and Derivatives Association (ISDA), LC bonds governed under domestic law do not trigger CDS payouts.<sup>11</sup> In addition, a credit event for a CDS contract is not always clearly defined.

## 2.2 Construction of Nominal Yield Curves

The construction of the nominal yield curve,  $y_{t,n}^{LC}$ , uses the Bloomberg Fair Value (BFV) curves. These curves report coupon-equivalent par yields. I convert them into continuously-compounded yields to obtain implied zero-coupon curves (see Gürkaynak et al., 2007).<sup>12</sup> For Brazil and Israel, Bloomberg does not provide BFV curves but zero-coupon yields with coupon-equivalent compounding, known as IYC curves, which I also convert into continuously-compounded yields.<sup>13</sup>

The resulting continuously-compounded zero-coupon curve for each country is what this paper refers to as the nominal yield curve  $y_{t,n}^{LC}$ .

## 2.3 Yield Curve Data

Nominal and synthetic yield curves are constructed for the 15 emerging markets originally studied by Du and Schreger (2016) and, to compare the results, for the 10 advanced economies considered by Du et al. (2018a).<sup>14</sup> All emerging markets in the sample, except Malaysia, have adopted an inflation targeting regime.<sup>15</sup> Some of them adopted it during the sample period.<sup>16</sup>

The data for nominal and synthetic yields is available daily. The sample starts in January 2000 and ends in January 2019. The starting dates, however, vary by country.

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<sup>11</sup>See the ISDA credit derivatives physical settlement matrix.

<sup>12</sup>As a robustness check, I estimate the nominal yield curves from actual prices for some of the countries in the sample using the Nelson–Siegel model. They closely follow the curves reported by Bloomberg.

<sup>13</sup>For some emerging markets, Bloomberg reports both BFV and IYC curves. BFV curves are preferred for several reasons: their history is longer, IYC curves are not available for advanced economies—the benchmark for some of the results reported later—and, compared to the BFV curves, the short end of the IYC curves seems disconnected from the rest of the curve at some dates for a few countries.

<sup>14</sup>Emerging markets: Brazil, Colombia, Hungary, Indonesia, Israel, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Russia, South Africa, Thailand, Turkey. Advanced economies: Australia, Canada, Denmark, Germany (based on the euro), Japan, Norway, New Zealand, Sweden, Switzerland, the U.K.

<sup>15</sup>Malaysia, however, has several characteristics that are aligned with an inflation targeting regime.

<sup>16</sup>Hungary in June 2001, the Philippines in January 2002, Indonesia in July 2005, Turkey in January 2006 and Russia in 2014. Hungary and Poland were accepted to join the European Union in April 2003.



All the yields for advanced economies start no later than September 2001. The sample sizes for emerging markets are generally smaller. The nominal yields of 9 and the synthetic yields of 7 emerging markets start before March 2004; both types of yields for the rest of the countries start no later than June 2007. There are thus at least 10 years of data for most of the emerging markets in the sample.<sup>17</sup> In principle, this is a reasonable time period for the estimation of the affine term structure model presented in section 3.1, but in practice there may be too few interest rate cycles per country. Surveys of professional forecasters help to address this small sample problem, as discussed in section 3.3.

The yields have maturities of 3 and 6 months, and 1 through 10 years, ranging from a minimum of nine to a maximum of twelve maturities per country.<sup>18</sup> The maximum maturity considered for the analysis is 10 years because bonds and swaps with larger maturities have less history and are less liquid, especially for emerging markets who do not issue longer-term bonds as often as advanced economies.

The construction of LC synthetic yield curves involves data from the U.S. yield curve and the forward premium for different maturities, as explained in section 2.1. Data for the U.S. zero-coupon yield curve comes from two sources. For maturities of 1 through 10 years, the yields come from the dataset constructed by Gürkaynak et al. (2007), who only consider Treasury securities with coupons. Since Treasury securities with less than one year to maturity behave differently, partly because they are less actively traded than longer-maturity ones, I follow Duffee (2010) and use the estimates from the Center for Research in Security Prices (CRSP), which are robust at the short end of the curve. Specifically, the 3- and 6-month yields are the annualized 13- and 26-week rates (bid/ask average) in the CRSP Risk-Free Rates series.<sup>19</sup>

The data to compute the forward premium also comes from two sources. For maturities of less than one year, I use data on the spot exchange rate along with 3- and 6-month

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<sup>17</sup>For Turkey, the nominal yields with a maturity of up to 10 years start on June 2010, although its synthetic yields start on May 2005. For Russia, data on both types of yields start in 2007 but due to low liquidity at the beginning of the sample, here it starts in July 2009.

<sup>18</sup>All countries have data for maturities from 3 months to 5 years and for 10 years. All countries except Brazil have data for the 7-year maturity. Data for 6, 8 and 9 years vary per country.

<sup>19</sup>The 3- and 6-month yields implied by the fitted model of Gürkaynak et al. (2007) are highly correlated with CRSP yields (0.9985 and 0.9995) but are on average (16 and 10 basis points) higher since 1983.

forwards from Bloomberg for all countries but Korea, the Philippines and Thailand, for which the data comes from Datastream. To construct the cross-currency swap rates, I use data on cross-currency basis swaps and interest rate swaps for each available maturity from 1 through 10 years. The data for the swap curves comes from Bloomberg.<sup>20</sup>

Table 1 reports descriptive statistics for different tenors of the nominal and synthetic yield curves for the emerging and advanced economies in the sample. The yield curves exhibit standard properties such as an upward slope. At the same time, the table provides information on how the curves of emerging markets differ from those of advanced economies. For instance, the level and the volatility (measured by the standard deviation) of their curves are larger than those of advanced economies. Also, the short end of their curves is more volatile than the long end, particularly so for the synthetic curve. Lastly, the spread between the nominal and the synthetic yields suggests that the credit risk compensation is on average positive.

### 2.3.1 Timing

The parameters of the affine term structure models are estimated using end-of-month data, as explained in section 3.3. Since the U.S. yield curve is the benchmark to construct the synthetic yield curves, the end-of-month dates are the last business days of each month according to the U.S. calendar.

Getting the timing right is key to adequately measure the responses of emerging market yields to surprises in Fed’s policy decisions. The analysis of monetary policy spillovers in section 5.3 uses daily changes in nominal and synthetic yields. Since the closing prices in non-Western Hemisphere countries happen before the Fed’s monetary policy announcements, their nominal yields are shifted one day back so that their daily changes adequately capture surprises in the announcements. The credit risk compensation for those countries is calculated using the shifted nominal yields.

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<sup>20</sup>A spreadsheet with the 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) similar files kindly posted online in Wenxin Du and Jesse Schreger’s websites.

### 3 Methodology

This section describes the affine term structure model used to decompose the yield curve of each country in the sample, and discusses the difficulties in estimating the parameters of the model. It then explains how survey data helps in the estimation. Among the many applications of the decomposition, this paper exploits it to analyze the transmission channels of U.S. monetary policy to the yields of emerging markets.

#### 3.1 Affine Term Structure Model

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

If there is no arbitrage, there exists a strictly positive stochastic discount factor that prices all nominal bonds. Let  $M_{t+1}$  be the nominal stochastic discount factor. Accordingly, the bond price today is recursively defined as follows

$$P_{t,n} = E_t^{\mathbb{P}} [M_{t+1} P_{t+1,n-1}], \quad (2)$$

in which  $E_t^{\mathbb{P}}[\cdot]$  denotes the conditional expectation at time  $t$  taken using the actual or physical probability measure,  $\mathbb{P}$ , that generates the data. The existence of the stochastic discount factor also implies that there exists a theoretical risk-neutral or risk-adjusted pricing measure  $\mathbb{Q}$ —different from the  $\mathbb{P}$  measure—that is defined as follows

$$P_{t,n} = E_t^{\mathbb{Q}} [\exp(-i_t) P_{t+1,n-1}], \quad (3)$$

in which  $E_t^{\mathbb{Q}}[\cdot]$  also denotes conditional expectation but taken under the  $\mathbb{Q}$  measure.

A discrete-time affine term structure model assumes that the dynamics of a  $K \times 1$  vector of unobserved pricing factors or state variables,  $X_t$ , follow a first-order vector autoregression, VAR(1), under the risk-neutral measure  $\mathbb{Q}$

$$X_{t+1} = \mu^{\mathbb{Q}} + \Phi^{\mathbb{Q}} X_t + \Sigma \nu_{t+1}^{\mathbb{Q}}, \quad (4)$$

in which  $\mu^{\mathbb{Q}}$  is a  $K \times 1$  vector and  $\Phi^{\mathbb{Q}}$  is a  $K \times K$  transition matrix,  $\Sigma$  is a  $K \times K$  lower triangular matrix with positive diagonal elements, and  $\nu_{t+1}^{\mathbb{Q}}$  is a  $K \times 1$  independent and identically distributed, normal vector with zero mean and covariance equal to the identity matrix conditional on the pricing factors, that is  $\nu_{t+1}^{\mathbb{Q}}|X_t \sim \mathcal{N}_K(0, I)$ .

The pricing factors drive the dynamics of the one-period interest rate as follows

$$i_t = \delta_0 + \delta_1' X_t, \quad (5)$$

in which  $\delta_0$  is a scalar and  $\delta_1$  is a  $K \times 1$  vector of parameters.

These assumptions imply that the bond price is an exponentially affine function of the pricing factors

$$P_{t,n} = \exp(A_n + B_n' X_t),$$

such that the corresponding continuously compounded yield of the bond is an affine function of those factors

$$y_{t,n}^{\mathbb{Q}} = A_n^{\mathbb{Q}} + B_n^{\mathbb{Q}}' X_t, \quad (6)$$

in which  $A_n^{\mathbb{Q}} = -\frac{1}{n}A_n$ ,  $B_n^{\mathbb{Q}} = -\frac{1}{n}B_n$ , where in turn the scalar  $A_n = \mathcal{A}(\delta_0, \delta_1, \mu^{\mathbb{Q}}, \Phi^{\mathbb{Q}}, \Sigma, n)$  and the  $1 \times K$  vector  $B_n = \mathcal{B}(\delta_1, \Phi^{\mathbb{Q}}, n)$  are loadings that satisfy the recursive equations

$$A_{n+1} = -\delta_0 + A_n + B_n' \mu^{\mathbb{Q}} + \frac{1}{2} B_n' \Sigma \Sigma' B_n, \quad A_0 = 0, \quad (7)$$

$$B_{n+1} = -\delta_1 + \Phi^{\mathbb{Q}}' B_n, \quad B_0 = 0. \quad (8)$$

The yields  $y_{t,n}^{\mathbb{Q}}$  are the model's fitted yields, which means that the risk-neutral measure  $\mathbb{Q}$  is sufficient for pricing bonds. However, to be able to decompose the yields into an average expected future short-term interest rate and a term premium, the model needs to specify the dynamics for the market prices of risk, which control the transformation between the  $\mathbb{Q}$  and  $\mathbb{P}$  measures. In this sense, the stochastic discount factor is assumed to be conditionally lognormal

$$M_{t+1} = \exp\left(-i_t - \frac{1}{2} \lambda_t' \lambda_t - \lambda_t' \nu_{t+1}^{\mathbb{P}}\right), \quad (9)$$

in which  $\lambda_t$  is a  $K \times 1$  vector of market prices of risk. And, following Duffee (2002), it

is also assumed to be an affine function of the pricing factors

$$\lambda_t = \lambda_0 + \lambda_1 X_t, \quad (10)$$

in which  $\lambda_0$  is a  $K \times 1$  vector and  $\lambda_1$  is a  $K \times K$  matrix of parameters.

A well-known implication of this structure for the market prices of risk is that the dynamics of the pricing factors under the physical measure  $\mathbb{P}$  can also be described by a VAR(1) as follows<sup>21</sup>

$$X_{t+1} = \mu^{\mathbb{P}} + \Phi^{\mathbb{P}} X_t + \Sigma \nu_{t+1}^{\mathbb{P}}, \quad (11)$$

in which  $\mu^{\mathbb{Q}} = \mu^{\mathbb{P}} - \Sigma \lambda_0$ ,  $\Phi^{\mathbb{Q}} = \Phi^{\mathbb{P}} - \Sigma \lambda_1$ ,  $\nu_{t+1}^{\mathbb{P}} | X_t \sim \mathcal{N}_K(0, I)$ . Note that the covariance matrix of the shocks is the same under both measures; that is, it is measure independent.

The yields consistent with the expectations hypothesis of the yield curve—as if investors were actually risk-neutral ( $\lambda_0 = \lambda_1 = 0$ )—are obtained as

$$y_{t,n}^{\mathbb{P}} = A_n^{\mathbb{P}} + B_n^{\mathbb{P}} X_t,$$

in which  $A_n^{\mathbb{P}} = -\frac{1}{n} A_n$ ,  $B_n^{\mathbb{P}} = -\frac{1}{n} B_n$ , and the loadings  $A_n = \mathcal{A}(\delta_0, \delta_1, \mu^{\mathbb{P}}, \Phi^{\mathbb{P}}, \Sigma, n)$  and  $B_n = \mathcal{B}(\delta_1, \Phi^{\mathbb{P}}, n)$  satisfy the same recursions as those above but using the parameters of the law of motion of the pricing factors under the  $\mathbb{P}$  rather than the  $\mathbb{Q}$  measure.<sup>22</sup>

The term premium for maturity  $n$  at time  $t$ ,  $\tau_{t,n}$ , is then estimated as the difference between the yields obtained under the  $\mathbb{Q}$  and  $\mathbb{P}$  measures<sup>23</sup>

$$\tau_{t,n} = y_{t,n}^{\mathbb{Q}} - y_{t,n}^{\mathbb{P}}. \quad (12)$$

A key assumption behind this model is that the yield  $y_{t,n}$  is free of credit risk, a reasonable assumption for advanced but not for emerging countries for which investors require to be compensated for credit risk (Du and Schreger, 2016, 2017). Thus, while the nominal yield curve  $y_{t,n}^{LC}$  is adequate for advanced economies, the synthetic yield curve

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<sup>21</sup>The stochastic discount factor in equation (9) and the law of motion of the vector of pricing factors in equation (11) can be formalized separately or jointly. For instance, in a utility maximization framework, the stochastic discount factor is usually interpreted as the intertemporal marginal rate of substitution.

<sup>22</sup>The loadings are obtained recursively after combining the no-arbitrage condition and the functional form for bond prices. See the appendices in Lloyd (2020) for derivations under both measures.

<sup>23</sup>Note that the term premium is also an affine function of the pricing factors since  $\tau_{t,n}$  can be written as  $(A_n^{\mathbb{Q}} - A_n^{\mathbb{P}}) + (B_n^{\mathbb{Q}} - B_n^{\mathbb{P}}) X_t$ .

$\tilde{y}_{t,n}^{LC}$  better aligns with the risk-free assumption in the case of emerging markets.

Finally, to ensure that the decomposition of nominal yields adds up, the credit risk compensation is computed as

$$\phi_{t,n} = y_{t,n}^{LC} - y_{t,n}^{\mathbb{Q}}. \quad (13)$$

Notice that the credit risk compensation equals the spread between the nominal and the fitted( $y_{t,n}^{\mathbb{Q}}$ ), rather than the synthetic ( $\tilde{y}_{t,n}^{LC}$ ), yields. However, since the model fits the synthetic yields reasonably well, the credit risk compensation here is largely similar to the LC credit spread reported by Du and Schreger (2016).

Although the unconditional mean of the credit risk compensation in the data is positive, there have been episodes in which it turns negative. These situations are unrealistic and can reflect financial market frictions (Du and Schreger, 2016), including market segmentation and short selling constraints. Thus, the nominal-synthetic spread is a valid measure of credit risk that is far from perfect, but definitely better than ignoring it. Otherwise, estimates of the term premium would be contaminated with credit risk. Given the unrealistic nature of being negative, for the analysis the credit risk compensation is set to zero when it turns negative in the data. In general, those episodes are brief and rare, so the conclusions from the analysis remain the same as if it is allowed to be negative.

### 3.1.1 Weak Identification

The estimation of the parameters in the affine term structure model only requires zero-coupon yields as an input. While this data provides sufficient information to identify the pricing coefficients under the  $\mathbb{Q}$  measure,  $\{\mu^{\mathbb{Q}}, \Phi^{\mathbb{Q}}\}$ , it is not enough to accurately identify the parameters under the  $\mathbb{P}$  measure,  $\{\mu^{\mathbb{P}}, \Phi^{\mathbb{P}}\}$ . This information imbalance is relevant for the estimation of the term premium (see equation (12)). Indeed, poorly identified parameters under the  $\mathbb{P}$  measure result in unstable yield decompositions. Different solutions have been proposed in the literature to address this instability.<sup>24</sup>

Survey data provides additional information on the  $\mathbb{P}$  dynamics. Guimarães (2014) ar-

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<sup>24</sup>Solutions include restrictions on parameters (Duffee, 2010), bias-corrected estimators (Bauer et al., 2012) and complementing bond yield data with survey forecasts of future interest rates (Kim and Wright, 2005; Kim and Orphanides, 2012).

gues that surveys anchor the long-run mean of interest rates and shows that incorporating survey data on interest rate forecasts in the estimation provides robust decompositions of the U.S. and U.K. yield curves.<sup>25</sup> Since bond yields are highly persistent, the additional information from surveys is particularly relevant when sample sizes are small, in which case there might be too few interest rate cycles in the data. This is precisely the case with emerging markets, so including survey data in the estimation of the term structure model is especially important to obtain robust decompositions of their yields. On top of that, surveys allow for model-free estimates of the term premium, which serve as a robustness check for the model-implied term premium.

### 3.2 Survey Data

Long-term forecasts are particularly helpful to pin down the parameters of the model under the  $\mathbb{P}$  measure,  $\{\mu^{\mathbb{P}}, \Phi^{\mathbb{P}}\}$ . Twice a year Consensus Economics provides 5-year ahead and long-term (between 6 and 10 years ahead) forecasts for consumer inflation and real GDP growth for most of the emerging countries in the sample; the data is available from March 2001 to October 2017.<sup>26</sup> Figure 1 plots the inflation forecasts. With the exception of Brazil and Turkey, inflation expectations in emerging markets have been stable or even declining, and are generally within the upper and lower bounds for their inflation target.

Although there is no source for long-term forecasts for the short rate of emerging markets, they can be inferred from existing data by considering those countries as small open economies and using the Fisher equation. Specifically, the implied forecast for the nominal short rate ( $i_{t,n}^{survey}$ ) equals an expected real interest rate over the same horizon ( $r_{t,n}^*$ ) plus the expected average inflation reported by Consensus Economics ( $\pi_{t,n}^{CESurvey}$ ). The first term is in turn equal to the expected global real interest rate in USD plus a real foreign exchange forward premium, akin to equation (1) but in real terms. The U.S.

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<sup>25</sup>He finds that the term premium estimated with the aid of surveys remains essentially the same after varying the number of pricing factors (from 3 to 5) and the sample periods, even with a sample starting in 1972, which includes the U.S. Great Inflation period.

<sup>26</sup>Data availability varies by country; for example, data for the Philippines starts in 2009, whereas it ends in October 2013 for Latin American countries. Although there is no survey data on long-term inflation forecasts for Israel and South Africa, appendix A shows that trend inflation is a good proxy.

real interest rate serves as a proxy for the global real interest rate and is inferred by a combination of survey forecasts of future short-term U.S. Treasury bill yields ( $i_{t,n}^{SPFsurvey}$ ) and future U.S. inflation ( $\pi_{t,n}^{SPFsurvey}$ ). Finally, the real forward premium is the residual of regressing the forward premium computed as explained in section 2.1 on the expected average inflation from Consensus Economics. Thus, the implied forecast for the nominal short rate is obtained as follows

$$i_{t,n}^{survey} = r_{t,n}^* + \pi_{t,n}^e = \left( i_{t,n}^{SPFsurvey} - \pi_{t,n}^{SPFsurvey} \right) + \rho_{t,n}^\perp + \pi_{t,n}^{CESurvey}. \quad (14)$$

The required U.S. data is available quarterly from the Survey of Professional Forecasters. I use the 5- and 10-Year CPI inflation forecasts and, for the T-bill rate, the 10-year forecast and the second longest available one since there is no 5-year forecast for the T-bill rate.<sup>27</sup> to calculate the implied forecast for the domestic short rate. The implied forecasts for the U.S. real rate obtained from surveys are compared against the 5- and 10-year zero-coupon real yields constructed by Gürkaynak et al. (2010) who use data from the U.S. TIPS market. The levels of the two series are comparable. TIPS yields are not the benchmark, however, because they are more volatile (their term premium is time varying) and suffer from liquidity problems.

Figure 2 shows that the implied long-term forecasts for the short rates are sensible, their level is in line with the synthetic 10-year yield in each country. An alternative way to infer the embedded expectations is to use Taylor rule-type regressions for the policy rate.<sup>28</sup> Both approaches yield similar values for the implied forecasts of the short rates.

I assume that the 5-year ahead (implied) forecast for the short rate of each emerging

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<sup>27</sup>The specific series are CPI5YR, CPI10, BILL10 and TBILLD. The BILL10 series is only released in the first-quarter of a year, so I use linear interpolation for the second to fourth quarters. Consensus Economics forecasts are considered at the end of the month in which they are published, at that time the most recent value for the U.S. real interest rate forecast is used in equation (14).

<sup>28</sup>I regress the policy rate on its lag, the year-on-year consumer price inflation and the year-on-year real GDP growth for all the countries except Israel and South Africa. The coefficient for the lag of the policy rate is a smoothing parameter that improves the fit of the model to the data. I assume that the estimated parameters for inflation and real GDP growth apply at each of the survey maturities. A potential drawback of this approach is precisely that it requires one to know the expectation of the policy rate for the previous forecast horizon. Nevertheless, it is reasonable to assume stationarity for the long-term forecasts (5 and 10 years), in which case only survey data for inflation and GDP growth are needed after dividing their coefficients by 1 minus the coefficient for the lag of the policy rate (due to stationarity). Data for the dependent variable comes from the policy rate statistics of the Bank for International Settlements.



market guides the expected average short rate under  $\mathbb{P}$  given by

$$y_{t,n}^e = \frac{1}{n} \mathbb{E}_t^{\mathbb{P}} \left[ \sum_{j=0}^{n-1} i_{t+j} \right] = A_n^e + B_n^e X_t,$$

in which  $A_n^e = -\frac{1}{n}A_n$ ,  $B_n^e = -\frac{1}{n}B_n$ , where in turn  $A_n = \mathcal{A}(\delta_0, \delta_1, \mu^{\mathbb{P}}, \Phi^{\mathbb{P}}, 0, n)$  and  $B_n = \mathcal{B}(\delta_1, \Phi^{\mathbb{P}}, n)$ ; that is,  $A_n^e$  and  $B_n^e$  also satisfy the recursions under the  $\mathbb{P}$  measure but setting  $\Sigma = 0$  (see appendix C of Guimarães (2014)).<sup>29</sup>

Long-term (implied) forecasts are in turn aligned with the 5-year forward rate starting 5 years hence. In the model, the forward rate from  $n$  to  $m$  periods hence given by  $f_{t,n|m} = (my_{t,m} - ny_{t,n}) / (m - n)$  becomes

$$f_{t,n|m}^e = \frac{1}{m - n} \mathbb{E}_t^{\mathbb{P}} \left[ \sum_{j=n}^{m-1} i_{t+j} \right] = A_{n|m}^e + B_{n|m}^e X_t,$$

in which  $A_{n|m}^e = (mA_m^e - nA_n^e) / (m - n)$  and  $B_{n|m}^e = (mB_m^e - nB_n^e) / (m - n)$ .

### 3.3 Estimation

The convergence to the global optimum in affine term structure models estimated by maximum likelihood has been traditionally subject to computational challenges and multiple local optima. Joslin et al. (2011) propose a normalization of the affine model that improves the convergence to the global optimum of the likelihood function.

The Joslin et al. (2011) normalization allows for the near separation of the model's likelihood function into the product of the  $\mathbb{P}$  and  $\mathbb{Q}$  likelihood functions, and reduces the dimension of the parameter space from  $(\delta_0, \delta_1, \mu^{\mathbb{Q}}, \Phi^{\mathbb{Q}}, \Sigma)$  to  $(i_{\infty}^{\mathbb{Q}}, \lambda^{\mathbb{Q}}, \Sigma)$ , where  $i_{\infty}^{\mathbb{Q}}$  is the short rate under  $\mathbb{Q}$  in the long-run and  $\lambda^{\mathbb{Q}}$  is a  $K \times 1$  vector of ordered eigenvalues of  $\Phi^{\mathbb{Q}}$ . It is common to assume that  $K$  linear combinations of the  $N$  observed bond yields are measured without error,  $K < N$ , so that  $N - K$  linear combinations of yields are measured with error. Following Joslin et al. (2011), I consider that the first three principal components—usually referred to as the level, slope and curvature—of the yield

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<sup>29</sup>The difference between  $y_{t,n}^{\mathbb{P}}$  and  $y_{t,n}^e$  is a convexity term due to Jensen's inequality, which increases with maturity. In practice, however, this term usually becomes relevant for maturities beyond ten years. Further, the term is constant across maturities in homoskedastic models like the ones used in this paper.

curve in each country are the linear combinations of yields measured without error.<sup>30</sup>

The estimation of the affine model uses the Joslin et al. (2011) normalization and follows a two-step procedure. First, the  $\mathbb{P}$  parameters are estimated by OLS of the VAR in equation (11) using the  $K$  principal components as pricing factors. This step provides initial values for the maximum likelihood estimation of the matrix  $\Sigma$ . Then, taking  $\hat{\mu}^{\mathbb{P}}$  and  $\hat{\Phi}^{\mathbb{P}}$  as given, the  $\mathbb{Q}$  parameters are estimated by maximum likelihood.

The estimation uses end-of-month data on *risk-free* yield curves; that is, synthetic yields ( $\tilde{y}_{t,n}^{LC}$ ) for emerging markets and nominal yields ( $y_{t,n}^{LC}$ ) for advanced economies. Only yield data is available for advanced economies, whereas for emerging markets the model is augmented with survey data on the last day of the month for which the surveys were published.<sup>31</sup> Since survey data is available twice a year (whereas yield data for the estimation is monthly), it is regarded as missing in non-release dates.

### 3.3.1 Survey-Augmented Model

The Kalman filter is well-suited to handle missing data. The transition equation is the law of motion of the pricing factors under the  $\mathbb{P}$  measure given in equation (11). The dimension of the observation equation varies depending on the availability of survey data.

On months in which there is no data on survey expectations, the observation equation adds measurement error to the fitted yields in equation (6) for each of the  $N$  maturities

$$\mathbf{y}_t = \mathbf{A} + \mathbf{B}X_t + \Sigma_Y \mathbf{u}_t, \quad (15)$$

in which  $\mathbf{y}_t$  is an  $N \times 1$  vector of observed bond yields,  $\mathbf{A}$  is an  $N \times 1$  vector with elements  $A_n^Q$ ,  $\mathbf{B}$  is an  $N \times K$  matrix with rows equal to  $B_n^Q$  for  $n = 1, \dots, N$ ,  $\mathbf{u}_t \sim \mathcal{N}_N(0, I)$  and  $\Sigma_Y$  is a lower triangular  $N \times N$  matrix with positive elements on the diagonal.

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<sup>30</sup>On average, the first three principal components explain more than 99.5% of the variation in the synthetic yields of emerging markets and 99.9% in the nominal yields of advanced economies.

<sup>31</sup>From 2001 to 2014, data is available in March and September for countries covered in the Eastern European release; starting in October 2014, it is released on April and October. For the rest of emerging markets, forecasts have always been released on April and October. I do not have access to survey data for advanced economies. They are, however, not the main focus of this paper, the affine model is estimated for them just for comparison purposes. Moreover, the results reported later for them are more comparable with other studies that do not use survey data. Finally, there are less concerns about small sample sizes for advanced economies.

On months when survey data is available, the observation equation increases by the number of survey forecasts  $S$  as follows

$$\begin{bmatrix} \mathbf{y}_t \\ \mathbf{y}_t^S \end{bmatrix} = \begin{bmatrix} \mathbf{A} \\ \mathbf{A}^S \end{bmatrix} + \begin{bmatrix} \mathbf{B} \\ \mathbf{B}^S \end{bmatrix} X_t + \begin{bmatrix} \boldsymbol{\Sigma}_Y \mathbf{u}_t & \mathbf{0} \\ \mathbf{0} & \boldsymbol{\Sigma}_S \mathbf{u}_t^S \end{bmatrix}, \quad (16)$$

in which  $\mathbf{y}_t^S$  is a  $S \times 1$  vector of survey forecasts with elements  $i_{t,n}^{survey}$ ,  $\mathbf{A}^S$  is a  $S \times 1$  vector with elements  $A_n^e$  or  $A_{n|m}^e$ ,  $\mathbf{B}^S$  is a  $S \times K$  matrix with rows equal to  $B_n^e$  or  $B_{n|m}^e$  for  $n = 1, \dots, S$ ,  $\mathbf{u}_t^S \sim \mathcal{N}_S(0, I)$  and  $\boldsymbol{\Sigma}_S$  is a lower triangular  $S \times S$  matrix with positive elements on the diagonal.

To estimate the survey-augmented model, I follow Guimarães (2014) and Lloyd (2020) in two aspects. First, I use the estimated parameters from the Joslin et al. (2011) normalization as initial values for the Kalman filter. Second, I assume homoskedasticity in the errors of yields and surveys, so that  $\boldsymbol{\Sigma}_Y = \sigma_y I_N$  and  $\boldsymbol{\Sigma}_S = \sigma_s I_S$ , in which  $I_N$  and  $I_S$  are  $N \times N$  and  $S \times S$  identity matrices, reducing the number of parameters to be estimated.

It is important to acknowledge that although surveys contain useful information, have good forecasting properties and help to anchor the model to reality, they are not a panacea. For instance, surveys might not represent market expectations nor the expectations of the marginal investor,<sup>32</sup> they might also be subject to measurement error, and relying too much on them can be counterproductive as it may lead to overfitting. Thus, I consider them as imperfect or ‘noisy’ measures of expectations. Accordingly, I follow Kim and Orphanides (2012) by fixing  $\sigma_s$  at a conservative level of 75 basis points.

### 3.3.2 Estimating Daily Pricing Factors

The parameters estimated with monthly data can be used to estimate the pricing factors at the daily frequency (Adrian et al., 2013). The model is not estimated directly at the daily frequency because there is noise that can undermine the estimation.

The Kalman filter maximum likelihood setup explained above gives estimates for both

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<sup>32</sup>Notwithstanding, in the case of the U.S., when comparing the 5-year ahead CPI inflation median forecast from the Survey of Professional Forecasters against the Survey of Primary Dealers and the Survey of Market Participants, the absolute difference over 2015:I and 2020:II is on average 5 and 13 basis points, respectively.

the parameters and the pricing factors. I regress the estimated monthly pricing factors on the end-of-month observed yields to obtain the matrix of loadings implied by those pricing factors. That matrix multiplied by the daily yields plus an intercept gives an estimate of the daily pricing factors. Finally, the estimated parameters (with monthly data) along with the estimated daily pricing factors are used to fit—and decompose—the yields at the daily frequency.

## 4 Decomposing the Yields of Emerging Markets

This section shows that the decompositions of the sovereign yields of emerging markets obtained with the survey-augmented model are sensible. It highlights the benefits of using synthetic curves and survey data when analyzing those yields. Among the many potential applications of the decompositions, the next section applies them to characterize the response of emerging market yields to U.S. monetary policy.

### 4.1 Model Fit

Figure 3 illustrates the fit of the model for the synthetic yields. The focus is on the 10-year maturity for the sake of brevity. In general, the model fits the data reasonably well. The squared root of the average (across months and maturities) squared difference between the actual and the fitted yields is commonly used to summarize the fitting errors. The average fitting error for the synthetic yields of emerging markets is 16 basis points, a reasonable fit. For reference, the average fitting error for the nominal yields of the advanced economies in the sample is 5 basis points, in line with previous studies (Wright, 2011). The dynamics of emerging market yields are thus relatively harder to capture.<sup>33</sup>

### 4.2 Robustness

The estimated model is used to decompose the yields, but the extent to which any application provides valuable insights hinges on the reliability of the decomposition. To

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<sup>33</sup>Notwithstanding, it is important to keep in mind that for some countries, large fitting errors might be an indication of less liquid and deep markets.

assess its robustness, I compute the standard errors for each component using the delta method. Specifically, since each yield component  $\Psi$  is a function of the parameters  $\theta$  in the model,  $\Psi = g(\theta)$ , its distribution is calculated based on the following

$$\sqrt{N} \left( \widehat{\Psi} - \Psi \right) \xrightarrow{d} \mathcal{N} \left( 0, \Gamma \Omega \Gamma' \right),$$

in which  $\Omega$  is the asymptotic covariance matrix of the estimator  $\widehat{\theta}$  and  $\Gamma$  is the Jacobian matrix of partial derivatives calculated numerically.  $\Omega$  is estimated using the sample Hessian estimator  $\widehat{\Omega} = \widehat{\mathcal{H}}_{\theta}^{-1}$ , for which the second derivative matrix of the log-likelihood function evaluated at the optimum,  $\widehat{\mathcal{H}}_{\theta}$ , is also calculated numerically.

Although there is uncertainty in both the parameters and the pricing factors after the estimation, the effect of uncertainty associated with the pricing factors on each component is usually small.<sup>34</sup> Therefore, when applying the delta method, I assume that the pricing factors are known with certainty. Figures D.1 and D.2 in the appendix display the term premium and the credit risk compensation along with their confidence bands. The bands seem reasonable and illustrate the benefits of using survey data. Specifically, surveys help in obtaining robust yield decompositions for emerging markets, consistent with the findings of Guimarães (2014) for the U.S. and the U.K.

### 4.3 Decomposition Assessment

Table 2 summarizes the decomposition of the nominal yields of emerging markets.<sup>35</sup> Average expected short rates explain most of the variability in nominal yields. Meanwhile, the relevance of the term premium increases with maturity, whereas the credit risk compensation is broadly stable. On average, the three parts respectively represent around 58, 30 and 12% of the 10-year nominal yields of emerging markets.

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<sup>34</sup>To verify this, at each period, I compute the standard errors by pre- and post-multiplying the variance of the pricing factors (generated by the Kalman filter) by the respective factor loadings for the fitted yields, the average expected future short rate and the term premium. In all cases, the average standard error (over time and across countries) is less than 9 basis points for emerging markets, and less than 3 basis points for advanced economies.

<sup>35</sup>The decompositions for advanced economies are not displayed for two reasons. First, they have already been studied before, see for instance Wright (2011) and Adrian et al. (2019). Second, the dataset does not include survey data for advanced economies and so their decompositions may not be robust. They are nonetheless a useful benchmark to assess some results (e.g. average fitting errors above).

Figure 4 shows the decomposition of the 10-year yield for each country, from which two patterns emerge. First, the term premium and the credit risk compensation are time-varying and both play an important role in the dynamics of yields. Although their relative importance varies by country, the term premium plays a relatively bigger role, in general. Second, there is a downward trend in the expected future short rate and the term premium of several countries, consistent with the evidence for advanced economies (Wright, 2011; Adrian et al., 2019).

In addition, the results for individual countries are consistent with their particular circumstances. For instance, the expected short rate in Mexico increased during the tightening cycle that started following the 2016 U.S. presidential election, after which market participants expected a deterioration in the bilateral relation. The credit risk compensation for Hungary increased after 2010, when the current populist government came into power. Also, the term premium in Poland declined after the global financial crisis as in other European countries in response to the unconventional monetary policies of the European Central Bank. The following sections assess each part individually.

#### **4.3.1 Expected Future Short Rate**

Figure 5 shows that the 10-year expected future short rate agrees with the (inferred) long-term forecasts for the short rate reasonably well, even though the model does not rely too much on them given the conservative value of 75 basis points used for  $\sigma_s$ . When  $\sigma_s$  is allowed to be estimated, its average value across all emerging markets is 31 basis points. Yet the results are based on the conservative value as discussed in section 3.3.1.

#### **4.3.2 Term Premium**

While the (bond) risk premium is usually associated with the term premium in advanced economies, the two concepts are different in emerging markets. The purpose of leveraging on synthetic yields (and surveys) is to estimate a genuine term premium, clean of credit risk. This subsection assesses the sensibility of this ‘clean’ term premium.

The survey-based term premium serves as a robustness check for the model-implied

term premium. It is a model-free measure that equals the difference between the *synthetic* yield and the short rate forecast over the same horizon. Since the model-implied expectations track the short rate forecasts closely (see figure 5), the two measures of term premia comove positively, with a correlation of 0.52 across countries.

Wright (2011) documents a downward trend in the term premia of advanced economies and argues that it owes in part to a reduction in inflation uncertainty. Since inflation in emerging markets tends to be higher and more volatile than in advanced economies (Ha et al., 2019), it is reasonable to assume that the relationship between the term premia and inflation uncertainty is particularly relevant in emerging markets. To test this hypothesis, I run the following panel regressions

$$\tau_{i,t} = \alpha_i + \beta_1 \sigma_{i,t}^\pi + \beta_2 GDP_{i,t} + u_{i,t}, \quad (17)$$

in which  $\alpha_i$  are country fixed effects,  $\sigma_{i,t}^\pi$  is a measure of inflation uncertainty,  $GDP_{i,t}$  is the domestic real GDP growth to control for the business cycle, and  $u_{i,t}$  is the error term. The dependent variable  $\tau_{i,t}$  is the model-implied term premium at different maturities. Following Wright (2011), the measure of inflation uncertainty is the standard deviation of the permanent component of inflation based on the Stock–Watson unobserved components stochastic volatility (UCSV) model, estimated using quarterly data for each country.<sup>36</sup> To test for significance, I use the Driscoll–Kraay estimator that allows the errors to be correlated across countries and over time.<sup>37</sup>

Table 3 shows that the response of the term premium to the standard deviation of the permanent component is significant and increases with maturity. The result becomes stronger after controlling for the business cycle. Even though the specification might be subject to econometric problems since it involves persistent variables and ignores measurement error, the results are aligned with the view that term premia compensate investors for bearing inflation uncertainty also in emerging markets.

Finally, a term premium becomes negative when investors see bonds as hedges and are

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<sup>36</sup>The UCSV model assumes that inflation has permanent and transitory components subject to uncorrelated shocks that vary over time.

<sup>37</sup>The Pesaran test of cross-sectional independence is rejected in all cases at the 1% significance level.

therefore willing to give up some investment return. This phenomenon has been reported for advanced economies before, especially after the global financial crisis. Figure D.3 in the appendix shows that negative term premia is not an advanced economy phenomenon. In Asia, the demand for LC bonds has increased since 2011 due to strong macroeconomic fundamentals (IMF-WB, 2020), which partly explains the negative term premia seen for Korea, Malaysia, the Philippines and Thailand. Moreover, figure D.3 also shows that some countries experience negative term premia only at the short end of their yield curves, suggesting that investors in LC bonds have a particular preference for short-term LC bonds, especially after the global financial crisis.<sup>38</sup>

### 4.3.3 Credit Risk Compensation

The role of the credit risk compensation in explaining yield variation is non-negligible (see table 2), and thus it matters which curve is used (nominal or synthetic) for decomposing the yields of emerging markets. Unlike the term premium, no clear trend is visible for the credit risk compensation, nor a pattern is detected when looking across maturities. The dynamics are in line with the results reported by Du and Schreger (2016) who, in particular, show that it is highly correlated with the CDS of the respective country.

Given that both the term premium and the credit risk compensation help explain yield variation in emerging markets, a natural question is whether and how they are related. However, while the term premium compensates investors for bearing the uncertainty that interest rates might suddenly increase, the credit risk compensation actually rewards them for two things. One is a compensation for the *expected* loss owing to default, whereas the other compensates them for bearing the *uncertainty* that defaults might be larger than expected. Attempting to isolate those two parts is beyond the scope of this paper. Therefore, interpreting any potential correlation between the term premium and the credit risk compensation is not straightforward. For several countries, the term premium and the credit risk compensation are negatively correlated in the data as is the case between the average expected future short rates and the credit risk compensation, which

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<sup>38</sup>Notice that figure D.3 also shows that term premia increase with maturity, indicating that long-term bonds are seen as riskier than short-term bonds.



suggests that the expected component of the credit risk compensation is empirically more relevant.<sup>39</sup> Intuitively, inflating away the debt would reduce the need to default. Galli (2020) shows that inflation and default are indeed substitutes in models of debt dilution, although he argues for a positive correlation between inflation and default.<sup>40</sup>

## 5 U.S. Monetary Policy Spillovers

This section applies the decomposition described in previous sections to analyze the transmission channels of U.S. monetary policy to emerging market yields. It documents a strong and persistent response of emerging market yields to U.S. monetary policy surprises, and provides evidence of a yield curve channel for the U.S. monetary policy.

### 5.1 The Yield Curve Channel

Under the traditional Mundell-Fleming trilemma—the impossibility of combining free capital flows, a fixed exchange rate and an independent monetary policy—a flexible exchange rate helps to insulate a financially-open economy from shocks abroad. Rey (2013) argues that a flexible exchange rate does not fully offset those shocks because there is a global financial cycle—mainly driven by U.S. monetary policy—operating through channels other than the exchange rate, like the comovement of global asset prices and cross-border bank lending. The cycle thus drives portfolio flows in or out of emerging markets, influencing their domestic financial conditions.

The literature describes different mechanisms—that can be collectively referred to as the yield curve channel—through which the global financial cycle in general and U.S. monetary policy in particular influence the yields of emerging markets. Central banks in those countries can independently exert control over the short end of their yield curves, but are less powerful swaying the long end because long-term yields are more influenced

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<sup>39</sup>On the one hand, the term premium and the *uncertainty* component of the credit risk compensation are likely to move in the same direction. On the other hand, the average expected future short rates and the *expected* component of the credit risk compensation are likely to move in opposite directions.

<sup>40</sup>Alternatively, market segmentation can also explain the negative correlation. For instance, if only foreign investors require to be compensated for bearing risks, synthetic yields will increase (potentially due to a higher term premium) but not nominal yields, reducing the spread between the two.

by global forces than short-term yields (Obstfeld, 2015). Therefore, the global financial cycle has larger effects at the long end than at the short end of the yield curve, limiting the effectiveness of domestic monetary policy to steer the economy since the entire yield curve is relevant for the spending decisions of households and firms. In particular, monetary policy decisions in advanced economies aimed at affecting long-term yields (particularly the term premium), like forward guidance and quantitative easing, spill over to emerging market yields via the term premium (Turner, 2014; Kolasa and Wesolowski, 2020),<sup>41</sup> as well as through the expected future short rate, particularly at the short end due to risk spillovers (Kalemli-Özcan, 2019). Thus, emerging markets indeed remain subject to global risks even when borrowing in local currency (Carstens and Shin, 2019).

### 5.1.1 Comovement of Yields

To formally assess whether different sections of the yield curves of emerging markets comove more than others, I use the connectedness index of Diebold and Yilmaz (2014) for different maturities.<sup>42</sup> The index assesses shares of forecast error variation in a country's bond market due to shocks arising elsewhere. It fluctuates between 0 and 100%, with higher numbers indicating a higher degree of comovement.

Figure 6a shows that the long-term yields of emerging markets are indeed more connected than short-term ones, especially since the taper tantrum episode of 2013. Figure 6b shows that the long-term yields of advanced economies are even more connected among themselves. The degree of comovement among the long-term yields of emerging markets is half (around 35%) that of yields of advanced economies (around 70%), suggesting that the medium- and long-term bonds of emerging markets are mostly held by local investors.<sup>43</sup> If so, local factors still play a role in explaining the long end of their curves.<sup>44</sup>

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<sup>41</sup>Adrian et al. (2019) find that the correlation of the term premia in long-term yields has increased after the global financial crisis. Turner (2014) argues that changes in the U.S. term premium spill over into the term premia of emerging markets.

<sup>42</sup>Following Adrian et al. (2019) and Bostanci and Yilmaz (2020), I compute the index using a VAR(1), with a forecast horizon of 10 days and a rolling window of 150 days for the daily changes of yields.

<sup>43</sup>According to Kolasa and Wesolowski (2020), the share of foreign investors in the LC bonds of emerging markets increased from 10% in 2008 to 25% in 2019.

<sup>44</sup>Figure D.4 in the appendix reports essentially the same patterns but using one-year rolling correlations of daily yield changes at different maturities rather than the connectedness index.

### 5.1.2 Drivers of Yields

The yield curve channel requires one to distinguish between interest rates at different maturities and calls attention to the role of the U.S. term premium. Here I assess the role of the components of U.S. yields (the average expected future short rate and the term premium) in explaining emerging market yields and their components at different maturities. In fact, the assessment of the yield curve channel would be limited without the decomposition of U.S. and emerging market yields. For this purpose, I run the following panel regressions

$$y_{i,t} = \alpha_i + \gamma'_1 z_{i,t}^1 + \gamma'_2 z_{i,t}^2 + u_{i,t}, \quad (18)$$

in which  $\alpha_i$  are country fixed effects,  $z_{i,t}^1$  is a vector containing the components of the U.S. yield curve,  $z_{i,t}^2$  is a vector of global and domestic variables that potentially drive the yields, and  $u_{i,t}$  is the error term. The dependent variables  $y_{i,t}$  are the nominal yields and their three components for the 10- and 2-year maturities.<sup>45</sup> As before, I use Driscoll–Kraay standard errors to test for significance.<sup>46</sup>

The explanatory variables of interest are the components of U.S. yields, which come from the model of Kim and Wright (2005), who address the small sample problem using survey forecasts of future short rates. I control for the monetary stance and local macroeconomic conditions using the policy rate reported by each country to the Bank for International Settlements, as well as domestic inflation and unemployment rates. Rey (2013) highlights the role of the Cboe’s volatility index (Vix) as an important driver of the global financial cycle, which reflects the implied volatility in stock option prices and is usually seen as a measure of risk aversion and economic uncertainty.<sup>47</sup> Baker et al. (2016) construct a news-based economic policy uncertainty (EPU) index that serves as the basis for the global and U.S. versions,<sup>48</sup> which are used as alternative, and arguably exoge-

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<sup>45</sup>Kalemli-Özcan (2019) focuses on yields with maturities of 1 year or less. Here I focus on the 2-year yield because is a benchmark commonly used by market participants. The conclusions based on the 10- and 2-year maturities carry on for the 5- and 1-year maturities, which are reported in appendix C. The 1-year maturity is the shortest one for which the decomposition of U.S. yields used here is available.

<sup>46</sup>The Pesaran test of cross-sectional independence is rejected in all cases at the 1% significance level.

<sup>47</sup>Given the sudden spikes in the index, it is common to use it in logs. For consistency, the other uncertainty indexes are also used in logs.

<sup>48</sup>Although the EPU index has been replicated for different countries, it is only available for five of

nous, measures of global uncertainty. The index of global economic activity proposed by Hamilton (2019) captures real variables. Finally, the exchange rate (LC per USD) is included to rule out explanations of changes in yields based on currency movements; the exchange rate is standardized for each country over the sample period.

Tables 4 and 5 report the results. The evidence is in line with the yield curve channel.<sup>49</sup> First, the response of the average expected future short rates of emerging markets to the domestic policy rate decreases with maturity and is positively associated with its U.S. counterpart only at the long end, both results are in line with the argument that monetary autonomy is stronger at the short end than at the long end of the curve. Second, the response of the term premia of emerging markets to the U.S. term premium increases with maturity and is positively associated with the Vix only at the long end, both results align with the claim that the U.S. term premium, and the global financial cycle in general, is more relevant for the long end than for the short end of the curve. Third, the U.S. term premium not only influences the yields in emerging markets through its effect on their term premia but through the other components too. In particular, I can directly test the hypothesis of Kalemli-Özcan (2019) regarding risk spillovers to the short rate thanks to the yield decompositions. Risk spillovers to the average expected future short rates of emerging markets indeed decrease with maturity and operate mainly through the U.S. term premium than via the Vix. These conclusions would be different if one fails to account for credit risk and thus merges the term premium and credit risk components.

A glimpse on the drivers of the yields of emerging markets is a byproduct of the analysis on the yield curve channel. For instance, inflation and unemployment are key domestic variables. In particular, the term premium and the credit risk compensation are countercyclical, investors demand higher compensations during recessions, when the unemployment rate increases. Moreover, the positive association between inflation and the term premium conforms with the idea that inflation erodes the value of nominal bonds and so, in periods of rising inflation investors expect the central bank to tighten

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the emerging markets in the sample: Brazil, Colombia, Mexico, Russia and South Korea.

<sup>49</sup>The tables report the estimates for the full specification of the model. The results are robust to specifications of the model that progressively include the regressors for each dependent variable.

its monetary stance going forward, demanding a higher term premium. As expected for measures of risk and uncertainty, shifts in the Vix are positively associated with the term premium and credit risk compensation. Also, higher global economic uncertainty induces a flight to quality, whereas higher U.S. economic uncertainty leads to a reduction in the perceived credit quality.<sup>50</sup> Lastly, there is evidence supporting the risk-taking channel of exchange rates,<sup>51</sup> according to which a currency appreciation is associated with easier financial conditions (and compressed sovereign bond spreads) due to balance sheet effects. However, here it works through the expected future short rate and the term premium rather than through the credit risk compensation as reported by Hofmann et al. (2019).

So far, the yield decompositions have been valuable to assess the validity of the yield curve channel and understand the driving forces behind the sovereign yields of emerging markets. Yet the specification in equation (18) may suffer from econometric problems such as persistent variables, reverse causality and omitted variables. Moreover, the measures of comovement are unconditional, so not specifically driven by monetary policy surprises.

## 5.2 Identification of Monetary Policy Surprises

Surprises in monetary policy decisions are identified using intraday data on asset prices around Fed’s monetary policy announcements in order to capture changes in the information set of market participants. Asset price changes are calculated from 15 minutes before to 1 hour and 45 minutes after each Federal Open Market Committee (FOMC) meeting since 2000 giving a total of 162 events.<sup>52</sup> The surprises are set to zero in non-announcement days. Neither minute releases nor speeches by Fed officials are included.

Gürkaynak et al. (2005) and Swanson (2018) show that monetary policy has more than one dimension. Asset prices respond to different types of news about monetary policy. Following Rogers et al. (2018), I consider three separate types of U.S. monetary policy surprises, referred to hereinafter as target, forward guidance and asset purchase

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<sup>50</sup>The coefficient for the EPU Global index in the expected short rate column is negative, while the coefficient for the U.S. EPU index in the credit risk compensation column is positive.

<sup>51</sup>According to the standard trade-channel effect, an appreciation is contractionary because it discourages exports and stimulates imports, reducing the trade balance.

<sup>52</sup>Following Gürkaynak et al. (2005), I exclude the meeting of September 2001.

surprises. Target surprises are equal to the change in the yield on the current- or next-month federal funds futures contracts, as proposed by Kuttner (2001). Forward guidance surprises are equal to the residual from regressing the yield change for the 8-quarters ahead Eurodollar futures contract onto the target surprise.<sup>53</sup> Asset purchase surprises are equal to the residual from regressing the yield change in the 10-year Treasury futures contract onto the target and forward guidance surprises. By construction, the three types of surprises are uncorrelated. Positive values in any of the surprises represent a tightening of the monetary policy stance, and vice versa.

The relevance of the surprises has varied over time. After 2008, there were no changes in the current policy rate until December 2015, so target surprises were essentially zero during that period. Meanwhile, asset purchase surprises are considered starting in October 2008 because their meaning is unclear before that date. Forward guidance surprises have nevertheless been relevant before and after the global financial crisis. Table C.3 in the appendix reports descriptive statistics for the three types of surprises. In general, the Fed has been more aggressive in stimulating than in contracting the U.S. economy, since easing surprises are larger on average and more common than tightening surprises.

### 5.3 The Effects on Emerging Market Yields

The transmission of U.S. monetary policy to the yields of emerging markets is assessed using panel local projections for the daily changes in the yields.<sup>54</sup> While event studies report the response of the variables on the day of a surprise, local projections additionally provide the responses over subsequent periods. It is important to be able to capture the persistence in the response of emerging market yields given the pervasive post-announcement drift in the bond markets of advanced economies documented by Brooks et al. (2019). In addition, I leverage on the yield decompositions at the daily frequency to better understand the transmission of Fed's decisions to the yields.

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<sup>53</sup>The 4-quarters ahead Eurodollar futures contract could also be used, but intraday changes in that contract were essentially zero after 2011 since market participants expected no change in the policy rate for at least a year. Eurodollar futures contracts are bets on the future level of 3-month interest rates.

<sup>54</sup>Jordà (2005) advocates the use of local projections as an alternative to VAR models in order to generate impulse responses that are robust to misspecification. See Hofmann et al. (2019) and Adrian et al. (2019) for recent applications of panel local projections.

Specifically, I run the following panel local projections:

$$y_{i,t+h} - y_{i,t-1} = \alpha_{h,i} + \sum_{j=1}^3 \beta_h^j \epsilon_t^j + \gamma_h \Delta y_{i,t-1} + \eta_h s_{i,t-1} + u_{i,t+h}, \quad (19)$$

in which  $h$  indicates the horizon (in days) with  $h = 0, 1, \dots, 45$  and each  $\epsilon_t^j$  represents one of the three types of monetary policy surprises.<sup>55</sup> The regressions include country fixed effects  $\alpha_{h,i}$ , a lag of the dependent variable,<sup>56</sup> and a lag of the exchange rate  $s_{i,t-1}$ . The regressions are ran for the 10- and 2-year nominal yields and each of their components. The confidence bands are constructed using Driscoll–Kraay standard errors, which allow for time and cross-sectional dependence.

The parameters of interest,  $\beta_h^j$ , measure the average response of the nominal yield (or its components) to monetary policy surprise  $j$  at horizon  $h$ . The contemporaneous effects (when  $h = 0$ ) are indicated with an arrow in the figures below. All responses are assessed relative to a one basis point reduction (an easing) in any of the surprises, since the Fed has been more aggressive in that direction over the sample period.

The response of U.S. yields and their components to the three surprises serves as a benchmark to assess the responses of the yields of emerging markets. As before, U.S. yields come from the dataset of Gürkaynak et al. (2007), and the components from the decomposition proposed by Kim and Wright (2005). The responses are reported in figures D.5 to D.8 in the appendix. They are consistent with the findings in the existing literature. For instance, target easing surprises reduce yields, mainly driven by a decline in the average expected future short rates; while forward guidance and asset purchase easing surprises decrease yields, in part due to a reduction in the term premium.

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<sup>55</sup>There is no need to control for past or future surprises since, by definition, they are unanticipated by the market. On the other hand, even though the types of surprises are uncorrelated by construction, the estimation is more efficient when all the surprises are included simultaneously.

<sup>56</sup>As argued by Hofmann et al. (2019), the large number of daily observations reduces the potential for Nickell bias that arises by including a lagged dependent variable in panel regressions with fixed effects and small time dimensions. Indeed, the impulse responses reported here are essentially the same when the lag of the dependent variable is excluded.

### 5.3.1 Target Surprises

Figure 7 shows the response of emerging market yields to a target easing surprise. Although the magnitude of the contemporaneous yield response is lower than in the U.S., it builds over time. This delayed response is documented by Brooks et al. (2019) for the U.S. and by Adrian et al. (2019) for a sample comprised mostly of advanced economies,<sup>57</sup> which they attribute to a portfolio rebalancing channel. Moreover, the reaction to forward guidance and asset purchase surprises is also sluggish, as discussed later. Therefore, slow-moving capital is also present in the bonds of emerging markets.<sup>58</sup>

Looking at the effects of a target easing surprise on the yield components in figure 7, investors expect central banks in emerging markets to follow the monetary stance of the Fed as can be seen in the decline of the expected future short rate (particularly at the short end); in fact, most of the effect is reflected on that component. Note that there is no effect on the credit risk compensation at the short end and there is essentially no effect on the term premia. However, the credit risk compensation at the long end increases one month after the surprise. Mechanically, both the nominal and synthetic yield curves steepen (since short rates decline) but in a way that the long end of the synthetic yield curve declines by more than the nominal one, and so borrowing (long-term) synthetically in LC becomes cheaper; equivalently, the opportunity cost of lending (long-term) directly in LC increases. As a result, the nominal-synthetic spread at the long end rises (by almost one-to-one) in the month following the surprise. Intuitively, loose financial conditions abroad trigger a ‘reach for yield’ behavior among investors (Hausman and Wongswan, 2011) that can incentivize more borrowing in emerging markets by sovereigns in local currency (Bigio et al., 2018) and by corporates in foreign currency<sup>59</sup>. In either case, the price of default risk (not necessarily the risk itself) increases. This effect can be seen as the fiscal implications in emerging markets of Fed’s monetary policies. Credit risk compensation is thus an important factor to understand the transmission of U.S. monetary policy to

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<sup>57</sup>It is also seen in the responses of U.S. yields reported in appendix D.

<sup>58</sup>Figure D.11 in the appendix shows that the delayed responses are not driven by the response of the forward premium, the term added to the U.S. yield curve to construct the synthetic yields.

<sup>59</sup>Du and Schreger (2017) show that higher reliance on foreign currency borrowing by corporates increases sovereign default risk in emerging markets.



emerging market yields.

In sum, economically significant spillovers from target easing surprises build over time reducing the expected future short rate and increasing the long term credit risk compensation of emerging markets, so U.S. monetary policy spillovers do not need to involve the term premium. The potential fiscal implications for emerging markets of Fed’s monetary policies has not been discussed so far in the literature.

### **5.3.2 Forward Guidance Surprises**

Since U.S. monetary policy spillovers to long-term yields increased after the global financial crisis (Albagli et al., 2019), figures 8 and 9 display the responses of emerging market yields to a forward guidance easing surprise before and after October 2008, respectively.

Before the global financial crisis, a forward guidance easing surprise led to a downward parallel shift in the yield curves of emerging markets in the month following the surprise. The effect on emerging market yields lasted longer than on U.S. yields, and was generally driven by a decline in all three components; at the long end, it was especially through a decline in the expected short rate and the term premium. In this sense, investors expected central banks in emerging markets to follow the Fed’s monetary stance.

After the global financial crisis, the transmission of forward guidance easing surprises changed. The decline in the nominal yields of emerging markets at the long end lasts less than in long-term U.S. yields. Therefore, the nominal yield curve in emerging markets steepens relative to the U.S. yield curve in the month following the surprise, so the nominal-synthetic spread in emerging market yields widens at the long end. The intuition is similar to the one for target surprises above. A loose future path of the U.S. policy rate trigger a ‘reach for yield’ behavior among investors and might incentivize more borrowing in emerging markets by sovereigns in local currency and/or by corporates in foreign currency, which increases the price of default risk.

Moreover, the response of the term premia at the long end is similar in emerging markets than in the U.S. By making announcements about the future path of the federal funds rate, the Fed attempts to reduce long-term U.S. yields mainly by reducing the term

premium (see figure D.7). Figure 9 shows that those announcements also reduce the term premia in emerging market yields at the long end. This is where accounting for credit risk pays off because if it were to be ignored, one would incorrectly conclude that forward guidance does not affect the term premia in emerging markets. The reason is that the ‘clean’ term premium and the credit risk compensation components respond in opposite directions with magnitudes that almost offset each other, so there is no net effect in the term premium contaminated with credit risk.

In relation to the yield curve channel, a forward guidance easing surprise not only reduces the term premia at the long end but also the expectation for the policy rate at the short end, which supports the risk spillovers mechanism in Kalemli-Özcan (2019).

### 5.3.3 Asset Purchase Surprises

Figure 10 shows that an asset purchase easing surprise flattens the yield curve in emerging markets, similar to the effect on the U.S. yield curve (see figure D.8). In both cases, the effect at the long end is larger than at the short end. The on-impact response of U.S. yields is larger, whereas the response of the nominal yields of emerging markets lasts longer. These two effects in turn explain the response of the credit risk compensation at the long end, which initially increases followed by a sluggish and considerable decline. The counterintuitive initial increase is more a reflection of the response in the U.S. Treasuries market than on the bond markets in emerging economies. Indeed, an asset purchase easing surprise triggers a strong investor reaction in the market for U.S. Treasuries, leading to a more than one-to-one on-impact decline in the long-term U.S. yield (see figure D.8a). The eventual decline in the credit risk compensation as well as the reduction in the term premium reflect a relaxation of global financial conditions, so investors are more willing to buy the long-term debt of emerging markets.

In terms of the yield curve channel, an asset purchase easing surprise reduces the term premia at the long end the expectation for the policy rate at the short end, similar to the effect of a forward guidance easing surprise after 2008. These results show up in figures 9 and 10 but not in figures 7 and 8, so the yield curve channel is a relatively recent

phenomenon that coincides with the implementation of unconventional monetary policies by the Fed after the global financial crisis. Those policies transmit to emerging market yields through their different components, thus limiting the influence central banks in emerging markets can exert over their domestic yield curves.

## 6 Concluding Remarks

This paper decomposes the sovereign yields of 15 emerging markets taking into account the credit risk embedded in them, and empirically quantifies the transmission channels of U.S. monetary policy to them. Emerging market nominal yields are decomposed into average expected future short rates, a term premium and compensation for credit risk.

The responses to target, forward guidance and asset purchase surprises are sluggish but amplify over time. In addition, surprises in Fed's policy decisions lead to a reassessment of policy rate expectations in emerging markets and a repricing not only of interest risk but also of credit risk. This last effect is an unexplored but prospective area for future research. Lastly, since the global financial crisis, U.S. monetary policy has spilled over to emerging markets through a yield curve channel, which limits their monetary autonomy along their yield curves. The results in this paper show that, in order to adequately characterize the transmission channels of U.S. monetary policy, it is important to explicitly account for credit risk in the local currency debt of emerging markets and to examine the effects at different maturities.

The results presented here can be extended in several directions. The proposed three-part decomposition of emerging market yields has many applications, such as analyzing the transmission of monetary policy domestically and further decomposing each part (e.g. average expected short rates can be split into inflation and real interest rate expectations). The results might also inform theoretical models for pricing sovereign defaultable bonds. Finally, surprises from other central banks in advanced economies can be included in the analysis of monetary policy spillovers.

**Table 1.** Descriptive Statistics of Yield Curves

		3M	6M	1Y	2Y	5Y	10Y
Nominal	Emerging Markets						
	Average	5.1	5.3	5.4	5.7	6.3	6.8
	Std. D.	3.2	3.3	3.2	3.2	3.0	2.9
	Advanced Economies						
	Average	2.0	2.1	2.1	2.3	2.7	3.2
	Std. D.	2.1	2.1	2.1	2.1	2.0	1.8
Synthetic	Emerging Markets						
	Average	5.1	5.2	5.3	5.3	5.8	6.3
	Std. D.	4.3	4.1	4.0	3.7	3.4	3.2
	Advanced Economies						
	Average	1.6	1.7	1.8	2.0	2.5	3.2
	Std. D.	2.1	2.1	2.2	2.1	2.0	2.0

*Notes:* This table reports the average and the standard deviation using end-of-month data for different tenors of the nominal and synthetic yields of the emerging markets and advanced economies in the sample. All figures are expressed in annualized percentage points.

**Table 2.** Descriptive Statistics for the Decomposition of Emerging Market Yields

	3M	6M	1Y	2Y	5Y	10Y
Expected Short Rate						
Average	4.9	4.9	4.9	4.9	4.7	4.2
S. Dev.	3.7	3.4	3.1	2.9	2.5	2.1
Term Premium						
Average	0.2	0.3	0.3	0.5	1.1	2.2
S. Dev.	1.0	1.3	1.4	1.4	1.6	2.0
Credit Risk Compensation						
Average	0.7	0.7	0.8	0.8	0.9	0.9
S. Dev.	1.0	0.9	0.9	0.9	0.9	0.9

*Notes:* This table reports the average and the standard deviation using end-of-month data for different tenors of the components of the emerging market nominal yields. All figures are expressed in annualized percentage points.

**Table 3.** Term Premia and Inflation Volatility

	6 Months		1 Year		2 Years		5 Years		10 Years	
UCSV-Perm	79.8*	81.1*	78.8**	93.0**	84.4***	105.2***	98.3***	128.7***	118.3***	159.3***
	(30.3)	(34.0)	(23.2)	(32.6)	(20.2)	(27.5)	(18.1)	(25.3)	(18.4)	(27.0)
GDP Growth		-0.49		0.021		1.35		1.66		-0.11
		(2.26)		(2.64)		(1.95)		(1.41)		(2.62)
Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Lags	3	3	3	3	3	3	3	3	3	3
No. Countries	15	14	15	14	15	14	15	14	15	14
Observations	870	796	870	796	870	796	870	796	870	796
$R^2$	0.07	0.06	0.06	0.06	0.08	0.10	0.13	0.16	0.14	0.18

*Notes:* This table reports the slope coefficients of panel data regressions of the model-implied term premia for different maturities on the standard deviation of the permanent component of inflation according to the UCSV model (UCSV-Perm) and GDP growth. The sample includes quarterly data for 15 countries starting in 2000:I and ending in 2018:IV. The term premia is expressed in basis points. GDP growth is expressed in percent. Driscoll–Kraay standard errors are in parenthesis; lag length up to which the residuals may be autocorrelated is indicated. \*, \*\*, \*\*\* asterisks respectively indicate significance at the 10%, 5% and 1% level.

**Table 4.** Drivers of the Emerging Market 10-Year Nominal Yield and Its Components

	Nominal	E. Short Rate	Term Premium	Credit Risk
U.S. Term Premium	0.97*** (0.14)	0.66*** (0.10)	0.73*** (0.05)	-0.37*** (0.10)
U.S. E. Short Rate	0.17 (0.09)	0.13* (0.06)	0.21*** (0.05)	-0.21*** (0.05)
Local Policy Rate	0.24*** (0.03)	0.50*** (0.03)	-0.20*** (0.02)	-0.03* (0.01)
Inflation	15.26*** (2.27)	-1.24 (2.70)	10.01*** (1.99)	5.69*** (1.48)
Unemployment	23.88*** (3.43)	-1.43 (2.74)	13.16*** (1.25)	10.93*** (2.11)
LC per USD (Std.)	41.58*** (5.74)	45.82*** (5.04)	9.60*** (2.25)	-10.02** (3.27)
Log(Vix)	49.95*** (12.63)	-28.79** (10.24)	37.61*** (8.12)	41.64*** (8.96)
Log(EPU U.S.)	7.08 (5.58)	-4.34 (3.82)	0.22 (2.93)	10.64** (3.74)
Log(EPU Global)	-61.04** (20.51)	-37.16** (11.88)	-21.37* (8.89)	-7.44 (9.62)
Global Ind. Prod.	1.16 (1.13)	-0.09 (0.84)	0.71* (0.36)	0.73 (0.86)
Fixed Effects	Yes	Yes	Yes	Yes
Lags	4	4	4	4
No. Countries	15	15	15	15
Observations	2194	2194	2194	2194
$R^2$	0.68	0.72	0.48	0.24

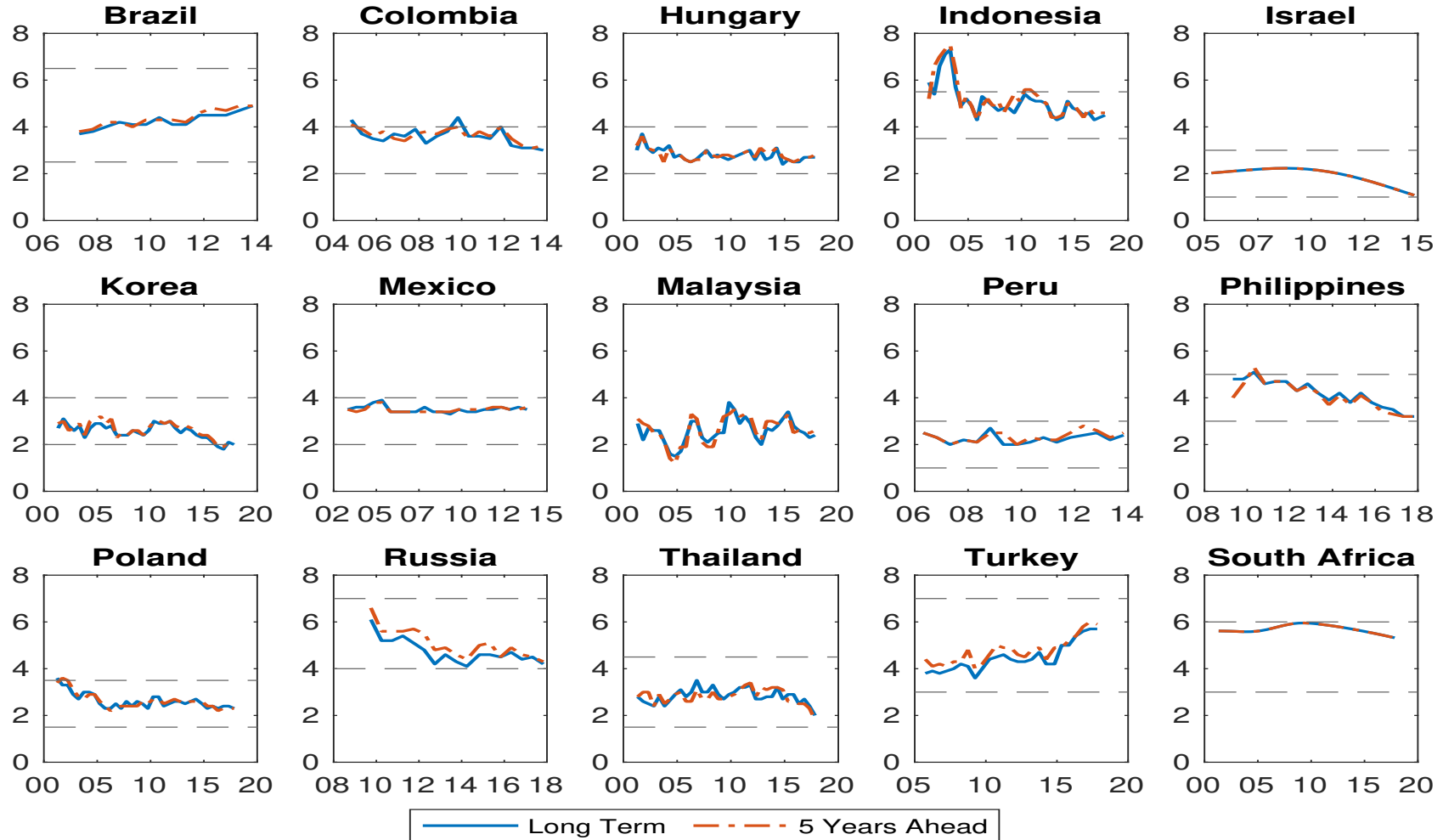
*Notes:* This table reports the estimated slope coefficients of panel data regressions of the 10-year nominal yield and its components (expected short rate, term premium and credit risk compensation) on selected explanatory variables. The sample includes monthly data for 15 emerging markets starting in 2000:1 and ending in 2019:1. The dependent variables are expressed in basis points. The explanatory variables are the U.S. term premium and the U.S. expected short rate according to Kim and Wright (2005) with the same maturity as the dependent variables, the policy rate, domestic inflation and unemployment, the standardized exchange rate (local currency per USD), the log of the Vix, the log of the U.S. and global economic policy uncertainty indexes based on Baker et al. (2016), the global economic activity index of Hamilton (2019). Driscoll–Kraay standard errors in parenthesis; lag length up to which the residuals may be autocorrelated is indicated. \*, \*\*, \*\*\* asterisks respectively indicate significance at the 10%, 5% and 1% level.

**Table 5.** Drivers of the Emerging Market 2-Year Nominal Yield and Its Components

	Nominal	E. Short Rate	Term Premium	Credit Risk
U.S. Term Premium	1.59*** (0.22)	1.57*** (0.22)	0.70*** (0.13)	-0.67*** (0.19)
U.S. E. Short Rate	-0.03 (0.04)	-0.05 (0.04)	0.08*** (0.02)	-0.08* (0.03)
Local Policy Rate	0.64*** (0.03)	0.72*** (0.04)	-0.03 (0.02)	-0.02 (0.02)
Inflation	8.91*** (2.25)	-0.76 (3.61)	7.97*** (2.16)	3.21 (1.92)
Unemployment	9.39** (2.91)	-5.52 (2.93)	4.99** (1.54)	9.20*** (1.73)
LC per USD (Std.)	27.18*** (4.84)	38.28*** (5.44)	5.04 (2.92)	-8.47* (3.86)
Log(Vix)	46.41*** (8.16)	-28.91* (12.45)	0.39 (7.85)	76.84*** (10.79)
Log(EPU U.S.)	8.42* (3.82)	-2.56 (5.04)	-5.16 (3.00)	13.09*** (3.74)
Log(EPU Global)	-60.39*** (13.69)	-48.37*** (12.20)	-6.33 (7.54)	-4.15 (9.71)
Global Ind. Prod.	2.61*** (0.68)	-0.72 (0.88)	-0.01 (0.51)	3.03*** (0.67)
Fixed Effects	Yes	Yes	Yes	Yes
Lags	4	4	4	4
No. Countries	15	15	15	15
Observations	2194	2194	2194	2194
$R^2$	0.80	0.74	0.22	0.34

*Notes:* This table reports the estimated slope coefficients of panel data regressions of the 2-year nominal yield and its components (expected short rate, term premium and credit risk compensation) on selected explanatory variables. The sample includes monthly data for 15 emerging markets starting in 2000:1 and ending in 2019:1. The dependent variables are expressed in basis points. The explanatory variables are the U.S. term premium and the U.S. expected short rate according to Kim and Wright (2005) with the same maturity as the dependent variables, the policy rate, domestic inflation and unemployment, the standardized exchange rate (local currency per USD), the log of the Vix, the log of the U.S. and global economic policy uncertainty indexes based on Baker et al. (2016), the global economic activity index of Hamilton (2019). Driscoll–Kraay standard errors in parenthesis; lag length up to which the residuals may be autocorrelated is indicated. \*, \*\*, \*\*\* asterisks respectively indicate significance at the 10%, 5% and 1% level.

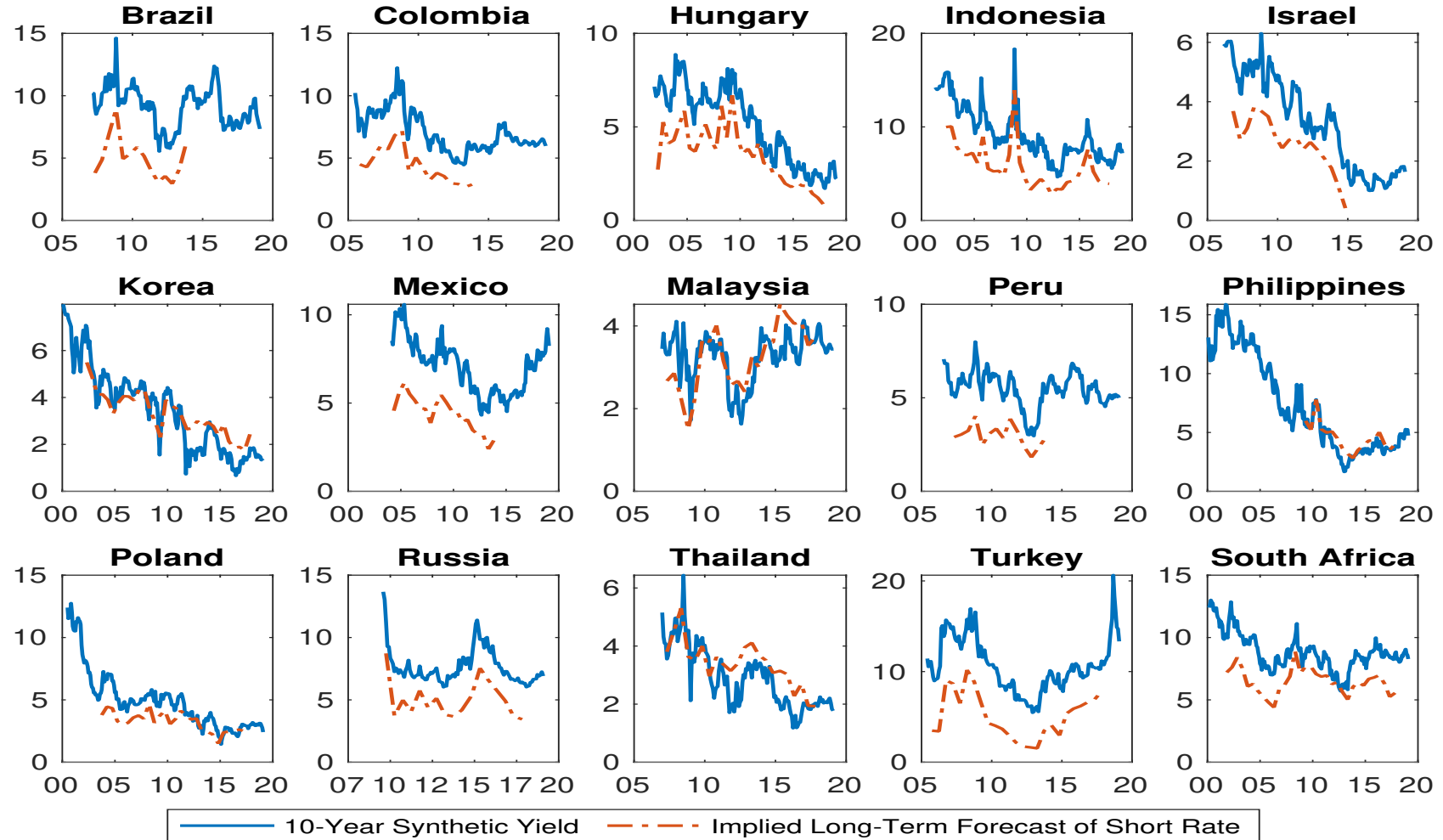
Figure 1. Long-Horizon Forecasts of Inflation



*Notes:* This figure plots the 5-years ahead (dashed line) and the 5- to 10-years ahead or long-term (solid line) average consumer price inflation forecasts against the survey date. For Israel and South Africa, the figure shows the inflation trend, see appendix A. The figure also includes the upper and lower bounds for the domestic inflation target, where applicable. The upper and lower bounds are the most recent ones for each country. For Russia, since it has updated its target range almost every year since early 2000s, the plotted band shows the highest and lowest bounds since 2009.

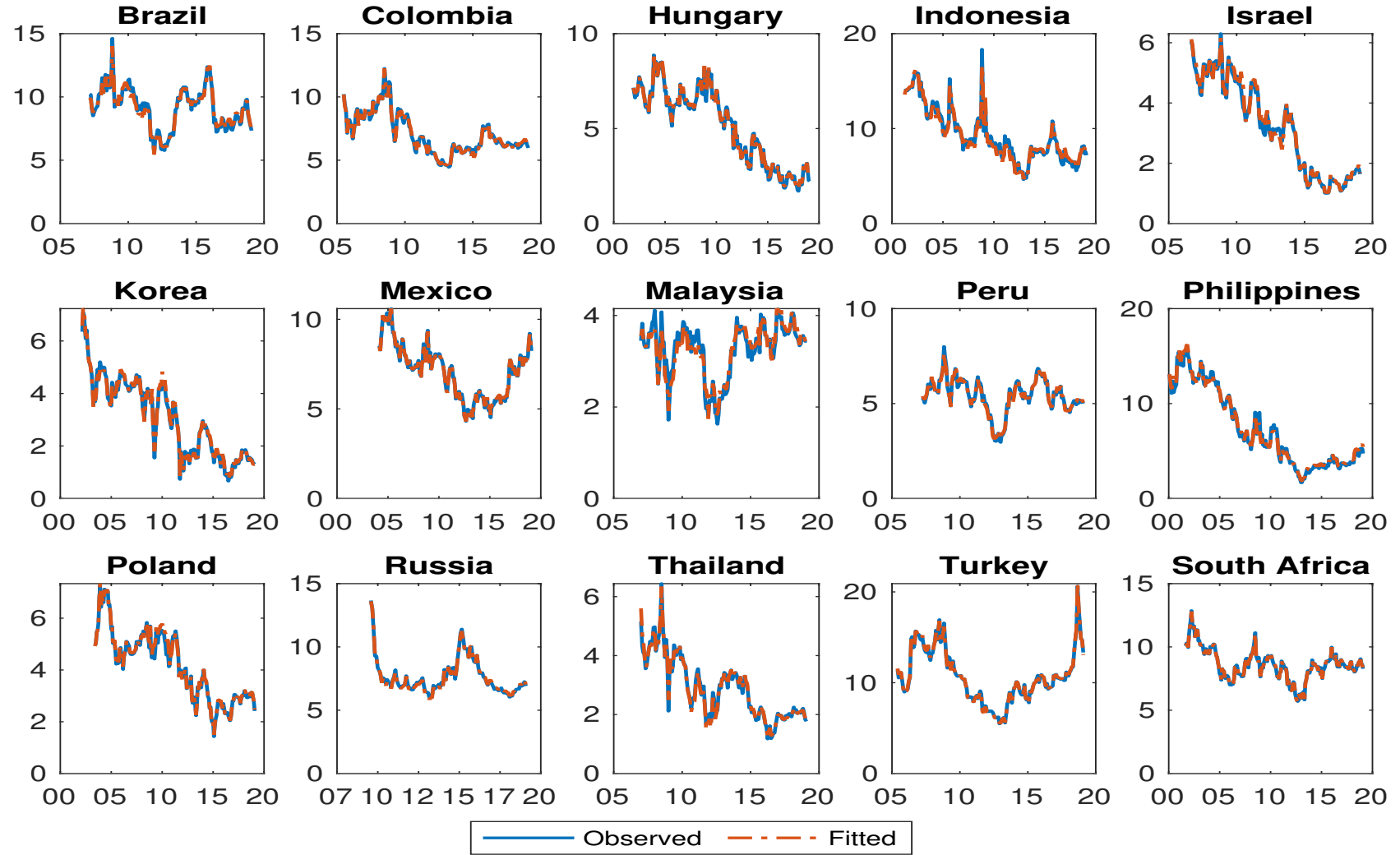


**Figure 2.** 10-Year Synthetic Yields and Long-Horizon Implied Forecasts of the Short Rate



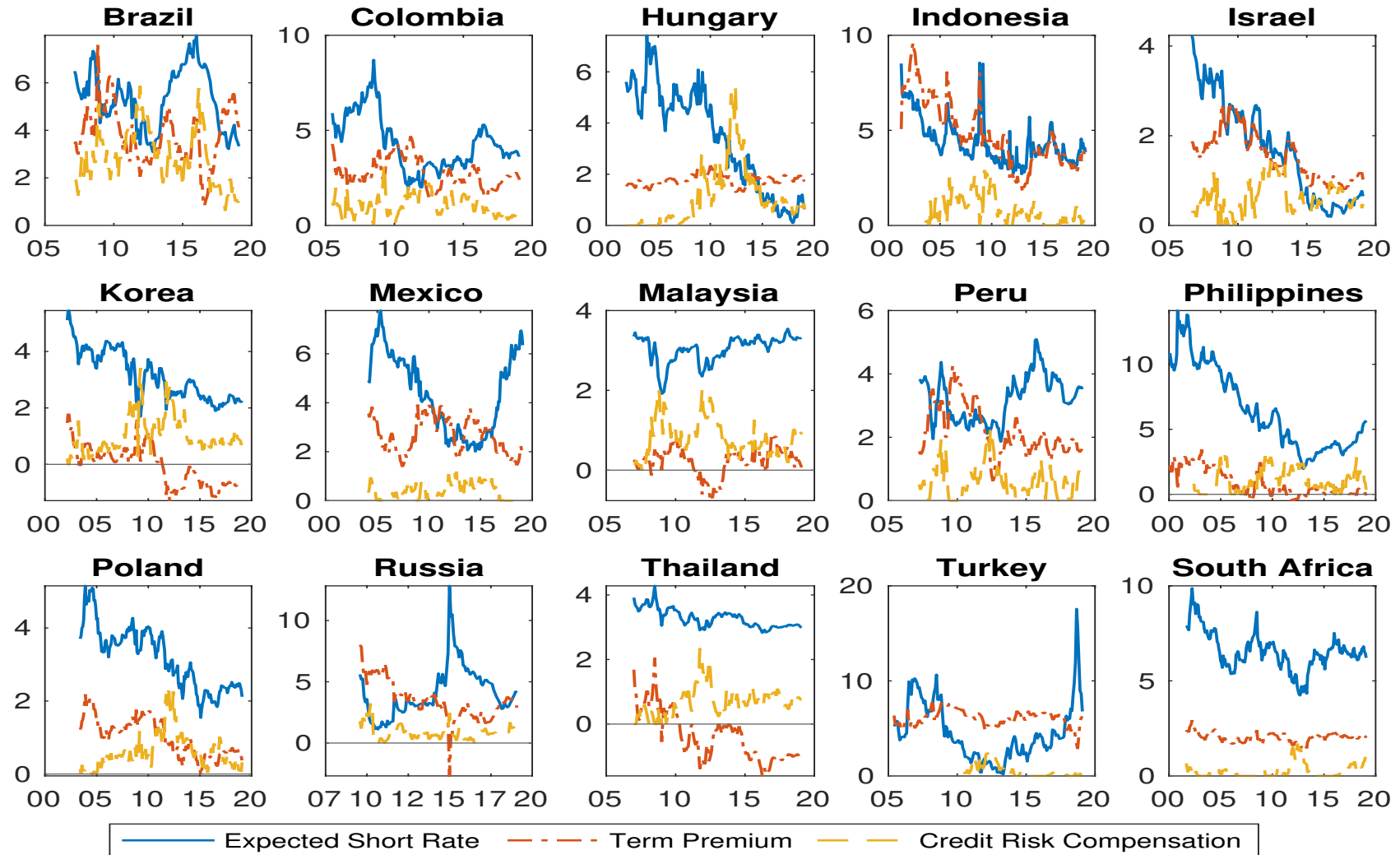
*Notes:* This figure plots the long-horizon implied forecast of the domestic nominal short-term interest rate (dashed line) and the 10-year synthetic yield (solid line). The implied forecast of the short rate is equal to the forecast of the U.S. real short-term interest rate corrected for a real forward premium plus the domestic consumer price inflation forecast, see text for details. The forecast of the U.S. real short-term rate is equal to the difference between the forecast of the three-month U.S. Treasury bill rate and the forecast of the U.S. consumer price inflation.

Figure 3. Model Fit: 10-Year Synthetic Yields of Emerging Markets



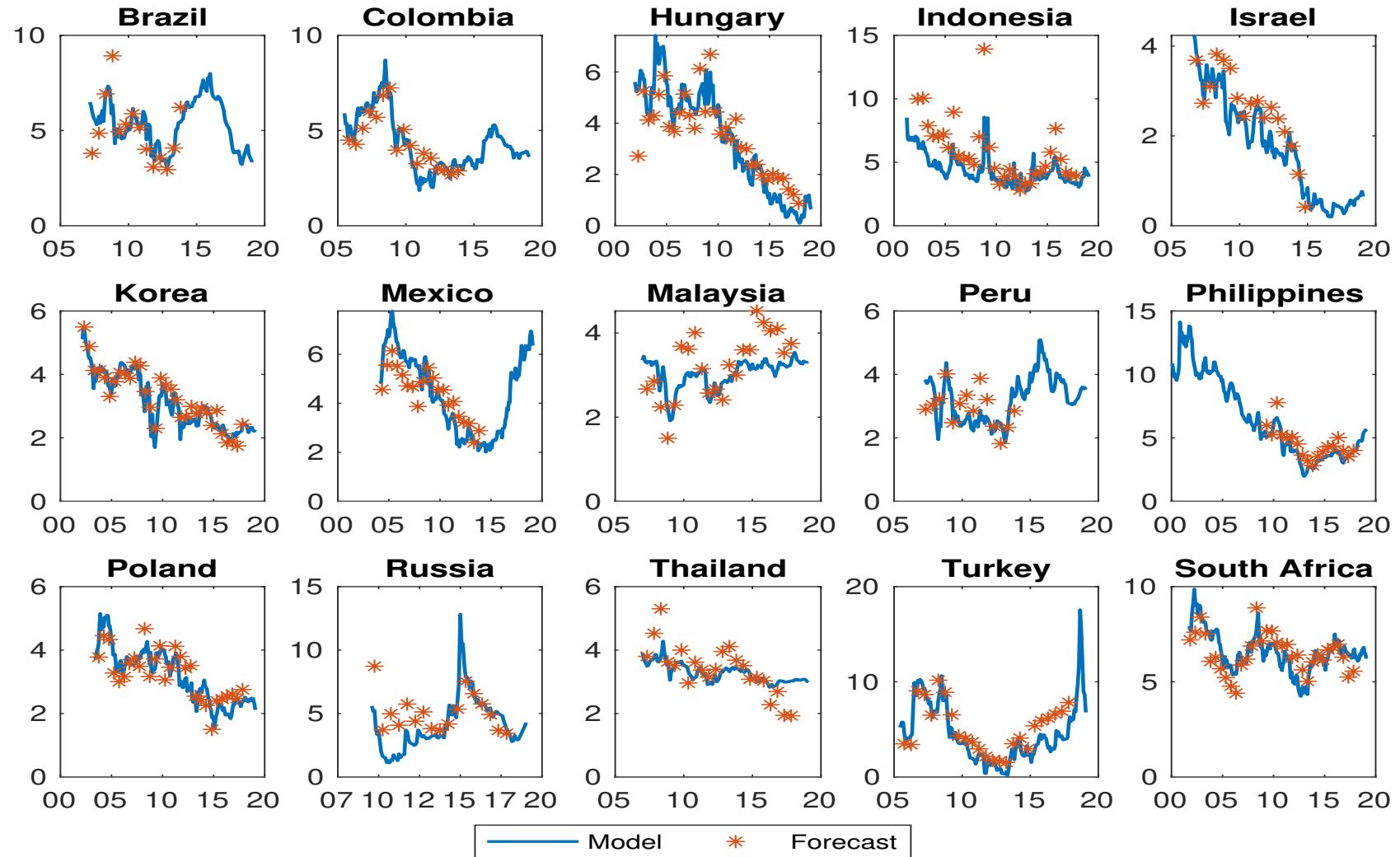
Notes: This figure plots the fitted (dashed line) and the actual (solid line) 10-year synthetic yields. The fitted yield is obtained after estimating the survey-augmented affine term structure model.

Figure 4. Decomposition of the 10-Year Nominal Yields of Emerging Markets



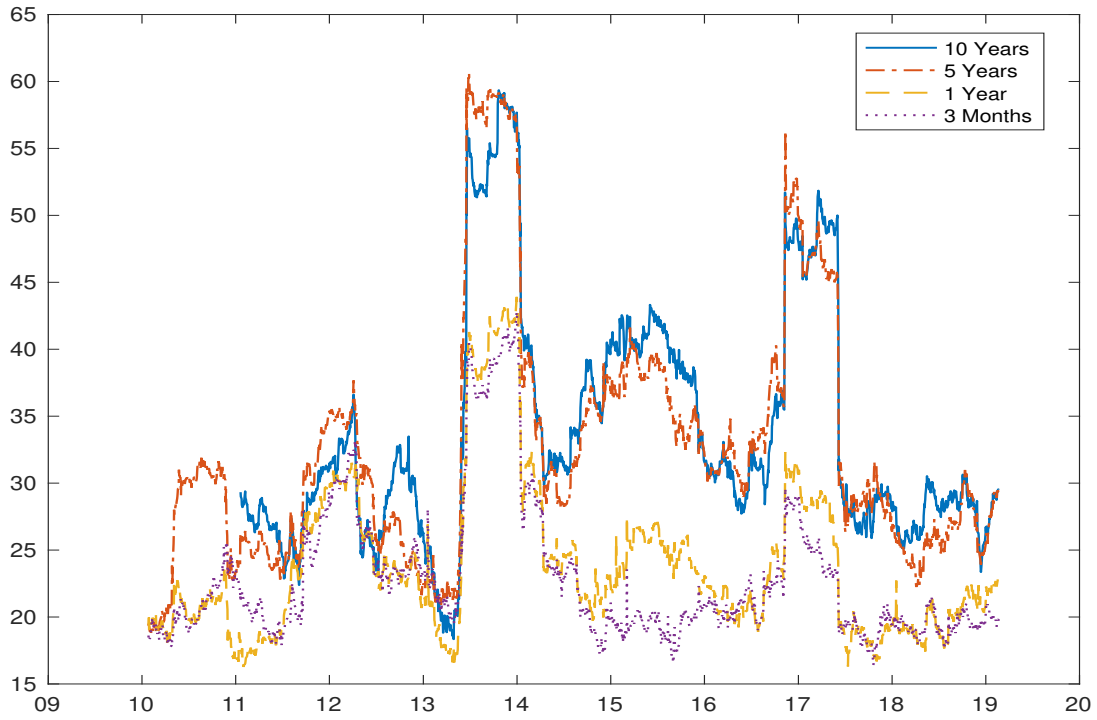
Notes: This figure plots the components of the 10-year nominal yields of emerging markets. The yields are decomposed into an average expected future short-term interest rate (solid line), a term premium (dash-dotted line) and a credit risk compensation (dashed line).

Figure 5. Long Horizon Forecasts vs Model-Implied 10-Year Expected Future Short Rate

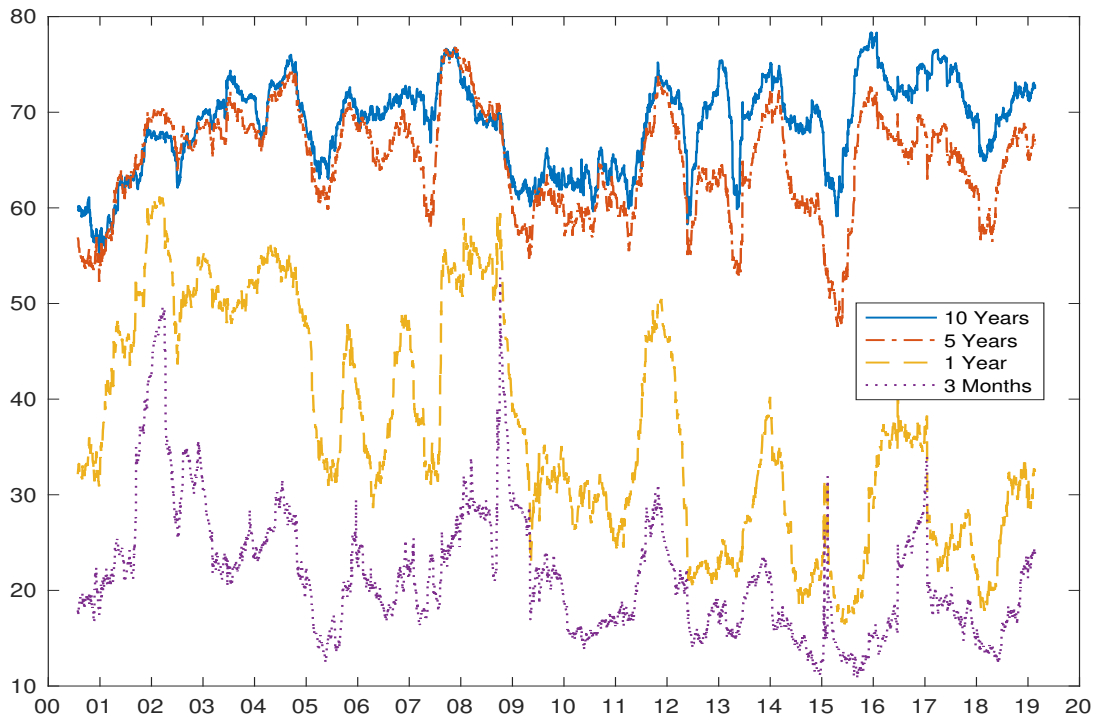


Notes: This figure plots the long-horizon forecast of the domestic short-term interest rate (asterisk) and the 10-year expected future short-term interest rate implied by the model (solid line).

**Figure 6.** Comovement of Yield Curves



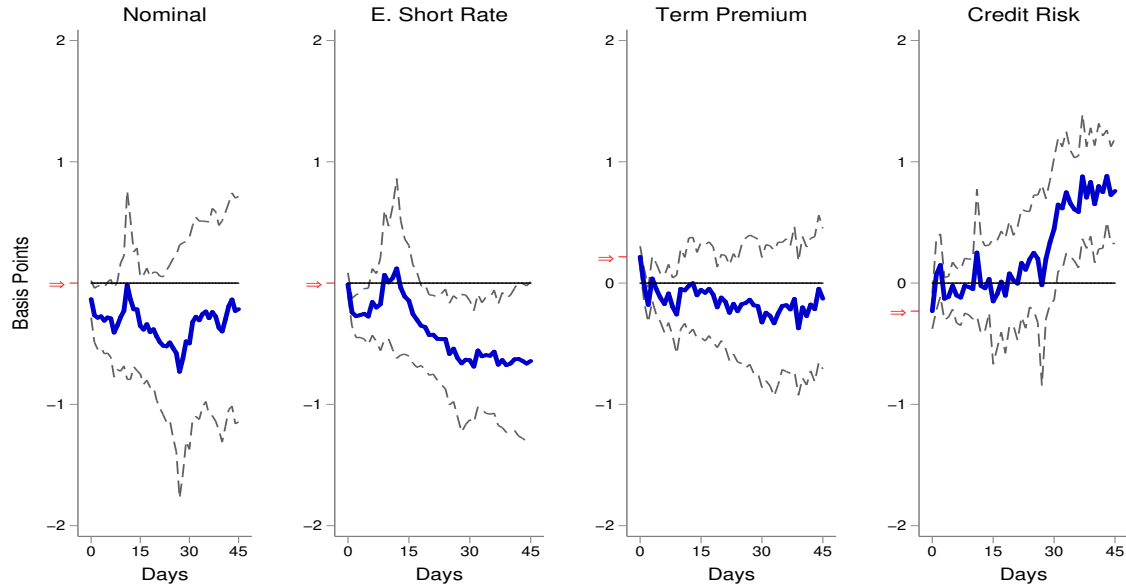
**(a)** Emerging Markets



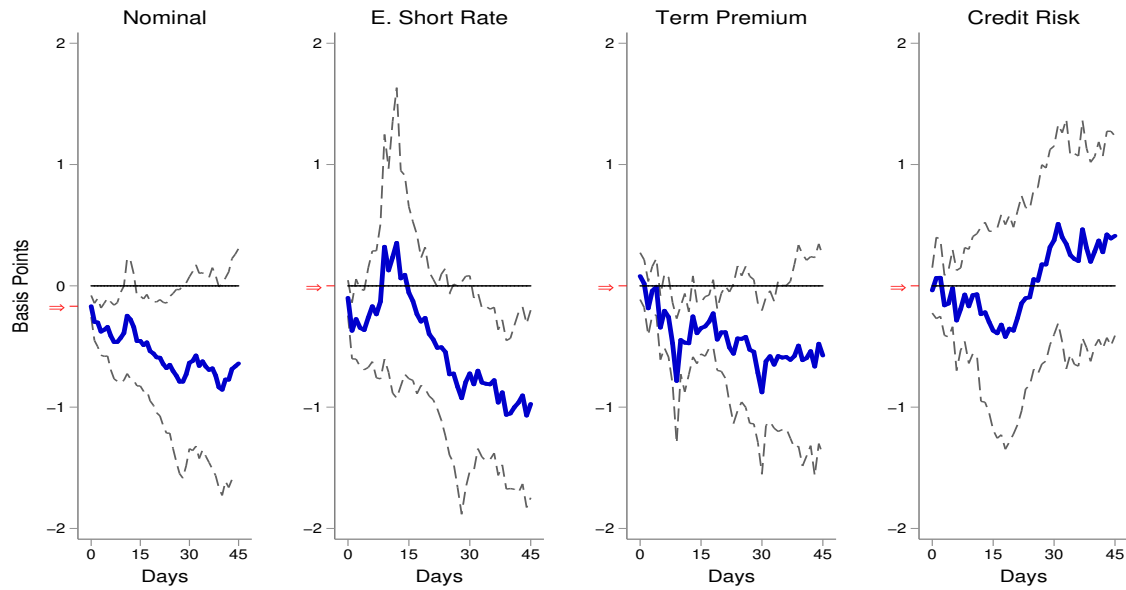
**(b)** Advanced Economies

*Notes:* This figure plots the connectedness index of Diebold and Yilmaz (2014) for the nominal yields of emerging markets and advanced economies for different maturities: 10 years (solid line), 5 years (dash-dotted line), 1 year (dashed line), and 3 months (dotted line). The index is obtained using a vector autoregression of order 1, with a forecast horizon of 10 days and a rolling window of 150 days for the daily changes of the nominal yields at each maturity.

**Figure 7.** Response of the Yield Curve to a Target Surprise



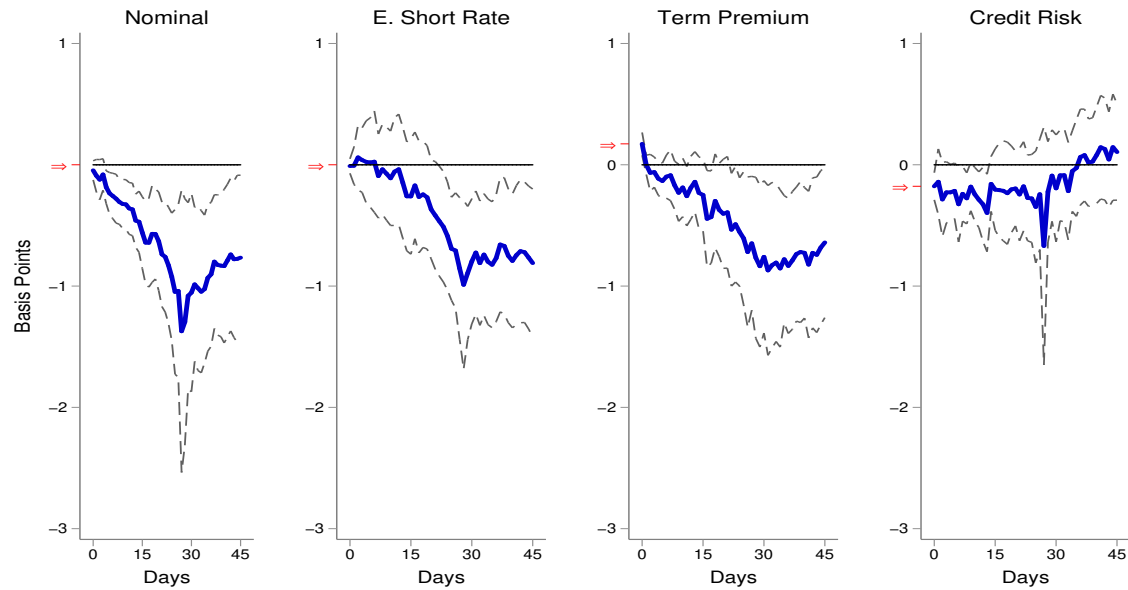
**(a)** 10-Year Yield



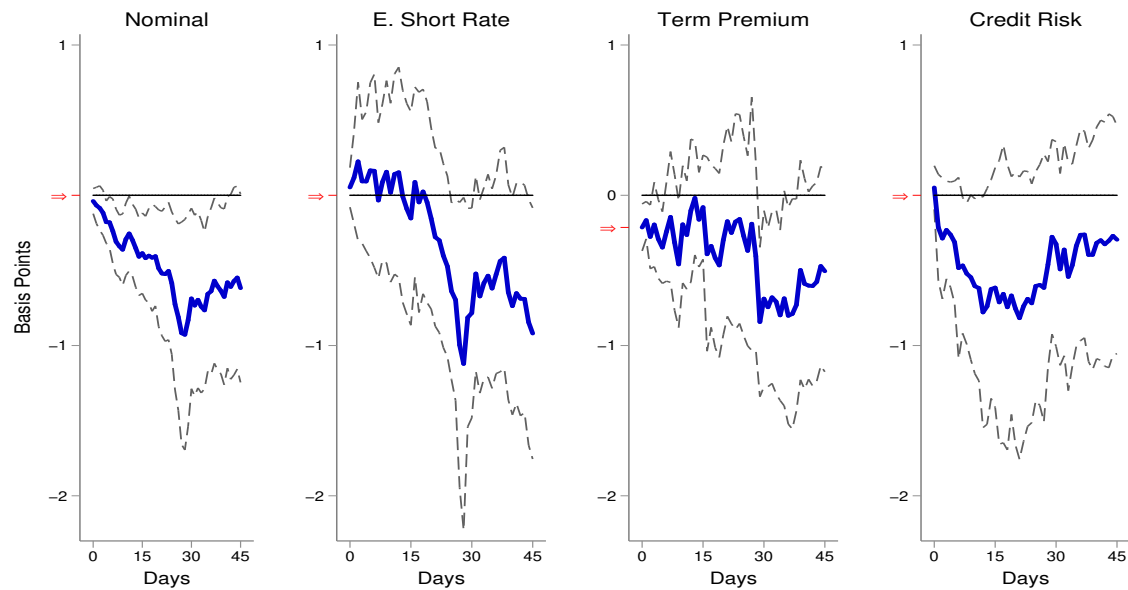
**(b)** 2-Year Yield

*Notes:* This figure shows the response following Jordà (2005) of the 10- and 2-year emerging market nominal yields and their components to a target easing surprise of 1 basis point. Nominal yields are decomposed into an expected future short-term interest rate, a term premium and credit risk compensation, see section 4 for details. Target surprises are identified using intraday data around Fed's monetary policy announcements, see section 5.2 for details. An arrow indicates the contemporaneous ( $h = 0$ ) effect. The 90% confidence bands are based on Driscoll–Kraay standard errors.

**Figure 8.** Response of the Yield Curve to a Forward Guidance Surprise: 2000-2008



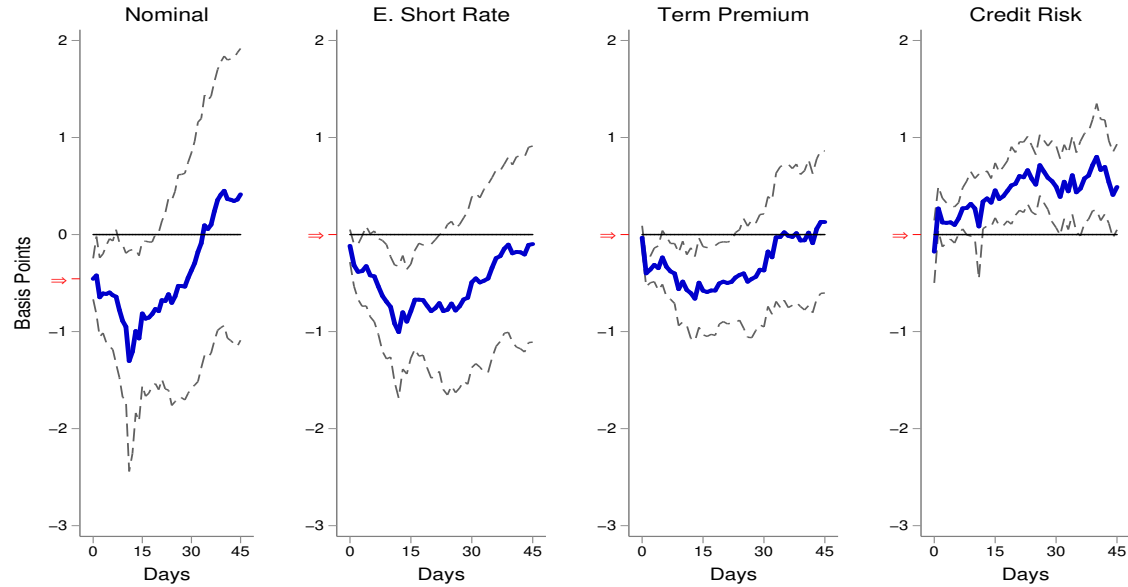
(a) 10-Year Yield



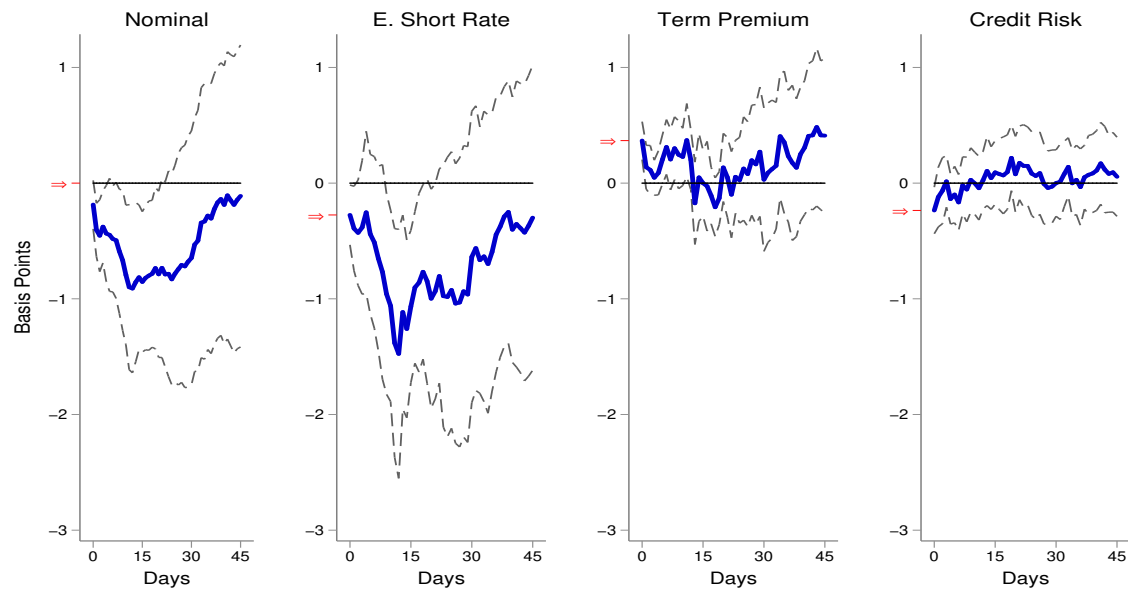
(b) 2-Year Yield

*Notes:* This figure shows the response following Jordà (2005) of the 10- and 2-year emerging market nominal yields and their components to a forward guidance easing surprise of 1 basis point. Nominal yields are decomposed into an expected future short-term interest rate, a term premium and credit risk compensation, see section 4 for details. Forward guidance surprises are identified using intraday data around Fed's monetary policy announcements, see section 5.2 for details. An arrow indicates the contemporaneous ( $h = 0$ ) effect. The 90% confidence bands are based on Driscoll–Kraay standard errors.

**Figure 9.** Response of the Yield Curve to a Forward Guidance Surprise: 2008-2019



(a) 10-Year Yield

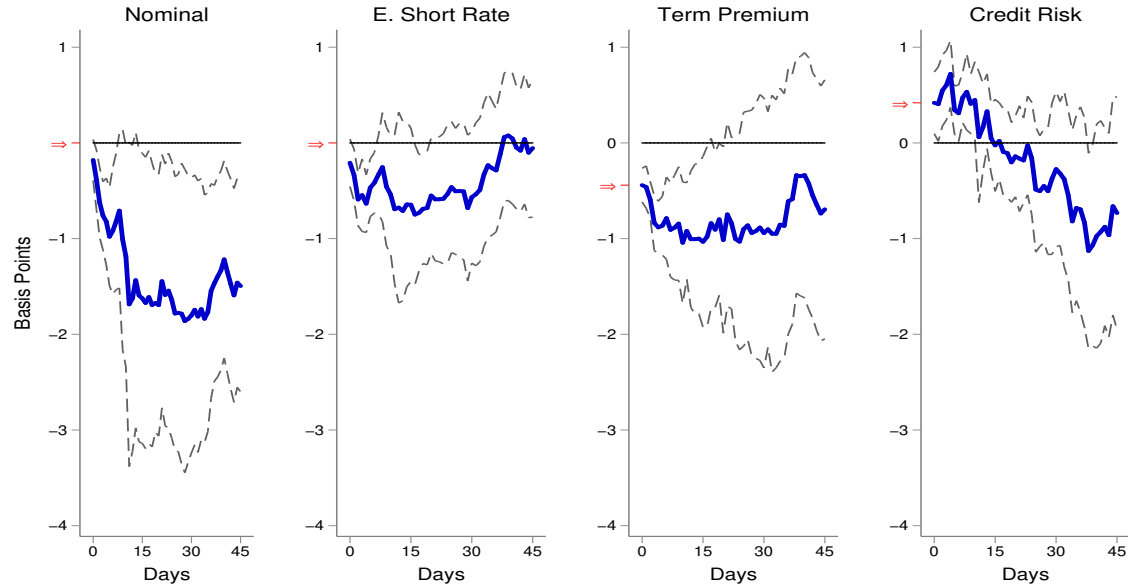


(b) 2-Year Yield

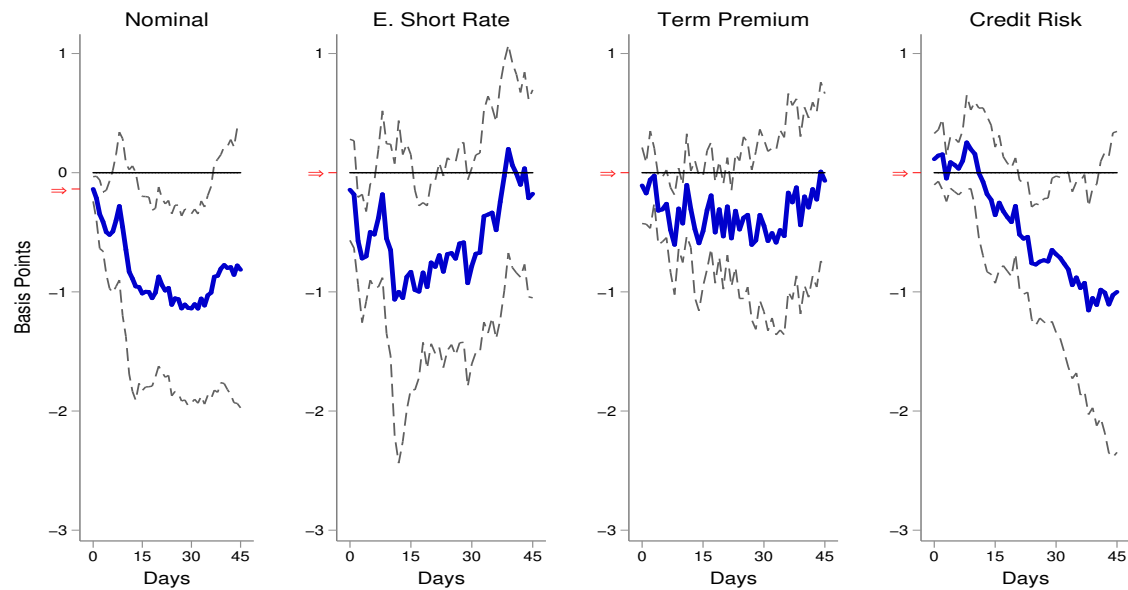
*Notes:* This figure shows the response following Jordà (2005) of the 10- and 2-year emerging market nominal yields and their components to a forward guidance easing surprise of 1 basis point. Nominal yields are decomposed into an expected future short-term interest rate, a term premium and credit risk compensation, see section 4 for details. Forward guidance surprises are identified using intraday data around Fed's monetary policy announcements, see section 5.2 for details. An arrow indicates the contemporaneous ( $h = 0$ ) effect. The 90% confidence bands are based on Driscoll–Kraay standard errors.



**Figure 10.** Response of the Yield Curve to an Asset Purchase Surprise



**(a) 10-Year Yield**



**(b) 2-Year Yield**

*Notes:* This figure shows the response following Jordà (2005) of the 10- and 2-year emerging market nominal yields and their components to an asset purchase easing surprise of 1 basis point. Nominal yields are decomposed into an expected future short-term interest rate, a term premium and credit risk compensation, see section 4 for details. Asset purchase surprises are identified using intraday data around Fed's monetary policy announcements, see section 5.2 for details. An arrow indicates the contemporaneous ( $h = 0$ ) effect. The 90% confidence bands are based on Driscoll–Kraay standard errors.

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