Available online at www.sciencedirect.com
ScienceDirect
ELSEVIER
Journal of International Money and Finance 26 (2007) 631–655
Journal of International Money and Finance
www.elsevier.com/locate/jimf

Home bias in global bond and equity markets: The role of real exchange rate volatility

Michael Fidora, Marcel Fratzscher, Christian Thimann*,[1]

European Central Bank, Kaiserstrasse 29, 60311 Frankfurt am Main, Germany

Abstract

This paper focuses on the role of real exchange rate volatility as a driver of portfolio home bias, and in particular as an explanation for differences in home bias *across* financial assets. We present a Markowitz-type portfolio selection model in which real exchange rate volatility induces a bias towards domestic financial assets as well as a stronger home bias for assets with *low* local currency return volatility. We find empirical support in favour of this hypothesis for a broad set of industrialized and emerging market countries. Not only is real exchange rate volatility an important factor behind bilateral portfolio home bias, but we find that a reduction of monthly real exchange rate volatility from its sample mean to zero reduces bond home bias by up to 60 percentage points, while it reduces equity home bias by only 20 percentage points.

JEL classification: F30; F31; G11; G15

Keywords: Home bias; Exchange rate volatility; Risk; Portfolio investment; Global financial markets; Capital flows

1. Introduction

Home bias towards holding domestic financial assets continues to be an important phenomenon of global financial markets which is poorly understood. At least since French and Poterba

* Corresponding author.
E-mail addresses: michael.fidora@ecb.int (M. Fidora), marcel.fratzscher@ecb.int (M. Fratzscher), christian.thimann@ecb.int (C. Thimann).
[1] The views expressed in this paper are those of the authors and do not necessarily reflect those of the European Central Bank.

0261-5606/$ - see front matter
doi:10.1016/j.jimonfin.2007.03.002

(1991) the fact that investors reveal a strong preference for their home countries' equity is known as home bias. A steadily growing literature has proposed several partly competing and partly complementary explanations.[2] An important strand of this literature focuses on the effect of transaction and information costs on international portfolio positions, as e.g. in Tesar and Werner (1995), Warnock (2001), Ahearne et al. (2004), Cai and Warnock (2004), Chan et al. (2005) and Daude and Fratzscher (2006).[3] Various recent empirical studies have challenged in particular the assumption that international diversification yields higher returns. They indeed find that investors frequently earn significantly higher returns on investments in firms that are located in close geographic proximity, due to information asymmetries and frictions (e.g. Coval and Moskowitz, 1999, 2001; Hau, 2001; Dvorak, 2005).

Other studies emphasize the role of policies and of the quality of domestic institutions, such as capital controls or corporate governance, in explaining cross-country differences in financial asset holdings (e.g. Gordon and Bovenberg, 1996; Burger and Warnock, 2003, 2004; Gelos and Wei, 2005). A more recent strand of the literature has proposed behavioral explanations such as patriotism (Morse and Shive, 2004) or investors who maximize expected wealth relative to a group of peers (Gómez et al., 2003). Finally, others have argued that the home bias in financial asset holdings is much smaller than often assumed because domestic financial assets may provide a natural hedge against idiosyncratic risk to domestic non-tradables, such as labour income (Engel and Matsumoto, 2005; Pesenti and van Wincoop, 2002).

Interestingly, although often mentioned and its relevance being widely acknowledged, the role of exchange rate volatility has received little attention in the empirical literature on home bias and trade in financial assets. To our knowledge, there is only one systematic analysis, by Cooper and Kaplanis (1994), which develops an indirect test of the impact of domestic inflation risk in the absence of purchasing power parity (PPP). While they find that uncertain domestic inflation cannot rationalize the observed home bias, their test is based on an examination of the correlation between domestic equity returns and inflation, rather than an analysis of the impact of real exchange rate volatility on cross-border investment or home bias.

The composition of global bond portfolios has also received much less attention than equity holdings. This is somewhat surprising given the fact that the over USD 50 trillion outstanding global debt securities exceeds by far the around USD 35 trillion of world stock market capitalization.[4] There are two notable exceptions. First, Burger and Warnock (2003, 2004) look from a US perspective at foreign participation in local currency bond markets and the composition of US foreign bond portfolios. They find that sound macroeconomic policies and institutions, such as creditor-friendly laws, attract foreign investment in local bond markets. Second, Lane (2005) shows that individual euro area economies' international bond holdings are biased towards intra-euro area holdings. Moreover, he finds that trade linkages and geographical proximity explain a considerable part of both intra- and extra-euro area bond holdings. These findings are broadly consistent with those of De Santis and Gérard (2006), which confirm that the introduction of the euro affected portfolio allocation within the euro area.

[2] Lewis (1999) provides an excellent review of the literature.

[3] A related literature analyzes the impact of information frictions on international portfolio flows, see Portes et al. (2001) and Portes and Rey (2005).

[4] Throughout the paper, data on stock market capitalization are taken from Standard and Poor's Global Stock Markets Factbook. Data on outstanding amounts of debt securities are taken from the Bank for International Settlements International Securities Statistics.