Discussion of

Demand-Driven Risk Premia in FX and Bond Markets

by I. Krohn, A. Uthemann, R. Vala, J. Yang

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CEPR International Macroeconomics and Finance Programme

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*The views expressed here do not necessarily represent those of the Bank of England or of any of its Committees.

My discussion

- The praise
  - Great paper connecting auction-based demand shocks to global bond and FX markets
  - Crucial for understanding how portfolio-balance forces transmit across borders and asset classes

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- The comments

[#1] Empirical set up

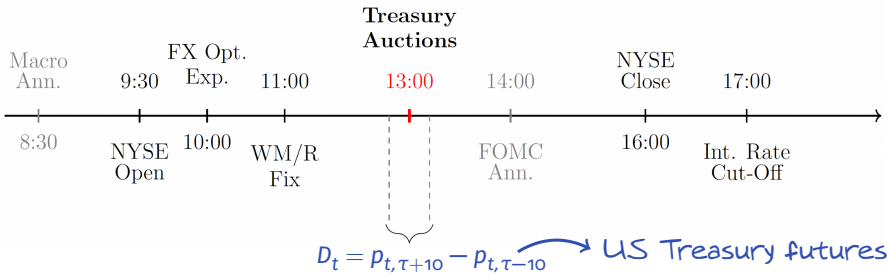
[#2] Linking empirics to theory

[#3] State dependence

[#] Empirical set up

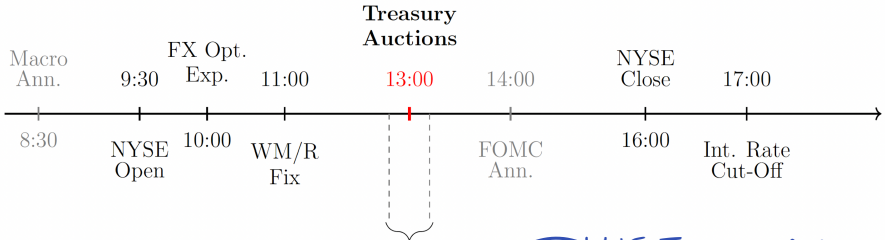
Empirical set-up

- **Shock** 20-minute log-change in US Treasury futures D_t



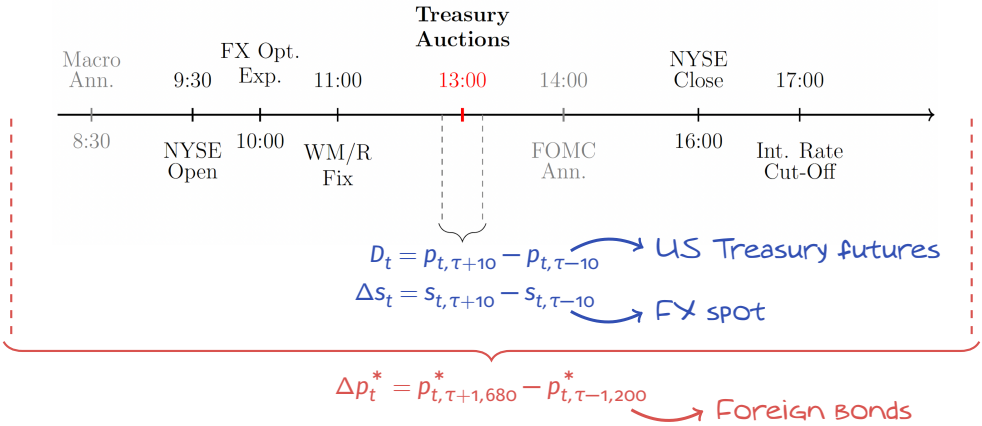
Empirical set-up

- **Dependent variable** 20-minute log-change in FX vis-a-vis USD Δs_t



Empirical set-up

- **Dependent variable** 2-day (!) log-change in foreign bond prices Δp_t^*



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- Foreign bond prices between $t-1$ and $t+1$ reflect more than Treasury demand shocks
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  - If uncorrelated → More noise in Δp^* than in Δs_t can lead to attenuation
- Solution
  - Check correlations
  - Align regression frequencies
  - Drop days with major macro announcements

[#2] Linking Empirics to Theory

Test the model more directly

Term premia

- **Theory** Key insight → Treasury demand shocks reduce domestic and foreign term premia
- **Suggestion** Use term premia estimates from term-structure models in empirical analysis
  - Most of the change in Δp^* should be driven by premia
  - Cross-sectional patterns should hold for term-premia sensitivity
- Term-premia responses would provide a more direct bridge between theory and empirics

Test the model more directly

CIP deviations

- **Theory** Under global-arbitrage benchmark, covered interest parity holds
  - A non-zero currency basis would arises only if derivative or funding markets were segmented
- **Suggestion** Use CIP deviations in empirical analysis
- An opening of the basis would indicate extra arbitrage frictions beyond the baseline model

[#3] State Dependence

State dependence: Balance-sheet constraints

- **State dependence** Treasuries as risky vs. safe haven assets
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- **Alternative interpretation** Arbitrageurs’ risk-bearing capacity
  - The theory includes a risk-tolerance parameter τ that scales all price-impact coefficients
  - The equity–bond correlation may partly capture variation in τ
  - Could test with other proxies: broker-dealer leverage, excess bond premium, etc.

In sum

- A very nice paper ⟶ Clean identification, intuitive results
- Suggestions:
  - Sharpen empirics
  - Tighten link with theory
- Read it!

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