Journal of Economics and Business 62 (2010) 347–366

Contents lists available at ScienceDirect

Journal of Economics and Business

From home bias to Euro bias: Disentangling the effects of monetary union on the European financial markets

Faruk Balli[a,*], Syed Abul Basher[b], Hatice Ozer-Balli[a,1]

[a] Department of Economics and Finance, Massey University, New Zealand
[b] Department of Research and Monetary Policy, Qatar Central Bank, P.O. Box 1234, Doha, Qatar

ARTICLE INFO

Article history:
Received 15 September 2008
Received in revised form 16 April 2010
Accepted 29 April 2010

JEL classification:
F21
F36
G11
G12

Keywords:
Financial integration
Home bias
Euro bias
Transaction costs

ABSTRACT

Following the launch of the Euro in 1999, integration among Euro area financial markets increased considerably. As a result, portfolio *home bias* declined across the European financial markets. However, greater market integration has generated a new bias: portfolio *Euro bias*, a situation where Euro investors tend to hold large proportion of assets issued within the Euro region. The first part of this paper presents an empirical analysis of the economic factors at play behind the switch from home bias to Euro bias. We find that decline in default risk and transaction cost are two key determinants of the rise in portfolio Euro bias. The second part of the paper goes deeper into the effects of Euro bias on Euro area bond and equity markets. We observe that both government and corporate bond markets revealed clear signs of strain during the recent financial turmoil. Our results also reveal that the risk-reduction potential from geographic diversification within the Euro equity market is lower than that of the Euro sector diversification.

1. Introduction

In the 1990s, a financial phenomenon that puzzled economists is why investors hold so much of their wealth in domestic equity rather than investing in an internationally diversified portfolio.

* Corresponding author at: Department of Economics and Finance, Massey University, Private Bag 11-222, Palmerston North, New Zealand. Tel.: +64 6 350 5699x2330; fax: +64 6 350 56 28.

E-mail addresses: F.Balli@massey.ac.nz (F. Balli), bashers@qcb.gov.qa (S.A. Basher), H.Ozer-Balli@massey.ac.nz (H. Ozer-Balli).

[1] Tel.: +64 6 350 5699x2666; fax: +64 6 350 56 28.

0148-6195/$ – see front matter
doi:10.1016/j.jeconbus.2010.04.004

Since the benefits of international diversification are well-known,[1] it therefore appeared as puzzling when French and Poterba (1991) observed very high domestic ownership of shares in the world's five largest stock markets: the United State (92.2%), Japan (95.7%), the United Kingdom (92%), Germany (79%) and France (89.4%). Since then, a large number of academic papers have been written explaining the portfolio home bias puzzle – see Lewis (1999) and Karolyi and Stulz (2003) for excellent surveys of the home bias literature.[2]

In recent years, however, portfolio home bias has notably decreased. For instance, measuring portfolio home bias on a 0–1 scale, where 1 equals complete home bias and 0 equals no home bias, Sørensen, Wu, Yosha, and Zhu (2007) demonstrated that, from 1993 to 2003, average debt (equity) home bias in 24 OECD countries declined from 0.63 (0.83) to 0.52 (0.67). Particularly in the Euro area, debt home bias declined for all countries; while, with the exception of Greece, equity home bias declined for all Euro countries. Figs. 1 and 5 of the present paper, respectively, provide visual evidence of rising foreign debt and equity holdings to GDP ratio for all Euro member countries.

Although portfolio home bias has declined among the Euro countries, a deeper inspection of the geographical patterns of international portfolio holdings reveal that Euro countries have been disproportionately investing in Euro originated assets over the assets originated from non-Euro countries. In other words, Euro investors have shown a strong preference for intra-Euro portfolios than international portfolios. This anomaly has in turn gave rise to a new bias, which now is known as portfolio *Euro bias*.[3]Figs. 2 and 6 confirm this assertion. Contributions of Euro debt and equity in Euro members' foreign portfolios have risen quite remarkably over the past years.

Answers to the questions of why the switch from home bias to Euro bias and what economic factors contributed to this switch are related to each other. In the past, foreign portfolio investment was considered risky because seldom investors had required information on foreign portfolios. With the launch of the Euro in 1999, the information problem has been significantly lessened. Besides the information asymmetry, the pace of foreign portfolio investment was often thwarted by numerous other classical factors such as exchange rate risk, interest rate risk or inflation risk. With the introduction of the common currency in 1999, these obstacles became obsolete overnight.[4] The notion of psychological barriers to international diversification that once prevailed among investors had disappeared, and money started to travel across borders more rapidly than ever before (see, among others, Adjaouté et al., 2000,De Santis, 2006).

One of the purposes for the creation of the Euro zone was the promotion of large and liquid Euro bond and equity markets that could increase the availability of liquid instruments to Euro zone investors. Indeed, the integration in European financial markets has brought a surge in cross-border trading. For example, competition among Euro area governments has led to increasing liquidity of government securities and larger volumes of outstanding issues. Likewise, the Euro area has witnessed an unprecedented boom of corporate bond issuance. Furthermore, the arrival of the Euro had a significant (negative) impact on the underwriting fees of international corporate bonds issued in the new currency.[5] In the equity markets, the total number of initial public offerings (IPOs) and their volume surpassed that of the U.S. and Japan for the first time during 1999–2000,[6] although the trend partly reversed in 2001 and 2002 in the midst of a global decrease both in volume and number of IPOs

[1] Grubel (1968) first pointed out that international diversification can improve mean-variance trade-off compared to holding a purely domestic portfolio.

[2] Various explanations for the home bias puzzle have been offered in the literature. For a summary of these explanations, see Foad (2008).

[3] Lane (2005) first introduced the concept of portfolio Euro bias. Recently, Giofré (2008) and Balli (2009) provide further evidence for portfolio Euro bias.

[4] Of course, these barriers were mechanical and disappeared immediately with the advent of the single currency. Other obstacles such as transaction costs, credit risk and so forth can slow down the process of cross-border investments in the Euro area. We will get back to this issue later in the paper.

[5] See Santos and Tsatsaronis (2003) for the impact of the Euro on the underwriting market for corporate bonds denominated in the new currency.

[6] At the end of 1999, Euro area stock market capitalization stood at US$ 5526 billion, the second largest after the U.S. (US$ 16,773 billion) but ahead of Japan (US$ 4445 billion) – see Kraus (2001) for further information.