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

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Abstract

We propose an integrated preferred-habitat model of bond and currency markets across two countries. Prices are determined by arbitrageurs trading with investors with preferences for specific assets. Risk premia vary over time in response to shocks to short rates and to bond and currency demand. This variation generates empirically documented violations of Expectations Hypothesis and Uncovered Interest Parity. Large-scale asset purchases in one country cause that country's currency to depreciate, bond yields in that country to drop, and yields in the other country to drop by a smaller amount. A short-rate cut in one country has the same qualitative effects, although our estimated model reveals that the spillovers to the other country's term structure are significantly smaller.

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