Exchange Rate Regimes and Home Bias in Bonds

Job Market Paper

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Abstract

Countries with more flexible exchange rate policies tend to hold more domestic bonds over foreign bonds, exhibiting what the literature terms a "home bias" in bond-holding. In this paper, I explain this as a consequence of optimal portfolio choice under heterogeneous monetary policy frameworks. First, I show that a lower share of domestic bonds in portfolios under a pegged regime than under a floating regime is mainly due to nominal bonds' inability to hedge against real shocks when the exchange rate is pegged. Therefore, exchange rate regimes are non-neutral for asset holdings through changing the hedging characteristics of nominal assets. Second, I show that, under a floating regime, more domestic bond holdings by countries with more volatile nominal exchange rates are due to more volatile real shocks. This finding implies that bond holdings under a floating regime are driven by real shocks, in contrast to bond holdings under a pegged regime. I develop two country DSGE models with endogeneous portfolio choice in which nominal bonds are traded internationally and exchange rate regimes are characterized by interest rate rules.

Keywords: International portfolio holdings, Home bias in bonds, Exchange rate regime

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