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Home bias, risk differential, and cultural spatial spillover effects



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ABSTRACT

This paper aims to uncover the role of heterogeneity and spillover effects of return and risk on home bias associated with common background characteristics of trading countries. We adopt a spatial panel model to utilize uniquely created weight matrices and capture the spatial spillover effects of the common background characteristics. A modified definition of home bias is used to explore the role of market risks associated with the common characteristics of cross-border portfolio flows in an international portfolio balance model. Using annual panel data of 17 countries spread over three different regions (i.e., Asia, Europe, and others) for the 2002–2012 period, evidence strongly supports our hypothesis that the effects of the return and risk differentials of trading countries on home bias depend on the correlation of each of the common characteristics with return and risk.

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1. Introduction

Financial globalization has progressed rapidly since the 1990s, following the introduction of low-cost electronic trading of assets across borders and the increasing openness of emerging markets

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(World Bank, 2013). In particular, international net inflows to Asian emerging countries have shown remarkable growth. For example, the amount of asset transactions increased from \$765 million to \$30 billion in China and from \$3.9 billion to \$16.9 billion in South Korea between 1998 and 2012 (World Bank, 2013). Despite this rapid increase in financial globalization, however, investors in general seem reluctant to reap the full benefit of international diversification and still hold disproportionate shares of local equities (Portes and Rey, 2005; Forbes, 2010).

The lack of cross-border diversification may be attributed to investors' risk-hedging incentives in frictionless markets, transaction costs in international capital flows, information friction, and behavioral bias (Heathcote and Perri, 2007; Artis and Hoffmann, 2007; Wincoop and Warnock, 2006; Cooper and Kaplanis, 1994; Coeurdacier, 2009). That is, domestic equities with low returns are preferred to foreign equities with high returns because the former are perceived to incur lower transaction costs and to hold less risk than foreign equities. This phenomenon is commonly called the "equity home bias puzzle" simply referred to as "home bias" hereafter (French and Poterba, 1991).

Home bias has been explained in four different modeling frameworks. One is the transaction cost model in which transaction cost is interpreted as a barrier to international capital flows (e.g., Coeurdacier and Rey, 2011; Forbes, 2010; Hau and Rey, 2008; Ramos and Thadden, 2003). Another is the theory of information asymmetry; in this model, home bias occurs from asymmetric information between domestic and foreign investors because domestic investors are better informed about pay-offs in their own markets (e.g., Kang and Stulz, 1994; Ahearne et al., 2004; Dahlquist et al., 2003; Edison and Warnock, 2004; Lau et al., 2010; Hamberg et al., 2013). The third is a gravity model based on relative market size and distance between trading countries where information asymmetry and transaction costs are considered barriers to bilateral portfolio flows (e.g., Portes and Rey, 2005; Tesar and Werner, 1995; Razin, 2010; Martin and Rey, 1999; Faruqee et al., 2004).¹ The last deals with risk-hedging incentives based on an international portfolio flows model in which home bias is structured to hedge non-tradable income and exchange rate risks (e.g., Coeurdacier, 2009; Coeurdacier and Rey, 2011; Heathcote and Perri, 2007; Artis and Hoffmann, 2007; Wincoop and Warnock, 2006; Cooper and Kaplanis, 1994).

Despite its contribution to explaining home bias, the literature based on the above four modeling frameworks has neglected the potential of home bias attributable to cultural, geographical, and historical dependence between trading countries (hereafter referred to as "common background characteristics"). While dealing with the common background characteristics, the international finance literature treats the degree of common culture, language, and economic distance as measures of information asymmetry between trading countries, which are fixed barriers to cross-border portfolio flows and the cost of obtaining information about foreign markets (e.g., Faruqee et al., 2004; Lau et al., 2010; Hamberg et al., 2013). Recent evidence seems to suggest that transaction costs are less important than informational asymmetries in explaining international portfolio investment. Most of the explanatory power seems to come from gravity-type variables such as culture, distance, or language. The effects of common culture and language on international capital flows have been studied by Grinblatt and Keloharju (2000, 2001); Choe et al. (2005); Dvořák (2005); and Portes and Rey (2005).

Despite such attempts to incorporate common background characteristics into the international finance literature, very few studies have explicitly considered the heterogeneity and spillover effects of the common background characteristics on home bias. This lack of research is surprising, given the fact that a country with home bias over another country with which it shares a common language (e.g., the United States and the United Kingdom) may have a similar home bias with another country that also shares this common language (e.g., the United States and Canada). Thus, the similarity generated by common background characteristics such as common language and culture can generate heterogeneity and spillover effects that need to be controlled for when modeling home bias.

¹ The gravity model of home bias (Portes and Rey, 2005; Martin and Rey, 2004) also emphasizes the role of geometric distance between markets as transaction costs and information asymmetry barriers to bilateral portfolio flows. However, distance in our model reflects cultural spatial dependence, including the implicit costs to cross-border portfolio flows such as culture, common language, historical background, and economic distance. Note that distance in the gravity model does not cause transaction costs since the asset is weightless. Thus, distance cannot be a proxy for transaction costs but may have information asymmetry risk and the diversification motives of risk for capital flows (Portes and Rey, 2005).

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