Home Bias in Open Economy
Financial Macroeconomics

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Abstract

Standard theory would predict that investors hold a well diversified portfolio of equities across the world but despite the process of ‘financial globalization’, investors still hold a disproportionate share of local equities in their portfolio: the ‘equity home bias’ (French and Poterba (1991)). We review the various explanations of this puzzling phenomenon in the context of recent developments in macroeconomic modelling that have allowed to incorporate sophisticated international portfolio choices in standard two-country general equilibrium models. We refer to this literature as Open Economy Financial Macroeconomics. We focus on three broad classes of explanations: (i) hedging motives in frictionless financial markets (real exchange rate and non-tradable income risk), (ii) asset trade costs in international financial markets (such as transaction costs, differences in tax treatments between national and foreign assets...), (iii) informational frictions and behavioural biases. These recent developments raise the need for new portfolio facts beyond the equity home bias and we will present some new evidence on cross-border asset holdings across different types of assets: equities, bonds and bank lending. We also present some new micro data on institutional holdings of equity at the fund level. These data should inform macroeconomic modelling of the open economy and a growing literature of models of delegated investment.

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1 Introduction

Standard finance theory would predict that investors hold a diversified portfolio of equities across the world if capital is fully mobile across borders. Because foreign equities provide great diversification opportunities, a point made early on in Grubel (1968), Levy and Sarnat (1970) and Solnik (1974), falling barriers to international trade in financial assets over the last twenty-years should have led investors across the world to re-balance their portfolio away from national assets towards foreign assets. The process of ‘financial globalization’ fostered by capital account liberalizations, electronic trading, increasing exchanges of information across borders and falling transaction costs has certainly led to a large increase in cross-border asset trade (Lane and Milesi-Ferretti (2003)). However, investors are still reluctant to reap the full benefits of international diversification and tend to hold a disproportionate share of local equities: the ‘home bias in equities’. Since the seminal paper of French and Poterba (1991), the home bias in equities constitutes one of the major puzzle in international finance. Despite better financial integration, it has not decreased sizably: in 2007, US investors still hold more than 80% percent of domestic equities and the home bias in equities is observed in all developed countries.

Many explanations have been put forward in the literature to explain this very robust portfolio fact. We will review these explanations looking at important recent developments on the subject. We do not intend to provide a definite answer to the question or choose among alternative explanations, as they probably all contribute to a part of the gap. Our goal is rather to explain where the theory stands and what might be the next challenges ahead. We will distinguish between three broad classes of explanations: (i) hedging motives in frictionless financial markets (real exchange rate and non-tradable income risk), (ii) asset trade costs in international financial markets (such as transaction costs, differences in tax treatments between national and foreign assets...) and (iii) informational frictions and behavioural biases. We will review these explanations in the context of the new developments in macroeconomic modelling of the open economy (we call this Open Economy Financial Macroeconomics) and in the context of asymmetric information models, considering the recent literature with endogenous information acquisition.

We will put some emphasis on the recent developments in the macro literature, which has embedded non-trivial portfolio choices in standard two country general equilibrium macro models. Such developments have been fostered by recent methodological breakthroughs that allow researchers in the field to solve for international portfolios in a broad class of macro models. The equity home bias has been one of the main motivation for this literature which has traditionally focused on models with equities only. However, the recent literature has put forward the importance of considering more sophisticated portfolio choices across a wider class of assets (bonds, corporate debt, equity...). To fix the ideas, we will develop a very standard two country/two good DSGE model with endogenous portfolio choice: one with equity-only as in the early literature and one with bonds and equity. This will allow us to present the recent methodological developments to fully characterize portfolios in this class of models and to show the limitations of the early literature. These
new developments also raise the need for new portfolio facts that these models with multiple asset classes intend to replicate and we will present some new evidence on international holdings across different types of assets: equities, public bonds, private debt. We focus on portfolio investment and abstract from Foreign Direct Investment, as its determinants may be of a very different nature and are studied extensively in the trade literature.

Finally, we present some new micro data on institutional holdings of equity at the fund level. These data should inform both macroeconomic modelling of the open economy and also finance models of delegated investment, which is a burgeoning literature and an important one as an increasing share of international investment is intermediated.

In section 2, we present the standard definition of home equity bias and some recent measures across countries and across time. In section 3, we focus on the recent developments in the macroeconomics literature (Open Economy Financial Macroeconomics). We focus on the two main explanations of the home bias in this literature, namely hedging motives and trade costs in financial markets (transaction costs, international taxation...). In section 4, we review the finance literature on information asymmetries and behavioural biases. In section 5, in line with recent theoretical work, we present some new evidence on aggregate portfolio holdings across a wider range of assets. We also present our new portfolio facts at the fund level and discuss leads for further research. Section 6 concludes.

2 The Equity Home Bias: Definition and Measure

French and Poterba (1991) were the first to our knowledge to document domestic ownership shares across countries: they use data for the US, Japan, UK France and Germany and show that for these countries, investors hold a disproportionate share of domestic assets in their equity portfolios and there is very little cross border equity diversification: in 1989, 92% of the US stock market is held by US residents. The analogous numbers for Japan, UK, France and Germany are respectively 96%, 92%, 89% and 79%. They label this pattern of the data as the equity home bias.\footnote{Bohn and Tesar (1996) estimate the share of foreign equities in the U.S. portfolio to be still very low in 1995, equal to 8 percent.} This is a well-known puzzle in international finance: in a world with frictionless financial markets, the most basic International CAPM model with homogenous investors across the world would predict that the representative investor of a given country should hold the world market portfolio. In other words, the share of his financial wealth invested in local equities should be equal to the share of local equities in the world market portfolio, a prediction that contradicts the most casual observation of the data on portfolio holdings. As a result, the measure of equity home bias (EHB) that is most commonly used is the difference between actual holdings of domestic equity and the share of domestic equity in the world market portfolio:\footnote{Commonly used as well are simple ”finance measures”. Benchmark portfolio weights are calculated from a mean variance optimisation problem with sample estimates of the means and variance-covariance matrix of returns. The main issue in the}
$$EHB_i = 1 - \frac{\text{Share of Foreign Equities in Country } i \text{ Equity Holdings}}{\text{Share of Foreign Equities in the World Market Portfolio}}$$ (1)

When the home bias measure for country $i$, $EHB_i$, is equal to one, there is full equity home bias; when it is equal to zero, the portfolio is optimally diversified according the the basic International CAPM.

While one could argue that at the end of the eighties, international capital markets were far from being frictionless, this might be a less valid explanation today. Despite an increased financial integration, the equity home bias remains a very pervasive phenomenon across countries and across time (classic surveys include Lewis (1999) and Karolyi and Stulz (2003). See also Sercu and Vanpee (2008) for recent evidence). In figure (1), we show the evolution of home bias measures in developed countries across regions of the world: it has decreased over the last twenty years with the process of ‘financial globalization’ but remains still very high in all countries (see also table (1) for a recent snapshot of home bias measures for selected countries). On average, the degree of home bias across the world is 0.63 (lower in Europe where monetary union seemed to have had an effect but higher in other countries), meaning that the share of foreign equities in investors portfolios less roughly a 1/3 of what it should be according to the most basic existing literature adopting the finance approach are how to measure returns and covariance matrices. Papers differ in the extent to which they use real or nominal returns, how they estimate expected returns and how they deal with structural breaks and nonstationarity. As a result, there is a degree of heterogeneity in the estimates of expected returns and second moments.  

3see Coeurdacier and Martin (2009) and Fidora et al. (2007) for studies on the impact of the Monetary Union on cross-border equity diversification.
International CAPM. In figure (2), we show the degree of home bias for emerging markets: emerging markets have even much less diversified equity portfolios than developed countries; the average degree of home bias in these countries is 0.9 (smaller in emerging Asia and larger in Latin America) and investors in these countries hold 1/10 of the amount of foreign equities they should be holding according to basic International CAPM.

<table>
<thead>
<tr>
<th>Source Country</th>
<th>Domestic Market in % of World Market Capitalization</th>
<th>Share of Portfolio in Domestic Equity in %</th>
<th>Degree of Equity Home Bias = $EHB_i$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>1.8</td>
<td>76.1</td>
<td>0.76</td>
</tr>
<tr>
<td>Brazil</td>
<td>1.6</td>
<td>99</td>
<td>0.98</td>
</tr>
<tr>
<td>China</td>
<td>7.8</td>
<td>99.2</td>
<td>0.99</td>
</tr>
<tr>
<td>Canada</td>
<td>2.7</td>
<td>80.2</td>
<td>0.80</td>
</tr>
<tr>
<td>Euro Area</td>
<td>13.5</td>
<td>57</td>
<td>0.625</td>
</tr>
<tr>
<td>Japan</td>
<td>8.9</td>
<td>73.5</td>
<td>0.71</td>
</tr>
<tr>
<td>South Africa</td>
<td>1.4</td>
<td>52</td>
<td>0.517</td>
</tr>
<tr>
<td>South Korea</td>
<td>1.4</td>
<td>89</td>
<td>0.88</td>
</tr>
<tr>
<td>Sweden</td>
<td>0.7</td>
<td>44</td>
<td>0.43</td>
</tr>
<tr>
<td>Switzerland</td>
<td>2.3</td>
<td>51</td>
<td>0.50</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>5.1</td>
<td>54.5</td>
<td>0.52</td>
</tr>
<tr>
<td>United States</td>
<td>32.6</td>
<td>77.2</td>
<td>0.66</td>
</tr>
<tr>
<td>South Africa</td>
<td>32.6</td>
<td>88</td>
<td>0.88</td>
</tr>
</tbody>
</table>

Table (1): Home Bias in Equities in 2008 for selected countries (source IMF and FIBV)

Note: For Euro Area countries, within Euro Area cross-border equity holdings are considered as Foreign Equity Holdings.

This robust stylized fact has received considerable attention from both the finance literature and the
macroeconomics literature. The main difference between these two sets of literature relies on some modelling assumptions: the traditional finance literature has tried to rationalize the equity home bias in multi-country models of portfolio choice where asset prices and their second moments are given (in particular in these models the risk-free interest rate is exogenously given). The macro literature has tried to integrate international portfolio decisions in otherwise standard Dynamic Stochastic General Equilibrium (DSGE) models of the international economy. These models have a fully general equilibrium structure and asset prices and their second moments are endogenously determined. Asset holdings are a mean to share risks internationally and to diversify optimally domestic output risks. The motivation is however the same: foreign equities seem to offer diversification benefits that are not reaped by investors and both types of literature aim to explain this fact.

3 Open Economy Financial Macroeconomics

The theoretical macro literature points towards potential gains from international diversification since diversification could help to hedge national production risk. In the presence of imperfectly correlated productivity shocks or output shocks across countries, owning foreign equity could help to smooth consumption. This is most obvious in the context of a two country model with one single tradable good, as e.g. in Lucas (1982): in such a world, domestic and foreign investors hold an identical portfolio of claims to output (equities), the market portfolio, thus diversifying optimally national output risks. As in the textbook finance portfolio theory, in such a world the home bias in equities is seen as a failure of the standard diversification motive. However, one should be cautious with such a statement: investors across the world would hold the same portfolio, only if they were homogeneous. In reality, heterogeneity across investors from different countries leads to departure from the world market portfolio and potentially a bias towards national assets. Various sources of heterogeneity leading to equity home bias have been explored in the macro literature; they fall in two broad classes of explanations: (i) hedging motives (real exchange rate risk and non-tradable income risk), (ii) asset trade costs in international financial markets (such as transaction costs, differences in tax treatments between national and foreign assets and other policy induced barriers to foreign investment...).

We will review in details these two explanations but before doing so, we present how recent methodological developments allow us to solve for (non-trivial) portfolio decisions in standard DSGE models of the open economy: we label this recent literature Open Economy Financial Macroeconomics.

3.1 Methodological breakthrough

Until recently, most macroeconomic models of the international economy did not incorporate portfolio decisions and rely mostly on the following asset structures: either one non-contingent bond traded internationally
or complete asset markets (through Arow-Debreu securities). None of these models could say anything about gross foreign asset holdings and the way tradable assets can be used to share risks internationally. This was mostly due to a technical difficulty of solving for portfolios with more sophisticated financial markets. Recent methodological advances have allowed a much richer structure of asset trade to be examined.

Devereux and Sutherland (2008a) develop a solution method that allows standard linear solution techniques for macroeconomic models to be adapted to solve for models with portfolio choice. Standard linear solution techniques cannot directly be applied since these methods rely on a first-order approximation around a non-stochastic steady state: to a first order approximation, assets are perfect substitutes, as they deliver the same expected return, so portfolio choice is not pinned down. Devereux and Sutherland’s work relies on several insights. Firstly, building on earlier work by Judd and Guu (2001) and Samuelson (1970), they show that the steady state portfolio can be derived as the portfolio in a noisy environment and letting the noise go to zero. Secondly, they show that in order for the steady state portfolio to be well defined, a second order approximation of the portfolio equations (Euler equations) needs to be considered, while only the first order dynamics of the other equations of the model are required to pin down steady state portfolios (also called zero order portfolio). Finally, the authors show that the first order dynamics of the model only depend on the steady state portfolio. In addition to these conceptual insights, Devereux and Sutherland (2008a) also provides a formula for portfolio which can be used to compute portfolios analytically in a fairly general class of models. In a companion paper, Devereux and Sutherland (2007a), the authors show that in order to solve for the first order dynamics of the portfolio, a second order approximation of the non-portfolio equations of the model is needed, while the portfolio equations need to be approximated to the third order. Portfolio changes (around the steady state portfolios) are indeed driven by changes in second moments (third-order term) which drive changes in expected returns across assets. It is then also true that the second order dynamics of the model depends on the first order dynamics of portfolios. The authors show that portfolios can again be computed analytically in many cases.

In simultaneous work, Tille and van Wincoop (2008) develop a solution technique that is analogous to the one presented in Devereux and Sutherland (2008a). The main difference consists of the fact that Tille and van Wincoop (2008) rely on numerical iterations to solve for portfolios, which requires more computational effort, but also implies that their solution method can be applied to a wider class of models. The main idea is however similar: steady state portfolios rely on a first-order approximation of the non-portfolio equations and a second-order approximation of the portfolio equations. Other recent work that tackles the challenge of solving for portfolio choice are Devereux and Saito (2005), Evans and Hnatkovska (2006) and Judd et al. (2002). Devereux and Saito (2005) use a continuous time framework which allows some analytical solutions to be derived, but it can only be applied to a very restricted class of models. The methods developed in Evans and Hnatkovska (2006) and Judd et al. (2002) can be applied to a very general class of models, but are quite complex and present a significant departure from standard DSGE solution methods.
These methods face some limitations as they rely on local approximations around the deterministic steady-state: as any local methods, they are valid around the point of approximation, which can raise some concerns in presence of large deviations away from this point. This can arise for instance in presence of large shocks or when the problem is non-stationary (models of incomplete markets for instance where the distribution of wealth across countries might have a unit-root). However, these new methods still constitute a major improvement which makes it possible to incorporate non-trivial portfolio choice in models of the open macroeconomy.

These methodological improvements have generated a recent explosion of the literature to investigate the origins of portfolio biases. A first generation of models of Open Financial Macroeconomics has looked at the hedging of real exchange rate risk and non-tradable income risk as a source of portfolio biases in models with equities only. A second generation of models has emphasized the importance of describing portfolios with a richer menu of assets and has developed models with multiple asset classes (bonds and equities). We will review these two strands of literature sequentially.

3.2 Hedging motives with equities only

Hedging motives lead to departure from the benchmark model of Lucas (1982) where homogeneous investors across the world hold identical portfolios. By hedging motives, we mean choosing financial claims (here equities) that help insulate investors from sources of risk affecting their income streams. The sources of risk developed in the literature are the following:

- Real exchange rate risk: the prices of investors’ consumption goods fluctuate which affects the purchasing power of their income.

- Non-tradable income risk: investors have a part of their income (in the form of wages in particular) that cannot be traded in financial markets.\(^5\)

In other words, because investors in different countries have different exposure to real exchange rate risk and/or to non-tradable income risk, they will hold different equity portfolios in equilibrium. It is important to understand that in these cases, equity portfolio biases are neither inefficient nor the consequence of some frictions in financial markets. The hedging of domestic sources of risks leads to different optimal portfolios across borders but perfect (or almost perfect) risk-sharing can still be preserved. We now review in more details how these sources of risks affect equity portfolio decisions.

3.2.1 Hedging Real Exchange Rate Risk

In the presence of deviations from purchasing power parity on tradable goods/or in the presence of non-tradable goods, agents in different countries face different prices and the real exchange rate fluctuates. Optimal portfolios should then reflect the risk arising from relative price changes. The optimal hedging of real exchange rate risk depends on two forces going in opposite direction: when local goods are more

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\(^5\)The presence of government spending shocks can also generate a source of non-tradable income risk due to tax changes.
expensive, consumers need to generate more income in order to stabilize their purchasing power. On the other hand, since local goods are more expensive, households could be better off consuming when goods are cheaper. The dominating effect depends on how much households want to smooth their consumption (across states of nature), in other words how risk averse they are. For consumers sufficiently risk-averse (with a relative risk aversion above unity as usually assumed), the former effect dominates and households want to increase their income when their consumption goods are more expensive. Thus, they build their portfolio by choosing assets with a high pay-off when local goods are expensive. This is at the heart of the potential divergence of portfolios across investors in the partial equilibrium portfolio choice models with real exchange rate risk. The key issue is whether local equities are a good hedge against relative price (real exchange rate) fluctuations, i.e. whether local equities have higher returns when local goods are (relatively) more expensive. If this is the case, then local investors should favor local equities. Early examples of this hypothesis are Solnik (1974), Adler and Dumas (1983), Krugman (1981), de Macedo (1984), de Macedo et al. (1985) and Stulz (1981). Cooper and Kaplanis (1994) start with the premise that for equity home bias to be rooted in a desire to hedge against relative inflation, equity returns need to be positively correlated with inflation. They test for such a correlation and reject it for all countries considered. This early finance literature takes relative prices (and the real exchange rate) and asset returns as given while in the recent Open Economy Financial Macroeconomics literature, the dynamics of goods prices and asset returns is endogenous, and so is the covariance between the two. We can distinguish among contributions that focus on the hedging of the relative price of tradables (terms-of-trade) and those that focus on the hedging of the relative price of non-tradable goods.

**Hedging the relative price of tradables**

In their influential contribution, Obstfeld and Rogoff (2000) argue that trade costs in goods markets should help to solve the equity home bias puzzle. Following their idea, Coeurdacier (2009) solves for equity portfolios in a two-country/two-good stochastic equilibrium model with trade costs in goods markets. Trade costs for goods are the only source of heterogeneity between countries. Uncertainty in the model is driven by supply (endowment) shocks in both countries. Due to the presence of trade costs, the real exchange rate fluctuates following supply shocks, which in turn affect portfolio decisions. Unfortunately, trade costs do not turn to be helpful to solve for the equity home bias. The main intuition goes as follows: for reasonable values of trade costs, when local output is low (relative to foreign output), the price of local goods increases due to their scarcity and investors require a high return on their equity portfolio to stabilize their purchasing power. They would rather bias their portfolio towards foreign equities as foreign equities have a higher pay-off than local equities when local output is lower: foreign equity is a better hedge for real exchange rate fluctuations than domestic equity and trade costs generate equity foreign bias.\(^6\) Such a result relies on three important assumptions though:

\(^6\)For very high values of trade costs, relative prices respond so much to changes in output that a fall in local output increase local equity returns. In that case, a ‘super’ home bias emerges and households short foreign equity. This case is discarded in the paper for realistic calibrations.
First, as explained above investors must be sufficiently risk averse (they must have a relative risk aversion above unity). This is why Coeurdacier (2009) provides a different answer from the one of Obstfeld and Rogoff (2000): in their paper, the coefficient of risk aversion is below unity (and equal to the inverse of the elasticity of substitution between the two goods). With such preferences, the agents prefer to hold local equities which pay less when local consumption is expensive. A similar point is made by Uppal (1993) in a two country, one good model in continuous time with trade costs: he shows that home bias only arises for the coefficient of relative risk aversion smaller than one.

Second, a fall in the supply of local goods must lower the return of local equity. This is not always true as it depends on the response of relative prices. If consumers cannot substitute easily local and foreign goods (technically speaking if the elasticity of substitution between local and foreign goods is roughly below unity), the fall in supply triggers a large increase in local goods prices which can increase local equity returns. In that case, local equity returns are precisely high when prices of local goods are high. Investors would rather hold local equities. This is the point made by Kollmann (2006a): he develops a two country, two good, endowment economy with home bias in consumption and shows that with a suitably low elasticity of substitution between domestic and foreign goods the model can produce home bias in equities. Hence, in this class of models, equity home bias relies on the response of relative prices, i.e. on the elasticity of substitution between local and foreign products. While time series macro data estimating the response of trade to exchange rate changes suggests a low elasticity of substitution, between 0.5 and 1.5 (see Hooper and Marques (1995), Backus, Kehoe and Kydland (1994) and Heathcote and Perri (2002)), bilateral sectoral trade data suggests a large elasticity, above 5 for most sectors (see Harrigan (1993), Hummels (2001) and Baier and Bergstrand (2001) among others). The parameter uncertainty makes it hard to get a conclusive answer from this class of models.

Third, output fluctuations in this class of models are driven by supply shocks. In the presence of demand shocks, equilibrium portfolios could turn out to be different: when local demand is high, both prices of local goods and payoffs of local firms increase. Hence, demand shocks can generate positive co-movements between local equity returns and the price of local goods (see Pavlova and Rigobon (2007)). In order to be able to consume when demand is high, local investors would prefer local equities.

Hedging the relative price of non-tradables

The presence of nontradable consumption also exposes domestic agents to a source of real exchange rate risk (driven by fluctuations in the price of non-tradable goods). In some specific cases, it is optimal for domestic agents to hold the entire stock of nontradable equity. If the share of nontradable consumption in total consumption is high, this would also imply aggregate home bias in equity holdings. Stockman and Dellas (1989) develops a two country model with endowment economies. Each country produces a (single) traded good and a nontraded good. The sources of uncertainty are shocks to the endowments of

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7 A recent paper by Imbs and Mejean (2009) claims that the discrepancy between macro and micro estimates comes from an aggregation bias; correcting for this bias, they find an elasticity up to 7 in line with the trade evidence.
traded and nontraded goods. There is trade in the equities of tradable and nontradable goods firm. The authors show that with utility separable in tradable and nontradable consumption, optimal portfolios imply that domestic agents hold all of the equity of domestic nontradable firms. This is because by holding all of the equity of nontraded goods, domestic agents hold an asset whose return is perfectly correlated with their expenditure on nontraded goods. Domestic agents hold the same share of Home and Foreign equity of tradable firms, implying perfect diversification in the tradable sector as in Lucas (1982). Thus, this model generates home bias in equity positions, and the home bias increases in the share of nontradable consumption in total output. Under more general conditions, the presence of nontradable consumption interacts with tradable consumption and more or less than full home bias in nontradable equities obtains. The mechanism at heart of the home bias towards non-tradable equity is the following: investors want to hold equities that pay high when the consumption of non-tradable goods is expensive. It turns out that for a sufficiently low elasticity of substitution between tradable and nontradable goods (roughly below unity as found in the empirical literature),\(^8\) a fall in local non-tradable output implies a strong increase the relative price of non-tradable goods together with an increase in local non-tradable equity returns: hence, local non-tradable equity returns comove positively with the price of non-tradable goods (and the real exchange rate), leading to local equity bias in that sector. The precise structure of portfolios is then strongly dependent on preference parameters, in particular the substitution elasticities between tradable and nontradable goods (and also between domestic and foreign tradable goods). For example, Baxter et al (1998) develops a two country endowment economy where each country produces a nontradable good and a single tradable good: they relax the assumption of separability in tradable and nontradable consumption and show that the optimal portfolio of tradable equities held is fully diversified, while home bias in nontradable equities depends on the degree of substitutability between tradables and nontradables.\(^9\) Collard et al. (2007) extends Stockman and Dallas (1989) and Baxter et al. (1998) in a two country (Home and Foreign), DSGE model in which each country receives a stochastic endowment of a tradable and a nontradable good in each period. Aggregate consumption is a CES aggregate of tradable and nontradable consumption and tradable consumption is a CES aggregate of the tradable goods of both countries. Compared to the previous papers, they investigate cases where utility is not separable between tradable and nontradable consumption, where tradable goods are imperfect substitutes, and where households exhibit home consumption bias in the tradable sector. For reasonable parameters values (in particular an elasticity of substitution between tradable and non-tradable goods below unity and elasticity of substitution between tradables roughly above unity), the typical equity portfolio is Home biased in the non-tradable sector and Foreign biased in the

\(^8\)Typical values used for the elasticity of substitution between tradable and non-tradable goods are: 0.44 (Stockman and Tesar (1995)), 0.74 (Mendoza (1995)), from 0.6 to 0.8 (Serrat (2001)). Ostry and Reinhart (1992) provides estimates for developing countries in the range of 0.6 to 1.4. See Matsumoto (2007) for a more detailed discussion.

\(^9\)Eldor et al (1988) in a general equilibrium model with \(n\) countries, each producing a nontradable good and the single tradable good that is consumed in all countries. The assets traded are “real equities” for the tradable and nontradable good. Tradable equities pay one unit of the traded good in each state of the world, while nontradable equity pays out \(\theta\) units of the nontradable good, where \(\theta\) is state contingent nontradable output. They point out that for home bias to arise the returns of nontraded equities have to be positively correlated with the price of the nontradable good and derive conditions for the risk aversion parameter, the price elasticity of demand for tradable goods and the income elasticity of demand for tradable goods such that it would be the case.
tradable sector: a fall in Home non-tradable output increases the relative price of Home non-tradable goods but despite the fall in output, Home equity (excess) returns in the non-tradable sector increases: the Home investor prefers Home stocks of non-tradables as they have high returns when those goods are expensive. He prefers Foreign stocks of tradable equity for the same reasons as in Coeurdacier (2009) and Kollmann (2006a): they have higher returns when the price of Home tradable goods increase following a fall in Home traded output.  

Pesenti and van Wincoop (2000) develops a two country continuous time model with nontradables consumption. The authors use this model to derive an expression that relates home bias to the correlation between equity returns and nontradable consumption growth. Using data on 14 OECD countries from 1970 to 1993, they find that, on average, nontradables consumption growth is positively correlated with the return on domestic capital. This would imply that home bias would arise if tradables and nontradable goods are complementary. The authors find, however, that even in those cases, hedging nontradables consumption could at best explain a relatively small fraction of the home bias observed in the data.

There are two empirical difficulties with this line of explanation. The first one is that the structure of portfolios is strongly dependent on preference parameters, which are not easy to estimate. The second one is that the home bias result relies on the ability of investors to hold separate claims on tradable and non-tradable output: as most products contain both tradable and non-tradable components, shares of firms automatically involve joint claims on tradables and non-tradables. This difficulty is all the more relevant that, when agents are allowed to trade separate claims on tradable and non-tradable output, optimal equity positions are very different across the two sectors. This different structure of portfolios across traded and non-traded sectors seems “inconsistent with casual empiricism” as argued by Lewis (1999). More broadly, empirical analysis of this channel is also hindered by the difficulty to identify nontradable consumption and tradable/nontradable equity.

**Are equities a good hedge for real exchange rate risk?**

In these models results are highly dependent on some preference parameters (risk aversion and substitution elasticities across goods). If one want to believe the parameters are such that the model delivers equity home bias, such an explanation would still face a major empirical issue: the hedging of real exchange rate risk lead to equity home bias if local equities have higher returns (than abroad) when local prices are higher (than abroad). In other words, equity home bias appears if excess local equity returns (over foreign) increase when the real exchange rate appreciates. As shown by van Wincoop and Warnock (2006), the empirical correlation between excess equity returns and the real exchange rate is very low, too low to explain observed equity home bias. Furthermore, most of the fluctuations in the real exchange rate represent fluctuations in the nominal exchange rate: as explained in section (3.3), this could be easily hedged using positions in the forward currency market or the currency bond market. In other words, equities do not seem empirically

10 see Obstfeld (2006) and Matsumoto (2007) for similar results.
11 Note that their model also includes leisure which drives another hedging motive.
to be an appropriate asset to insure investors against real exchange rate fluctuations. Hence, while these models are theoretically appealing, there is now a consensus that the hedging of real exchange rate risk cannot account empirically for the equity home bias.

### 3.2.2 Hedging non-tradable income risk

Most of the wealth held by households is human wealth rather than financial wealth. Labor income accounts for more than 2/3 of total income and expose households to a source of risk, which might lead to portfolio biases. Indeed, households cannot trade financial claims on their labor incomes and will use existing financial assets to hedge this non-tradable income risk. The main intuition is the following: households want to insure themselves against a fall in their labor incomes and in the returns to their human wealth by holding financial assets that have higher returns in these bad states. If local equities have higher (resp. lower) returns (than abroad) when local returns to human wealth are lower (than abroad), they will bias their portfolio towards local (resp. foreign) equities. Portfolio biases are thus driven by the covariance between equity excess returns and excess returns to human wealth. The focus of this literature has been twofold: first, from a theoretical perspective, the literature has discussed the conditions under which standard macroeconomic models imply a negative or positive correlation between local equity returns and returns to human wealth. Second, from an empirical perspective, a series of papers have provided estimates of the covariance between relative equity returns and relative returns to human wealth which is the key empirical counterpart of portfolio biases in this class of models.

The first and most influential contribution in this literature is Baxter and Jermann (1997). They argue that the presence of non-tradable income risk worsen the equity home bias puzzle. Their argument goes as follows: in a standard N-country real business cycle model with a single tradable good and a Cobb-Douglas production function using capital and labor, changes in output are shared in constant proportion between capital and labor. Hence, labor and capital incomes are perfectly correlated in this class of models. As investors are already strongly exposed to domestic risk due to their labor income, they should not hold local capital whose returns move in lock-steps with returns to human wealth. Due to the relatively large labour share in all countries, the effects of hedging domestic human capital dominate the benefits of diversification: investors should short-sell local equities and diversify their non-tradable risk by holding foreign equities. The equity home bias puzzle is worse than we think! The authors then estimate a vector error correction model that allows the correlation between labour and capital returns to vary over time and be imperfect, while maintaining the assumption that the ratio of labour to capital income is stationary. Using data from the OECD National Accounts (1994) for Japan, UK, Germany, and US for 1960-1993, they find that within countries, labour and capital returns are highly correlated, while the correlation between domestic labour returns and foreign equity returns is quite low. Using the observed correlations, the authors then construct diversified portfolios and find that the optimal position in domestic equity is negative in all the countries considered.

Their empirical findings have been challenged by a series of papers: Bottazzi et al (1996) use a
continuous time VAR model of portfolio choice and data on a large set of OECD countries and find that returns to domestic capital and human capital are negatively correlated for most countries but the US and this can explain a large fraction of equity home bias in these countries. Julliard (2002) argues that the Baxter and Jermann (1997)'s empirical findings are due to an econometric misspecification: the correlation between returns to human capital and local equity returns is overstated in Baxter and Jermann (1997) because they implicitly assume that innovations to capital and labor incomes are independent across countries. Once the misspecification is corrected, considering human capital risk does not unequivocally worsen the home bias puzzle. Using micro-level data, Massa and Simonov (2006) show that non-financial income is uncorrelated with the market portfolio of financial assets, but actual investors' portfolios (which differ from the market portfolio) are more positively correlated with non-financial income than the market portfolio is. Thus, the authors cast doubt on the rationality of investors and on their desire to hedge non-tradable income risk.

From a theoretical perspective, Heathcote and Perri (2008) shows that Baxter and Jermann (1997)'s result relies on a very strong assumption: one single and perfectly tradable good. Relaxing this hypothesis (in a benchmark two-country/two-good international RBC model à la Backus, Kehoe and Kydland (1994)) and introducing differentiated product across countries together with consumption/investment home bias changes drastically the picture and help solve the equity home bias puzzle. Their result relies on two key elements: endogenous capital accumulation and a strong adjustment of relative prices. The main intuition goes as follows: suppose a positive (persistent) productivity shock hits the Home economy. This leads to:

(i) a fall in the relative price of Home goods (Foreign goods are scarcer).

(ii) an increase in Home investment (more than abroad) as Home investment uses more intensively cheaper Home goods (due to home bias in investment spending).

(iii) an increase in Home wage incomes (more than abroad) and in the returns on non-tradable wealth (despite the fall in the price of Home goods).

(iv) A decrease in the returns on Home capital (relative to Foreign) if the (relative) price response of Home goods is strong enough.

The main difference with Baxter and Jermann (1997) is the last point (iv): excess returns on Home capital fall following a positive productivity shock if the adjustment of (relative) prices is large enough. Indeed, if the market price of Home goods falls sufficiently and Home investment is increasing, dividends distributed by Home firms (which are net of investment) are lower than abroad, and so are Home returns to capital. Hence the model is able to generate negative co-movements between Home (excess) returns to human wealth and Home (excess) returns to capital. Contrary to Baxter and Jermann (1997)'s argument, if the response of relative prices is strong enough, hedging non-tradable income risk can lead to home bias in equities. In other words, when productivity is high at Home, Home households have a wage increase and can finance the increase in investment at Home without cutting their consumption, the reason why
ex-ante they hold more shares of Home firms. Home bias in investment/consumption spending is important as it triggers a stronger response of investment at Home, thus a larger fall of Home dividends and a larger increase of Home wages. Importantly, the model generates a positive link between consumption home bias and equity home bias as found in the data.\footnote{Lane (2000), Aizenman and Noy (2004), Heathcote and Perri (2008) among others show a positive relationship between trade openness and foreign equity holdings looking at a cross section of countries. Aviat and Coeurdacier (2007) and Lane and Milesi-Ferretti (2008) show that country equity portfolios are strongly biased towards trading partners.} Note that Heathcote and Perri (2008) focus on log-utility and unitary elasticity of substitution between Home and Foreign goods. Relaxing these hypothesis affects the optimal equity portfolio: increasing the level of risk aversion introduces a real exchange rate risk motive as in Coeurdacier (2009) and Kollmann (2006a). Increasing the elasticity of substitution reduces the response of relative prices and makes the portfolio converging towards the one of Baxter and Jermann (1997).

### 3.2.3 A Benchmark Model for Open Economy Financial Macroeconomics with *equities only*

In this section, we present the simplest possible model that formalizes our above discussion on hedging motives when the only traded asset is equity. We show how log-linearization techniques can be used to derive (zero-order) steady-state portfolios. We also revisit some of the results of the literature regarding the hedging of real exchange rate risk and non-tradable income risk in an *equity only* model. In particular, we show the difficulties to rationalize the equity home bias in such a framework. In section (3.3.2), we will show how a multiple asset class model provides an answer to most of these difficulties.

#### Set-up

There are two symmetric countries, Home (H) and Foreign (F), each with a representative household. Country $i = H, F$ produces one good using labor and capital. We assume that capital is fixed\footnote{The model is thus equivalent to a model without capital and a constant mark-up in a monopolistic competition framework} for now and will allow for endogenous capital accumulation in the subsequent section (3.3.2). All markets are perfectly competitive.

#### Preferences

Country $i$ is inhabited by a representative household who has the following life-time utility function:

$$E_0 \sum_{t=0}^{\infty} \beta^t \left( \frac{C_{i,t}^{1-\sigma} - \frac{l_{i,t}^{1+\omega}}{1+\omega}}{1-\sigma} \right),$$

where $\omega$ is the Frish-elasticity of labor supply ($\omega > 0$) and $\sigma$ the relative risk aversion parameter ($\sigma > 0$). $C_{i,t}$ is $i$’s aggregate consumption in period $t$ and $l_{i,t}$ is labor effort. $C_{i,t}$ is a composite good given by:

$$C_{i,t} = \left[ a^{1/\phi} (c_{i,t}^{\phi-1}/\phi) + (1-a)^{1/\phi} (c_{j,t}^{\phi-1}/\phi) \right]^{\phi/(\phi-1)}, \text{ with } j \neq i,$$

where $c_{j,t}^j$ is country $i$’s consumption of the good produced by country $j$ at date $t$. $\phi > 0$ is the elasticity...
of substitution between the two goods. In the (symmetric) deterministic steady state, \( a \) is the share of consumption spending devoted to the local good. We assume a preference bias for local goods, \( \frac{1}{2} < a < 1 \).

The welfare based consumer price index that corresponds to these preferences is:

\[
P_{i,t} = \left[ a (p_{i,t})^{1-\phi} + (1-a) (p_{j,t})^{1-\phi} \right]^{1/(1-\phi)}, \quad j \neq i, \tag{4}
\]

where \( p_{i,t} \) is the price of good \( i \).

**Technologies and firms’ decisions**

In period \( t \), country produces \( y_{i,t} \) units of good \( i \) according to the production function

\[
y_{i,t} = \theta_{i,t} (k_0)^{\alpha} (l_{i,t})^{1-\alpha}, \tag{5}
\]

with \( 0 < \alpha < 1 \). \( k_0 \) is the country’s initial stock of capital. It is fixed. Total factor productivity (TFP) \( \theta_{i,t} > 0 \) is an exogenous random variable.

There is a (representative) firm in country \( i \) that hires local labor and produces output, using technology (5). Due to the Cobb-Douglas technology, a share \( 1 - \alpha \) of output at market prices is paid to workers. Thus, the country \( i \) wage incomes are:

\[
w_{i,t}l_{i,t} = (1 - \alpha)p_{i,t}y_{i,t} \tag{6}
\]

where \( w_{i,t} \) is the country \( i \) wage rate.

A share \( \alpha \) of country \( i \) output at market prices is paid as a dividend \( d_{i,t} \) to shareholders:

\[
d_{i,t} = \alpha p_{i,t}y_{i,t} \tag{7}
\]

**Financial markets and instantaneous budget constraint**

Financial markets are frictionless. There is international trade in stocks. The country \( i \) firm issues a stock that represents a claim to its stream of dividends \( \{d_{i,t}\} \). The supply of shares is normalized at unity. Each household fully owns the local stock, at birth, and has zero initial foreign assets. Let \( S_{j,t+1}^i \) denote the number of shares of stock \( j \) held by country \( i \) at the end of period \( t \). At date \( t \), the country \( i \) household faces the following budget constraint:

\[
P_{i,t}C_{i,t} + p_{i,t}S_{i,t+1}^i + p_{j,t}S_{j,t+1}^i = w_{i,t}l_{i,t} + (d_{i,t} + p_{i,t})S_{i,t}^i + (d_{j,t} + p_{i,t})S_{j,t}^i, \quad j \neq i, \tag{8}
\]

where \( p_{i,t}^S \) is the price of stock \( i \).

**Household decisions and market clearing conditions**

Each household selects portfolios, consumptions and labor supplies that maximize her life-time utility (2) subject to her budget constraint (8) for \( t \geq 0 \). The following equations are first-order conditions of that
decision problem:

\[ c_{i,t} = a \left( \frac{p_{i,t}}{P_{i,t}} \right)^{-\phi} C_{i,t}, \quad c_{j,t} = (1 - a) \left( \frac{p_{j,t}}{P_{j,t}} \right)^{-\phi} C_{i,t}, \quad \lambda_{i,t} \left( \frac{w_{i,t}}{P_{i,t}} \right) C_{i,t} \]

(9) represents the optimal allocation of consumption spending across goods, and the labor supply decision. (10) shows the Euler equations with respect to the two stocks.

Market-clearing in goods and asset markets requires:

\[ c_{H,H,t} + c_{F,F,t} = y_{H,t}, \quad c_{F,H,t} + c_{H,F,t} = y_{F,t}, \]

(11)

\[ S_{H,H,t} + S_{H,F,t} = S_{F,H,t} + S_{F,F,t} = 1 \]

(12)

Zero-order equilibrium portfolios

Equilibrium portfolio holdings chosen at date \( t \) \((S^i_{j,t+1}, S^j_{j,t+1})\) are functions of state variables at date \( t \). Devereux and Sutherland (2006b) show how to compute Taylor expansion of the portfolio decision rules, in the neighborhood of the deterministic steady state. In this Section, we provide closed form solutions for ‘zero-order portfolios’ (denoted by variables without time subscripts) \( S^i, S^j \), i.e. portfolio decision rules evaluated at steady state values of state variables. These portfolios can be determined by linearizing the model around its deterministic steady state. We show that the asset structure here (two assets with two exogenous shocks) is “locally-complete” in the sense that up to a first order linear approximation, the consumption allocation is efficient (perfect risk sharing allocation up to a first-order approximation of the model).

Log-linearization of the model

In what follows, \( z_t \equiv \frac{z_{H,t}}{z_{F,t}} \) denotes the ratio of Home over Foreign variables; \( \xi_t \equiv (z_t - z)/z \) denotes the relative deviation of a variable \( z_t \) from its steady state value \( z \).

The Home country’s CPI-based real exchange is \( \overline{RER}_t \equiv \frac{P_{H,t}}{P_{F,t}} \). Linearizing this expression gives (using (4)):

\[ \overline{RER}_t = \frac{P_{H,t}}{P_{F,t}} = (2a - 1) \hat{q}_t. \]

(13)

where \( q_t \equiv p_{H,t}/p_{F,t} \) denotes the country \( H \) terms of trade. Due to consumption home bias \((a > \frac{1}{2})\), an improvement of the Home terms of trade generates an appreciation of the Home real exchange rate (without home bias in consumption, the real exchange rate is constant).

In an equilibrium with “locally-complete” markets, the ratio of Home and Foreign marginal utilities of aggregate consumption is proportional to the consumption-based real exchange rate (Backus and Smith...
Linearization of this risk sharing condition gives:

\[-\sigma (\hat{C}_{H,t} - \hat{C}_{F,t}) = (2a - 1) \hat{q}_t.\]  

Using intratemporal first-order condition for consumption (9) and market-clearing condition (11), one can show that when (14) holds, relative world consumption demand for the Home good \(y_t = y_{H,t}/y_{F,t} \equiv (c_{H,t}^H + c_{F,t}^H)/(c_{F,t}^F + c_{H,t}^H)\) satisfies in log-linearized terms:

\[\hat{y}_t = -\left[\phi \left(1 - (2a - 1)^2\right) + (2a - 1)^2 \frac{1}{\sigma}\right] \hat{q}_t \equiv -\lambda \hat{q}_t\]  

where \(\lambda \equiv \phi(1 - (2a - 1)^2) + \frac{(2a-1)^2}{\sigma} > 0\). Thus Home terms of trade worsen when the relative supply of Home goods increases as Foreign goods are scarcer.

**Derivation of zero-order portfolios**

Ex-ante symmetry implies that the zero-order portfolios have to satisfy these conditions: \(S \equiv S_H^F = S_F^F = 1 - S_F^H = 1 - S_H^F\); \(S\) describes the (zero-order) equilibrium equity portfolio. Note that \(S\) denotes a country’s holdings of local stock.

We will show that there exists a unique portfolio \(S\) that satisfies the following 'static' budget constraint, for consumptions that are consistent with the linearized risk sharing condition (14):

\[P_{i,t}C_{i,t} = w_{i,t}l_{i,t} + Sd_{i,t} + (1 - S)d_{j,t}, \quad \text{for } i = H, F.\]  

Thus (up to first order), efficient country \(i\) consumption spending at date \(t\) equals date \(t\) wage income, \(w_{i,t}l_{i,t}\), plus the financial income generated by the equity portfolio \(S\).

Subtracting the 'static' budget constraint of country \(F\) from that of country \(H\) and using the risk-sharing condition (14) yields the following log-linearized 'static' budget constraint:

\[(P_{H,t} \hat{C}_{H,t} - P_{F,t} \hat{C}_{F,t}) = (1 - \frac{1}{\sigma})(2a - 1) \hat{q}_t = (1 - \alpha)\hat{w}_t \hat{l}_t + (2S - 1) \alpha \hat{d}_t\]  

where \(\hat{w}_t \hat{l}_t \equiv w_{H,t} \hat{l}_{H,t} - w_{F,t} \hat{l}_{F,t}\) denotes relative labor income and \(\hat{d}_t \equiv \hat{d}_{H,t} - \hat{d}_{F,t}\) denotes the relative dividend.

This expression shows the changes in country \(H\) income (relative to the income of \(F\)) necessary to finance the consumption consistent with efficient risk-sharing (up to first order).

The 'static' budget constraint is useful to derive the equilibrium portfolio as a function of variance/covariance ratios; indeed, taking the covariance with \(\hat{d}_t\) in (17) gives the following portfolio (here we implicitly assume that the equity portfolio supports efficient risk-sharing up to a first-order, which is verified below):

\[\text{See Coeurdacier (2009) and Coeurdacier, Kollmann, Martin (2007) for similar expressions.}\]

\[\text{Kollmann (2006) and Coeurdacier, Kollmann and Martin (2009) shows that if this 'static' budget constraint holds, then the present value budget constraint of country } i \text{ is likewise satisfied, up to a first order.}\]
$$S = \frac{1}{2} \left( 1 - \alpha \frac{\text{cov}(\tilde{w}_t, \tilde{d}_t)}{\text{var}(\tilde{d}_t)} \right) + \frac{1 - \frac{1}{\sigma}}{2} \frac{\text{cov}(\text{REER}, \tilde{d}_t)}{\text{var}(\tilde{d}_t)}$$

(18)

This expression holds in many class of models (with equity only) as we only need the budget constraints and generic first order conditions to derive it. It is the departure of many empirical studies (note that the same expression also holds in terms of returns instead of income flows). The portfolio departs from the fully diversified one with weights 1/2 in both equities (as in Lucas (1982)) in presence of labor income risk and/or real exchange rate risk. It tells us that investors would favor local equity if:

(i) Relative dividends covary negatively with (relative) labor income (hedging of non-tradable income risk driven by the term $\frac{\text{cov}(\tilde{w}_t, \tilde{d}_t)}{\text{var}(\tilde{d}_t)}$); investors prefer local equities if they have high-payoffs when labor incomes are low.

(ii) Relative dividends covary positively with the real exchange rate if $\sigma > 1$ (hedging of real exchange rate risk driven by the term $\frac{\text{cov}(\text{REER}, \tilde{d}_t)}{\text{var}(\tilde{d}_t)}$); investor more risk averse than the log-investor prefer local equities if they have high-payoffs when local consumption is expensive.

Note that expression (18) is a partial equilibrium expression. In general equilibrium macro models, the above variance/covariance can be expressed as a function of the underlying parameters of the model. Since labor income and dividends are a constant share of output ((6) and (7)), relative labor income $(\tilde{w}_t \tilde{l}_t)$ and dividends $(\tilde{d}_t)$ are equal and given by: $\tilde{w}_t \tilde{l}_t = \tilde{d}_t = \tilde{q} + \tilde{y}$.

Substituting into (17) and using (15) gives:

$$(1 - \frac{1}{\sigma}) (2a - 1) \tilde{q}_t = \{ (1 - \alpha) + \alpha (2S - 1) \} (\tilde{q} + \tilde{y}) = \{ (1 - \alpha) + \alpha (2S - 1) \} (1 - \lambda) \tilde{q}_t$$

(19)

The asset structure supports full risk sharing, up to first-order, if (19) holds for all realizations of the (relative) exogenous productivity shocks ($\tilde{\theta}_t$) (or equivalently all realizations of the terms-of-trade $\tilde{q}_t$). The following portfolio $S$ ensures that (19) holds for arbitrary realizations of $\tilde{q}_t$:

$$S = \frac{1}{2} - \frac{1 - \alpha}{\alpha} \frac{1}{\frac{1}{2}(1 - \frac{1}{\sigma}) (2a - 1)}$$

(20)

The portfolio is the sum of three terms:

- The first term $\frac{1}{2}$ is a pure diversification term. It would prevail if there were no hedging motives as in Lucas (1982). In the absence of heterogeneity across investors, there is full diversification of national output risk. We derive the Lucas portfolio when $\alpha \to 1$ (no human capital risk) and when $a = 1/2$ (no real exchange rate risk).

- The second term $-\frac{1 - \alpha}{\alpha} \frac{1}{\frac{1}{2}(1 - \frac{1}{\sigma}) (2a - 1)}$ is the hedging of non-tradable income risk of Baxter and Jermann (1997): changes in output driven by productivity shocks are shared in constant proportion (Cobb-Douglas production). This leads to a perfect correlation between labor incomes and capital incomes: households should short the local stock to hedge human capital risk. Note that we derive exactly the portfolio of
Baxter and Jermann (1997) in the absence of real exchange rate risk (a = 1/2)

- The third term $-\frac{1}{2}(1 - \frac{1}{\sigma})^\left(\frac{2\alpha-1}{\alpha(\lambda-1)}\right)$ is the hedging of real exchange rate risk. This term is the same as the one derived in Coeurdacier (2009) and Kollmann (2006) in the absence of human capital risk ($\alpha \to 1$). This term cancels out for a log-investor ($\sigma = 1$). As explained above (see equation (18)), investors bias their portfolio towards equities that have high returns when local goods are more expensive (if $\sigma > 1$). The appropriate asset depends on the value of $\lambda$ i.e on the elasticity of substitution $\phi$. Three different cases emerge:

(i) $\lambda > 1$ (i.e. an elasticity of substitution $\phi$ roughly above unity): the hedging of real exchange rate risk generates a Foreign equity bias. The reason is the following: a (relative) fall in local output driven by a bad productivity shock triggers an increase in the Home terms-of-trade, an appreciation of the Home real exchange rate together with a decrease in Home equity returns: Foreign equities are more cherished by Home investors since they have higher returns when the Home real exchange rate appreciates.

(ii) $\lambda < 1$ (i.e. elasticity of substitution $\phi$, roughly below unity): a (relative) fall in local output triggers a stronger improvement of the Home terms-of-trade and a stronger appreciation of the Home real exchange rate. As the relative price response is stronger, Home equity excess returns increase: Home investors exhibit Home equity bias as Home equity have higher returns when the Home real exchange rate appreciates. This is the case emphasized by Kollmann (2006).

(iii) $\lambda = 1$: Any increase in local output is perfectly offset by a fall in the terms-of-trade. Both equities are perfect substitutes and there is portfolio indeterminacy. This is an extension of Cole and Obstfeld (1991)'s result.

Overall, for most reasonable calibrations, the equity portfolios is foreign biased and the hedging terms, if anything, worsen the equity home bias puzzle.

3.3 Hedging motives with multiple asset classes

3.3.1 Hedging with bonds and equities: the role of "conditional risk"

The first generation of papers presented above focus on equity positions to rationalize the home bias. However, equities are only a part of financial assets traded internationally. Debt securities (nominal bonds in different currencies, corporate bonds...) are instruments that can also be used to share risks internationally (see section (5)). There are no reasons to exclude them from the models, first for realism, since they constitute a large share of international asset flows but above all because there might be substitution across asset classes. Hence, the equity positions derived in equity only models might be sensitive to the presence of other financial assets. Recent models with portfolio decisions have been incorporating multiple assets (equities
Recent contributions with multiple asset classes include: Engel and Matsumoto (2008a,b), Coeurdacier, Kollmann and Martin (2007 and 2009), Coeurdacier and Gourinchas (2009), Berriel and Bhattarai (2008).
rate become less closely related, making forward contracts less able to hedge fluctuations in relative prices. In the extreme case of full price flexibility, we go back to Baxter and Jermann (1997): labor incomes and profits are perfectly correlated and investors do not take any forward position as they do not want any exposure to purely nominal risk. Engel and Matsumoto (2008b) generalise the results above to the cases of local bias in consumption, producer currency pricing and wage rigidity. They find that all three factors do not change the qualitative results of the paper.

Coeurdacier, Kollmann and Martin (2009) extends the framework of Heathcote and Perri (2008) by allowing trade in (real) bonds in an environment with investment specific shocks and productivity shocks. Home bias in this model arises for reasons similar to Heathcote and Perri (2008): with local bias in investment, an increase in local investment raises labour demand and wages more than abroad, while (relative) dividends fall to finance investment. But contrary to Heathcote and Perri (2008), the equity portfolio becomes robust to changes in preference parameters (elasticity of substitution and risk aversion) and does not rely on a strong response of relative prices to productivity shocks. This is due to the presence of real bonds, as only the covariance of labour income and dividends orthogonal to relative prices matters (i.e. the covariance conditional on cross-country bond returns differentials). The degree of risk aversion affects the desire to hedge real exchange rate risk, which is taken care of by the appropriate bond position. The model below (see section 3.3.2) illustrates their findings.

Rabhari (2009) develops a two-country DSGE model with price stickiness, endogenous capital accumulation, trade in nominal bonds and equities and endogenous monetary policy. In his setting, equity home bias is again driven by the motive to hedge human capital risk. Real exchange rate risk is mainly hedged through bond positions, as price stickiness implies that cross-country bond returns differentials are highly correlated with the real exchange rate. He also shows that the combination of price stickiness and endogenous capital accumulation can produce relative equity returns that are unconditionally positively correlated with human capital returns, but conditionnaly negatively correlated, once he controls for bond returns. This correlation pattern is confirmed using US data. Rabhari (2009) also presents an interesting theoretical analysis of the effect of a currency union and different monetary policy rules, which affect the real exchange rate hedging motives on equilibrium portfolios.

Devereux and Sutherland (2008b, 2008c) develops a two country, two goods DSGE model with nominal rigidities a la Calvo, producer currency pricing and endogenous monetary policy. The monetary authority sets the nominal interest rate in response to changes in producer price inflation. There is no local bias in consumption and productivity shocks are assumed to be perfectly persistent. The authors consider different asset market structures (portfolio autarky, trade in nominal bonds and trade in nominal bonds and equity). They can generate home bias in equities for the same reason as Engel and Matsumoto (2008a). They also find that monetary policy assumes an additional role in these models. By affecting the returns on nominal bonds, monetary policy affects portfolios and thus risk sharing. They find that while monetary

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17 Two types of uncertainty are necessary to pin down zero order portfolios. However, Coeurdacier et al. (2009) shows that their results are not dependent on the additional shocks introduced. See model below.
policy has no impact on portfolios with trading in nominal bonds and equities, in the case of bond trading only, there is an additional motive for price stability. With price stability, cross-country nominal bonds returns differentials become more correlated with the real exchange rate, which improves international risk sharing.

**Berriel and Bhattarai (2008)** solves for equity and nominal bonds portfolios in a standard two-country general equilibrium model in presence of government spending shocks and nominal shocks (shocks to the price level): they investigate a new source of non-tradable income risk, namely tax changes. In order to hedge fluctuations in taxes, households exhibit home bias towards local (government) nominal bonds and local equities. The main mechanism goes as follows: price level shocks at home (increase in home inflation) lowers the value of home government debt and the government can lower taxes (while still satisfying its intertemporal constraint). Hence, returns on domestic nominal bonds and local taxes co-move positively and the household prefers to hold local nominal bonds. Government spending shocks lead to an increase in taxes. In the mean time, as government expenditures are biased towards local goods, the relative price of locally produced goods increase and so does the pay-off of the claim to local output (local equity). Hence, returns on local equity and taxes co-move positively and households will optimally bias their portfolio towards local equity.

### 3.3.2 A Benchmark Model for Open Economy Financial Macroeconomics with bonds and equities

In this section, we use a similar set up as in section (3.2.3) that but we add two important ingredients to formalize our above discussion on hedging motives: endogenous capital accumulation and trade in real bonds. They allow us to overcome the limitations of the model presented in (3.2.3): first, endogenous investment in a two-good model breaks the perfect link between returns on physical capital and returns on human capital; second, bond trading modifies the hedging properties of equities: bonds will be used to hedge fluctuations in the real exchange rate. Equities will be used to hedge non-tradable income risk, conditionally on bond returns. This model is similar to **Heathcote and Perri (2008)** and **Coeurdacier, Kollmann and Martin (2009)**.

**Set-up**

In presence of productivity shocks only, we would face a portfolio indeterminacy in a first-order approximation of the non-portfolio equations since the number of available assets (bonds and equities in each country) would exceed the exogenous sources of uncertainty. We have to add an additional source of uncertainty. We choose to add shocks to the disutility of leisure.\(^ {18} \) Hence, preferences are now defined by:

\[
E_0 \sum_{t=0}^{\infty} \beta^t \left( C_{i,t}^{1-\sigma} \frac{1}{1-\sigma} - \lambda_{i,t}^{1+\omega} \right),
\]

\(^ {18} \)Note that the nature of the additional shock used to alleviate the the portfolio indeterminacy does not not matter for the portfolio (see Coeurdacier, Kollmann and Martin (2009)).
where $\chi_{i,t}$ is an exogenous shock to the disutility of labor.

**Technologies and capital accumulation**

Production in each country uses capital and labor with a Cobb-Douglas production function:

$$y_{i,t} = \theta_{i,t} (k_{i,t})^\alpha (l_{i,t})^{1-\alpha}, \quad (22)$$

The law of motion of the capital stock is:

$$k_{i,t+1} = (1 - \delta)k_{i,t} + I_{i,t} \quad (23)$$

where $0 < \delta < 1$ is the depreciation rate of capital. $I_{i,t}$ is gross investment in country $i$ at date $t$. In both countries, gross investment is generated using Home and Foreign inputs:

$$I_{i,t} = h_{i}^{a_1} = i_{i,t}^{1-\phi} + (1 - a)^{1/\phi} i_{j,t}^{(\phi-1)/\phi} \phi^{(\phi-1)}, \quad j \neq i, \quad (24)$$

where $i_{j,t}$ is the amount of good $j$ used for investment in country $i$. We assume local bias for investment spending (identical to the one for consumption)$^{19}$, $\frac{1}{2} < a < 1$. The associated investment price index is the same as for consumption $P_{i,t}$ (see equation (4)).

**Firms’ decisions**

A share $1 - \alpha$ of output at market prices is paid to workers as in equation (6). A share $\alpha$ of country $i$ output, net of physical investment spending is paid as a dividend $d_{i,t}$ to shareholders:

$$d_{i,t} = \alpha p_{i,t} y_{i,t} - P_{i,t} I_{i,t} \quad (25)$$

The firm chose $I_{i,t}$ to equate the expected future marginal gain of investment to the marginal cost. This implies the following first-order condition:$^{20}$

$$P_{i,t} = E_t \beta (C_{i,t+1}/C_{i,t})^{-\sigma} (P_{i,t}/P_{i,t+1}) [p_{i,t+1} \theta_{i,t+1} \alpha k_{i,t+1}^{a-1} i_{i,t+1}^{1-\alpha} + (1 - \delta)P_{i,t+1}], \quad (26)$$

The firm chooses the Home and Foreign investment inputs $i_{i,t}^i, i_{j,t}^i$ that minimize the cost of generating $I_{i,t}$. This leads to the following intratemporal allocation for investment goods:

$$i_{i,t}^i = a \left( \frac{p_{i,t}}{P_{i,t}} \right)^{-\phi} I_{i,t}, \quad i_{j,t}^i = (1 - a) \left( \frac{p_{i,t}}{P_{i,t}} \right)^{-\phi} I_{i,t}, \quad j \neq i. \quad (27)$$

$^{19}$See Coeurdacier, Kollmann and Martin (2009) and Castello (2009) for a model where bias in investment spending is different from the bias in consumption spending.

$^{20}$Note that we use the intertemporal marginal rate of substitution of the country $i$ household for investment decisions in country $i$. This assumption is however irrelevant here since up to the degree of the approximation, the intertemporal marginal rate of substitution of the country $i$ household and the country $j$ household are the same.
Financial markets and instantaneous budget constraint:

There is now international trade in stocks and (real) bonds. Stocks in country $i$ represents a claim to its stream of dividends $\{d_i,t\}$. There is a bond denominated in the Home good, and a bond denominated in the Foreign good. Buying one unit of the Home (Foreign) bond in period $t$ gives one unit of the Home (Foreign) good in all future periods. Both bonds are in zero net supply. We denote by $S_{i,t+1}$ the number of shares of stock $j$ held by country $i$ at the end of period $t$, while $B_{j,t+1}^i$ represents claims held by country $i$ (at the end of $t$) to future unconditional payments of good $j$. At date $t$, the country $i$ household now faces the following budget constraint:

$$P_{i,t}C_{i,t} + w_{i,t}l_{i,t} + (d_i,t + p_{i,t}S_{i,t})S_{i,t+1} + (d_j,t + p_{i,t}S_{j,t})S_{j,t+1} + (p_i,t + p_{i,t}B_{i,t})B_{i,t+1} + (p_j,t + p_{j,t}B_{j,t})B_{j,t}^i, \ j \neq i,$$

where $p_{i,t}^S$ is the price of stock $i$ and $p_{i,t}^B$ is the price of bond $i$.

Household decisions and market clearing conditions

Households’ first-order conditions of that decision problem are still given by (9) and (10). One need to add the Euler equations for the two bonds:

$$1 = E_t \beta \left( \frac{C_{i,t+1}}{C_{i,t}} \right)^{-\sigma} \frac{P_{i,t} + p_{j,t}B_{j,t+1}}{P_{i,t+1}} \ f o r \ j = H, F.$$

Market-clearing in goods and asset markets now requires:

$$c_{H,t}^H + c_{H,t}^F + i_{H,t}^H + i_{H,t}^F = y_{H,t} ; \ c_{F,t}^H + c_{F,t}^F + i_{F,t}^H + i_{F,t}^F = y_{F,t} ;$$

$$S_{H,t}^H + S_{F,t}^H = S_{F,t}^H + S_{H,t}^H = 1 ;$$

$$B_{H,t}^H + B_{F,t}^H = B_{F,t}^H + B_{H,t}^H = 0.$$

Zero-order equilibrium portfolios

As in section (3.2.3), equilibrium portfolio holdings $(S_{i,t+1}^i, S_{j,t+1}^i, B_{i,t+1}^i, B_{j,t+1}^i)$ can be determined by linearizing the model around its deterministic steady state. With the asset structure here (four assets with four exogenous shocks), efficient risk sharing can be replicated up to a first-order (“locally-complete” markets).

Linearization of the model

We use the same notation as in section (3.2.3). Equations (13) and (14) still hold.
Linearization of the relative demand for investment $y_{I,t} = \frac{i_{H,t}^H+i_{F,t}^F}{i_{F,t}^F+i_{H,t}^H}$ gives (using the intratemporal allocation across investment goods (27)):

\[
\ddot{y}_{I,t} = -\phi \left(1 - (2a_t - 1)^2\right) \ddot{q}_t + (2a_t - 1)\ddot{I}_t,
\]

(32)

where $I_t = I_{H,t}/I_{F,t}$ is relative real aggregate investment. Holding constant the terms of trade, the relative demand for Home investment goods, $y_{I,t}$, increases with relative real investment in the Home country, $I_t$, since Home aggregate investment is biased towards the Home good ($a > \frac{1}{2}$).

The relative demand for consumption $\ddot{y}_{C,t}$ is still defined by (from (15)):

\[
\ddot{y}_{C,t} = \left[\phi \left(1 - (2a_t - 1)^2\right) + (2a_t - 1)^2 \frac{1}{\sigma}\right] \ddot{q}_t \equiv -\lambda \ddot{q}_t
\]

(33)

The market clearing condition for goods (30), together with (32) and (33) implies:

\[
(1 - s_I)\ddot{y}_{C,t} + s_I \ddot{y}_{I,t} = -\mu \ddot{q}_t + s_I (2a_t - 1) \ddot{I}_t = \ddot{y}_t,
\]

(34)

where $\mu = \phi(1 - (2a_t - 1)^2) + (1 - s_I)\frac{(2a_t - 1)^2}{\sigma} > 0$ and $s_I \equiv \frac{P_{H,t}^H}{P_{H,H}} = \frac{P_{F,t}^F}{P_{F,F}}$ is the steady state investment/GDP ratio.

Not surprisingly, Home terms of trade worsen when the relative supply of Home goods increases, for a given amount of relative Home country investment. Home terms of trade improve when Home investment rises (due to home bias in investment spending), for a given value of the relative Home/Foreign output.

**Zero-order portfolios**

Ex-ante symmetry implies that the zero-order portfolios have to satisfy the following conditions: $S = S_H^H = S_F^F = 1 - S_H^F = 1 - S_F^H$; $B = B_H^H = B_F^F = -B_H^F = -B_F^H$. The pair $(S; B)$ thus describes the (zero-order) equilibrium portfolio. $B$ denotes a country holdings of bonds denominated in its local good. $B > 0$ means that a country is long in local-good bonds (and short in foreign good bonds).

As before there exists a unique portfolio $(S; B)$ that satisfies the following ‘static’ budget constraint, for consumptions that are consistent with the linearized risk sharing condition (14):

\[
P_{i,t}C_{i,t} = w_{i,t}l_{i,t} + Sd_{i,t} + (1 - S)d_{j,t} + B(p_{i,t} - p_{j,t}), \text{ for } i = H, F.
\]

(35)

Efficient country $i$ consumption spending at date $t$ equals date $t$ wage income, $w_{i,t}l_{i,t}$, plus the financial income generated by the portfolio $(S; B)$

Subtracting the ‘static’ budget constraint of country $F$ from that of country $H$ and linearizing gives:\n
\[
(1 - s_I)(P_{H,t}C_{H,t} - P_{F,t}C_{F,t}) = (1 - s_I)(1 - \frac{1}{\sigma})(2a_t - 1) \ddot{q}_t = (1 - \alpha) w_{i,t} \ddot{l}_t + (2S - 1)(\alpha - s_I) \ddot{d}_t + 2b \ddot{q}_t, \quad b \equiv B/y_H,
\]

(36)

\textsuperscript{21} We assume $\alpha > s_I$ to have strictly positive dividends in the steady-state.
where $b = \frac{B}{y}$ denotes holdings of debt denominated in local good, divided by steady-state GDP.

Like in the previous model, one can derive from the 'static' budget constraint (36) a partial equilibrium portfolio that sheds light on the hedging terms in terms of covariance-variance ratios. This expression holds in a large class of models with bonds and equities.

Projection of (36) on $\widehat{d}_t$ and $\widehat{q}_t$ gives the following expression for the portfolio of bonds and equities ($S, b$):

$$S = \frac{1}{2} \left[ 1 - \frac{1 - \alpha}{\alpha - s_I} \frac{\text{Cov}_t(w_iI_t, \widehat{d}_t)}{\text{Var}_t(\widehat{d}_t)} + \frac{(1 - \frac{1}{\sigma})}{\alpha - s_I} \frac{\text{Cov}_t(RER_t, \widehat{d}_t)}{\text{Var}_t(\widehat{d}_t)} \right] \tag{37}$$

$$b = \frac{1}{2} \left[ (1 - s_I)(1 - \frac{1}{\sigma}) \frac{\text{Cov}_t(RER_t, \widehat{q}_t)}{\text{Var}_t(\widehat{q}_t)} - \frac{1 - \alpha}{\alpha - s_I} \frac{\text{Cov}_t(w_iI_t, \widehat{q}_t)}{\text{Var}_t(\widehat{q}_t)} \right] \tag{38}$$

where $\text{Cov}_t(\widehat{x}_t, \widehat{y}_t)$ is the covariance between $\widehat{x}_t$ and $\widehat{y}_t$ conditional on the pay-off $\widehat{z}_t$.

These expressions give two important insights: first, the covariance of asset payments with the real exchange rate risk and labor income risk conditional on payments of the other assets matters for the portfolio. Second, real exchange rate hedging should be taken care of by the bond position since bond return differentials across countries are almost perfectly correlated with the real exchange rate (see Coeurdacier and Gourinchas (2009)). Note that in the present model with real bonds, the correlation is perfect and the real exchange rate hedging term on the equity position $\left( \frac{\text{Cov}_t(RER_t, \widehat{d}_t)}{\text{Var}_t(\widehat{d}_t)} \right)$ will be exactly zero.

We now turn to the zero-order portfolio as a function of the model parameters. Relative labor income $(w_iI_t)$ is still given by: $w_iI_t = \widehat{q}_t + \widehat{y}_t$. Due to the presence of endogenous investment, relative dividends $(\widehat{d}_t)$ are now given by (using (25)):

$$\widehat{d}_t = \frac{\alpha}{\alpha - s_I} (\widehat{q}_t + \widehat{y}_t) - \frac{s_I}{\alpha - s_I} (P_{H,t}I_{H,t} - P_{F,t}I_{F,t}) = \frac{\alpha}{\alpha - s_I} (\widehat{q}_t + \widehat{y}_t) - \frac{s_I}{\alpha - s_I} ((2a - 1) \widehat{q}_t + \widehat{I}_t). \tag{39}$$

Hence, using (34), we can re-express (36) as follows:

$$(1 - s_I)(1 - \frac{1}{\sigma}) (2a - 1) \widehat{q}_t = [(1 - \alpha) + \alpha (2S - 1)]((1 - \mu)\widehat{q}_t + s_I(2a - 1)\widehat{I}_t) - s_I (2S - 1) [(2a - 1) \widehat{q}_t + \widehat{I}_t] + 2b\widehat{q}_t + \frac{2}{\sigma} \frac{1 - \alpha}{1 - (2a - 1)\alpha}$$

The asset structure supports full risk sharing, up to first-order, if (40) holds for all realizations of the two (relative) exogenous shocks $(\widehat{\theta}_t, \widehat{\chi}_t)$. To solve for that portfolio, we do not have to solve for output and investment, as a unique pair of terms of trade and relative real investment $(\widehat{q}_t, \widehat{I}_t)$ is associated with each realization of $(\widehat{\theta}_t, \widehat{\chi}_t)$.

The following portfolio $(S, b)$ ensures that (40) holds for arbitrary realizations of $(\widehat{q}_t, \widehat{I}_t)$:

$$S = \frac{1}{2} \left[ 1 + \frac{(2a - 1)(1 - \alpha)}{1 - (2a - 1)\alpha} \right] > \frac{1}{2}, \tag{41}$$

$$b = \frac{1}{2} \left[ (1 - s_I)(1 - \frac{1}{\sigma}) (2a - 1) + \frac{(1 - \alpha) [(2a - 1)/\alpha] + s_I(2a - 1)^2]}{1 - (2a - 1)\alpha} \right] \tag{42}$$
The equity portfolio feature equity home bias and is sum of two terms only. The hedging-term for the real exchange rate is indeed zero in this model since relative price movements are fully hedged by the appropriate (real) bond position (cross-country differentials in bond payments are perfectly correlated with the real exchange rate).

- The first term $\frac{1}{2}$ is still the **Lucas (1982)** term which prevails in the absence of non-tradable income risk ($\alpha \to 1$)

- The second term $\frac{(2a-1)(1-\alpha)}{1-(2a-1)\alpha}$ is the hedging of non-tradable income risk **conditionally** on bond payments: this term is unambiguously positive and drives home equity bias in the model. To understand this term, assume a combination of shocks $(\hat{\theta}_t, \hat{\chi}_t)$ such that relative investment $\hat{I}_t$ increases but leaves the terms-of-trade (bond payments differential) $\hat{q}_t$ unchanged. Such a combination of shocks will increase labor demand and labor incomes since investment spending is using more intensively local goods ($a > 1/2$). In the mean time, dividends net of investment spendings are falling. This generate negative comovements between labor income and dividends holding relative prices constant (or equivalently conditional on bond payments differentials).

The equity portfolio is indeed the same as in **Heathcote and Perri (2008)** but for any values of the preference parameters: **Heathcote and Perri (2008)** considers the same model but with equities and productivity shocks only. In their benchmark case, parameters are such that $\sigma = \phi = \mu = 1$. With such parameter values, only fluctuations in investment matters for the equity portfolio, for two reasons: (i) fluctuations in output are hedged through terms-of-trade movements (as in **Cole and Obstfeld (1991)**) due to $\mu = 1$; (ii) $\sigma = 1$ cancels out any real exchange rate hedging term. As a consequence, with such preferences, the equity portfolio is the same as in the present model.

The bond portfolio $b$ is also the sum of two terms:

- The first term $\frac{1}{2}(1 - s_I)(1 - \frac{1}{\sigma})(2a - 1)$ is the hedging of real exchange rate risk. This is the desired exposure to real exchange rate in the absence of non-tradable income risk ($\alpha \to 1$). This term is unambiguously positive since local bonds have higher pay-offs when local goods are more expensive.

- The second term $\frac{(1-\alpha)+s_I(2a-1)^2}{1-(2a-1)\alpha}$ is the hedging of non-tradable income risk **conditionally** on relative dividend payments: this term can be positive or negative. Roughly speaking, it is negative if relative wages are positively (resp. negatively) correlated with the terms-of-trade, which happens for low values of $\mu$, i.e. low elasticity of substitution $\phi$ (resp. for high values of $\mu$, i.e. high elasticity of substitution $\phi$).

Note that with $a = 1/2$, this term is equal to zero since increases in domestic investment changes do not increase more domestic demand than foreign. Wages increase as much in both countries.

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22
3.3.3 Empirical evidence on the hedging of non-tradable income risk

We now present some simple empirical evidence on the hedging of non-tradable risk similar to the one in Coeurdacier, Kollmann and Martin (2009). The evidence is based on the expression of the portfolio in terms of variance/covariance ratio (equation (37))

We use national accounts data for G7 countries to compute the conditional covariance-variance ratio \( \left( \frac{\text{Cov}(\hat{w}_t l_t, \hat{d}_t)}{\text{Var}(\hat{d}_t)} \right) \) for each country. Data are quarterly over the period 1980Q1-2008Q3. We compute relative labor income deviations \( \hat{w}_t l_t \) and relative dividend deviations \( \hat{d}_t \) for each country with respect to the other six countries (wages are computed for each country as the share of output going to labor and dividends are computed as the share of output going to capital net of investment spending).\(^{23}\) Deviations are either first-difference of the variables or HP-filtered data (smoothing parameter 1600). We compute bond payments differentials \( \hat{q} \) using the (trade-weighted) real exchange rate of one country with respect to the other six (see appendix for data construction). Note that results are virtually the same when using nominal exchange rate instead of the real exchange rate (i.e. considering nominal bonds instead of real bonds). We also report the unconditional covariance-variance ratio \( \left( \frac{\text{Cov}(\hat{w}_t l_t, \hat{d}_t)}{\text{Var}(\hat{d}_t)} \right) \), the one that matter in an equity-only model (see equation (18)). As shown in table (2), conditioning for exchange rate movements has a strong impact on the hedging properties of equities for non-tradable income risk: unconditionally, wages and dividends comove positively for all countries, which would lead to a very large foreign equity bias in the equity-only model of section (3.2.3). Conditionally, wages and dividends comove negatively for all countries, which lead to a home equity bias in the present equity-bond model. Contrary to Baxter and Jermann (1997), the presence of bonds makes the international diversification puzzle better than you think, both in the model and in the data! Coeurdacier and Gourinchas (2009) find qualitatively similar results looking at returns rather than income flows.

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<th>CA</th>
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<td>(1) ( \frac{\text{Cov}(\hat{w}_t l_t, \hat{d}_t)}{\text{Var}(\hat{d}_t)} )</td>
<td>0.16 (0.041)</td>
<td>0.28 (0.064)</td>
<td>0.32 (0.067)</td>
<td>0.58 (0.065)</td>
<td>0.42 (0.052)</td>
<td>0.49 (0.057)</td>
<td>0.37 (0.065)</td>
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<tr>
<td>(2) ( \frac{\text{Cov}(\hat{w}_t l_t, \hat{d}_t)}{\text{Var}(\hat{d}_t)} )</td>
<td>-0.015 (0.014)</td>
<td>-0.128 (0.015)</td>
<td>-0.095 (0.025)</td>
<td>-0.076 (0.030)</td>
<td>-0.080 (0.019)</td>
<td>-0.122 (0.026)</td>
<td>-0.051 (0.020)</td>
</tr>
<tr>
<td>(3) ( \frac{\text{Cov}(\hat{w}_t l_t, \hat{d}_t)}{\text{Var}(\hat{d}_t)} )</td>
<td>0.08 (0.035)</td>
<td>0.47 (0.085)</td>
<td>0.33 (0.073)</td>
<td>0.33 (0.031)</td>
<td>0.46 (0.045)</td>
<td>0.39 (0.043)</td>
<td>0.55 (0.075)</td>
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<tr>
<td>(4) ( \frac{\text{Cov}(\hat{w}_t l_t, \hat{d}_t)}{\text{Var}(\hat{d}_t)} )</td>
<td>-0.032 (0.009)</td>
<td>-0.139 (0.023)</td>
<td>-0.135 (0.031)</td>
<td>-0.011 (0.015)</td>
<td>-0.097 (0.015)</td>
<td>-0.084 (0.018)</td>
<td>-0.070 (0.022)</td>
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(1) and (2): in first-difference; (3) and (4): HP filter

Table (2): The hedging of non-tradable risk: conditional and unconditional covariance-variance ratios

(source: National Accounts Data and IFS)

\(^{23}\)We follow Gollin (2002) to allocate mixed-incomes from the national accounts to labor or capital. We assume that the share of mixed income going to labor is equal to the share of labor income in value added.
3.3.4 Extensions and shortcomings

**Other assets?**

The recent literature has shown the importance of extending existing models with a larger menu of assets. Due to substitution across asset classes (bonds and equities in the previous case), the hedging role of an asset is modified by the presence of other available types of assets. Thus, an important issue is why we should restrict our attention to bonds and equities instead of considering an even larger set of assets. There is no simple answer to this question: potentially any candidate asset that is traded publicly could affect the equity portfolio if it has some hedging properties on the top of what bonds and equities can achieve. Note that the empirical tests of these hedging properties based on covariance-variance ratios could be potentially extended to a larger menu of assets, one just needs to condition for returns on these other potential candidate assets. In particular, including housing as an additional asset seems a natural extension of existing work.

A related question is the role of corporate debt in these models. We have fully ignored debt as a way to raise capital for firms and have focused on firms that are fully financed through equity. Coeurdacier, Kollmann and Martin (2009) tackle this issue by allowing for an exogenous financial structure of firms in a world of ‘locally complete’ markets. They show that in an environment where the financial structure is irrelevant for the value of the firm (when the Modigliani-Miller theorem applies), the presence of corporate debt has no impact on investment decisions and the equilibrium consumption allocation (up to the first order) since markets are complete. Moreover, the equilibrium equity portfolio is also not affected by the presence of corporate debt. They show that domestic investors will hold a fraction of the corporate debt issued by domestic firms that is equal to the fraction of stocks of the same firms that they hold. Hence, *if the model delivers home bias in equity, it will also deliver home bias in corporate debt in the same proportion*. The reason is simple: when the Modigliani-Miller theorem applies, investors want a certain exposure to the total value of the firm which is independent of its financial structure. In particular, the fraction of the value of the firm they hold optimally is pinned down in the case where firms are fully financed through equity. When firms are partially financed through debt, holding the same fraction of debt and equity guarantees that investors have their optimal exposure to the value of the firm. One shortcoming though is that such a result might not hold if Modigliani-Miller theorem does not apply or if financial markets are incomplete. We are not aware of any models that pins down international portfolios in a world where the financial structure of firm, optimal or not, affects the value of the firm and matters for the real allocation.

***Too much risk-sharing?***

Another important shortcoming of these models with endogenous portfolio decisions is that they predict far too much international risk-sharing, compared to what is found in the data. Like in most of the literature, the portfolios in the previous models are such that the perfect risk-sharing consumption is replicated, at least up to the degree of the approximation. This implies an equality between the ratio of marginal utilities of
consumption and the real exchange rate in all states of nature. With standard CRRA preferences, this leads to a perfect correlation between real exchange rate changes and relative consumption growth (Home relative consumption falls when Home relative prices are higher; see equation (14) in the previous models). In the data, this is strongly rejected, the correlation is close to zero and if anything Home relative consumption increases when Home relative prices are higher: the consumption-real exchange rate anomaly (Kollmann-Backus-Smith puzzle; see Backus and Smith (1993) and Kollmann (1995)). The previous models are quite specific in the sense that the asset structure and the dimension of uncertainty are such that one can replicate up to first order the efficient allocation. One could believe that adding additional sources of uncertainty such that markets are incomplete even locally would help to solve the consumption-real exchange rate anomaly. It turns out to be extremely hard to lower the correlation between relative consumption and the real exchange rate in models with endogenous portfolio decisions, even under incomplete markets (see Coeurdacier, Kollmann and Martin (2007) and Benigno and Kucuk-Tuger (2009)). In all existing models with endogenous portfolio choice, international risk-sharing is still far above what the data suggest and this remains an important challenge for future work.

3.4 Asset trade costs in international financial markets

So far, we have focused on hedging motives as a source of heterogeneity in portfolios assuming frictionless financial markets. Another strand of the macroeconomics literature considers frictions in financial markets as the main source of heterogeneity across investors. Portfolio home bias is the natural outcome of these frictions. Such frictions could include fixed or proportional transaction costs in foreign portfolio investments, difference of tax treatments across domestic and foreign portfolio incomes and other policy induced restrictions on foreign investments (such as limits to foreign investment and capital controls) (see French and Poterba (1991), Lewis (1999), Stulz et al. (2003)). Other important frictions to international investments are informational frictions. The role of information has been extensively investigated in the finance literature but less so in the Open Financial Macroeconomics literature (Hatchondo (2008), Tille and van Wincoop (2009) and Dumas et al. (2009) are recent notable exceptions). For this reason, we will review the literature on informational frictions (and behavioural biases) in a separate section (see section (4)).

Transaction costs would need to be very large to explain equity home bias...

There is a wide debate on the importance of transaction costs to explain international portfolio decisions. French and Poterba (1991) initially argue in a mean-variance framework that these costs must be much larger than the one typically observed if one want to rationalize equity home bias. Using stock returns data from 1975 to 1989 for the US, Japan, UK, France, Germany, Canada, the authors use estimates of a covariance matrix of returns together with an optimal portfolio rule that is implied by constant relative risk aversion in order to back out the differences in expected returns needed to explain actual portfolio shares for
these countries. The implicit excess return on domestic equity implied by observed portfolio holdings is then interpreted as a measure of the cost of international asset trading needed to generate the observed home bias: they find an order of magnitude for these costs of several hundred basis points, too big to be true! Numerous subsequent studies have provided such indirect estimates of the costs. Most studies are in line with French and Poterba (1991)’s results and argue that costs need to be very large to explain portfolio holdings (see Cooper and Kaplanis (1994) among others). A notable exception is Sercu and Vanpee (2008) who find that, once they control for many factors (currency risk, inflation hedging, fixed-interest investments, round-tripping and omitted countries) and allow for time varying covariances, the implicit inward investment costs are much lower than in earlier studies in developed markets (in the order of magnitude of 0.10-0.20 percent per annum).

Another piece of evidence pointing that transaction costs cannot rationalize portfolio holdings is Tesar and Werner (1995): transaction costs based explanation of the equity home bias should in general imply that turnover should be lower for foreign equity holdings than for domestic ones (unless they apply only to dividend repatriation). Tesar and Werner (1995) find that turnover is in fact higher for foreign holdings.24

...Unless diversification benefits are very small

As stated above, transaction costs are often assumed to be small although direct measures of these costs do not often exist (see below). However, as shown by Martin and Rey (2004) and Coeurdacier and Guibaud (2008), even small transaction costs may lead to sizable home bias when Home and Foreign stocks are close substitutes: any small transaction cost is amplified if the benefits of diversification provided by foreign assets are small.

Indeed, small diversification benefits is a crucial ingredient for the transaction costs based story to work. A key contribution in this literature is Cole and Obstfeld (1991) who show in the context of a two country/two good model that gains from international risk sharing are probably quite small, as changes in the terms of trade help to share risk internationally even with portfolio autarky. The intuition is simple. Assuming Cobb Douglas preferences over the consumption of the two good, an increase in local output triggers an equivalent fall their relative prices as local goods are now more abundant (terms-of-trade adjustment). In this economy portfolio autarky implies perfect correlation of marginal utilities - the complete market outcome. It is worth noting however, that this argument implies that portfolio would be indeterminate if trade in equities were possible since home and foreign stocks would be perfect substitutes. Cole and Obstfeld (1991) show that the equivalence between portfolio autarky and complete markets also obtains in a setting with investment under the following assumptions: i) unitary elasticity of substitution between the two goods, ii) unitary elasticity of intertemporal substitution, iii) full depreciation. For the

24Rowland (1999) and Amadi and Bergin (2008) construct models that can generate higher turnover for foreign asset holdings than for domestic ones, in the former case with proportional trading costs, while the latter use fixed trading costs.
no-investment case, the authors calculate welfare gains of moving from autarky to perfect international risk-sharing. They find small welfare gains for a broad range of values of the elasticity of substitution between the two goods. Since the seminal paper of Cole and Obstfeld (1991), a large number of papers using consumption data have computed welfare gains from international risk sharing with quite a lot of variation across studies. Van Wincoop (1999) documents the extent to which the results are strongly sensitive to assumptions about preferences (the coefficient of relative risk-aversion and the elasticity of substitution between traded and nontraded goods), the assumed ‘autarky’ consumption process, the implicitly chosen risk-free interest rate and the horizon of calculations. Without closing the debate, he tries to narrow the range of reasonable estimates and does find significant gains from risk sharing among OECD countries over a long horizon: 1.1 to 3.5% of permanent consumption for a 50 year horizon, and 2.5 to 7.5% for a 100 year horizon.

Overall though, explicit consumption based calculations of the welfare cost of underdiversification tend to imply low costs. These results are very often driven by the low variability of consumption in the data. In contrast, costs of underdiversification based on stock returns data are usually much larger, due to the much larger volatility of stock returns. This point is clearly made by Lewis (2000): she finds that moving from portfolio equity autarky towards an optimally diversified portfolio (efficient frontier in a mean-variance framework with a relative risk aversion of 2) leads to a gain of 10 to 30% of current wealth while moving from autarky consumption to perfect international risk-sharing leads to an increase in permanent consumption of less than a percent. The gap between the two metrics remains an open question; one will need to reconcile risk-sharing gains using consumption and asset prices data to fully evaluate the impact of transaction costs on international portfolios.

Finally, another argument in the literature has been that domestic multinationals already provide benefits of diversification by being active in many countries, reducing the gains from international diversification. However, Lewis (1999) and Tesar and Rowland (2004) argues that the correlation between the returns of multinational and their national stock indices is quite high, thus limiting the diversification benefits they can actually offer.

Direct measures of the costs?

It is important to note that most existing work provides indirect measures of transaction costs using stock returns data and observed portfolio allocation (as in French and Poterba (1991)). There are no papers we are aware of that presents an extensive measure of actual costs in investing in foreign assets. While directly observed transaction costs on the stock markets are typically very low, they might not be the appropriate measure for these asset trade costs. For instance, most households go through financial intermediaries to invest in stock markets (pension funds, mutual funds...) but there is so far very little empirical evidence investigating the difference in fees collected for foreign investments compared to domestic ones.
The question of the role of international taxation also remains opened. For simplicity, we abstract from taxation issues within multinationals and the effects on international taxation on Foreign Direct Investment and focus on the taxation of portfolio incomes. When considering the rules of international taxation, one could expect some large impact on home portfolio biases. First, dividends when repatriated are subject to non-negligible withholding taxes (of a magnitude of roughly 10% in developed countries). Even if many bilateral tax treaties lead to some exemptions of these withholding taxes (through tax credits schemes), this is not true for all investors and these exemptions are often subject to some ceilings. Second, most developed countries have dividend imputation schemes: capital incomes (profits) are indeed taxed twice in most countries, at the corporate tax level and at the income tax level (when profits are distributed to shareholders). To avoid this double-taxation, shareholders receive a tax rebate. The tax rebate is such that, on net, investors end up paying the income tax only. Such dividend imputation schemes do not apply to foreign asset holdings. This drives an additional significant differential in the taxation of capital incomes coming from domestic or foreign firms (see Gordon and Hines (2002) and the chapter 10 of the Mirlees Review (2009) for excellent surveys). However, as argued by Gordon and Hines (2002), these tax differentials might not be effective in practice since this is very difficult for governments to enforce the taxation on foreign asset incomes. Tax evasion on income from foreign securities through foreign financial intermediaries (in tax havens in particular) might be an issue if one wants to measure exactly the costs associated to international taxation. Hence, while most papers tend to argue that taxation differentials between domestic and foreign asset incomes cannot fully account for the size of portfolio biases, it remains very hard to provide a quantitative estimate of their impact on portfolio decisions. Studying optimal taxation of capital in a model where home bias is endogenous would be a very natural extension of the literature. Gaspar and Gordon (2001) provides an interesting treatment of optimal tax policies in a partial equilibrium model where home bias in equity or bonds is endogenously generated.

4 Informational Frictions and Behavioural Biases

4.1 Informational frictions

4.1.1 Exogenous information sets

The impact of informational asymmetries on portfolio decisions has been first studied in the finance literature. In this literature, domestic and foreign investors differ on their (exogenously given) information sets regarding future domestic and foreign stock returns. Gehrig (1993) and Brennan and Cao (1997) develop a simple two country noisy rational expectations model with one stock per country. They assume that agents in each country receive a signal on the future performance of each stock but the signal on the

\footnote{From a theoretical perspective, Bovenberg and Gordon (1996) show in a model with equity home bias due to asymmetric information that governments should subsidize capital imports contrary to what is observed in the data.}

\footnote{Contrary to the standard DSGE macro models, the finance literature described here relies on some partial equilibrium assumptions: stock returns characteristics (risk and expected returns) are exogenously given and the risk-free asset is in infinite supply.}
foreign asset is less precise. Hence, domestic investors perceive the foreign stock as riskier and reduce their foreign stock holdings, which leads to equity home bias. Moreover, Brennan and Cao (1997) show that less well informed foreign investors respond more strongly to public signals on domestic stocks conveyed by stock prices. Hence foreign investors buy more of the domestic stocks when the domestic market performs well. The authors find evidence for this 'return chasing' effect in the data. Brennan and Cao (2005) extend their initial work by developing a noisy expectations model where investors receive public and private information signals. The private signal is less precise for foreign investors. The authors show that there is a link between information disadvantages and the expectations (degree of bullishness) about a market: foreign investors tend to become more bullish about a certain market following a positive return on that market. Pastor (2000) examines whether an investor that updates his views on the distribution of domestic and foreign returns in a Bayesian fashion may choose a strongly home biased portfolio. He finds that in order for that to be the case, the investor needs to hold a strong biased prior towards the domestic asset. Albuquerque et al. (2006) solve for international equity flows when a set of home and foreign investors have superior information. They argue that this informational heterogeneity within the foreign set of investors is more important than informational heterogeneity across countries to explain international equity trades. In line with the data, the model explains why (i) U.S. investors trade in waves, with simultaneous buying and selling; (ii) U.S. investors change their foreign equity positions gradually; and (iii) U.S. investors increase their equity position in a country following a raise in its stock price.

The finance literature described above had a recent impact on more standard general equilibrium macro models along the lines of the Open Economy Financial Macroeconomics approach. Hatchondo (2008) builds a single good two country model with two assets per country with two departures from standard models. Firstly, he assumes that only local investors receive informative signals about local assets. This informational advantage induces agents to invest in the “good” local asset. Secondly, engaging in short selling is assumed to be costly. When the signal is sufficiently informative and short selling costs are high enough, agents do not sell the “bad” local asset short in order to invest more in the “good” local asset but rather reduce their holdings of foreign assets. This leads to equity home bias in equilibrium. Bovenberg and Gordon (1996), present a small open economy model where home bias results from information asymmetries, which decrease the return home investors get on their foreign capital investment. In such a set up, subsidizing capital imports is optimal. Razin et al. (1999) assume that domestic investors can observe the productivity of domestic firms before making their loan decisions, while foreign investors cannot. This results in foreign underinvestment and domestic oversaving. Building on a similar asymmetric information set up but adding the possibility of liquidity shocks, Goldstein and Razin (2006) study the trade-off between FDI and portfolio investment, the latter being more liquid than the former.

Tille and van Wincoop (2009) applies the noisy rational expectations framework from the finance literature to a standard two country/one good DSGE model. They depart from standard open macro models by introducing information dispersion across investors. Each investor receives a private signal on the future
fundamentals (productivity) of domestic and foreign stock, the signal on its own stock being more precise (as in Gehrig (1993) and Brennan and Cao (1997)). The noise is introduced in the form of (unobserved) stochastic transaction costs to invest abroad which generates portfolio shifts towards or away from foreign assets. This makes sure that stock prices cannot fully aggregate private signals in equilibrium. These transaction costs generate equity home bias in equilibrium but this is not the purpose of the paper. They show that dispersed private information disconnects stock prices from the currently observed fundamental values but also international capital flows (gross and net). Moreover, capital flows should help forecast future fundamentals. They find some empirical support for their results.

4.1.2 Endogenous information acquisition

The early noisy rational expectations literature when applied to international portfolio choice relies on exogenous information structures. A recent challenge has been to extend it by allowing for endogenous information acquisition. In this line of research, information is a tool to reduce the conditional variance of the asset payoffs. Using a model of rational inattention (Sims (2001)), Van Nieuwerburg and Veldkamp (2008) build a model where a tiny information advantage is enough to generate significant home bias if investors have a limited capacity to process information. In this model, agents are endowed with a small informational advantage on the local asset, which lowers its perceived riskiness. Thus, the investor will tend to hold more of the local asset. However, this effect is amplified as the more of an asset the agent owns, the more attractive it becomes to learn about the asset. Thus, endogenous and costly acquisition of information amplifies the initial small informational advantage and leads to specialization in local stocks. Learning turns out to amplify information asymmetries instead of reducing them. In their set up, countries which are learnt about a lot by investors should have lower returns compared to the prediction of a standard CAPM model, as lower uncertainty goes hand in hand with a lower return. Van Nieuwerburg and Veldkamp (2009) apply variations of their rational inattention model to explain investment strategies of investors, varying the specification of the preferences or of the information constraint that they face. Depending on the convexity of the objective function of investors, they can rationalize concentrated or diversified portfolios.

Mondria (2009) generalizes the information acquisition problem by allowing rationally inattentive investors to decide not only on the precision but also on the structure of the information they process. In equilibrium, agents choose to learn not only about individual assets but also about linear combination of assets, i.e. indices. Such a learning strategy makes sense as the structure of the signal the agents choose in equilibrium should depend on their objective function. Since investors will choose to hold a somewhat diversified portfolio in equilibrium, they choose to process information about combinations of assets (they are interested not only in the volatility of each asset but also in their covariance). Mondria and Wu (2009) use a similar framework to explain the time series of home bias. When financial liberalization takes place in the developed economies in the 1980s, investors start to be able to diversify their portfolios and home bias decreases but only gradually as investors have an initial information advantage on domestic assets. The authors show that persistence of asset pay-offs and increases in information processing capacity tends to
4.1.3 Empirical evidence on informational frictions

A number of papers regress portfolio holdings or measures of home bias directly on factors that proxy for information asymmetries. Portes and Rey (2005) shows that physical distance affects international equity flows and holdings very significantly: doubling the distance reduces cross-border equity flows by half. Coval and Moskowitz (1999) find that U.S. mutual fund managers prefer to invest in nearby firms even within a country. Ahearne et al. (2004) find that U.S. holdings of foreign equities are significantly biased towards countries that have a higher share of their stock market listed on U.S. stock exchanges. Grinblatt and Keloharju (2001) emphasizes the key role of distance, language and cultural similarities in international asset allocation. Aviat and Coeurdacier (2008) revisits the impact of distance on cross-border equity holdings (and bank loans). They find that the impact of distance is drastically reduced once we control for bilateral goods trade: countries portfolios are strongly biased towards trading partners (see also Lane and Milesi Ferretti (2008)). Using instrumental variables, they show that the causality goes essentially one-way: reducing barriers to trade in goods enhances cross-border asset holdings. However, one cannot reject the role of goods trade in fostering information flows across borders. Using survey data on Italian investors, Guiso and Japelli (2006) find that investors who spend more time to acquire information also tend to hold less diversified portfolios.

While these explanations, based on an exogenous information structure, have some intuitive appeal, the question remains why investors may not follow an investment strategy that minimizes the effect of informational disadvantages, such as investing in index funds. A possible answer to this criticism are the theoretical models of endogenous information acquisition as in Van Nieuwerburg and Veldkamp (2008), who can, under specific assumptions, generate concentrated portfolios. Such models though also imply that domestic investors should earn a higher return than foreign investors. However, the empirical evidence is mixed. Coval and Moskowitz (1999), Hau (2001), Dvorak (2005) and Choe et al (2005) find that domestic investors do in fact earn higher returns, while Grinblatt and Keloharju (2000) and Huang and Shiu (2006) find the opposite.

4.2 Behavioural biases

Some recent papers have put forward a behavioral explanation for the equity home bias. Using departures from rational expectations and maximization of standard von Neumann-Morgenstern utility functions used in standard macro literature, this literature has highlighted some behavioural biases consistent with the data on international portfolio allocation. The seminal paper of French and Poterba (1991) already considers overconfidence towards local assets as a potential explanation: if investors systematically have higher expectations of relative returns for domestic equities, this difference in expected returns, while inconsistent, can overturn any perceived diversification gains. In the same vein, Shiller et al. (1991) document large
differences in expected returns of Japanese and U.S. investors for the same stockmarkets. They find that Japanese investors tend to expect relatively higher returns for Japanese stocks, while U.S. investors expect higher returns on U.S. equity. A similar argument can be applied to estimated variances (either the standard deviation of domestic equity is systematically believed to be lower or correlations with foreign equities are overestimated). Studies by Huberman (2001), Benartzi (2001) and Karlsson and Norden (2007) (see also Barberis and Thaler (2003) for a survey) suggest that ‘familiarity’ might be the main determinant of portfolio choice: investors choose ‘familiar’ assets while ignoring the principles of portfolio theory. However, it remains extremely difficult to disentangle empirically informational frictions linked to distance from ‘familiarity’ effects. Solnik (2006) explains the equity home bias by the Regret Theory: investors use the domestic portfolio as a benchmark and feel the pain when their foreign investments underperform. Morse and Shive (2006) find that home bias is empirically related to measures of patriotism.

To our knowledge, building on Dumas, Kurshev and Uppal (2007), Dumas, Lewis and Osambela (2009) are the first ones to develop a standard two-country general equilibrium model (in continuous time) where investors exhibit behavioural biases in the form of differences in their beliefs. Investors have access to the same information set (no asymmetric information) but differ in their beliefs about the information contained in economic public signals: local investors trust more the information contained in local signals and incorrectly believe that the information in the foreign signal is partly noise. These asymmetric beliefs help the authors to solve for some anomalies at the international level: investors exhibit home equity bias, asset prices are the combination of a local CAPM and an international CAPM (in line with the empirical evidence of Bekaert and Harvey (1995)) and as in models of asymmetric information (see Brennan and Cao (2005)), capital flows towards a country covary positively with returns in that country. Their model with differences in beliefs is indeed observationally equivalent to existing models of segmented markets due to asymmetric information.

5 New Portfolio Facts and Leads for Future Research

5.1 Aggregate Data on Portfolio Holdings

The Open Economy Financial Macroeconomics models have implications for international bond holdings as well as international equity holdings. Hence, we provide some measure of the extent of risk-sharing through international bonds holdings (public and private) for a large cross section of countries by using data on cross-border bond holdings. For completeness we also present some data on international bank lending, as we expect that the Open Economy Financial Macroeconomics will soon incorporate formally bank intermediation in their models. For these data, we rely on CPIS and IFS data from the IMF and the data form the BIS (see appendix for a detailed description of the data).
5.1.1 Cross-Border Bond Holdings

We use data from IFS and BIS to compute international bond holdings for selected countries. Unfortunately, available data do not allow to disaggregate data of foreign bond holdings across types of bonds (corporate versus public, across maturities) and we had to focus on bond holdings aggregates.

To measure the degree of international diversification of bond portfolios, we compute a measure of home bias in bond holdings similar to the one we computed for equity holdings. Hence, our measure of Bond Home Bias for country $i$ ($BHB_i$) is defined as follows:

$$BHB_i = 1 - \frac{\text{Share of Foreign Bonds in Country } i \text{ Bond Holdings}}{\text{Share of Foreign Bonds in the World Bond Market Portfolio}}$$ (43)

In figure (3), we show the evolution of bond home bias measures in developed countries across regions of the world: it has decreased over the last twenty years with the process of ‘financial globalization’ but remains still very high in all countries. Portfolios exhibit a home bias in bond holdings of a slightly larger magnitude than the one documented for equity in section 2. On average across the world, the degree of home bias across the world is 0.75 (like for equities lower in Europe where monetary union seemed to have had an effect but higher in other countries), meaning that the share of foreign bonds in investors portfolios roughly a 1/4 of what they would hold if they were holding the world bond market portfolio. Despite a large degree of home bias, these data indicates that some international risk-sharing occurs through bond holdings and it seems necessary to incorporate cross-border bond holdings in the theoretical portfolios model we are using.

In figure (4), we show the degree of bond home bias for emerging markets: like for equities, emerging markets have even much less diversified bond portfolios than developed countries.

5.1.2 Cross-Border Bank Loans

We use data from the BIS and the OECD to compute cross-border banking assets for selected countries. Like for bonds, available data do not allow to disaggregate data of foreign bank loans across types of loans and we had to focus on aggregate foreign asset holdings by banks.

To measure the degree of international diversification of banks’ portfolios, we compute a measure of home bias in bank loans comparable to the one used for equities and bonds. Hence, our measure of Home Bias in Loans for country $i$ ($LHB_i$) is defined as follows:

$$LHB_i = 1 - \frac{\text{Share of Foreign Banking Assets in Country } i \text{ Banking Assets}}{\text{Foreign Banking Assets as a share of Total Foreign Outstanding Loans}}$$ (44)

In figure (5), we show the evolution of home bias in bank loans measures across OECD countries using OECD data. Figure (6) shows the same statistic but using BIS statistics (available for a larger number of countries but over a shorter time period; see appendix for a detailed description of the data). Despite

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27 See Lane and Milesi Feretti (??), Coeurdacier and Martin (2009) and Fidora et al. (2007) for studies on the impact of the euro on cross-border bond diversification.
Figure 3: Measures of Home Bias in Bonds across developed countries (the country measure $BHB_i$ is Market Capitalization-weighted for each region; source: BIS and IFS. See appendix for the list of countries included)

Figure 4: Measures of Home Bias in Bonds across emerging countries (the country measure $BHB_i$ is Market Capitalization-weighted for each region; source: BIS and IFS. See appendix for the list of countries included)
Figure 5: Measures of Home Bias in Banking assets across OECD countries (in each region, the country measure $LHB_i$ is weighted by the share of outstanding loans of the country in the region; source: OECD. See appendix for the list of countries included)

Figure 6: Measures of Home Bias in Banking assets across Regions (in each region, the country measure $LHB_i$ is weighted by the share of outstanding loans of the country in the region; source: BIS. See appendix for the list of countries included)
an increased diversification, banking portfolios still exhibit a very strong home bias. The magnitude of the home bias in banking assets is similar to the one observed for equity holdings. Like for equities and bonds, the degree of Home Bias is the smallest in Europe (due to the EMU in particular) and the largest in emerging markets (here Latin America).

5.2 Institutional Investors Home Bias Data

An increasing share of capital flows are intermediated through institutional investors. For example, using the Survey of Consumer Finance, Polkovnichenko (2004) documents that in 2001, 62% of all equity holdings by US households were indirect holdings. Information asymmetries explanations of the home bias seem more plausible for households than for fund managers, who can devote a substantial amount of resources to gather relevant information. Also, if home bias can be explained by the degree of sophistication of investors regarding their investment strategies, one would expect that professional investors should be fully aware of the theoretical benefits of diversification. Furthermore, with delegated investment comes an agency problem and the incentives of the final investor and of the fund manager are not necessarily well aligned. It should therefore be informative to look at portfolio allocations at the fund level to understand better the determinants of home bias. Hau and Rey (2008) provides some descriptive statistics on domestic and foreign holdings of mutual funds in 4 countries. We use the same data set - data of global equity holdings from Thomson Financial Securities (TFS)- to estimate home bias at the fund level on a larger cross section of countries. The data document individual mutual funds holdings at the stock level. TFS was created by the merger of The Investext Group, Security Data Company and CDA/Spectrum. The data cover the five year period 1997 to 2002 and has an interesting cross sectional and time series dimension.28 The TFS holding data comprise fund number, fund name, management company name, country code of the fund incorporation, stock identifier, country code of the stock, stock position (number of stocks held), reporting dates for which holding data is available, security price on the reporting date and the security price on the closest previous days in case the reporting date had no price information on the security, total return index (including dividend reinvestments) in local currency, and daily dollar exchange rates for all investment destinations. Most funds report only with a frequency of 6 months. Reporting dates differ somewhat, but more than 90 percent of the reporting occurs in the last 30 days of each half-year. A limitation of the data is that they do not include any information on cash holdings, financial leverage, investments in fixed income instruments or investments in derivative contracts. The portfolio characteristics we calculate therefore concern only the equity proportion of a fund’s investment. Table 1 gives the breakdown of the average market capitalization over the sample in billions of dollars by country of fund origin. Table 2 gives the breakdown of the average number of funds also by country of fund origin.

Graph 1 present the percentage of mutual funds based in a given country whose shares of domestic holdings in total asset holdings is 0%, strictly larger than 0% but smaller than 10%, between 10 and 20%,

28Chan et al. (2005) used a similar dataset -albeit only for one year. They aggregated the data across all funds to document home bias at the country level.
.., between 90 and 100% (but strictly below 100%) and equal to 100%. The numbers are averages for the
1997-2002 period. To simplify, we call these different shares of domestic holdings in total holdings "different
degrees of home bias". For each country, the percentages are based on number of funds in a given home bias
category out of the total number of funds for that country and on the share of the market capitalization of
funds in a given category relative to the total market capitalization of funds of that country. Thus, funds
may change from one home bias category to another over the course of the sample.

The most striking stylized fact may be that there is a great deal of heterogeneity both across countries
and within country in the extent of domestic holdings in total holdings. For most countries, the distribution
usually exhibits peaks at 0% and 100% (or between 0 and 10% and between 90 and 100%) indicating sub-
stantial specialization of funds into either (close to) fully domestic or (close to) fully international investment.
But, interestingly, there is a non negligible part of the distribution lying in between those two extremes,
indicating a great deal of heterogeneity in diversification choices by the fund managers even within country.
Thus one conjecture is that the observed investment pattern at the fund level reflects both some increasing
returns in the information technology leading to some concentration in stock holdings of either domestic or
foreign countries and a particular market structure inducing product differentiation at the fund level. As
mentioned in Hau and Rey (2008), there is a positive correlation between the number of sectors and the
number of countries funds invest in, suggesting that more diversified funds diversify both across sectors of
activity and across countries. Larger funds tend also to be the most diversified. The role of fund mandates in
the observed asset holdings is of course of great interest. We find that for example, in 2002, 701 funds out of
our 1,291 US funds had some kind of explicit mandates, which could range from "investing in world equities"
to "primarily small cap north American companies" or "at least 80% in Latin American companies". These
mandates seem to exhibit considerable variations across countries and are clearly not exogenous. They too
result from the optimizing behaviour of financial companies. Explaining home bias or indeed investment
strategies at the fund level thus probably requires a theory of fund mandates.

6 Conclusions and leads for future research

Our view is that the home bias puzzle is now less of a puzzle. From the literature we labeled “Open Economy
Financial Macroeconomics” to the rational inattention models featuring endogenous information acquisition,
notable progress has been made to understand the determinants of portfolio allocations. We may now be at
a stage where we should be studying a broad array of implications of these new models rather than focusing
only on the stylized fact of home bias. Confronting their predictions with a large set of other stylized facts
on portfolio holdings will surely lead us to refine them further and ultimately assess their true explanatory
power.

The Open Economy Financial Macroeconomics literature has an interesting set of predictions on the
holdings of a broad menu of financial assets. It should be very fruitful to introduce in that literature some
more detailed models of the capital structure of firms and to get finer empirical implications for corporate
debt, equity and government debt holdings in particular. One major issue going forward will be the modelling
of the official sector. Introducing an optimal monetary or fiscal policy and modelling their interactions with
endogenous portfolio choices of the private sector is a major challenge. It is likely that as a first step
focusing on realistic but not necessarily optimal monetary policy or fiscal rules will be the way to go. It is an
important goal to have realistic and workable macroeconomic models of the open economy with endogenous
portfolio choice, as large cross border holdings of assets (see Gourinchas and Rey (2007a)) are likely to
affect the channels of transmission of monetary and fiscal policy. Understanding the short run dynamics of
the exchange rate, a formidable but crucial task, is also intimately linked to agents portfolio choices and
gross external positions as shown in Gourinchas and Rey (2007b) and Della Corte et al. (2009).
Furthermore, a closer look at the maximization problems faced by Central Banks when they decide on their
reserve holdings and by sovereign wealth funds would be warranted as both actors now account for a non
trivial share of international capital flows. The portfolio choice of the official sector is also an important
determinant of the international use of a currency. The dollar market share in world transactions and the
"exorbitant privilege" of the United States may be challenged by the new portfolio diversification strategies
of emerging markets in general and China in particular. We have few models which can tackle these issues
in a general equilibrium set up with a rich asset structure. The role of international currencies and their
importance in determining portfolios and asset price movements is an area of active research (see Devereux
and Shi (2009) or Gourinchas et al. (2010)).

As more detailed survey data on households become available, one will also be better able to test at the
microeconomic level the empirical relevance of various hedging motives underlying the mechanism of these
Open Economy Financial Macroeconomic models. Estimating the correlation of labour income risk with
various asset returns at a disaggregated level - for instance according to levels of wealth- would probably
enhance our understanding of the plausibility of the mechanisms. Importantly, introducing models with
heterogeneous agents in an international economics set up seems a priority to understand better some of the
most stubborn puzzles of international economics such as the Consumption-Real Exchange Rate anomaly
(Kollmann-Backus-Smith puzzle). Limited participation in asset markets is a promising way to help resolve
some asset pricing puzzle as shown in particular in the context of a closed economy by Guvenen (2009).
Some steps have been taken by Kollmann (2009) and by Coeurdacier et al. (2010) in particular to
introduce limited participation in an open economy set up. Furthermore, much like the closed economy
macroeconomics literature, the modeling of financial intermediaries is a key missing building bloc in our
current DSGE models of the open economy. As the literature stands, we have nothing interesting to say
about leveraged intermediaries for example and their role in the international transmission of shocks.

If we want to take a more detailed microeconomic view of the home bias, we have to recognize the large
heterogeneity of investment strategies both at the household level and at the fund manager level. A large
share of household investment is not direct portfolio holdings but intermediated. In the US, according to
the Survey of Consumer Finance (see Polkovnichenko (2004)), the share of equity held indirectly by households through mutual funds, pension funds or other investment vehicles has risen from about 46% in 1989 to close to 62% in 2001. The Federal Reserve Bulletin (2009) indicates that between 2004 and 2007, the fraction of families holding publicly traded stocks rose to 51.1 percent. Among families that held equity, either directly or indirectly, in 2007, ownership through a tax-deferred retirement account was most common (84% of families), followed by direct holdings of stocks (35% of families), direct holdings of pooled investment funds (21% of families), and managed investment accounts (8% of families). If we take a different angle and look at the total amount of equity, 37.8 percent was held in tax-deferred retirement accounts, 33.6 percent as directly held stocks, 22.1 percent as directly held pooled investment funds, and 6.5 percent as other managed assets. Strikingly if we look at the families holding stocks directly 36% of them hold only 1 stock and 48% hold between 2 and 9 stocks. The typical portfolio of households who participate in the financial market is therefore very dichotomic: it contains a very small number of stocks, which are directly held and a more diversified stock portfolio, which is usually managed by a third party. It is still a major challenge for the existing literature to reproduce such a dual investment strategy at the household level. It is even more of a challenge to reproduce it together with the great heterogeneity in investment strategies at the fund level. It was documented in Graph 1. The endogenous information acquisition literature (see Van Nieuwerburg and Veldkamp (2008)) seems promising since in the presence of increasing returns to information acquisition, it is possible to generate concentrated portfolios, a prediction which accords well with the directly held portion of household equities. It should however probably be enriched with a model making explicit delegated portfolio management strategies. A first step in this direction has been taken by Mondria and Dziuda (2008). In their paper, asymmetrically informed households delegate their investment decisions to fund managers of stochastic abilities. Since domestic households know more about home country assets, they are better able to evaluate the performance of managers investing in home assets. Hence more highly skilled managers, who benefit from transparency, are more likely to operate in domestic markets. Therefore a small information asymmetry at the household level is able to generate home bias due to the endogenous decision of skilled fund managers to operate in the domestic market. This framework however cannot generate the heterogeneous distribution of investment strategies observed at the fund level. It also does not have anything to say regarding the determinants of funds mandates and benchmarks. It would be interesting to explain the determinants of the distribution of funds mandates across countries for example, as it seems to exhibit considerable heterogeneity. It is likely that the literature on endogenous information acquisition and delegated investment still misses an important component of the incentives of fund managers, which could be marketing and product differentiation. Some more data on the number and type of distinct funds owned by each households would be necessary to fully understand the tradeoffs. There is little doubt however that understanding better delegated investment strategies and the constraints and incentives of fund managers would be an important step to study the extent and time series variation of international risk sharing, the international transmission of financial shocks and the propagation
of crises. Recent work by Pavlova and Rigobon (2009) is a first step in that direction: they show how regulatory constraints and investment mandates can generate financial contagion through cross-border portfolio decisions. More generally, a promising avenue of research would be to study optimal regulatory or taxation policies in environment featuring endogeneous asymmetric information or principal agent problems due to delegated investment.
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Table 1: MARKET CAPITALIZATION (AVERAGE FOR 1997:1 TO 2002:2) - BN DOLLARS

<table>
<thead>
<tr>
<th>Country</th>
<th>United States</th>
<th>Germany</th>
<th>United Kingdom</th>
<th>Canada</th>
<th>Switzerland</th>
<th>France</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2851</td>
<td>225.8</td>
<td>174.6</td>
<td>84.81</td>
<td>74.18</td>
<td>53.43</td>
</tr>
<tr>
<td>Sweden</td>
<td>43.84</td>
<td>26.22</td>
<td>26.03</td>
<td>21.52</td>
<td>12.88</td>
<td>12.55</td>
</tr>
<tr>
<td>Japan</td>
<td>11.96</td>
<td>9.052</td>
<td>6.35</td>
<td>6.215</td>
<td>3.076</td>
<td>2.559</td>
</tr>
</tbody>
</table>

Table 2: NUMBER OF FUNDS (AVERAGE FOR 1997:1 TO 2002:2)

<table>
<thead>
<tr>
<th>Country</th>
<th>United States</th>
<th>Germany</th>
<th>United Kingdom</th>
<th>Canada</th>
<th>Switzerland</th>
<th>France</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3165</td>
<td>1223</td>
<td>495</td>
<td>353</td>
<td>140</td>
<td>212</td>
</tr>
<tr>
<td>Sweden</td>
<td>168</td>
<td>66</td>
<td>74</td>
<td>231</td>
<td>66</td>
<td>101</td>
</tr>
<tr>
<td>Japan</td>
<td>48</td>
<td>47</td>
<td>54</td>
<td>26</td>
<td>35</td>
<td>34</td>
</tr>
</tbody>
</table>
Graph 1

- United States
- United Kingdom
- Canada
- Germany
- Sweden
- France

Graphs showing the Home-Bias Degree of Number of Funds for each country, with the x-axis representing Home-Bias Degree and the y-axis representing the Number of Funds (Density) or Value-Weighted Fund Portfolio.
Home Bias Data (Figure (1) and Table (1))

Source: CPIS (IMF) and FBIV

- Japan
- Europe: Austria, Belgium, Denmark, Finland, France, Germany, Italy, Nehterlands, Spain, Sweden, Switzerland, United Kingdom
- North America: Canada and United States
- Oceania: Australia and New Zealand