



Essays on Economic Policy (ESPE in Spanish) - Uncovering the Portfolio Balance Channel with the Use of Sovereign Credit Ratings

Access this article at Elsevier Access this article at REPOSITORIO BANREP Keep in mind

In the journal Essays on Economic Policy (ESPE) - we disclose the results and policy proposals that arise from academic research carried out at the *Banco de la República*. When you read us, always keep in mind that the content of our articles, as well as the analyzes and conclusions derived from them, are the sole responsibility of their authors. The material disclosed in our ESPE magazine does not compromise or represent the opinion of *Banco de la República* or that of its Board of Directors.

AUTHOR OR EDITOR Laura Andrade Oscar Valencia Vásquez-Escobar, Diego Mauricio Villamizar-Villegas, Mauricio Publication Date: Monday, 19 of December 2016

Abstract

In this paper we study exchange rate effects due to shifts in the portfolio composition of the Colombian financial sector during 2003–2014. We first provide a theoretical understanding of the channel's transmission mechanism by modeling how the banking sector optimally allocates its portfolio composition. This allows us to characterize departures from the uncovered interest rate parity condition (UIP) in terms of foreign and domestic assets. In the empirical application, we control for a potential simultaneity bias by using a novel instrument for portfolio compositions: the use of sovereign credit ratings and outlook changes made by Moody's, Standard and Poor's and Fitch Ratings. Our findings indicate that shifts in portfolio balances affect only the long term (5-year) risk premium in up to five months before the effects subside. Additionally, we find stronger and more persistent portfolio effects in cases in which US ratings increased relative to Colombian ratings.