

# UNPACKING GLOBAL CAPITAL FLOWS

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Discussion by

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## THE PAPER

- Paper “unpacks” a block of data from Morningstar on the near universe of positions held by mutual funds in several countries
- Paper documents facts about the positions of mutual funds
- Three main results
  - 1 Mutual funds have a bias toward bonds denominated in local currency (Canadian funds hold mostly securities that pay in Canadian dollars, irrespective of the nationality of the issuer)
  - 2 Issuer located in the U.S. and in the euro area are able to place bonds in their own currency
  - 3 After the crisis, shift away from bonds denominated in euros

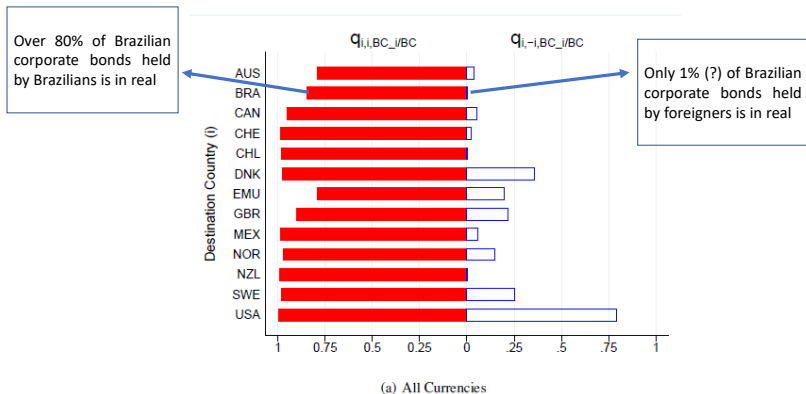
## THIS DISCUSSION

- Ambitious project, sheds light on important aspects of cross-border flows
- This discussion: review main findings, ask three questions along the way
  - 1 Is the domestic currency bias puzzling?
  - 2 What can explain it?
  - 3 Why are U.S. firms different?

## THE DATA

- Self-reported monthly positions of mutual funds to Morningstar (an investment research company). Match positions with characteristics of security
- Covers most of the market value of mutual funds holdings in the U.S., around 80% outside the U.S.
- Authors perform wide range of tests to assess quality of data
- Even if near universe, data represents only a fraction of all cross-border positions worldwide (FDI, bank lending, non-mutual fund portfolio investments, ...)
- However, when possible authors check for external validity

## THE MAIN FINDING IN ONE GRAPH



Results are robust to several checks (security level regressions with controls and fixed effects)

## QUESTION 1: IS THE HOME CURRENCY BIAS A “PUZZLE”?

Solnik (1974) provides a useful benchmark

- Portfolio model, choice of equities in multiple currencies
- Real exchange rate fluctuates, and it is orthogonal to equity payouts

**Solution:** Portfolio diversified in equity, but **biased** toward local currency

**Intuition:** Payouts in foreign currency risky because of movements in RER

**Remarks:** Stochastic properties of RER crucial for result

- Froot (1993): at long horizon, correlation between RER and equity returns
- Campbell, Viciera and White (2002): foreign currency natural hedge for long term fixed income assets. Estimated model implies fairly large positions in foreign currency

## SUGGESTION 1

- Verify how far basic portfolio theory goes in accounting for the home currency bias (my prior: not that far . . .)
- Can use potentially many dimensions for validating theory
  - Equity vs. bonds
  - Short assets vs. long assets
  - Stochastic properties of real exchange rates (cross-country)

## QUESTION 2: WHAT EXPLAINS THE HOME CURRENCY BIAS?

If a puzzle, what explains it?

- 1 There is selection on whether firms issue in foreign currency or not (Ex: exporters, large firms, ...)
  - Results in the paper rule out issuer-specific time-invariant characteristics
- 2 Potentially more problematic is the fact that local and foreign currency bonds might not necessarily be the same security
  - Different legal environment (perhaps more relevant for emerging markets: Gourio, Siemer and Verdelhan, 2014)
  - Different tax treatment (Black and Munro, 2010). Example: in Korea, non-residents exempt from withholding tax only for foreign currency bonds
  - Different government guarantees. Example: during the crisis, Portugal guaranteed only euro-denominated bonds issued by banks

**Suggestion 2:** Good to include institutional variables in the analysis



## QUESTION 3: WHY ARE U.S. FIRMS DIFFERENT?

Paper provides a tentative answer to this question, based on demand

- U.S. dollar is an international reserve currency
- Foreigners willing to hold it

New benefit for a reserve currency: firms can issue in their own currency

Alternative story, based on supply

- Firms issue foreign currency debt to hedge their revenues
- U.S. dollar is the dominant currency in international trade

**Suggestion 3:** Use data to distinguish among competing stories

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# CONCLUSION

- Ambitious project, documents striking home currency bias for advanced economies
- Three suggestions
  - 1 Verify if home currency bias puzzling from viewpoint of theory
  - 2 Document role of institutional factors
  - 3 Use granularity of the data to distinguish among competing stories