Discussion of:

"Does Monetary Policy Impact International Market co-Movements?"

by Caporin, Pelizzon, and Plazzi

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Summary of the Paper

✓ **What does this paper do?**

- ✗ On the impact of ECB ad FED's announcement on the comovements of equity and Credit Default Swap (CDS) markets,
- ✗ Large cross-section of 18 developed and 21 emerging countries.
- ✗ A five-day window centered around the monetary policy announcements from Aug-2007 to Nov-15.

✓ **What is the key question?**

- ✗ Is unconventional monetary policy associated with a higher degree of comovement?

✓ **What do we learn from the data?**

- ✗ The FED's unconventional monetary policy correlates with an increase in the international comovement, especially for emerging economies and for sovereign credit risk,
- ✗ The ECB's unconventional monetary policy correlates with a decrease in the international comovement.

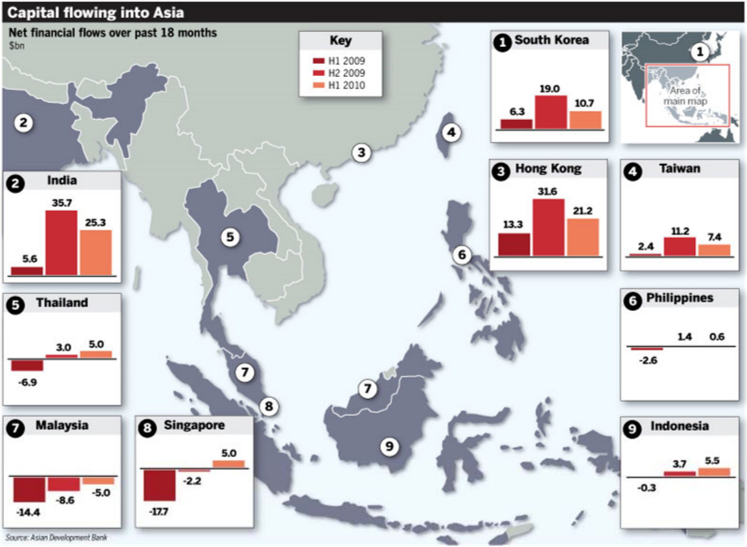
My First Reaction

FED's Unconventional Monetary Policy

- **Federal Reserve and Quantitative Easing**
  - **QE1:** in November 2008, the Fed started buying \$600 billion in mortgage-backed securities
  - **QE2:** in November 2010, the Fed started buying an additional \$600 billion of long-term Treasury securities
  - **QE3:** in September 2012, the Fed launched a \$40 billion per month bond-buying programme of agency mortgage-backed securities, increased to \$85 billion per month in December 2012.

- **Emerging Markets and Quantitative Easing**
  - Asian economies with more open and developed capital markets, have experienced large swings in capital inflows
  - large capital flows were manifest more in portfolio investment and other investment such as bank loans than in foreign direct investment
  - monetary easing of advanced countries have affected Asian countries through either appreciation of currency values or increases in the prices of housing.

Capital Flows to Emerging Markets



The 'Fragile Five'

✓ **Tapering**

- ✗ in May 2013, Ben Bernanke said the Fed will reduce its $85 billion a month in bond purchases by $10 billion starting in January 2014
- ✗ as soon as the Fed scaled back its massive monetary stimulus, emerging economies started to have serious pressures

✓ **The Fragile Five**

- ✗ Morgan Stanley identified Brazil, India, Indonesia, South Africa and Turkey as the "fragile five"
- ✗ these economies are particularly vulnerable to capital outflows due in part to large current account deficits
- ✗ the central banks of these countries have been busy hiking rates to counter plunging currencies
- ✗ governments have yet to face difficult domestic reforms (tax and labour) to attract the long-term investment they need.

Comment I: Creditor vs Debtor Countries?

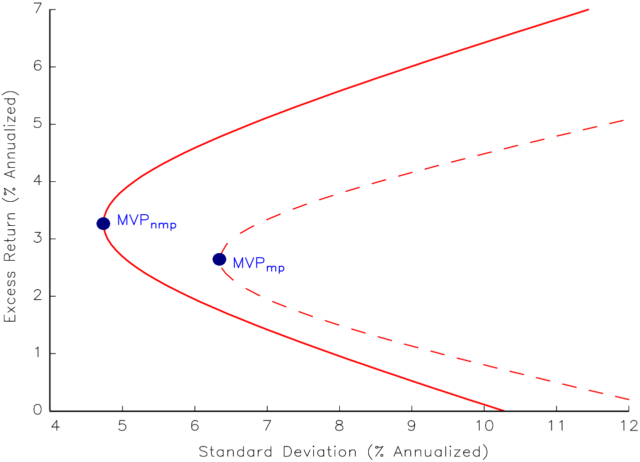
✓ Gross External Financing Requirement: short-term foreign debt + current account deficit

Comment II: What is Economic Value?

“Big or small?”

Comment II: What is the Economic Value

- ✓ Perhaps you can construct the minimum variance portfolios
  - ✗ Under MP announcements, you should observe a diversification loss
  - ✗ the solution only requires the VCV matrix as $w = (\Sigma^{-1}\iota)(\iota'\Sigma^{-1}\iota)$



Comment III: An Alternative Approach?

✓ A dynamic conditional correlation (DCC)

$$\Sigma_t \equiv D_t R_t D_t \tag{1}$$

where D_t is a diagonal matrix of conditional volatilities

$$D_t = diag\left\{h_{1t}^{1/2}, \ldots, h_{kt}^{1/2}\right\} \tag{2}$$

and R_t is the conditional correlation matrix decomposed

$$R_t = \{diag(Q_t)\}^{-1/2} Q_t \ \{diag(Q_t)\}^{-1/2} \tag{3}$$

$$Q_t = \overline{R}(1 - a^2 - b^2) + a^2 z_{t-1} z_{t-1}' + b^2 Q_{t-1} \tag{4}$$

✓ Augment the standard specification with a dummy variable and test if correlation increases around monetary policy announcement.

Additional Comments

- ✓ You can extend the analysis to additional asset classes
  - ✗ Akin to Lettau, Maggiori and Weber (2014), you can test whether there is an additional factor during MP announcements that explains average returns.
- ✓ You could run an event studies
  - ✗ Using intraday returns around MP announcement (two-hour window)
  - ✗ Within a five-day window, short-term reversal and intraday momentum could offset each other
- ✓ It is worth to explore the impact of MP on the FX swap market
  - ✗ The outstanding amount of dollar debt in USD is worth more than $30 trillion

Conclusion

- ✓ It is an interesting paper with lots of new results.
- ✓ The author should look for a plausible explanation.
- ✓ I have enjoyed very much reading it.
- ✓ I look forward to reading the revised version of this paper.
- ✓ I will definitely add it to my reading list.

Thank you!