A Preferred-Habitat Model of Term Premia, Exchange Rates, and Monetary Policy Spillovers

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Motivation

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- Four broad empirical facts
  1. Strong patterns in currency returns: deviations from Uncovered Interest Parity (UIP) (Fama 1984...)
  2. Strong patterns in the term structure: deviations from the Expectation Hypothesis (EH) (Fama & Bliss 1987, Campbell & Shiller 1991...)
  3. The two risk premia are deeply connected (Lustig et al 2019, Lloyd & Marin 2019, Chernov & Creal 2020...)
  4. Quantitative easing (which affects term premia) seems to have strong effect on exchange rates even with policy rates unchanged at the ZLB...

- Making sense of these facts is important
  - To understand what determines exchange rates (volatility, disconnect...)
  - To understand how monetary policy transmits domestically (along the yield curve)...
  - ...but also internationally, via exchange rates and the foreign yield curve (spillovers)

Motivation

- On the theory side:
  - Standard representative agent no-arbitrage models have a hard time
  - Recent literature emphasizes the optimization of financial intermediaries and the constraints they face (Gabaix & Maggiori 2015, Itskhoki & Mukhin 2019, Koijen & Yogo 2020)
  - Revives an old literature on portfolio-balance (Kouri 1982, Jeanne & Rose 2002)
- This paper: introduce risk averse 'global rate arbitrageur' absorbing supply and demand shocks in bond and currency markets
  - FX and bond markets populated by different investor clienteles (pension funds, importers/exporters)
  - Arbitrageurs (hedge funds, fixed income desk of broker-dealer) partly overcome segmentation
- Formally: Two-country version of Vayanos & Vila's (2021) preferred-habitat model
  - Contemporaneous paper by Greenwood et al (2020) in discrete time with two bonds

Findings

1. Can reproduce qualitative and quantitative facts about the joint behavior of bond and currency risk premia

2. Rich transmission of monetary policy shocks (particularly unconventional) via exchange rate and term premia, contrasting with standard models

3. General message: floating exchange rates provide limited insulation. Failure of Friedman-Obtsfeld-Taylor's Trilemma

Framework is very rich. Can use it to answer more ambitious questions (not there yet):

(a) plunge into standard open economy macro model (general equilibrium; Ray 2019)
(b) think about deviations from LOP (from UIP to CIP; Hebert, Du & Wang 2019)

Set-Up

Set-Up: Two-country Vayanos & Vila (2021)

- Continuous time $t \in (0, \infty)$, 2 countries $j = H, F$
- Nominal exchange rate e_t: H price of F (increase $\equiv$ depreciation of H's currency)
- In each country j, continuum of zero coupon bonds in zero net supply with maturity $0 \leq \tau \leq T$, and $T \leq \infty$
- Bond price (in local currency) $P_{jt}^{(\tau)}$, with yield to maturity $y_{jt}^{(\tau)} = -\log P_{jt}^{(\tau)} / \tau$
- Exogenous nominal short rate ("monetary policy") $i_{jt} = \lim_{\tau \to 0} y_{jt}^{(\tau)}$:

$$\mathrm{d}i_{jt} = \kappa_{ij}(\bar{i}_j - i_{jt})\,\mathrm{d}t + \sigma_{ij}\mathrm{d}B_{ijt}$$

Arbitrageurs and Preferred-Habitat Investors

Three types of investors:

- Home and Foreign preferred-habitat bond investors
  (hold bonds in a specific currency and maturity)
  - Eg, pension funds, money market mutual funds
- Preferred-habitat currency traders
  (hold foreign currency)
  - Eg, importers/exporters
- Global Rate Arbitrageurs
  (can trade in both currencies, in domestic and foreign bonds)
  - Eg, global hedge funds

Global Rate Arbitrageur

- Wealth W_t:
  - W_{Ft} invested in country F short rate (denominated in Home currency)
  - $X_{jt}^{(\tau)}$ invested in bond of country j and maturity τ (denominated in Home currency)
  - Remainder in country H short rate
- Instantaneous mean-variance optimization (limit of OLG model)

$$\max \mathbb{E}_t(\mathrm{d}W_t) - \frac{a}{2}\mathbb{V}\mathrm{ar}_t(\mathrm{d}W_t)$$

$$\text{s.t. } \mathrm{d}W_t = W_t i_{Ht}\,\mathrm{d}t + W_{Ft}\left(\frac{\mathrm{d}e_t}{e_t} + (i_{Ft} - i_{Ht})\,\mathrm{d}t\right) + \int_0^T X_{Ht}^{(\tau)}\left(\frac{\mathrm{d}P_{Ht}^{(\tau)}}{P_{Ht}^{(\tau)}} - i_{Ht}\,\mathrm{d}t\right)\mathrm{d}\tau + \int_0^T X_{Ft}^{(\tau)}\left(\frac{\mathrm{d}(P_{Ft}^{(\tau)}e_t)}{P_{Ft}^{(\tau)}e_t} - \frac{\mathrm{d}e_t}{e_t} - i_{Ft}\,\mathrm{d}t\right)\mathrm{d}\tau$$

Key insight: Risk averse arbitrageurs' holdings increase with expected return

Preferred-habitat Bond and FX Investors

- Demand for bonds in currency j, of maturity τ (denominated in Home currency):

$$Z_{jt}^{(\tau)} = -\alpha_j(\tau) \log P_{jt}^{(\tau)} - \theta_j(\tau)\beta_{jt}$$

  - $\theta_j(\tau) \geq 0$, $\beta_{jt} > 0 \iff$ decrease in net demand for bonds of maturity τ

- Demand for foreign currency (spot) (denominated in Home currency):

$$Z_{et} = -\alpha_e \log(e_t) - \theta_e \gamma_t,$$

  - Can accommodate forward demand. Under CIP, equivalent to spot + H and F bond trades

- Exogenous bond and FX demand risk factors:

$$\mathrm{d}\beta_{jt} = -\kappa_{\beta j}\beta_{jt}\,\mathrm{d}t + \sigma_{\beta j}\mathrm{d}B_{\beta jt} \quad ; \quad \mathrm{d}\gamma_t = -\kappa_\gamma \gamma_t\,\mathrm{d}t + \sigma_\gamma \mathrm{d}B_{\gamma t}$$

Key Insight: Price elastic habitat traders. Price movements require portfolio rebalancing

Market Clearing (Stocks)

- Home bonds

$$X_{Ht}^{(\tau)} + Z_{Ht}^{(\tau)} = 0$$

- Foreign bonds

$$X_{Ft}^{(\tau)} + Z_{Ft}^{(\tau)} = 0$$

- Currency market

$$W_{Ft} + Z_{et} = 0$$

- Risk factors: short rates ($\mathrm{d}B_{ijt}$), bond demands ($\mathrm{d}B_{\beta jt}$) and currency demand ($\mathrm{d}B_{\gamma t}$)

Risk Neutral Global Arbitrageur (aka Standard Model)

1. Benchmark: Risk Neutral Global Rate Arbitrageur (aka Standard Model)

Consider the benchmark case of a risk neutral global rate arbitrageur: $a = 0$

- Expectation Hypothesis holds:

$$\mathbb{E}_t \, \mathrm{d}P_{Ht}^{(\tau)} / P_{Ht}^{(\tau)} = i_{Ht} \quad ; \quad \mathbb{E}_t \, \mathrm{d}P_{Ft}^{(\tau)} / P_{Ft}^{(\tau)} = i_{Ft}$$

  - No effect of QE on yield curve, at Home or Foreign
  - Yield curve independent from foreign short rate shocks

- Uncovered Interest Parity holds:

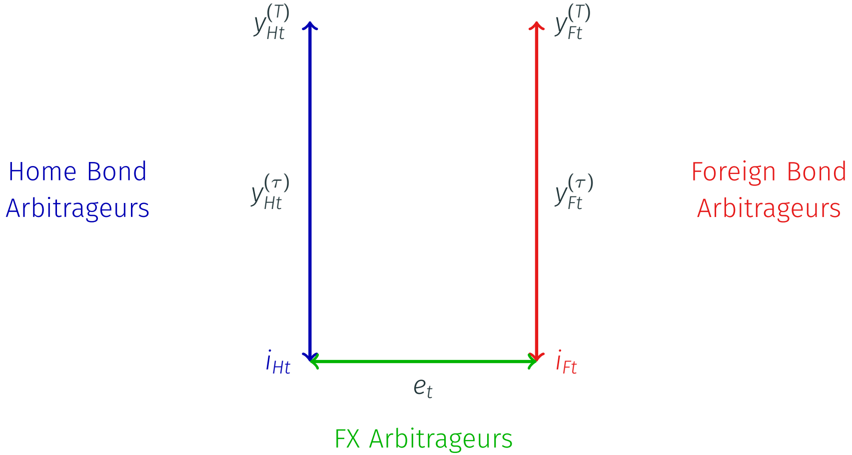
$$\mathbb{E}_t \, \mathrm{d}e_t / e_t = i_{Ht} - i_{Ft}$$

  - 'Mundellian' insulation: shock to short rates 'absorbed' into the exchange rate
  - Classical Trilemma: capital flows and floating exchange rates deliver monetary autonomy

Segmented Arbitrage

2. Segmented Arbitrage and No Demand Shocks ($\beta_{jt} = \gamma_t = 0$)

Assume foreign currency and bonds traded by three disjoint sets of arbitrageurs



2. Segmented Arbitrage and No Demand Shocks ($\beta_{jt} = \gamma_t = 0$)

Postulate: $\log P_{jt}^{(\tau)} = -A_{ij}(\tau) i_{jt} - C_j(\tau)$; $\log e_t = A_{iFe} i_{Ft} - A_{iHe} i_{Ht} - C_e$

Proposition (Segmented Arbitrage, Currency Carry Trade CCT and UIP Deviations)

When arbitrage is segmented, risk aversion $a > 0$ and FX price elasticity $\alpha_e > 0$

- Attenuation: $0 < A_{ije} < 1/\kappa_{ije}$
- CCT expected return $\mathbb{E}_t \, \mathrm{d}e_t \, / e_t + i_{Ft} - i_{Ht}$ decreases in i_{Ht} and increases in i_{Ft} (UIP deviation)

Intuition: Similar to Kouri (1982), Gabaix and Maggiori (2015)

- When $i_{Ft} \uparrow$, FX arbitrageurs want to invest more in the CCT
- Foreign currency appreciates ($e_t \uparrow$)
- As $e_t \uparrow$, price elastic FX traders reduce holdings ($\alpha_e > 0$): $Z_{et} \downarrow$
- FX arbitrageurs increase their holdings $W_{Ft} \uparrow$, which requires a higher CCT return

2. Segmented Arbitrage and No Demand Shocks ($\beta_{jt} = \gamma_t = 0$)

Proposition (Segmented Arbitrage and Bond Carry Trade BCT)

When arbitrage is segmented, $a > 0$ and $\alpha(\tau) > 0$ in a positive-measure subset of $(0, T)$:

- Attenuation: $A_{ij}(\tau) < (1 - e^{-\kappa_{ij}\tau})/\kappa_{ij}$
- Bond prices in country j only respond to country j short rates (no spillover)
- BCT_j expected return $\mathbb{E}_t \, \mathrm{d}P_{jt}^{(\tau)} / P_{jt}^{(\tau)} - i_{jt}$ decreases in i_{jt}

Intuition: Similar to Vayanos & Vila (2021)

- When $i_{jt} \downarrow$, bond arbitrageurs want to invest more in the BCT
- Bond prices: $P_{jt}^{(\tau)} \uparrow$
- As $P_{jt}^{(\tau)} \uparrow$, price-elastic habitat bond investors ($\alpha_j(\tau) > 0$) reduce their holdings: $Z_{jt}^{(\tau)} \downarrow$
- Bond arbitrageurs increase their holdings $X_{jt}^{(\tau)} \uparrow$, which requires a larger BCT return

Macro Implications of the Segmented Model

Assume $a > 0$, $\theta_j(\tau) > 0$ and $\theta_e > 0$:

- Unexpected increase in bond demand in country j (QE_j) reduces yields in country j
- No effect on bond yields in the other country or on the exchange rate
  - QE purchases: $Z_{jt}^{(\tau)} \uparrow$
  - Bond arbitrageurs reduce holdings $X_{jt}^{(\tau)} \downarrow$, reducing risk exposure and pushing down yields
  - Arbitrageurs in other markets are unaffected

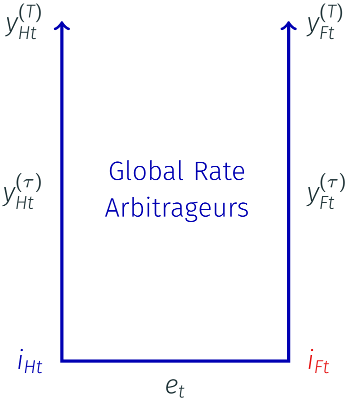
Open Economy Macro Implications:

- Changes in Home monetary conditions (conventional or QE) have no effect on the Foreign yield curve. Full insulation
- Insulation is even stronger in the case of QE: exchange rate is unchanged
- Trilemma? As we will see, this result arises because of markets segmentation (limited capital flows), not because of floating exchange rates

Global Arbitrage

3. Global Rate Arbitrageur and No Demand Shocks ($\beta_{jt} = \gamma_t = 0$)

Assume now global rate arbitrageur can invest in bonds (H and F) and FX



3. Global Rate Arbitrageur and No Demand Shocks ($\beta_{jt} = \gamma_t = 0$)

Postulate $\log P_{jt}^{(\tau)} = -A_{ijj}(\tau)i_{jt} - A_{ijj'}(\tau)i_{j't} - C_H(\tau)$; $\log e_t = A_{iFe}i_{Ft} - A_{iHe}i_{Ht} - C_e$

Proposition (Global Arbitrage and Carry Trades CCT, BCT)

When arbitrage is global, risk aversion $a > 0$ and price elasticities $\alpha_e, \alpha_j(\tau) > 0$:

- The results of the previous propositions obtain: both *CCT* and *BCT*$_H$ return decrease with i_{Ht}, and attenuation is stronger than with segmented markets
- ⚠ In addition, *BCT*$_F$ increases with i_{Ht}
- The effect of i_{jt} on bond yields is smaller in the other country: $A_{jj'}(\tau) < A_{jj}(\tau)$

Intuition: Bond and FX Premia Cross-Linkages

- When $i_{Ht} \downarrow$ global arbitrageurs want to invest more in *CCT* and *BCT*$_H$
- e_t and $W_{Ft} \uparrow$: increased FX exposure (risk of $i_{Ft} \downarrow$)
- Hedge by investing more in *BCT*$_F$ since price of foreign bonds increases when i_{Ft} drops: foreign yields decline and *BCT*$_F$ decreases

Macro Implications of Global Rate Arbitrageur Model

Assume $a > 0$ and $\alpha_e, \alpha_j(\tau) > 0$:

- Unexpected QE_H reduces yields in country H
- ⚠ Also reduces yields in country F, and depreciates the Home currency
  - Arbitrageurs decrease H bond exposure (less exposed to risk of $i_{Ht} \uparrow$)
  - More willing to hold assets exposed to this risk: increase holdings of F bonds and currency, pushing down F yields and depreciating the H currency

Open Economy Macro Implications:

- Changes in Home monetary conditions (conventional or QE) affect both yield curves and the exchange rate: potential spillovers from monetary policy. Imperfect insulation even with floating rates
- QE or FX interventions in one country affect monetary conditions in both countries and depreciate the currency
- Failure of the Classical Trilemma

The Full Model

The Full Model: Adding Demand Shocks $\beta_{jt} \neq 0$, $\gamma_t \neq 0$

- Can allow for rich demand structure embodied in VCV of risk factors. DGP:

$$\mathbf{q}_t = \begin{bmatrix} i_{Ht} & i_{Ft} & \beta_{Ht} & \beta_{Ft} & \gamma_t \end{bmatrix}^\top$$

$$\mathrm{d}\mathbf{q}_t = -\mathbf{\Gamma}\left(\mathbf{q}_t - \overline{\mathbf{q}}\right)\mathrm{d}t + \boldsymbol{\sigma}\,\mathrm{d}\mathbf{B}_t$$

- In general: dynamics matrix $\mathbf{\Gamma}$ and correlation matrix $\boldsymbol{\sigma}$ completely unrestricted
  - Retains equilibrium affine structure:

$$-\log P_{jt}^{(\tau)} = \mathbf{q}_t^\top \mathbf{A}_j(\tau) + C_j(\tau) \quad , \quad -\log e_t = \mathbf{q}_t^\top \mathbf{A}_e + C_e$$

  - Complicates hedging behavior of arbitrageurs
- Today: we assume independent processes for all factors, except shocks to short rates may be correlated, and currency demand γ_t may respond to short rates
  - $\implies$ block-lower-triangular $\mathbf{\Gamma}$, block diagonal $\boldsymbol{\sigma}$

Numerical Calibration

Data: Zero coupon data: US Treasuries (H) and German Bunds (F); exchange rate data: German mark/euro

Targets: second moments of short/long term rates, exchange rates, and volumes

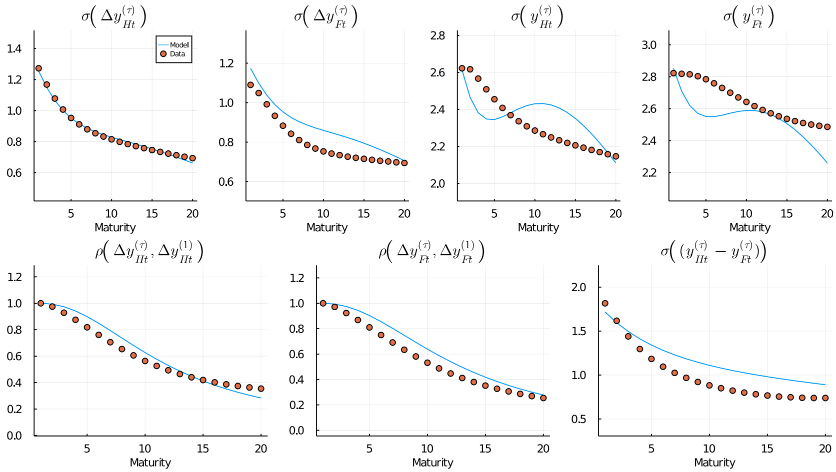
Parameter	Value	Parameter	Value	Parameter	Value
κ_{iH}	0.126	κ_{γ}	0.134	$a\sigma_{\beta}\theta_0$	90.6
κ_{iF}	0.0896	$\kappa_{\gamma,iH}$	-0.267	$a\alpha_e$	73.4
σ_{iH}	1.43	$\kappa_{\gamma,iF}$	0.252	$a\alpha_0$	4.74
σ_{iF}	0.751	$a\sigma_{\gamma}\theta_e$	763.0	α_1	0.144
$\sigma_{iH,iF}$	1.05	κ_{β}	0.0501	θ_1	0.374

For policy experiments: CRRA $\gamma = 2$ and arbitrageur wealth $\frac{W}{GDP_H} \approx 5\% \implies a = 40$

Model Fit: Short Rates and Exchange Rates

Moment	Data	Model	Moment	Data	Model
$\sigma\left(y_{Ht}^{(1)}\right)$	2.622	2.614	$\rho\left(\Delta\log e_t, (y_{Ht}^{(1)} - y_{Ft}^{(1)})\right)$	-0.105	-0.096
$\sigma\left(\Delta y_{Ht}^{(1)}\right)$	1.273	1.254	$\rho\left(\Delta\log e_t, \Delta y_{Ht}^{(1)}\right)$	-0.095	-0.214
$\sigma\left(y_{Ft}^{(1)}\right)$	2.822	2.853	$\rho\left(\Delta\log e_t, \Delta y_{Ft}^{(1)}\right)$	0.048	0.071
$\sigma\left(\Delta y_{Ft}^{(1)}\right)$	1.09	1.174	$\rho\left(\Delta^{(5)}\log e_t, (y_{Ht}^{(5)} - y_{Ft}^{(5)})\right)$	0.12	0.06
$\sigma\left((y_{Ht}^{(1)} - y_{Ft}^{(1)})\right)$	1.816	1.717	$\tilde{V}_H(0 \leq \tau \leq 3)$	0.361	0.378
$\sigma\left(\Delta\log e_t\right)$	10.186	10.183	$\tilde{V}_H(11 \leq \tau \leq 30)$	0.08	0.116

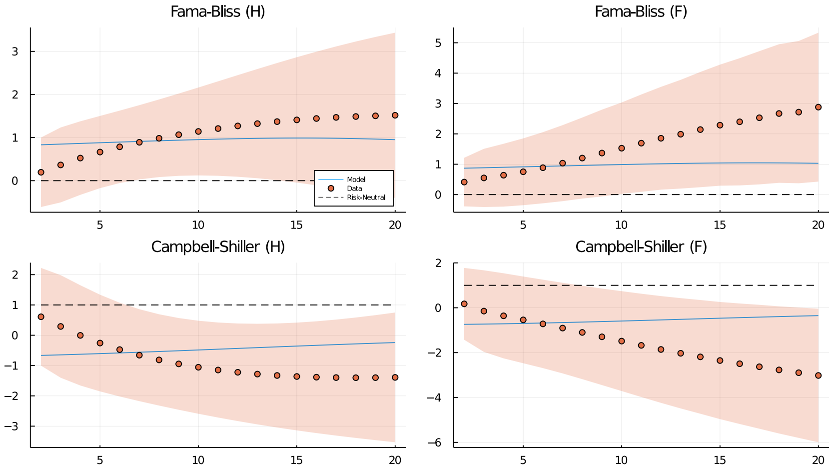
Model Fit: Long Rates



Return Predictability

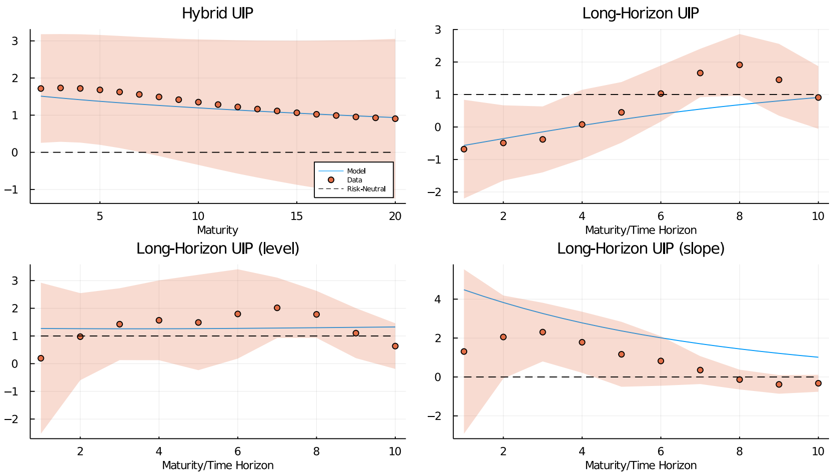
- Bond returns and slope of the term structure
  - Fama & Bliss (1987), Campbell & Shiller (1991)
- Currency returns and UIP
  - Fama (1984), Chinn & Meredith (2004)
- Cross-country bond and currency returns
  - Lustig, Stathopoulos & Verdelhan (2019)
  - Chernov & Creal (2020), Lloyd & Marin (2019)

Regression Coefficients: Term Structure



Implications: Positive slope-premia relationship

Regression Coefficients: UIP



Implications: CCT is profitable, but profitability goes to zero if CCT is done with long-term bonds or over long horizon. Slope differential predicts CCT return

Policy Spillovers

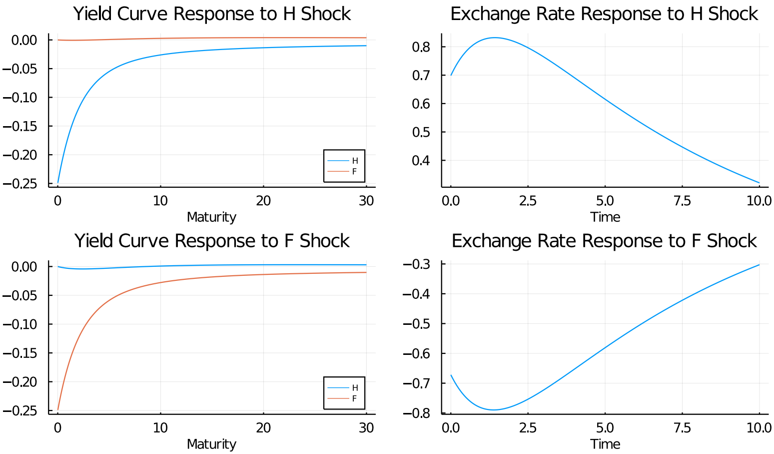
Conduct policy experiments:

- Monetary policy shock: unanticipated 25bp decrease in policy rate (H and F)
- QE shock: unanticipated positive demand shock (H and F) $= 10\%$ of GDP

Examine spillovers:

- Across the yield curves (short and long rates; and across countries)
- To the exchange rate

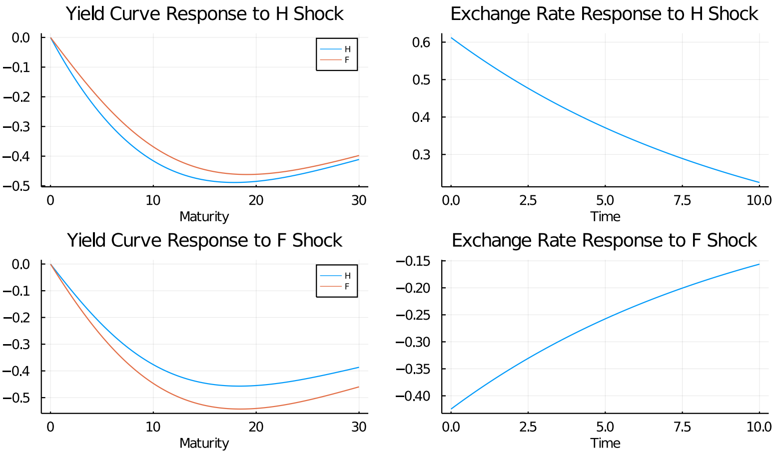
Monetary Shock Spillovers



Implications: small cross-country yield response; exchange rate “delayed overshooting”

- Intuition: correlated short rates, currency demand response

QE Shock Spillovers



Implications: large spillovers of QE, both to foreign yields and exchange rate

- Intuition: correlated short rates, elastic currency traders

Concluding Remarks

- Present an integrated framework to understand term premia and currency risk
- Resulting model ties together
  - Deviations from Uncovered Interest Parity
  - Deviations from Expectation Hypothesis
- Allows rich demand specification with complex potential interactions between hedging demands
- Break the ‘Friedman-Obstfeld-Taylor’ Trilemma: monetary policy transmits to other countries via FX and term premia
- Extensions:
  (a) Endogenize policy rates as in Ray (2019)
  (b) Consider deviations from LOP as in Hebert, Du & Wang (2019)
  (c) Consider non-conventional monetary policy and official interventions

Thank You!