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Exchange rate regimes and asset prices

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We study the implications of alternative exchange rate regimes for asset prices in a portfolio balance model motivated by the recent US-China experience. We establish that asset price responses to various shocks differ across a flexible regime and a -unilateral- peg but the differences for most shocks tend to be rather small. Moreover, while both monetary and public debt expansions have inflationary effects on equity prices, the latter's impact is stronger under a flexible exchange rate regime. These two findings suggest that a flexible USD/rimni rate would not have limited the recent asset price inflation in the US.

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1. Introduction

Does the current international monetary regime encourage asset price inflation? During the last decade, the prices of many assets, including stocks, bonds and real estate, experienced significant, sustained upward movement in the USA (and also in other industrial countries). Even after a temporary retreat during the financial crisis, asset prices have continued (with the exception of real estate) their climb. At the same time, real long term interest rates have been quite low. And the US has run very large current account deficits, in particular vis a vis the East Asian countries, and this has been accompanied by massive foreign (USD) reserve accumulation by the central banks in those countries. Are these phenomena linked? And do they have anything to do with the prevailing international monetary arrangements?

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Several papers have attempted to account for the nexus of large capital flows from developing countries into US safe assets (government bonds), persistently low US long term real interest rates and large US current account deficits. For instance, Caballero et al., 2008, have argued that fast growth in countries with underdeveloped financial systems (countries that cannot supply “good” financial assets to their residents) led to increased global demand for the “high quality” assets of the developed countries. Caballero and Krishnamurthy, 2009, trace out the implications of these flows for asset prices and rates of return on safe and risky assets in the US and also discuss their potential contribution to the financial crisis. Similarly, Dooley et al., 2004, have argued that the placement of a large share of the savings of emerging markets in US safe assets depressed real interest rates in the US and altered relative yields of risky and safe assets.

In Dooley et al., the decision of LDC governments to place much of domestic savings in US safe assets is closely related to their choice of the exchange rate regime, and in particular, to what has come to be called Bretton Woods II (BWII). BW II involves the pegging of the Chinese currency (as well as those of other East Asian countries) to the US dollar. The peg has been motivated by China’s export-led growth, excess-labor absorption strategy. It has been supported by China’s foreign reserves policy in conjunction with capital controls on private capital outflows. And it has led to the accommodation of large US current account deficits through the accumulation of vast, liquid, foreign reserves by the Central Bank of China. For instance, the change in China’s official foreign reserves in 2007 was more than 50% of the US current account for that period (258bn and 450bn respectively). Most of the official reserves are in US government or GSE bonds. China’s desire to finance US current account deficits at -relatively- stable terms of trade by holding safe, liquid, dollar denominated assets seems to have been a key driving force behind the decline in long term real interest rates in the US during that period notwithstanding the large increase in the supply of such assets that occurred through loose monetary policy and government budget deficits.

The implications of the decline in real interest rates for private portfolios and asset prices are straightforward. Facing a lower riskless rate of return, US and international investors change the composition of their portfolios in favor of riskier assets (stocks, real estate), pushing their prices up. As long as the forces outlined in the basic scenario above (fast growth in China, stabilization of the US-Chinese terms of trade) remain active, the upward pressure on asset prices remains.

How does the exchange rate regime matter in this scenario? There are two elements of relevance here, one general and the other specific. The general element concerns the fact that -at least over the short run when nominal goods prices are sticky- a peg means that the terms of trade cannot move much. For some shocks, this may imply that foreign account imbalances cannot be mitigated by countervailing terms of trade adjustments, contributing to larger US deficits, larger foreign reserve accumulation in China and a larger effect on US real interest rates than what would have occurred if the terms of trade could adjust (under a flexible exchange rate system). The specific element is that the peg is accompanied by controls on the outflow of capital as well as by limited wage adjustment in China. The latter implies that exchange rate policy also matters for the terms of trade over the medium term. And the former supports the bias of Chinese portfolios in favor of low risk, liquid USD assets.

Our view is that the increase in the demand for US safe assets may have multiple sources. But whatever the sources, the fact that China has been managing its exchange rate and that it has accumulated vast, safe, liquid USD assets (reserves) in this process (a large fraction of the US CA deficits) cannot be ignored in the analysis of the determination of asset prices in the US. A flexible exchange rate regime might have conceivably implied quite different paths of the Chinese terms of trade, current account surpluses and international portfolios. It is thus of interest to know whether asset prices behave differently under alternative exchange rate systems. In particular, whether fixed regimes may encourage higher price inflation than flexible regimes and for what types of shocks.

The objective of this paper is to address this question. We employ a simple, flexible price, portfolio balance model, with bonds and equity and compare the effects of various shocks on asset and goods prices across a unilateral peg and a flexible exchange rate regime. We find that the two shocks that have figured prominently in recent studies (an increase in the effective labor supply in China and an increase in the appetite of LDCs for US safe assets) do deliver a decrease in US real interest rates and an increase in asset prices. Nonetheless, the differential impact across exchange rate regimes for these two shocks is quite limited. We also find that monetary and public debt expansion in the US can exert a powerful and persistent effect on equity prices in the US, even under flexible prices. Interestingly, the latter’s

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