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HOME BIAS EFFECT IN PROSPECT OF FINANCIAL GLOBALIZATION

Abstract

The author analyzes theoretical approaches to the problem of home bias effect. The tendency to a weakening home bias effect on the macro- and micro-levels is shown empirically. The author asserts that this tendency roads to higher allocation efficiency of global capital markets and the capacity of the macro-policy to level out consumption. However, it also bears certain risks from the global financial stability perspective.

Key words:

Allocation efficiency, financial globalization, global financial system, home bias effect, investing, transborder assets.

JEL: E20; E22.

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A «home bias effect» means that out of the available investing options, an investor will prefer resident financial instruments even when an international portfolio would perform better in terms of risk and return. The revealed effect has given theoretical grounds for assessing the actuality of global financial integration. Capital mobility and market integration – according to presumed evolution of globalization – should have smoothed the preferential position of resident financial instruments. Respectively, the early studies of financial globalization show that the existence of this effect in addition to paradoxes of Fieldstein-Horioka and Barro-Sala-i-Martin gives evidence that the present state of things is far from the idea born by the category of «globalization». As a matter of fact, during the recent time, the continued structural reforms of the financial markets, deregulation of financial systems in context of the Eurozone functioning, financial transformations in Japan and other Asian tigers, sluggish financial opening-up of China and other post-socialist countries make us reconsider the thesis that home bias becomes a barrier to development of globalization and thus impedes from benefiting from simplified balance-of-payments financing, consumption smoothing, new sources for investing, and risk diversification. On the other hand, one or another tendency to actualization of the given effect has important structural consequences for the functioning of global financial system, as well as for support of global financial stability, which makes the investigation of this phenomenon urgent.

K. French and J. Poterba were first to study this phenomenon. Their research became a surprise for those theorists who substantiated fast development of global financial integration processes. The main idea here consists in the fact that preferential investing in domestic assets casts doubt on the doctrinal proposition that removal of capital constraints will automatically lead to increased allocative efficiency on financial markets and balance out interest rates [1]. In view of the actuality of this effect, the global financial system should be considered as nationally fragmented, whereas financial market integration – as a certain theoretical model that cannot form the basis for decision-making in the sphere of macroeconomic policy. However, the bias towards national financial instruments has long run counter to the expansion of financial sector as a whole, and cross-border operations in particular. Today this phenomenon is deemed to belong to the so-called «secrets of globalization», when some data testify for and some against it [2]. Proceeding from such an approach, P. Hirst and H. Thompson also prove that from the mid-1980s to early 1990s, the share of foreign financial holdings has not increased fundamentally in spite of the global tendency to liberalization of capital flows. These include the foreign holdings in the assets of financial institutions, internationalization of deposits in pension funds, foreign assets and liabilities as a share of investment bank assets, interest on financial assets held by households in foreign stocks and bonds. Consequently, regardless of certain tendency towards deepening internationalization, the division into relatively closed and relatively open financial systems has remained, calling the expansion of globalization in question [3: 36–41].

A. Amir and P. Bergin bring up another aspect of the given problem. They say that the way of calculating the costs related to transactions on the global market is important for determining the direction for home bias intensification. This is especially important in the context of increasing volumes of trans-border trade. Fixed costs related to this trade are not a pure alternative to costs calculated as a share of turnover. Taking into consideration the combination of the two types of costs, there appears a situation when transborder operations are concentrated with the biggest traders, which leads to decreased relative magnitude of such costs and increased volumes of such operations. Consequently, the faster develop the firms capable of realizing large-scale transborder operations, the smaller the home bias effect is [4].

S. Claessens and S. Schmuckler are more sceptical about the evolution of global financial integration. Having analyzed 39517 firms from 111 countries in the period of 1989-2000, they find that such integration develops asymmetrically. It is progressing, but the number of truly global companies or companies that participate on the international market, allowing for whether their securities are traded on several exchanges, remains minor. In general, internationalization is typical of the firms from mainly large and open economies (without capital controls) offering high incomes, good macroeconomic policy and institutional environment. In its turn, the asymmetry of global financial integration rest upon the following: on the one hand, both in the developed and in the developing countries increase the number of new international companies, the proportion between market capitalization of firms and general market capitalization, the proportion between the value of foreign-traded securities and the value of home-traded securities, the share of both groups of countries, where international companies are present, the ratio of international and domestic firms. On the other hand, in terms of firm value, all indicators are biased towards developed countries, where the biggest global corporations are located, whereas in terms of geography, the latter dominate in the countries of the West and Asia. As a result, the process of global financial integration is significantly constrained by characteristics of firms and countries [5]. A similarly sceptical point of view on the actuality of global financial integration is seen in other studies as well [6].

An alternative viewpoint on this problem is presented in the variety of works, which admit a deep tendency to changing nature of global monetary and financial processes under the influence of weakening home bias effect. Thus, it is the actuality of diminishing home bias effect that explains the support of globally low interest rates, the dynamics of which is today much less defined by the policy of leading central banks, primarily the FRS, as it was some decades ago. In its turn, the situation with relieved financing of large-scale financing of global imbalances and provision of large influx of resources to the US capital markets is connected with the falling home bias effect. The decreasing magnitude of investor sensitivity towards the financial instrument's country of origin respectively raises the elasticity of reaction to deviation of interest rates from some global average that prompts significant capital spillovers [7; 8]. These studies, however, mostly do not consider the weakening of the given effect from positions of structural changes in the functioning of global financial system and assurance of global financial stability. Thus, the task of this article is to demonstrate that the weakening of home bias effect is the result of increased importance of international activity at the micro- and macro- levels, leading to emergence of the new incentives for development of financial globalization which nevertheless are not neutral with respect to the problem of global financial stability.

When examining the home bias effect from the theoretical positions, we should single out a broad set of structural changes that have taken place during the recent years and essentially modified the nature of the global financial system.

Firstly, the development of Euro-integration and introduction of the Euro created preconditions for levelling of exchange risk in the interest rate structure. In the intra-European operations, the dominant role is ascribed not to macroeconomic, but to sectoral and microeconomic risks. Along with decreased transaction costs and progressing unification of institutional-regulatory factors in the functioning of national financial systems of the Eurozone member-countries, the fundamental preconditions for weakening of the home bias effect have been formed. This is equally important for both the market of corporate instruments and the bond market. In the light of growing importance of the Eurozone in the system of global financial and monetary processes, we can assert that the weakening of home bias effect in the integration area will spill over to the entire global financial market. The reason for this is not as much the set of objective preconditions, as the assimilation of adopted behavioural stereotypes as for the practical application of gains from diversification and rejection of investment stereotypes that have generated the «home bias» in the preferences of financial players.

Secondly, the development of financial systems in the countries with emerging markets brings to the emergence of companies, whose financial instruments have the investment qualities similar to those of the traditional «blue chips». In view of this, it becomes obvious that the appearance in the listings of the world's leading exchange markets tends to make such instruments accessible for investments from the entire world. Taking into consideration their higher riskiness, they become a sure element in the overall market segmentation. In terms of portfolio risk, market segmentation – by means of including financial instruments from countries with emerging markets – provides for better allocation of resources and satisfaction of differing investor preferences. On the other hand, it is the enhancing role of the countries with emerging markets in the global economy that causes the structural regularity of including their securities into the global portfolio schemes, which by itself weakens the home bias effect.

Thirdly, the structural gap in the development of financial systems in the most innovative – in terms of financial systems reformation – countries and financial systems of less reformed countries is being formed. Thus, there appears a situation when the former seek more diversified options for portfolio formation in accordance with changes in investor preferences, whereas the latter generate demand for high-quality assets provided by the former. Hence, in the modern conditions, the movement of capital follows not the vertical model («North-South»), but the horizontal model: from holders of surplus savings to generators of financial assets with certain properties. This forms a tendency to supplying capital to the financial systems capable of forming an effective portfolio at the global scale by means of both generating financial assets and providing access to assets that are inaccessible from the standpoint of a separate country's financial system.

From the empirical point of view, an important attribute of weakening home bias effect is the quick growth of trans-border portfolio assets. Throughout 2001-2005, the overall volume of such assets has grown from $10trln to $19trln. The given indicator has grown from $2.3trln to $4.6 in the USA, from $0.6trln to 2.1trln in Japan, and from $5.8trln to $11.9trln in Europe [9: 6]. Similar situation is true for financial instruments. During the respective period, the volume of debt securities has increased from $1trln to $1.6trln in the transborder assets of the developed countries of Asia, from $0.7trln to $1.4trln – in the USA and Canada, and from $3.1trln to $7.2trln – in Europe. Therefore, the volume of transborder shareholdings has grown, respectively, from $0.3trln to $0.6trln, from $1.9trln to $3.8trln, and from $2.5trln to $4.6trln [10: 68]. However, it should be admitted that aggregate volumes of transborder operations with bonds significantly outrun similar operations with shares. Equally, the weakening of the home bias effect is most typical of Europe, whereas in the USA the increase in transborder holding of stock essentially exceeds the respective indicator for bonds. In general, we can see that this variance stems from the fact that the USA prefer to diversify stock investments while keeping loyal to their own bonds. At the same time, typical of Europe is the overall growth of transborder operations resulting from the policy of financial deregulation intensified by the creation and functioning of the Eurozone.

After the volumes of transborder portfolio assets in the developed countries had grown, the correlation between portfolio investing in foreign assets and home market capitalization has significantly changed. Thus, for Canada this correlation has grown from 1.9% to 2.4% during the period of 1975 – 1985, and from 6.0% to 14.3% in the period of 1990-2005; for the USA this indicator has grown, respectively, from 2.1% to 2.2% and from 3.5% to 7.4%; for Germany – from 2.4% to 5.8% and from 10.2% to 31.1%; for Great Britain – from 8.6% to 27.5% and from 34.0% to 48.1%; for Japan – from 1.3% to 6.9% and from 10.7% to 16.7% [11: 114]. The presented data show that during the first period the correlation between foreign investments and home capitalization has been growing much slower than during the second period. The latter period shows a considerable decrease in the preferences concerning national financial instruments, and – taking into account that this period is also characterized by fast growth of capitalization volumes, – this gives all grounds to consider the weakening of the home bias effect as a factor of structural changes in the sphere of global finance. Noticeably, the presented data corroborate the abovementioned thesis about accelerated growth of the European economy's interest in foreign activity compared to the rest of the world, since it is in the European countries (of those considered above) that the correlation between foreign investment and home market capitalization exhibits the most significant growth. From this evidence, the US trends somewhat contrast with the European tendencies, since for the former the increase in this ratio is not as significant. This can be explained by the fact that the increase in the US home market capitalization was very significant, and against this background the mentioned correlation seemed negligible. Such an approach is a somewhat imperfect instrument for assessing the strength of this effect since it does not account for multi-factor changes in the dynamics of the basic indicator necessary for setting the correlation – home market capitalization. Its dynamics can be defined by autonomous national changes in the functioning of the financial system, which reduces the expository power of such a correlation.

An approach which permits to avoid distortions in the estimation of home bias effect by smoothing over the magnitude of internal capitalization in the system of relative valuation of foreign investment volumes stipulates for the comparison of the factual share of external assets in a portfolio with the share of other countries in the global market capitalization (Table 1).

Table 1.

The factual share of external assets in a portfolio against the share of the rest of the world (ROW) in global market capitalization [11: 115]

	Shares				Bonds	
	1990	1995	2000	2005	2000	2005
Canada						
In fact	9.0	20.6	25.5	19.3	4.0	4.5
Share of ROW	97.4	97.9	97.4	97.5	97.8	98.1
Germany						
In fact	13.2	13.6	23.9	26.3	20.6	22.9
Share of ROW	96.2	96.8	96.1	97.1	92.7	92.2
Japan						
In fact	2.2	4.2	9.1	10.6	14.8	15.1
Share of ROW	69.0	79.4	90.2	90.9	82.2	83.8
Great Britain						
In fact	29.5	30.1	38.4	45.7	62.0	69.4
Share of ROW	91.0	92.1	92.0	92.0	95.9	95.4
USA						
In fact	5.7	9.1	10.4	12.5	4.6	3.0
Share of ROW	67.5	61.4	53.1	52.8	54.4	59.6

The data presented in Table 1 also point to growing significance of the transborder investment operations. Thus, the value of home capitalization in the presented countries, except the USA, has not changed noticeably during the give years for neither shares nor bonds. Only the American market share has grown. However, all countries including the USA tend to comparably increase investments in the external assets. The American companies' decreasing investments in the external assets (as seen in Table 1) is an exception, which to some extent confirms the thesis that the USA are characteristically more interested in their own bonds against the background of the growing interest towards investing in the non-debt transborder financial instruments.

The weakening of the home bias effect in the USA in terms of both inflow and outflow of capital is of fundamental importance for global financial stability. This is preconditioned by the physical and financial scales of the American economy, as well as by the fundamental significance of the country's balance-of-payments deficit for the global monetary and financial processes. The weakening of this effect with respect to capital inflows means that the opportunities for financing sizeable BOP and federal budget deficits increase without running the risk of raising global interest rates. Such a situation will provoke further unwinding of the spiral of global imbalances. The weakening of the given effect with respect to capital outflows will create the situation of potential neutrality of the US external position towards exchange rate fluctuations given that the above-named regularity – US investors prefer own bonds and foreign investments in non-debt assets – holds. For example, devaluation of the dollar – considered as a natural event from considerations of the volume of current account deficit – will not necessarily result in an expected readjustment of demand in the USA from considerations of the structure of accumulated gross claims and liabilities. The value of US-owned foreign assets increases, thus actualizing the income effect and consequently creating incentives to consumption, whereas the value of the US external obligations will not change since they are already denominated in dollars. From the empirical point of view, this in fact is the case: non-debt instruments dominate in US assets, while debt instruments prevail in US liabilities [12]. This fully agrees with the discovered tendency to weakening home bias effect with regard to foreign non-debt assets held by the USA and remaining loyalty to domestic debt instruments exhibiting a decreased exogenous effect of home bias.

On the other hand, the double weakening of the home bias effect in the USA means an increase in the equilibrium volume of global capital flows. Such a situation can provoke a number of risks for global financial stability, in particular raise the vulnerability towards changing investor preferences as to asset categories in terms of risk and return, as well as enhance the correlation of market behaviour, which will urge the inclusion of new and newer instruments into the global circulation, hence multiplying the level of risk (due to middling investment qualities of these instruments) and encouraging further accumulation of capital market imperfections[1]. Ta-

[1] For demonstration of the fact that the growing number of instruments on the global market, irrespective of the physical market volume, leads to multiplication of capital market imperfections see [13: 14].

bles 2 and 3 confirm the tendency to weakening home bias effect regarding capital inflows and outflows in the case of the USA with retention of the gap concerning the structure of external assets and liabilities.

Table 2.

Home bias of US investing into shares, % [10: 70]

	Share in the US portfolio (A)		Share in global market portfolio (B)		Home bias (1-A/B)	
	2001	2006	2001	2006	2001	2006
Western Europe	6.52	9.21	26.94	26.20	0.76	0.65
Other developed countries	2.68	5.89	15.14	22.39	0.82	0.74
Developed countries of Asia	0.26	0.84	4.18	5.67	0.94	0.85
Post-socialist countries of Europe	0.07	0.24	0.67	2.38	0.89	0.90
Latin America	0.37	0.78	2.18	2.54	0.83	0.69
Middle East	0.10	0.19	0.37	0.60	0.74	0.69
Africa	0.05	0.19	0.59	1.51	0.92	0.87
All countries	10.4	17.35	50.07	61.29	0.80	0.72

Table 3.

Foreign holdings of US securities [10: 78]

	1995	2000	2005
Shares			
Total par value, US$bn	7767.0	24703.0	22041.0
Foreign holdings, %	5.1	6.9	9.7
of which by official institutions	0.4	0.4	0.8
Marketable Securities of the Treasury			
Total par value, US$bn	2392.0	2508.0	3093.0
Foreign holdings, %	19.4	35.2	51.7
of which by official institutions	10.9	18.5	34.1
Securities of US Agencies			
Total par value, US$bn	1982.0	3575.0	5591.0
Foreign holdings, %	5.4	7.3	14.1
of which by official institutions	0.6	2.5	5.8
Corporate and other debt instruments			
Total par value, US$bn	3556.0	5713.0	8858.0
Foreign holdings, %	7.8	12.3	19.5
of which by official institutions	0.1	0.2	0.7

The data in Tables 2 and 3 empirically confirm the tendency to weakening home bias effect in the operations related to formation of US assets and liabilities. However, we should state that the intensified foreign demand for US securities can reflect a double tendency. On the one hand, this is really the weakening of the home bias effect that allows widening the opportunities for investing by access to the US market. On the other hand, observed are the outrunning international holdings of specifically US debt instruments. The volumes of issued instruments (as shown in Table 3) by category have been increasing fundamentally during the recent years (except for shares, which is connected with chilling-off of the high-tech market), thus bringing along an increase in the share of holdings by investors from abroad as well. Similarly increases the share of official holdings of such instruments, although it cedes to that of the unofficial sector. The only exception here are Treasury instruments, the share of which in the global portfolio leaves over other categories of securities far behind, in particular at the cost of considerable official holdings. Such a situation altogether corresponds with the rapid growth of global currency reserves placed in US government securities, which thereby consolidates the structure of external position of the American economy making it less vulnerable to exchange rate fluctuations of the dollar and to correction of financial imbalances. In the light of this fact, the autonomous growth of global holdings of US instruments, connected with falling home bias effect with respect to this asset category, produces a considerable impact on the formation of threats to global financial stability. Their new property will consist in the prolongation of the correction of global financial imbalances, which increases uncertainty and vulnerability of current trends to subjective investor moods.

Another important aspect of the weakening home bias effect is the micro-level transformations of preferences as to international portfolio structure. The functioning of financial companies is being increasingly connected with growing investments in foreign assets. Table 4 shows that the accumulation of investments in international stocks and bonds has strikingly increased compared with mid-1990s, whereas investments in domestic assets remained unchanged or even fell.

We should admit that sizeable differences in the volumes of investing in external assets can be connected with the nature of regulations governing the activity of financial companies. More liberal regimes permit to diversify assets, as in the case of the Netherlands and Spain, whereas there can be cases when financial companies prefer foreign investing only into a certain group of assets, as it is in Canada and Great Britain. In the case of the USA, we observe the same disregard of foreign fixed-income instruments against the background of interest in corporate rights. The aggregated data on pension funds and insurance companies help to see the same tendency towards weakening home bias effect leading to the increased share of investing in foreign shares and bonds in the structure of overall financial assets.

Table 4.

Cash allocation by private pension funds, % [10: 71]

	Shares		Bonds	
	Domestic	International	Domestic	International
The USA				
1994	41	7	42	1
1999	55	10	27	1
2005	48	15	32	1
Japan				
1994	24	6	55	6
1999	40	19	32	7
2005	30	18	24	13
Great Britain				
1994	54	23	9	4
1999	51	24	13	4
2005	34	32	22	3
The Netherlands				
1994	10	13	62	4
1999	12	38	22	19
2005	6	43	5	33
Australia				
1994	35	12	30	3
1999	39	16	22	3
2005	32	27	14	5
Canada				
1994	32	13	48	-
1999	34	17	45	-
2005	30	26	36	-
Spain				
1994	4	1	57	3
1999	11	14	40	13
2005	6	16	18	28

Thus, during 1990–2006 this share in Great Britain increased from 20% to 25%, in Japan – from 7% to 12%, in Australia – from 7% to 17%, in Canada – from 6% to 40%, in Spain – from 2% to 40%, in Belgium – from 8% to 50%, and only in France it decreased from 34% to 30% [16: 84]. The weakening home bias effect at the micro-level also modifies the problem of ensuring global financial stability. While the aggregate data in support of this effect's weakening at the national scale reflect a tendency to strengthening interdependence and equilibrium growth of capital mobility, the weakening of this effect at the micro-level demonstrates that each separate company operating in one or another segment of financial market becomes ever more dependent on the global processes and exogenous shocks. In fact, under intensifying global portfolio diversification operations and foreign asset holdings, the very understanding of the notion of an «exogenous shock» looses its autochthonous sense. The global-centrism of financial and monetary processes provides a combination of internal and external shocks, which results in transposition of vulnerability onto the level of a company, and thence – taking into account the leading modern financial institutions' global scale of operation – onto the level of a financial market segment and onto the system as a whole. For these reasons, the stability of the entire financial system in conditions of its market type formation will all the more depend on how well the micro-level sources of instability will be isolated at the system-wide level.

Another important dimension of the general tendency to weakening home bias effect is the fact that it holds for countries with emerging markets as well. On the example of their pension funds, we can see that the growth of assets in relation to GDP corresponds with the increase in foreign holdings of securities. For example, in the countries of Latin America during 2000-2005 the correlation between the value of pension funds' assets and GDP has increased from 9% to 15%; at that, the share of foreign asset holdings increased from 7% to 16%. This tendency was most expressed in Chile, where the value of the respective assets has increased in relation to GDP from 48% to 63%, while the share of foreign asset holdings has grown from 11% to 30%. In Asia the situation is somewhat different. The pension funds there had not held foreign assets until the early 2000s; thence, in 2005 the share of such assets fluctuated at 1%-11% at the country profile, even though the funds' asset value doubled in relation to GDP, reaching 18%. In the countries of Central and Eastern Europe the increase in this correlation from 2% to 8% was accompanied by maintenance of the analogous share of foreign asset holdings at the level of 2% [16: 136]. From the standpoint of global financial stability, the weakening of this effect in the countries with emerging markets means that these countries take the financing of the BOP deficits of the developed countries upon themselves by supplying resources to the global market. Such exports of capital will become an important factor of forming structural preconditions for support of large unbalanced payment positions in the world. On the other hand, it will demonstrate the continuing interest of companies from this country group in global operations, thereby accelerating the integration of global capital markets.

Altogether, these tendencies demonstrate that in result of progressing structural transformations caused by globalization, the home bias effect weakens in conformity with the theory of financial markets.

Nevertheless, we need to single out a set of regularities that limit the impact of the mentioned tendencies, not as much by strengthening the effect as by making the fluctuations of the intensity of its manifestation rather relative. Independent changes in investor risk aversion can lead to increased demand for common and traditional instruments. Likewise, the shocks and macro-financial destabilizations in the countries with emerging markets can reduce risk aversion;

thus, more balanced – in terms of risk and return – portfolios will become more attractive. As a result, there will appear a tendency towards rising demand for first-grade assets, which are perceived by most investors in the developed countries as resident assets. Consequently, a situation will appear when the strengthening of the home bias effect will in fact not reflect the real situation in the sphere of global financial markets integration. Since such sporadic changes in investor risk aversion are rather subjective, so the transition from the more actual to less actual home bias effect ceases to correspond with the logic of global integration.

For all that, the transformation of financial systems in the countries with emerging markets increases the demand for high-quality assets, for example, for reasons of investing reserve funds of the pension and insurance companies. This is also timely for considerations of capital exports and search for better investment opportunities compared to those offered by the national financial system. This lays long-term structural preconditions for an excessive demand for first-grade assets in the developed countries or on the market of one country, for example, the USA. The yield on such assets will fall, whereas capitalization will grow. Such a tendency will sharpen competition for first-grade assets by requesting extension of the effective portfolio range, especially if globalization is supportive of it. At the same time, it will become the precondition for weakening of the given effect. As a result, changes in the degree of actualization of the home bias effect will be defined from the above-stated reasons as well.

We can now conclude: the home bias effect is regarded as a reflection of the absence of real financial globalization. However, during recent years there has been a clear tendency towards its weakening. This reveals itself at the macro-level – in the aspect of enhancing transborder diversification of assets, and at the micro-lever – in the aspect of increasing share of transborder assets held by financial institutions. This tendency can be viewed as positive as it reflects the growing allocative efficiency of global capital markets and enables easier access to global savings for financing payment and budget deficits. Nevertheless, from the standpoint of global financial stability, this phenomenon bears a number of caveats: increased vulnerability of capital flows to interest rate fluctuations; increased significance of operating effectiveness of global companies at the micro-level owing to the fact that the overall market stability will be more and more dependent on the quality of their assets; increased probability of enhanced fluctuations in the value of financial assets. We should separately underline that in the case of the USA we can observe the weakening of the given effect with regard to investments in foreign shares, the strengthening of it with respect to domestic bond investments and its weakening with respect to US fixed-income instruments. Such a combination gives the USA a set of advantages in terms of robustness to exchange rate fluctuations and BOP readjustment, which potentially prompts the unwinding of the global financial imbalances spiral.

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