



POLICY IMPLICATIONS FOR THE BANK'S FUNCTIONS

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OVERVIEW

- Challenges in this literature
- Financial System: Fin. Mkt. Effic. & Stability
- Monetary Policy I: Extracting Information
- Monetary Policy II: Transmission
- Funds Management: Debt Management for the Government
- Conclusions: Continuing Challenges



CHALLENGES

- (Challenges for researchers and for interpretation for policy)
- "Omitted variables"
 - macro variables
 - foreign variables
 - variables from other markets
 - volatility and jumps (to explain levels)



CHALLENGES

- "Stability" of relationships
 - changes in monetary policy regimes (I.T., FAD)
 - changes in market practices
 - new markets introduced (eg, derivatives)
 - "normal" versus "extreme events"
- Comparisons across markets & across countries
 - to understand deep structural parameters, need to look across regulatory regimes
- Need for more explicit analysis of welfare effects via General Equilibrium Models



F.M. EFFICIENCY & STABILITY

- Campbell & Hendry on price discovery information shares
 - efficiency of price discovery process for Canada & U.S. bond markets is similar
- Lo-D'Souza-Sapp on price and liquidity dynamics
 - suggests a liquidity pact in Canada may not improve market quality
- Edwards-Nimalendran-Piwowar on transparency
 - regulated or driven by market and technological change



F.M. EFFICIENCY & STABILITY

- Deuskar-Gupta-Subrahmanyam on systematic common factor for options liquidity
 - the more important the common driver, the greater the possibility of contagion
- Duarte on the impact of MBS hedging on volatility in interest rate markets
 - MBS hedging has potential to increase such volatility



MONETARY POLICY I: EXTRACTING INFORMATION

- BoC interest in extracting information and expectations about current and future economic fundamentals
- Bikbov & Chernov on entire yield curve
 - macro variables explain 80% of level, 50% of slope
 - residuals correlated with credit spread, money, public debt growth



MONETARY POLICY I: EXTRACTING INFORMATION

- Chabi-Yo & Yang on international influences on domestic asset prices
 - U.S. macro shocks explain more than Canadian macro shocks
 - implies data need to be "filtered" for foreign influences
 - (changes since fixed announcement dates (Parent, Johnson))



MONETARY POLICY I: EXTRACTING INFORMATION

- Jiang & Yan on flexible specification of jumps
 - how jumps are related to interest rate movements and macro shocks
 - potential for assessing immediate impact of monetary policy shocks
- Almeida-Graveline-Joslin on volatility in dynamic term structure models
 - models with option prices help predict long rates
 - effects of volatility need to be incorporated into models of interest rate levels



MONETARY POLICY I: EXTRACTING INFORMATION

- Duarte on information from asset prices
 - options and option-like markets must be monitored
 - effects from derivatives markets on cash markets
 - some focus on MBS market



MONETARY POLICY II: TRANSMISSION

- Diez de los Rios on behaviour of interest & exchange rates
 - how moves in short rates translate into movements in longer-term yields and the exchange rate
- Fleming & Piazzesi on FOMC announcements and the term structure
 - the manner in which monetary policy announcements are made can affect market prices and liquidity
- Pasquariello and Vega on effect of uncertainty of "news" impact on bond yields
 - reinforces importance of communications strategy



DEBT MANAGEMENT

- Duarte-Longstaff-Yu
 - exploiting deviations of market prices from theoretical model-based prices
 - similarly, BoC/GoC bond repurchase program for off-the-run securities
- Chabi-Yo & Yang
 - excess holding period returns of long-term bonds are mainly driven by U.S. aggregate supply shocks
 - suggests optimal issuance of GoC debt may depend on both domestic and international considerations



DEBT MANAGEMENT

- Bikbov & Chernov
 - strong relationship between fiscal shock, inflation, and long-term yields
 - suggests optimal debt management may need to take into account this relationship (at least in U.S.)



DEBT MANAGEMENT

- Andersen & Benzoni
 - hedging interest rate volatility risks by trading a portfolio of bonds will yield a very poor hedge
 - suggests may need to use other instruments to manage risks inherent in Exchange Fund Account & associated liabilities, and domestic debt



DEBT MANAGEMENT

- Almeida-Graveline-Joslin
 - there could be a relatively complicated trade-off between risk and return and the macro factors that drive both
 - again, possible implications for "optimal" EFA and domestic debt



DEBT MANAGEMENT

- Jiang & Yan
 - helps us understand how jumps are related to interest rate movements and economic shocks
 - could help manage risk factors associated with random jumps experienced in yields on EFA assets and associated liabilities



CONCLUSIONS

- I learned a lot – a lot of meat in these papers
- Papers are beginning to deal with some of the challenges I laid out at the beginning
 - omitted variables (macro, foreign, other mkts)
 - comparisons across markets
- But more could be done to meet challenges
 - especially on stability of relationships (testing)

