

Exchange rates, Equity prices and capital flows

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We develop an equilibrium model in which exchange rates, stock prices and capital flows are jointly determined under incomplete forex risk trading. Incomplete hedging of forex risk, documented for U.S. global mutual funds, has three important implications: 1) exchange rates are almost as volatile as equity prices when the forex liquidity supply is price elastic; 2) differences in equity returns in the foreign market relative to the home market are negatively correlated with foreign currency returns; 3) net equity flows into the foreign market are positively correlated with foreign currency returns. The model predictions are strongly supported at daily, monthly and quarterly frequencies for 17 OECD countries vis-à-vis the U.S. Moreover, correlations are strongest after 1990 and for countries with higher market capitalization relative to GDP, suggesting that the observed exchange rate dynamics is indeed related to equity market development.
