Discussion of "The Role of Liquidity and Term Premia in Emerging Bond Markets: Evidence from Mexico" by Bush, Christensen, Fischer and Solís

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The views expressed here are mine and do not necessarily represent Banco de México's or its board of governors' opinions.

5th CEMLA-Dallas Fed Financial Stability Workshop

Summary: What This Paper Does

Main Question: What are the distinct roles of liquidity and term premia in emerging bond markets, and how do they respond to monetary policy?

Approach:

- Arbitrage-free dynamic term structure model with a liquidity risk factor (Andreasen et al., 2021)
- Estimated on individual Mexican *bonos* prices (2007–2024)
- Decomposes yields into: expected short rates + term premium + liquidity premium

Then uses the decomposition to:

- Study the determinants of each premium (debt-to-GDP, exchange rate, foreign share, bid-ask spreads, . . .)
- Trace the transmission of Banxico and Fed monetary policy surprises (high-frequency surprises + local projections)

Main Findings

- **Liquidity premia** trend upward over the sample, in tandem with the increasing age of outstanding bonds
- **Term premia** fluctuate around a stable level, with short-lived and sometimes abrupt swings
- Exchange rate and debt-to-GDP are important correlates of both premia
- **Monetary policy:**
  - Banxico surprises move mostly expectations, with partially offsetting term premium changes
  - U.S. surprises are a large driver of bonos yields, but with some delay

Key Strengths of the Paper

- First joint estimates of liquidity *and* term premia for an emerging bond market
- Mexico is a natural laboratory: deep market by EM standards, maturities up to 30 years, large foreign participation
- Uses individual bond prices rather than fitted synthetic curves
- Extensive robustness: data frequencies, alternative factor structures, comparison with other term premium measures
- Rich description of the institutional features of the Mexican bond market, valuable in itself
- Decomposes monetary policy transmission (domestic and U.S. spillovers) into expectations, term and liquidity components

Comments

Caveat: I am not an expert in term structure estimation, so I will not focus on the technical aspects of the model

I will focus on four areas:

1. Economics and narrative
2. Interpretation of the liquidity premium
3. Determinants of the premia
4. Monetary policy transmission

1. Economics and Narrative

The paper could tell the reader more about the economics behind the results

- Why is it important to disentangle liquidity and term premia? For policy makers? For debt management? Motivating this upfront would increase the impact

Key question: what explains the post-pandemic liquidity premium?

- Falls to around zero by early 2022, then rises sharply to about 100bp by end-2024, its sample maximum
- Is it age? Age rises gradually over the sample and is roughly flat in 2022–2024 $\Rightarrow$ hard to reconcile with an abrupt jump
- Is it the post-pandemic inflation surge and tightening? Possibly, but what is the economic mechanism?

Suggestion: complement the regressions with an episode-by-episode narrative; specific stories would make the results more credible

2. Interpretation of the Liquidity Premium

Age is central to the identification and to the interpretation of liquidity premia

- Bond-level panel of bid-ask spreads on age: the age effect disappears once time fixed effects are included
  - Not necessarily a problem, but it suggests the relation may be driven by aggregate developments (e.g., end of sample)
  - Could you report whether the relation also holds before the most recent period?
- The lock-up mechanism is supported by "anecdotal evidence": could this be documented somehow?
- Since age enters the liquidity loadings by construction, the link between the estimated premium and average age could be partly built into the model?

Suggestion: exploit the cross section of bonds more, e.g., heterogeneous responses of bonds with different characteristics to the same aggregate shocks

3. Determinants of the Premia

- The regressions are informative, but it is hard to disentangle liquidity from term premia in the data
  - E.g., bid-ask spreads should be more related to the liquidity premium than to the term premium: how should we read their significance for term premia?
- Several regressors (debt-to-GDP, average age, exchange rate, foreign share) are persistent and trending, as are the premia
  - Regressions in first differences, or with detrended variables, could be a useful robustness check
  - It would help to show which relations are driven by common trends and which by shorter-run co-movements

4. Monetary Policy Transmission

A very interesting exercise; some points to clarify:

- If surprises are exogenous, why control for the lagged exchange rate? For efficiency? What happens without it?
- U.S. target easing *raises* Mexican term and liquidity premia (Figure 29)
  - The paper explains this by noting that Fed easing "usually happens in response to a weakening in the economic outlook"
  - If so, identification may not be correct
  - Orthogonalizing to Bauer–Swanson predictors addresses the Fed's response to news channel, but not information effects
  - If the surprise reveals news about the U.S. economy, responses may capture this news rather than monetary policy itself
- **Suggestion:** separate pure policy shocks from information effects (e.g., Jarociński and Karadi, 2020)

Summary of Discussion

Strengths:

- First joint analysis of liquidity and term premia in an emerging bond market
- Careful empirical work with bond-level data and extensive robustness
- Policy-relevant for central banks and debt managers

Suggestions:

- More economics and narrative, especially on the end-of-sample dynamics
- Additional external validation of the liquidity premium
- Robustness of the determinants regressions to persistent variables
- Clarify identification of the monetary policy effects

A valuable paper on an important topic for emerging market policy makers