Discussion of 'Measuring Global Interest Rate Comovements with Implications for Monetary Policy Interdependence' by Renée Fry-McKibbin, Kate McKinnon and Vance L. Martin

Alex Heath, June 2022

The paper is a welcome and innovative empirical investigation of the comovement of interest rates across advanced economies. It highlights the challenge of analysing the stance of monetary policy and measuring comovement in interest rates when rates are subject to the effective lower bound. It seeks to overcome this challenge through the use of shadow short rate measures and by looking beyond cross-country correlations to consider higher-order moments of comovement.

The causes and consequences of the comovement of monetary policy and financial conditions more generally are of great interest for policymakers at the Reserve Bank of Australia. Though Australia operates independent monetary policy alongside a floating exchange rate, our integration with global capital markets means that global financial conditions have an influence on domestic developments.

A number of the empirical results in the paper fitted stylised facts about similarities and differences in economic and financial conditions across the advanced economies over recent decades. For instance, the comovement of shadow short rates in Australia and the United States is lower from 2008–2020 compared to prior decades. This is consistent with the divergence of the Australian economy caused by the post-GFC mining boom, while the United States was recovering from the GFC. Similarly the comovement of shadow short rates in the euro area and the United States is lower from 2008–2020 compared to prior decades, consistent with the euro area debt crisis causing a divergence in outcomes there. A final example is the high comovement of shadow short rates between the United Kingdom and the United States over the period in which both – economies with large financial sectors and notable financial institution failures – were recovering from the GFC. Some other results in the paper did not align particularly well with our priors.

The authors could consider extensions to their work that attempt to explain why interest rate comovement is larger at certain times and between certain country pairs. In particular, policymaker readers would benefit from work on where the observed comovement comes from.

- Does it reflect co-movement of business cycles? The paper extracts some of the role of business cycle comovement by 'conditioning' its measures of interest rates on some macroeconomic and financial variables, prior to the calculation of comovement. Perhaps there is a way to investigate comovement before and after adjusting for the role of the business cycle, in order to gauge its relative importance as a cause.
- Does it reflect co-moving trends in neutral interest rates across advanced economies? If this were the case, what kind of 'interdependence' does this represent, versus other causes?
- Does it reflect financial market channels? That is linkages between financial systems that generate comovement over and above that which can be explained by similarities in economic fundamentals.

The authors might also consider how these different channels might be captured by the different moments of comovement that they measure. For instance, might particular types of shocks, such as financial market volatility shocks generate comovement in skew and kurtosis particularly? In addressing such a question, care would need to be taken in the 'conditioning' of the interest rate measures on measures of volatility.

Finally, two minor methodological comments that the authors might consider. First, and most consequentially, shadow short rates are a useful summary statistic for central bank's policy stance, but can be challenging to interpret. The authors might reflect on how well these measures capture the channels of monetary policy at times of quantitative easing and other unconventional monetary policies. Another channel is to consider the role of exchange rates in the stance of policy, particularly for those central banks like the Swiss National Bank for which exchange rates are a big part of monetary policy decisions. The authors might also consider in more detail the macroeconomic and financial variables on which they 'condition' their interest rate estimates. Should these variables be forward looking to account for the forward-looking nature of monetary policy and financial market pricing?