Comments by Rafael Repullo on

The Euro as a Reserve Currency for Global Investors

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Introduction

- Survey paper of a few recent contributions

  → Positive side: Many interesting topics and insights

  → Negative side: No clear structure or unifying theme

Background

- Portes and Rey (1998): Possible implications of the euro:
  - → For the international monetary system ✗
  - → For the currency composition of portfolios ✓
  - → For exchange rates and hence monetary policies ✗
  - → For economic efficiency and welfare ✗

Contents of paper

- Definitions of reserve currencies
- Conventional view: currency exposures should be hedged
- Alternative views on currency exposures:
  - → Hedge against real interest risk for long-term investors
  - → Hedge against stock or bond market risk
- Interest rate effects of currency unions
- Capital markets integration before and after the euro

Overview of discussion

- What are reserve currencies?
- To hedge or not to hedge
- Benefits (and costs) of currency unions
- Benefits (and costs) of capital market integration
- Concluding remarks

Reserve currencies

- Currencies held by central banks

  → Does it matter? Why? What are the effects?

- Currencies used for trading in some international markets

  → Does it matter? Why? What are the effects?

- Currencies that investors hold in their portfolios

  → First theme of paper: Why hedge (or not) currency risk?

- Currencies whose adoption promotes capital market integration

  → Second theme of paper: How important is the effect?

To hedge or not to hedge

→ Campbell, Viceira, and White (2003)

- Setup
  - Portfolio allocation of long-term investor
  - Two assets: domestic and foreign short-term bonds
  - Domestic bonds are risky: reinvestment and inflation risk
- Main result
  - Currency exposure helps to hedge real interest rate risk
  - Non-reserve currencies depreciate with low domestic rates

To hedge or not to hedge

Comment 1.1

• Why focus on variance of returns (and not on covariance)?

→ Hedging is about correlation in returns!

Comment 1.2

• What happens with reserve currencies (dollar and euro)?

→ Does the result apply to US and European investors?

→ Can we say anything with a six year sample (1999-2005)?

To hedge or not to hedge

Comment 1.3

• Empirical regularity (negative correlation of asset returns)

→ How can it be explained from a theoretical perspective?

To hedge or not to hedge

→ Campbell, Serfati de Medeiros, and Viceira (2009)

- Setup
  - Two models: Global equity and global bond investors
  - Exogenous asset holdings: how much currency exposure?
  - Focus on nominal returns (unlike the other paper)
- Main results
  - Equity investors should <u>not</u> hedge reserve currencies
  - Bond investors should hedge all currency exposures
  - Euro is becoming a reserve currency

To hedge or not to hedge

Comment 2.1

- What happens for endogenous asset holdings?
- What happens for investors in <u>both</u> equities and bonds?

  → Results may change!

Comment 2.2

- Many things have happened during sample period (1975-2005)

  → Fall in inflation and interest rates, arrival of the euro, etc.

  → Probability distribution of asset returns may not be stable

To hedge or not to hedge

Comment 2.3

• Before 1999 “Euroland” is basket of DE, FR, IT & NL

→ Results should be interpreted with great care

Benefits of currency unions

→ Hassan (2008)

- Setup
  - International asset pricing with countries of different size
- Main results
  - Larger countries have lower real interest rates
  - Currency unions lower member countries' real interest rates
  - Empirical evidence supports these predictions

Benefits of currency unions

Comment 3.1

- Is there a flip side?

  → Lower rates may foster development of asset price bubbles

Capital markets integration

→ Viceira and Gimeno (2009)

• Setup

- Decomposition of national stock market betas
- Following Campbell and Voulteenaho (2004)

• Main result

- Increase in cash-flow and discount rate betas after euro
- Evidence of greater capital markets integration

Capital markets integration

Comment 4.1

• Effect significant for some countries but not for others (Spain)

→ Is there an explanation?

Comment 4.2

• Is there a flip side?

→ Greater integration may facilitate contagion of shocks

→ Increase likelihood of global crisis?

Concluding remarks

- On empirical international asset pricing

  → Many interesting partial models

  → How far from a comprehensive model?

- On theoretical international asset pricing

  → How can we account for empirical regularities?

- On currency unions and capital market integration

  → Are there any (significant) costs?