Foreign Investors in Local-Currency Bond Markets

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WashU Olin

June 23, 2026

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- Are these identified intermediaries "the" marginal investor as in the model?
  - The empirical evidence supports they are, but there might be others

Starting Point: Foreign Bond Flows Come With FX Flows

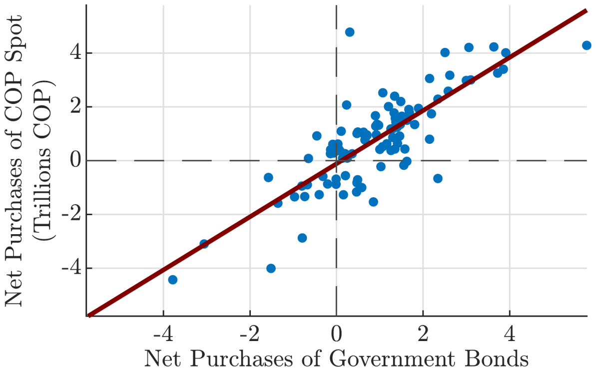

Figure 1(a): foreign investors.

- Foreign investors fund peso bonds with dollars.

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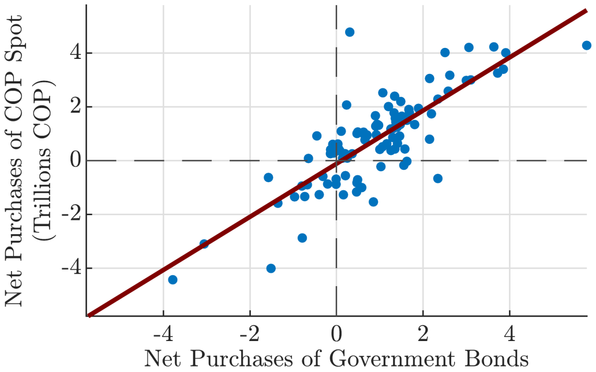

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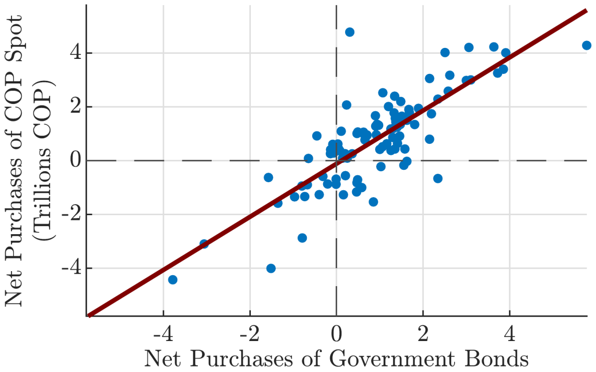

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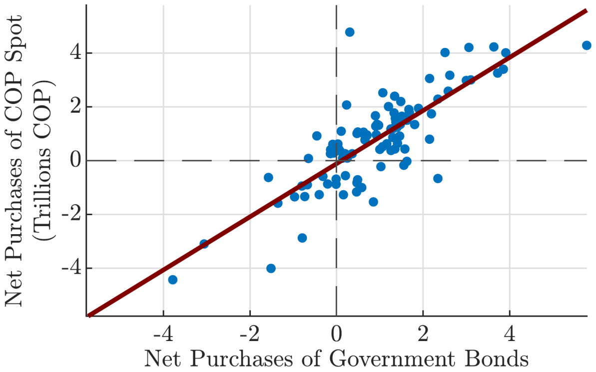

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$$\mathrm{corr}(dB^* - dCOP^*,\, dCOP^* - dUSD^*) \simeq 1$$

where B denotes the peso bond, COP & USD the currency holdings

Unpacking the Trade

- A typical foreign purchase combines two legs: USD to COP, and COP to peso bonds

$$\underbrace{(dB^* - dCOP^*)}_{\text{bond leg}} + \underbrace{(dCOP^* - dUSD^*)}_{\text{FX leg}} = dB^* - dUSD^*$$

- Net effect: foreign investors swap USD assets for local-currency bonds.

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- In practice, global asset managers do not have mandates/infrastructures to arbitrage FX (Hau and Rey, 2006; Camanho et al., 2022; Fu, 2024)

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- Note that given (1), the source of increase in intermediary positions—foreign or domestic flows—doesn't really matter

Tests of the Model Mechanism

An extensive list of tests:

- Index-inclusion: foreign inflows appreciate both peso & peso bonds
- Return predictability: intermediary positions forecast excess returns
- Cross-sectional event study: supply shocks to intermediaries move both prices

Evaluate the evidence in terms of two questions:

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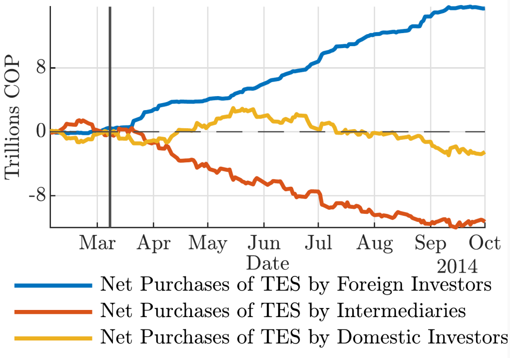
Catching the mythical arbitrageurs is a much more challenging problem!

- Since GM15, the literature seeks to identify “the” arbitrageur but not too successful
- Most papers stop at “a” postulated arbitrageur

  (e.g. Greenwood, Hanson, Stein & Sunderam 2023; Kekre & Lenel 2024; Fu 2024)

Evidence I: Index-inclusion



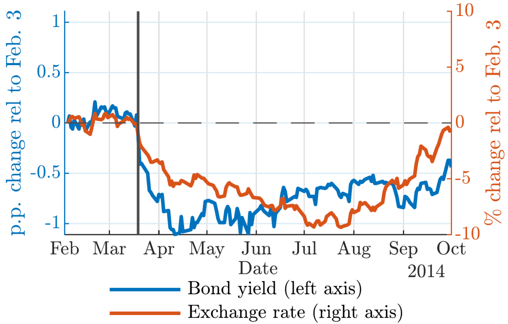


Fig 2(b): yields fall, peso appreciates

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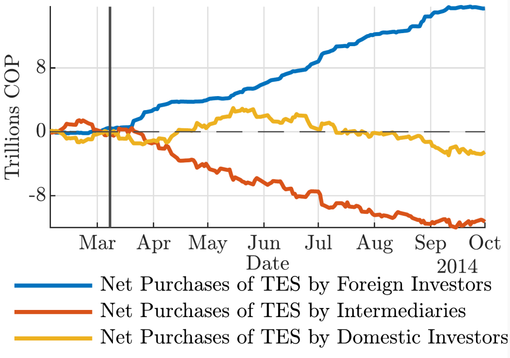

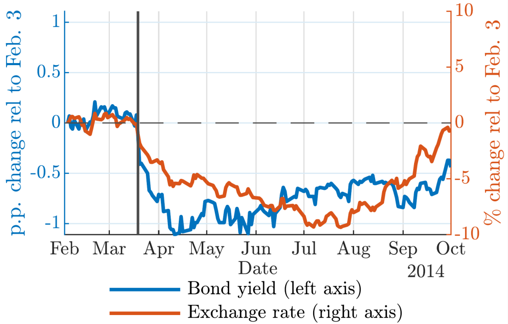

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- Are these intermediaries "the" arbitrageur: consistent, but alternative interpretation exists

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  - Still needs the intermediaries who can trade freely to pin down the movement

Evidence 2: Return Predictability

	UIP Trade Returns				Yield-Curve Trade Returns			
Horizon	1M	3M	6M	12M	1M	3M	6M	12M
	3.4	15.3**	38.8***	74.4***	4.5	13.2**	18.6***	24.9***
	(2.4)	(7.0)	(11.8)	(21.6)	(5.2)	(6.1)	(7.0)	(8.2)
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- Solution: test cross-predictability: $\text{UIP}^{cx}_{t,h} = dB_t^I \cdot rx_{t+h}^{COP}$, $\text{Yield-curve}^{cx}_{t,h} = dCOP_t^I \cdot rx_{t+h}^B$ ...

Evidence 3: Event Study

Exogenous supply shocks by auctions — strongest evidence

- Shocks to either position of intermediaries induce price changes in both markets

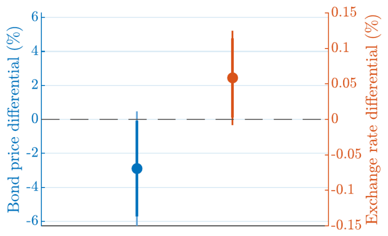
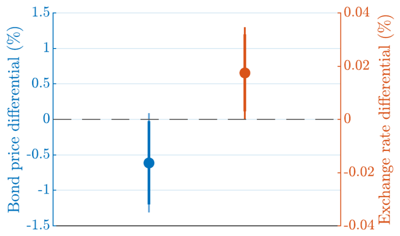


Fig 4(a): local-currency bond sales



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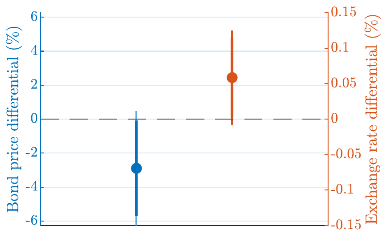

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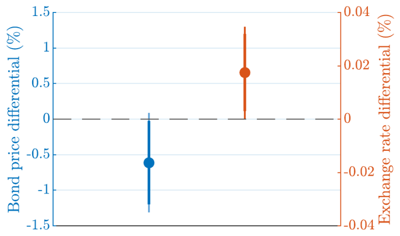

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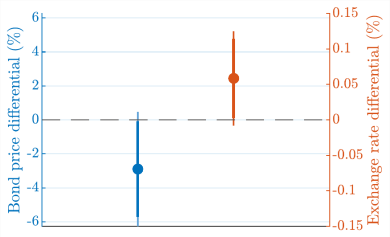

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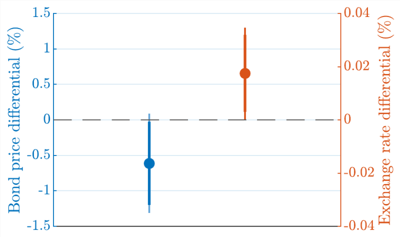

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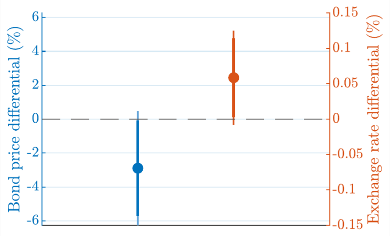

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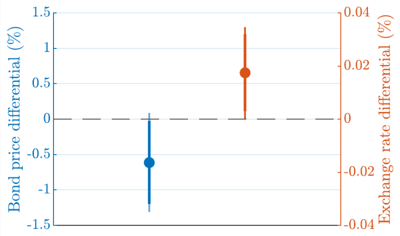

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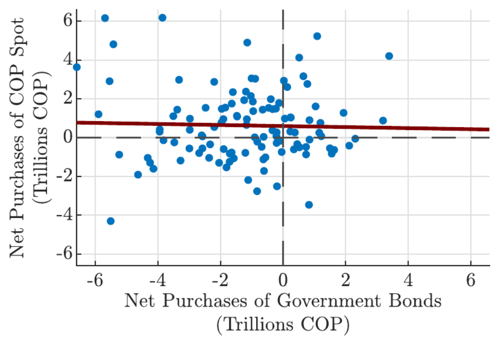
- Only quibble: difficult to interpret its quantitative importance in terms of the aggregate price

Domestic Investors: A Bit Puzzling



- They do trade FX and bonds separately, in significant amount

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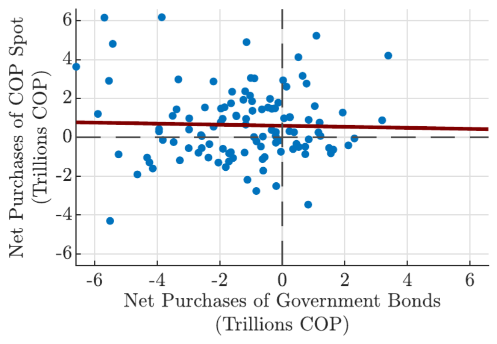

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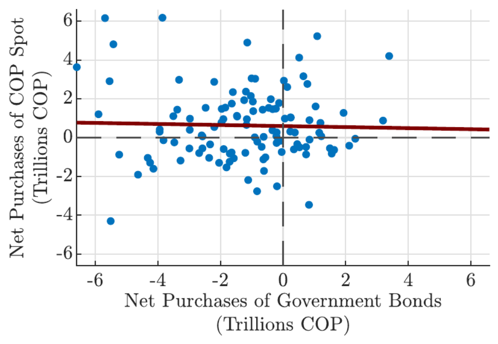

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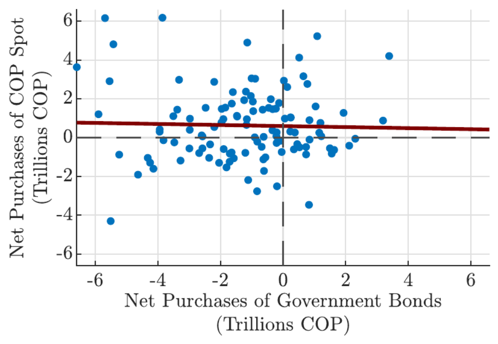

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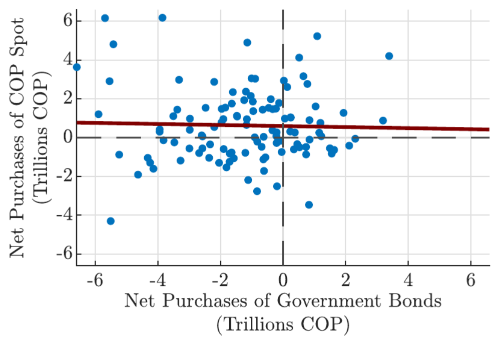

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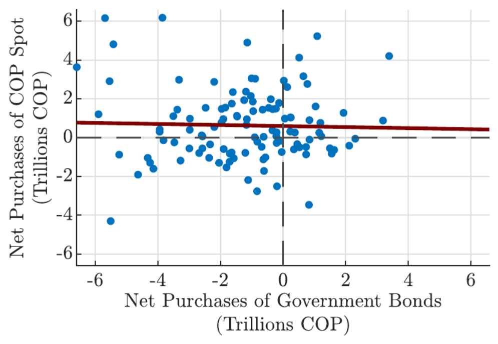

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- More discussion on the nature of domestic investors would be helpful

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  - Several suggestions to sharpen the discussion of the roles of intermediaries, foreign & domestic investors