Discussion
Flattening Yield Curve Amidst Rapid Inflows: The Malaysian Experience

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This paper

- Quantifies the impact of foreign participation on long-term Malaysian bond yields
- Provides a comprehensive narrative on the factors that drove the (declining) flattening of the yield curve (long-term bond yields), focusing on trends in foreign participation in the Malaysian bond market
- Discusses monetary policy and financial stability implications of lowering of long-term interest rates
Motivation

- Long-term bond yields are increasingly determined by movements in the international front, calling into question the effectiveness of monetary policy.
- In order for monetary authorities to safeguard policy space to respond to external shocks, it is clearly relevant to analyse the extent to which government bond yields are influenced by external factors.

\[ r^{LT} = \alpha + \beta_1 r^{ST}_t + \beta_2 \pi_t + \beta_3 l_t + \beta_4 g_t + \beta_5 x_t + \beta_6 v_t + \beta_7 f_t \]

- \( r^{LT}_t \), the dependent variable (either 10-year or 1-year MGS yields)
- \( r^{ST}_t \), the 3-month Tbill rate
- \( \pi_t \), the inflation rate
- \( l_t \), the turnover ratio of the bond market
- \( g_t \), fiscal deficit/GDP ratio in percent
- \( x_t \), GDP growth
- \( v_t \), volatility index
- \( f_t \), foreign participation variable
Positive and significant impact of fiscal deficit/GDP ratio, GDP growth on long-term yields

Negative and substantial effects of short-term rates increase and turnover ratio on long-term yields

An increase in foreign holdings of bonds is associated with a statistically significant decline in long-term and short-term bond yields
Foreign holdings (do not) figure in significantly in the (long-term) short-term bond yield specification.

Liquidity ratio as a partial determinant of bond yields seems to be a robust finding in both monthly and quarterly frequencies.
Does increased foreign participation in domestic bonds dampen domestic bond yields, hence flattening the yield curve?

- Foreign investors target markets depending on the expected return on their assets
- Unobservable factors such as inflation and growth expectations which could be correlated with the foreign holdings of domestic bonds.
Remarks

- Instrumental variables estimation in order to account for the two-way causality that is found in the literature on foreign bond holdings and nominal yields
- Forward-looking variables of say, inflation and growth (e.g., consensus forecasts)
- Differencing the data such as yields or the use of real interest rates
Would be interesting to explore the idea that the relationship between foreign participation and yields in the Malaysian case may also be non-linear.

Classical interaction terms between foreign participation and a measure of global risk aversion, and fiscal variables, among others, could provide an interesting story.

Given that there is an observed structural break in the yields, rolling regressions to account for the time-varying beta of foreign participation.

As more data come along, would also be interesting to look at long-run relationships, e.g. cointegrated VAR models, which are also suitable for regressing non-stationary variables.
A relevant and timely contribution to the ongoing policy discussions on long-term yields