

# Comment on: Cross-border portfolios: assets, liabilities and wealth transfers

Martin Berka<sup>1</sup>

## Summary

The paper documents the geographical composition in domestic and international asset and liability positions in emerging economies, with a heavy focus on emerging market economies in Asia (EME Asia thereafter). The authors further study the changes in these positions between 2006 and 2011. This is a very interesting paper with potentially important implications for both international macroeconomics as well as finance.

The authors characterise domestic as well as international asset positions. They find that the overall change in the valuation of the external portfolio of the EME Asia was a loss of \$63 billion. While this loss may appear to be large, it is dwarfed in comparison to the valuation gain of approximately \$2 trillion in the EME Asia's domestic portfolio. This implies that the disproportionately large size of domestic portfolio should be explicitly taken into consideration when assessing the overall riskiness of the EME Asian portfolio, or a portfolio of any individual country. The authors also note that these valuations should not be misinterpreted as wealth transfers because both domestic and foreign investors gain when home equity prices increase.

The important main message of the paper is that cross-border portfolios constitute only a small fraction of EME Asia's overall portfolio. For example, the authors estimate that only 2.6% of equity and 5.7% of bond portfolio holdings in EME Asia are cross-border.

## Comments

I now discuss some comments about the paper. I start with comments about the data that may help improve the paper. I then offer some suggestions on interpreting the findings and possible links to the literature.

## Data

When discussing the data quality, the authors note that their findings are based on data of varying quality:

<sup>1</sup> Department of Economics, University of Auckland. E-mail: m.berka@auckland.ac.nz.

“We want to stress that numbers reported in this paper should be viewed as estimates from imperfect and at times inconsistent data sources. They constitute our best guesses given the data constraints, but the wise reader should view the reported numbers with a healthy degree of skepticism.”

The data come from four data sets. Three are from the IMF: the *International Investment Position* (IIP), *Coordinated Portfolio Investment Survey* (CPIS), and the *Balance of Payments* (BOP) data sets, while the World Development Indicators database of the World Bank provides the remaining data. More details on the exact nature of data inconsistencies would be beneficial for assessing the extent of the measurement error included in the authors' calculations. It could facilitate modelling of any measurement errors econometrically.<sup>2</sup>

## Home bias

The severity of the home bias found in EME Asia's asset holdings is an important finding of the paper. The authors could significantly extend their discussion of this finding. In 2006, on average, 82% of EME Asian equity holdings were domestic (this number drops to 74% if one excludes China). This is actually lower than the domestic asset holdings in other emerging markets (84% of total) and not very far away from the advanced economies (70%). However, the distance of EME Asia from the advanced economies has risen by 2011. Furthermore, debt holdings see more home bias than equity holdings in EME Asia: 94% of debt is domestic (91% if one excludes China), compared with 80% in other emerging economies and 72% in the advanced economies. Given that the debt is generally considered to be less risky than equity, the larger extent of home bias in debt markets in EME Asia seems surprising. The authors should discuss this new aspect of the EME Asian asset home bias, possibly with the help of statistical analysis of the covariates of the “outward” and the “inward” home bias. Additionally, these ownership patterns could be illustrated with some geographic maps.<sup>3</sup>

## Differences in foreign portfolio compositions

The authors also highlight the well known accumulation of foreign exchange reserves in Asia. According to their calculations, the pattern remains rather constant, with reserves constituting 61% of foreign assets in EME Asia (54% in EME Asia excluding China) in 2006, and 64% (53%) in 2011.

However, while the share of reserves remained roughly constant, the share of foreign equity in total foreign asset holdings rose from 10% to 16% in EME Asia and from 17% to 28% in EME Asia excluding China. Consequently, the debt holdings have shrunk from 29% to 20% in EME Asia and 27% to 19% in EME Asia excluding China.

<sup>2</sup> The reader would also benefit from an exact specification of the calculation of the portfolio equity and debt returns. These are calculated as a function of MCSI total equity return index (JP Morgan GBI USD-denominated total return index) and returns from the IIP and BOP data. However, said function is not specified.

<sup>3</sup> One interesting aspect that could be documented is whether these broad equity/debt home-bias patterns hold across the subcategories, or not.

This composition of foreign asset positions in EME Asia contrasts sharply with the composition in advanced economies. The table below summarises such compositional differences, in 2011.

	Reserves	Debt	Equity
EME Asia ex-China	53%	19%	28%
Advanced	4%	54%	42%

Assuming that reserves are least risky, the composition of foreign asset holdings in EME Asia is U-shaped in risk, while it has an inverse-U shape in the advanced economies. This observation is consistent with the earlier point about EME Asia's relatively stronger home bias in debt, and deserves further investigation.

### Other comments

The current draft has a few links to a large literature about home bias in international asset markets. The authors should try to connect their results to this literature.

There are macroeconomic counterparts to asset market segmentation. International macroeconomics has long studied the growth of gross asset positions since the 1990s, and its macroeconomic implications. One topic worth highlighting for a possible link to a broader macroeconomic literature is the risk-sharing puzzle due to Backus and Smith (1993) and Kollmann (1995). This is one of the key puzzles in international macroeconomics as highlighted by Obstfeld and Rogoff (2000). In a world with complete financial markets, marginal utilities of consumption per dollar should be equalised between countries. Under some assumptions, this leads to a prediction that real exchange rates and consumption differentials should be perfectly positively correlated. However, evidence strongly contradicts this prediction: correlation is generally between  $-1$  and  $0$ . A plausible source of the Backus-Smith puzzle is a failure of an underlying assumption of the asset market integration. Indeed, the authors seem to provide strong evidence to support the notion that, in EME Asia, asset markets are not internationally integrated. Another side of the same coin relates to the home bias in consumption between countries. This tends to be difficult to explain in models with perfectly integrated capital markets, but becomes more theoretically justifiable if asset markets are segmented.

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