Term Premium Spillovers from the US to International Markets

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Summary

US inflation risk has tilted to the upside recently amid concerns over surging energy inflation and expectations of a large-scale fiscal expansion under the Trump administration at a time when economic slack in the US is diminishing. Such a repricing of inflation risk quickly reverberates globally, leading to widespread and notable increases in long-term yields not only in advanced economies (AEs), but also in many emerging market economies (EMEs). Against this background, this paper assesses the potential spillover impact of higher interest rate expectations in the US on sovereign bond markets in other economies.

Long-term interest rates can be decomposed into two key components according to the expectations hypothesis: (1) the expectation of future short-term rates; and (2) term premium. As term premium is not directly observable in the data, we estimate an affine term structure model to extract term premia from the yield curves of twenty six economies. We find that

while term premium only contribute about 30% in explaining short-term bond yields, it accounts for more than 80% of movements in long-term bond yields.

We estimate a vector autoregression model and perform an impulse response analysis to evaluate how term premia in other economies respond to an interest rate shock of a 200-basis-point increase in term premium. This interest rate shock mimics a rise of the US term premium from the current level of almost zero percent to its long-run pre-crisis mean level of 2% between 1980 and 2008. The estimated responses of all economies in the post-tapering period are mostly stronger than those in the pre-tapering period.

Our results suggest that the impact of a repricing of inflation risk can potentially be large. In particular, the increase in sovereign bond yields can translate directly to higher borrowing costs which would have a material impact on EMEs with weaker fundamentals and heavier sovereign debt financing burden. How the expansionary fiscal policies proposed by the new US administration may impact the US economy and affect the future trajectory of US long-term interest rates should be closely monitored.