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Uncertainty and the uncovered interest parity condition: how are they related?

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— *Discussion by Matias Ossandon Busch* —

Summary

High interest rates

Low interest rates

Financial flows

UIP: Real will depreciate once capital flows back to the U.S.

Reality: Mixed evidence, often Real ends up appreciating.

Main finding: differentials lead to an appreciation if local uncertainty is high.

Comment 1 — setting

On UIPs and CIPs...

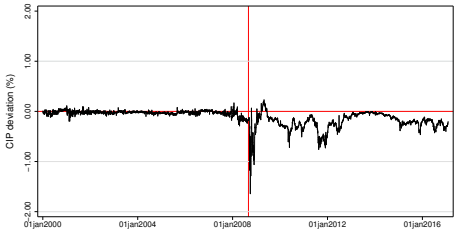

Fig.1: *Average CIP deviations as GBP cross-currency basis. Source: Ossandon Busch et al. (2019).*

- Fama regressions assume that CIP holds, but it doesn't!
  - A broken CIP indicates dysfunctional FX swap markets that impair arbitrage.
  - If foreign investors cannot hedge FX exposures, UIP is unlikely to hold...
  - Given the focus on financially advanced economies, authors could justify why on the first place the focus is on UIPs...

Comment 1 — setting (cont'd)

On omitted variables and definitions...

- The paper argues that exploring uncertainty is important as this can be an omitted variable that 'affects the Fama regression'...
  - But both uncertainty and the UIP condition can be the result of other omitted variables (macro volatility, financial market fragmentation).
  - The paper could explain how including thresholds solves a potential misspecification of the Fama model.

Comment 2 — metrix

Authors may clarify doubts about the econometric setting.

- For me it remains unclear why the authors decide to explore the presence of thresholds in the first place.
  - Isn't a simple interaction model a more simple solution?
  - Exploring the marginal effects of interest rate differentials across the whole distribution of uncertainty provides a much detailed answer to the research question!

Comment 2 — metrix (cont'd)

Authors may clarify doubts about the econometric setting.

- Robustness tests could consider replacing the uncertainty measures by potential confounding variables.
  - Adding further country-level controls (that vary little over time) adds little heterogeneity in a FE model.
  - Can the results can be replicated if uncertainty is replaced (especially in the 'second stage') by macro variables or measures of financial integration?

- It remains unclear how the analysis deals with serial correlation within countries.
  - Only reference is in the tables' notes, suggesting the use of a Newey-West estimator.
  - This approach does not address the presence of serial correlation within clusters. What happens when you cluster S.E. at the country (or time) level?

Literature & Appendix

Literature I

C.-W. J. Chiu and J. Hill. The rate elasticity of retail deposits in the united kingdom: A macroeconomic investigation. *International Journal of Central Banking*, 14(2):113–158, 2018.

M. Ossandon Busch, F. Eguren-Martin, and D. Reinhardt. Global banks and synthetic funding: the benefits of foreign relatives. *Bank of England working papers 762*, 2019.

Further comments

It would be advisable to provide more details on the variables and the econometric setting. For example...

- Is the exchange rate used local currency to US dollar, or the other way around? No explanation is provided.
- If some treatment is included for the S.E., this should be specified in the main text.
- Which deposit rates are the ones considered and how comparable are they across countries?
- Measuring interest rate differentials in deposits can be misleading considering the documented lack of elasticity of deposit rates (see, e.g., Chiu and Hill, 2018). The paper could provide a discussion of whether deposit rates are indeed a proper measure for the UIP.