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
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.
Over 80% of Brazilian corporate bonds held by Brazilians is in real

Only 1% (?) of Brazilian corporate bonds held by foreigners is in real

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