Asset Allocation and Monetary Policy: Evidence from the Eurozone

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Summary

Following the worst financial crisis (2007–2009) since the Great Depression, a controversial debate has focused on the role of monetary policy in causing asset price inflation and financial risk taking in general. Critiques of the U.S. monetary policy have asserted a powerful risk-taking channel whereby excessively low monetary policy rates induce more risky asset allocations by various economic agents. Households as well as financial intermediaries might seek higher risk in search for higher yields, and such return chasing may impact leverage and asset prices. The exceptionally low (and even negative) real short-term interest rate in the current post-crisis environment has raised concerns that leverage adjustment is being delayed and asset risk allocations are becoming distorted again.

This paper uses the monetary policy process in the European currency union with its different national real short-term interest rates to identify how geographic variation in monetary policy conditions affects investors' asset allocations in equity and money market funds. A well-documented strong investor bias toward nationally distributed investment funds allows us to link local relative monetary conditions to fund-level inflows and outflows in the equity and money markets of different eurozone countries.

Both the fund level and the country level panel regressions show that loose monetary policy conditions correlate strongly with cross-sectional differences in equity fund inflows and money market fund outflows. A decrease of ten basis points in the real short-term interest rate is associated with a 1% incremental equity fund inflow relative to fund assets and a 0.8% incremental outflow from money market funds. The evidence supports a powerful risk-shifting channel whereby investors react to low real rates by risk shifting from money market to equity investments. Various robustness checks are undertaken to discard alternative explanations for the fund flow evidence.

As financial stability encompasses the asset price impact of household risk shifting, we also estimate the stock price dynamics triggered by differences in monetary policy conditions in the eurozone using our identification of the monetary-policy-related equity flows. Our analysis focuses on the equity fund returns measured relative to a country-specific benchmark group of 15% of stocks with the lowest fund flows in the past three years. We find an average excess equity fund return of approximately 1.4% for a 10 basis point decrease in the local real short rate. Furthermore, the excess return is strongest in countries where local institutional investors are important and exhibit a large home bias. In the light of our evidence, financial integration appears to be an underappreciated prerequisite for an optimal currency area and a stable monetary union.