Dissertation Abstract

Essays in international portfolio choice and monetary policy

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Over the past few decades, asset trade across countries has reached a historical high and the financial linkage across borders has become stronger. On the one hand, we observe a large increase in asset flows between emerging economies and developed economies, also in conjunction with enlarged asset trade between emerging economies. On the other hand, households in most countries still hold most of domestic equities in their country-level equity portfolios. This thesis mainly investigates international portfolio choice in the context of financial globalization and explores how financial integration improves international risk-sharing.

The first chapter of my dissertation focuses on explaining why households prefer more domestic equities to foreign equities when both equities are accessible to households, and on exploring the business cycle properties of international portfolios. I find that standard international monetary business cycle models with nominal bonds hardly generate equity home bias for plausible preference parameter values. Nonetheless, empirical evidence shows that equity home bias is a prevailing fact for most countries. The aim of this chapter is to reconcile international monetary business cycle models with equity home bias. By incorporating inflation-indexed bonds, I show that the model can explain home bias in equities, since inflation-indexed bonds hedge real exchange rate risk and domestic equities provide a hedge against domestic labour income risk conditional on real exchange rates. Moreover, the model accounts for counter-cyclical movements of net foreign asset positions. These results are robust to environments either with complete asset markets or with incomplete asset markets. In addition, I also present empirical evidence that the motive for hedging labour income risk makes domestic households hold more domestic equities for a sub-sample of OECD countries conditional on real exchange rates, which is supported by the model.

Recently, portfolio flows across emerging economies have increased dramatically. A following question is to investigate how financial integration between emerging economies (say Thailand and Korea) affects their risk sharing across countries, when they connect with a developed economy (say, the US) tightly. The second chapter studies portfolio choice and international risk sharing in a center-periphery framework. After solving for the portfolios in each country, I find that the financial integration between periphery countries reduces the volatility of consumption in periphery countries, but it doesnôt necessarily reduce the volatility of consumption in the center country. The reason is that periphery countries can diversify income risk through more integrated international markets, whereas the center country has already access to global financial markets before financial integration and thereby, it doesnôt necessarily gain from financial integration.

The third chapter explores optimal monetary policy in a dynamic stochastic general equilibrium monetary model with credit-market imperfection (collateral constraints). In this chapter, I pose the following question: should monetary policy accommodate the financial accelerator? Credit frictions distort allocations and prices, and therefore generate large volatilities of aggregate variables in an economy via the financial accelerator. Accordingly, they have an adverse effect on social welfare. When inter-period debt contracts are signed in nominal terms, policy-makers can use the debt-deflation channel to push down the volatility of aggregate variables through the financial decelerator. The results of my investigation show that external finance premium positively co-moves with output under the optimal monetary policy. In the optimized linear interest rate rule, interest rate should decrease in response to a rise in asset price and exhibits a high inertia. Within a class of simple linear interest rate rules, the strictly inflation-targeting rule has large welfare loss, whereas a rule with a high inertia has relatively low welfare cost.