



No.124/March 2006

A Portfolio Theory of International Capital Flows

Michael B. Devereux
University of British Columbia &
IIS, Trinity College, Dublin

Makoto Saito
Hitotsubashi University



IIS Discussion Paper No. 124

A Portfolio Theory of International Capital Flows

Michael B. Devereux

Makoto Saito

Disclaimer

Any opinions expressed here are those of the author(s) and not those of the IIS.

All works posted here are owned and copyrighted by the author(s).

Papers may only be downloaded for personal use only.

A Portfolio Theory of International Capital Flows¹

Michael B. Devereux²

University of British Columbia

Makoto Saito³

Hitotsubashi University

January 30, 2006

¹The authors would like to thank Toni Braun, Fumio Hayashi, and Shinsuke Ikeda for helpful and precious comments, and seminar participants at The University of British Columbia, Hitotsubashi University, Osaka University, The University of Tokyo, and The Bank of Japan for useful discussion. They are also grateful to Shiba Suzuki for research assistance. The second author acknowledges for hospitality Department of Economics, The University of British Columbia in which the current work was initiated. In addition, he is grateful for a grant-in-aid from the Ministry of Education and Science, Japan.

²Correspondence to: Department of Economics, University of British Columbia, #997-1873 East Mall, Vancouver, BC, V6T1Z1, Canada, devm@interchange.ubc.ca.

³Faculty of Economics, Hitotsubashi University, 2-1 Naka Kunitachi, Tokyo, 186-8601, Japan, makoto@econ.hit-u.ac.jp.

Abstract

This paper constructs a model in which the currency composition of national portfolios is an essential element in facilitating capital flows between countries. In a two country environment, each country chooses optimal nominal bond portfolios in face of real and nominal risk. Current account deficits are financed by increases in domestic currency debt, but balanced by increases in foreign currency credit. This is combined with an evolution of risk-premiums such that the rate of return on the debtor country's gross liabilities is lower than the return on its gross assets. This ensures stability of the world wealth distribution.

1 Introduction

Recent global imbalances have revived interest in models of current account dynamics and sustainability¹. One of the key new messages in this literature is that current account adjustment may depend critically on the structure of international financial markets. In particular, Gourinchas and Rey (2004) and Tille (2004) note that the U.S. net international portfolio involves substantial gross liabilities held in U.S. dollar denominations, but also substantial gross assets in non-U.S. currencies. As shown by Tille (2004), this significantly alters the link between the exchange rate and the current account. Much of the real adjustment to a large current account deficit could take place automatically through re-valuation effects on the U.S. net international portfolio.

In light of the importance of the structure of external country portfolios in understanding current account imbalances, Lane and Milesi-Ferretti (2004) and Obstfeld (2004) have called for a renewed effort in integrating portfolio structure into theoretical dynamic open economy models. Traditional open economy portfolio balance models (see Kouri 1976, Dooley and Isard 1982) have been limited both by their empirical failure as well as their lack of clear micro-foundations. On the other hand, technical difficulties limit the application of the recent generation of dynamic open economy models (e.g. Obstfeld and Rogoff 2002) to questions where portfolio structure is of first order importance.

This paper takes a first step at bridging this gap. We develop a stochastic, continuous time model in which trade in nominal bonds represents an essential component of the external adjustment process. Specifically, our model has two countries in which independent monetary authorities pursue inflation targeting objectives, and private agents can issue internationally traded nominal bonds in the currency of either country. All international asset trade is mediated through the use of these nominal bonds.

We find that there is a unique optimal portfolio structure for each country. The form of national portfolios depends critically on the stance of monetary policies. When the price level is counter-cyclical, countries hold short positions in their own currency, and long positions in the Foreign currency. Moreover, the structure of portfolios is an essential component of current account adjustment. Capital flows will take the form of ‘cross-hauling’, whereby a country in current account deficit will borrow by issuing debt in its own country, but simultaneously accumulate assets in Foreign currencies. Moreover, debtor countries will pay a lower rate of interest on their gross liabilities than they receive on their gross assets.

In the model with two nominal bonds, we find that the share of world wealth held by

¹See, for instance, Gourinchas and Rey (2004), Obstfeld (2004), Obstfeld and Rogoff (2004), Tille (2004), and Lane and Milesi Ferretti (2004).

any country follows a symmetric, stationary distribution. But the presence of diversified nominal bond portfolios is an essential element of this stationarity result. If returns on nominal bonds were independent (not correlated with technological shocks at all), then the wealth distribution would be no longer stationary.

Finally, our model implies a critical role for monetary policy. As in the model of Neumeyer (1997), eliminating exchange rate movements by a fully pegged exchange rate, or a single currency area would reduce welfare, so would the elimination of nominal assets which operate as a risk-sharing mechanism. By contrast, the model implies a unique welfare maximizing monetary rule for each country to follow (which requires flexible exchange rates).

There are limitations of our analysis. To focus exclusively on a portfolio approach to the current account, we have only a single world commodity, and full purchasing power parity (PPP). This means that the real exchange rate plays no role at all in current account adjustment. In this sense, our analysis is strictly a marriage of the inter-temporal approach to the current account (Obstfeld and Rogoff 1996) with a Merton (1971) type consumption-portfolio model. In addition we restrict preferences to have an inter-temporal elasticity of substitution of unity. This is the only tractable approach to portfolio dynamics in an economy with time-varying rates of return (see for instance, Devereux and Saito 1997).

Section 2 develops the basic model. Section 3 explores the equilibrium portfolio holdings in the model, and analyses the interaction between portfolio structure, capital flows, and the world wealth distribution. Section 4 briefly discusses the models implications for the current account and optimal monetary policy. Section 5 concludes.

2 The Model

We take a one-good two-country model of a world economy. In each country there is a risky linear technology which uses capital and generates expected instantaneous return α_i with standard deviation σ_i , where $i = h$ or f , signifying the ‘Home’ and ‘Foreign’ country. Capital can be turned into consumption without cost. The return on technology i (in terms of the homogeneous good) is given by:

$$\frac{dQ_i}{Q_i} = \alpha_i dt + \sigma_i dB_i,$$

for $i = h$ or f , where dB_i is the increment to a standard Weiner process. For simplicity, we assume that the returns on the two technologies are independent, so that

$$\lim_{\Delta t \rightarrow 0} \frac{Cov_t(\Delta B_h(t + \Delta t), \Delta B_f(t + \Delta t))}{\Delta t} = 0.$$

We will assume that residents of one country cannot directly own the technology of the other country. Hence, shares in the technology are not traded across countries. Nominal bonds can be traded between the countries, however. Bonds may be denominated in Home or Foreign currency. Although nominal bonds are risk-free in currency terms, their real returns are subject to inflation risk. We assume that inflation in country i may be represented as²:

$$\frac{dP_i}{P_i} = \Pi_i dt + v_i dM_i.$$

Thus, inflation has mean Π_i and standard deviation v_i , $i = h$ and f . dM_i represents the increment to a standard Weiner process. The monetary policy followed by country i is represented by the parameters Π_i and v_i , and the covariance of dM_i with dB_i . We let

$$\lim_{\Delta t \rightarrow 0} \frac{Cov_t(\Delta M_i(t + \Delta t), \Delta B_i(t + \Delta t))}{\Delta t} = \lambda_i, \quad (1)$$

and

$$\lim_{\Delta t \rightarrow 0} \frac{Cov_t(\Delta M_i(t + \Delta t), \Delta M_j(t + \Delta t))}{\Delta t} = 0. \quad (2)$$

for $i \neq j$. Equation (2) here says that inflation shocks are independent across countries. This is not critical, but simplifies the algebra.

The covariance term λ_i in equation (1) is the most critical parameter for the analysis. It describes the cyclical characteristics of the price level, and hence the real return on nominal bonds. In general we allow for any value of λ_i , such that $-1 < \lambda_i < 1$. Most of our discussion however will focus on the case where $\lambda_i < 0$, so that the price level is countercyclical³. Empirical evidence for this comes from various sources for the U.S. economy as well as other developed countries⁴.

Let the instantaneous nominal return on currency i bonds be \widehat{R}_i . Then the real return

²We do not explicitly model a source of demand for money. As in Woodford (2003), we can think of the model as representing a ‘cashless economy’. What matters is that there is an asset whose payoff depends on the price level, and monetary policy can generate a particular distribution for the price level.

³Note that an alternative approach to interest rate determination would be to allow the monetary authorities to set short term interest rates (e.g. money market rates) directly, and allowing bond market rates to equal the policy determined interest rate, plus an endogenous risk premium term, plus a disturbance (diffusion term). When the innovation to interest rates was positively correlated with domestic GDP, this would represent the equivalent to the case with $\lambda_i < 0$ in the present model.

⁴Measuring the correlation coefficient between logarithmic outputs detrended by Hodrick-Prescott filter and detrended logarithmic consumer price indexes based on U.S. quarterly data, Kydland and Prescott (1990) report -0.57 for the period between 1954 and 1989, and Cooley and Hansen (1995) report -0.52 for the period between 1954 and 1991. Using more recent data of OECD for the period between 1980 and 2004, the same correlation coefficient we have computed is -0.42 (U.S.), -0.04 (Japan), -0.71 (Canada), -0.05 (France), and -0.57 (U.K.). For the sample set, the correlation coefficient between output growth and CPI inflation is -0.21 (U.S.), -0.09 (Japan), -0.39 (Canada), -0.09 (France), and -0.35 (U.K.).

on bond i is

$$(R_i - \Pi_i)dt - v_i dM_i,$$

where $R_i = \widehat{R}_i + v_i^2$ is an adjusted nominal interest rate⁵. This will be determined endogenously as part of the world bond market equilibrium⁶.

The budget constraint for the Home country may then be written as:

$$\begin{aligned} dW_h = & W_h [\omega_T^h(\alpha_h - r_h) + \omega_h^h(R_h - \Pi_h - r_h) + \omega_f^h(R_f - \Pi_f - r_h) + r_h] dt \\ & - C_h dt + W_h (\omega_T^h \sigma_h dB_h - \omega_h^h v_h dM_h - \omega_f^h v_f dM_f), \end{aligned} \quad (3)$$

where ω_T^h , ω_h^h , and ω_f^h are the portfolio shares, respectively, of the domestic technology, Home currency nominal bonds, and Foreign currency nominal bonds. It facilitates the presentation of the model to allow for a non-traded domestic risk-free real bond, with return r_h . The equilibrium value of r_h can be used as a measure the risk-free real interest rate in the Home economy⁷. Since all Home agents are alike, this bond is in zero supply in equilibrium. C_h denotes consumption of the representative Home household⁸.

Assume that each country is populated by a continuum of identical agents, that preferences are identical across countries, and are given by logarithmic preference, or

$$E_0 \int_0^\infty \exp(-\rho t) \ln C_i(t) dt,$$

where ρ is the rate of time preference.

⁵The adjustment factor comes from a Jensen's inequality term in evaluating the real return on nominal bonds.

⁶In this nominal bond equilibrium, long-term bonds are redundant assets and derivatives of instantaneous nominal bonds. Therefore, given the equilibrium path of instantaneous nominal interest rates, determined by equations (9) and (10) together with equation (15), longer-term nominal interest rates are derived completely by arbitrage pricing.

⁷Devereux and Saito (1997) investigate a case where instantaneous real bonds are traded between two countries in the absence of cross-border equity trading. A major difference of the current model from the previous model is that risk-free rates are not equalized between two countries in the current model.

⁸Note that despite the fact that all capital flows are facilitated with nominal bonds, the exchange rate plays no independent role in our analysis. Since we have the single-good world and PPP holds, then the rate of the change in the exchange rate $S (= \frac{P_h}{P_f})$ is just determined residually by:

$$d \ln S = \left(\Pi_h - \frac{1}{2} v_h^2 - \Pi_f + \frac{1}{2} v_f^2 \right) dt + v_h dM_h - v_f dM_f.$$

The model could be extended to a multi-good environment with the real exchange rate playing a critical role. At present, however, we focus on the single-good case so as to emphasize the role of portfolio structure in current account adjustment.

2.1 Optimal Consumption and Portfolio Rules

We derive optimal consumption and portfolio rules in our context. At present, we simplify the analysis by assuming identical drift and diffusion parameters across countries; that is, $\alpha_h = \alpha_f = \alpha$, $\sigma_h = \sigma_f = \sigma$, $\Pi_h = \Pi_f = \Pi$, $\nu_h = \nu_f = \nu$, and $\lambda_h = \lambda_f = \lambda$. Section 4 will explore cases with asymmetric parameters between the two countries.

Given logarithmic utility, expected utility maximizing agents follow the myopic consumption rule:

$$C = \rho W.$$

The optimal portfolio rules may be obtained as the solution to:

$$\begin{bmatrix} \omega_T^h \\ \omega_h^h \\ \omega_f^h \end{bmatrix} = \begin{bmatrix} \sigma^2 & -\lambda\sigma\nu & 0 \\ -\lambda\sigma\nu & \nu^2 & 0 \\ 0 & 0 & \nu^2 \end{bmatrix}^{-1} \begin{bmatrix} \alpha - r_h \\ R_h - \Pi - r_h \\ R_f - \Pi - r_h \end{bmatrix} \quad (4)$$

A similar set of conditions hold for the Foreign economy. In what follows we make the following parameter assumptions governing the behavior of optimal portfolios: $\sigma^2 + \lambda\nu\sigma > 0$ and $\nu^2 + \lambda\nu\sigma > 0$. These conditions ensure that the behavior of portfolio demands satisfy regularity properties. In particular, the first condition ensures that a rise in the risk-free rate reduces the demand for Home currency nominal bonds, while the second ensures that a rise in the risk-free rate reduces the demand for shares in the domestic technology. These conditions are not necessary for the key stability results of the paper developed below, but they make the exposition of the results substantially easier.

2.2 Autarky versus Complete Markets

In order to provide a reference point, we describe the characteristics of the model first when there is no asset trade of any kind, and secondly, when there are complete markets (full trade in shares of each country's technology).

Without any asset trade, each country is in autarky. The risk-free rate in each country is given by $r = \alpha - \sigma^2$. In this case, equilibrium nominal bond holdings (in either currency) are zero, so that $\omega_T^i = 1$. The equilibrium nominal interest rate on Home currency bonds is $R_h = \Pi + \alpha - \sigma^2 - \lambda\nu\sigma$. This includes a risk premium term $\lambda\nu\sigma$. When $\lambda < 0$, the Home nominal bond is a bad hedge against technology risk, and must have a return higher than the risk-free rate, adjusted for inflation. When $\lambda > 0$, the opposite logic applies. The zero-trade equilibrium interest rate on Foreign currency bonds is $R_f = \Pi + \alpha - \sigma^2$. Since the Foreign price level is independent of Home output, it is a better hedge against consumption

risk when $\lambda < 0$, and therefore carries a lower autarky return than the Home currency bond.

From a welfare perspective, with preferences given by (2), the relevant measure of expected consumption (or wealth) growth in any equilibrium is the *risk-adjusted growth rate*, given by:

$$\lim_{\Delta t \rightarrow 0} \frac{\Delta \ln C_i(t + \Delta t)}{\Delta t} = \lim_{\Delta t \rightarrow 0} \frac{E_t \left(\frac{\Delta C_i(t + \Delta t)}{C_i(t)} \right) - \frac{1}{2} Var_t \left(\frac{\Delta C_i(t + \Delta t)}{C_i(t)} \right)}{\Delta t}.$$

In an autarky equilibrium, the risk-adjusted growth rate is given by $\alpha - \rho - \frac{1}{2}\sigma^2$.

With trade in shares of technology, there are effective complete markets. In this case, trade in nominal assets is redundant, as full diversification can be attained through trading in shares. The equilibrium share of each technology will be $\omega_T^i = \frac{1}{2}$, and the equilibrium risk-free rate will be $r = \alpha - \frac{1}{2}\sigma^2$. Hence, the risk-pooling effect of complete markets implies a higher risk-free interest rate than under autarky. Finally, the risk-adjusted growth rate with complete markets is $\alpha - \rho - \frac{1}{4}\sigma^2$. Risk pooling between the countries raises welfare by raising the risk-adjusted consumption growth rate.

2.3 Nominal Bond Trading Equilibrium

Since autarky nominal returns on Home and Foreign currency bonds differ, we anticipate that there will be trade between countries in the two bonds. At any moment in time, an equilibrium in the market for Home and Foreign currency bonds determines the nominal rates of return R_h and R_f . Nominal bonds in each currency are in zero net supply, so that the sum of domestic and foreign holdings is zero for each nominal bond:

$$\omega_h^h W_h + \omega_h^f W_f = 0, \tag{5}$$

and

$$\omega_f^h W_h + \omega_f^f W_f = 0. \tag{6}$$

In addition, since equilibrium holdings of the non-traded risk-free bond must be zero, in each country, the portfolio shares of the domestic technology plus the two nominal bonds must add to one, in each country:

$$\omega_T^h + \omega_h^h + \omega_f^h = 1, \tag{7}$$

and

$$\omega_T^f + \omega_h^f + \omega_f^f = 1. \quad (8)$$

These four conditions may be solved for R_h , R_f , r_h , and r_f . Define $\theta = \frac{W_f}{W_h + W_f}$ as the ratio of Foreign wealth to world wealth. From equations (5) through (8), it is clear that we may write the solution nominal interest rates and domestic risk-free rates as $R_h(\theta)$, $R_f(\theta)$, $r_h(\theta)$, and $r_f(\theta)$. The solutions are quite tedious to derive, but can be written as:

$$R_h(\theta) = \left[\alpha + \Pi - \sigma^2 + \frac{1}{2} (\lambda^2 \sigma^2 - \lambda \sigma v) \right] + \Phi_h(\theta), \quad (9)$$

$$R_f(\theta) = \left[\alpha + \Pi - \sigma^2 + \frac{1}{2} (\lambda^2 \sigma^2 - \lambda \sigma v) \right] + \Phi_f(\theta), \quad (10)$$

$$r_h(\theta) = \left[\alpha - \sigma^2 + \frac{1}{2} \lambda^2 \sigma^2 \right] + \Gamma_h(\theta), \quad (11)$$

and

$$r_f(\theta) = \left[\alpha - \sigma^2 + \frac{1}{2} \lambda^2 \sigma^2 \right] + \Gamma_f(\theta), \quad (12)$$

where we define the expressions Φ_i and Γ_i as:

$$\Phi_h(\theta) = \frac{\lambda \sigma (2\theta - 1) (v + \lambda \sigma (1 - 2\theta)) (v + 2\lambda v \sigma - \sigma^2 (\lambda^2 - 2))}{2 (v^2 + 2\lambda v \sigma + \sigma^2 (2 - (1 - 2\theta)^2 \lambda^2))},$$

$$\Phi_f(\theta) = \frac{v - \lambda \sigma (1 - 2\theta)}{v + \lambda \sigma (1 - 2\theta)} \Phi_h(\theta),$$

$$\Gamma_h(\theta) = \frac{\lambda^2 \sigma^2 (2\theta - 1) (v^2 + 2\lambda v \sigma \theta + \sigma^2 (2\theta - 1) (\lambda^2 - 2))}{2 (v^2 + 2\lambda v \sigma + \sigma^2 (2 - (1 - 2\theta)^2 \lambda^2))},$$

and

$$\Gamma_f(\theta) = \frac{\lambda^2 \sigma^2 (2\theta - 1) (v^2 + 2\lambda v \sigma (1 - \theta) + \sigma^2 (2\theta - 1) (\lambda^2 - 2))}{2 (v^2 + 2\lambda v \sigma + \sigma^2 (2 - (1 - 2\theta)^2 \lambda^2))}.$$

Using these solutions with the optimal rules from the portfolio problem allows us to write the equilibrium Home country portfolio shares as:

$$\omega_h^h = \frac{\theta \lambda \sigma (v^2 + 2\sigma^2 + 3\lambda \sigma v - 2\lambda \sigma v \theta)}{v (v^2 + 2\sigma^2 + 2\lambda \sigma v - \sigma^2 \lambda^2 + 4\sigma^2 \lambda^2 \theta (1 - \theta))}, \quad (13)$$

and

$$\omega_f^h = -\frac{\theta \lambda \sigma (v^2 + 2\sigma^2 + \lambda \sigma v + 2\lambda \sigma v \theta)}{v (v^2 + 2\sigma^2 + 2\lambda \sigma v - \sigma^2 \lambda^2 + 4\sigma^2 \lambda^2 \theta (1 - \theta))}. \quad (14)$$

The model has an appealing recursive structure. Given the myopic consumption rule, portfolio equilibrium has the property that returns depend only on the current world distribution of wealth, captured by the term θ . Even with this, however, portfolio holdings and returns are complicated functions of θ . It is helpful therefore to focus first on a special case of an equal wealth levels in each country.

3 Portfolios, Returns, and Capital Flows

3.1 A Special Case: $\theta = 0.5$

Take first the case where $\theta = 0.5$, so that wealth levels are equal in the Home and Foreign countries. From inspection of the above solutions for interest rates, we see that $\Phi_i(0.5) = 0$ and $\Gamma_i(0.5) = 0$. Hence,

$$R_i = \alpha + \Pi - \sigma^2 + \frac{1}{2}(\sigma^2\lambda^2 - \lambda\sigma v),$$

and

$$r_i = \alpha - \sigma^2 + \frac{1}{2}\sigma^2\lambda^2.$$

The real risk-free interest rate is between that of autarky and complete markets. The critical parameter determining the equilibrium real risk-free rate is λ . Since $-1 < \lambda < 1$, generically, the real risk-free rate is higher than under autarky, but lower than under complete markets. Recall that λ captures the correlation between the return on the Home (Foreign) nominal bond and the return on the Home (Foreign) technology. When $\lambda = 0$, the nominal bond can play no role at all as a hedge against technology (and therefore consumption) risk. Hence the presence of nominal bonds does not affect the equilibrium real risk-free rate, which is equal to the autarky rate. But as λ rises toward unity in absolute terms, bonds can act as a real hedge against technology risk, and the fall in consumption risk raises the real risk-free rate in each country. In the limit, as λ goes to unity in absolute value, we approach the risk-free rate under complete markets.

In the symmetric economy with nominal bond trading, nominal interest rates on Home and Foreign currency bonds are equalized across countries. The movement of the nominal interest rate, relative to autarky, depends on the sign of λ . When $\lambda < 0$, the Home currency bond is a poor hedge against consumption risk for the Home economy, and will have a high autarky return. By the same token, however, this bond is a relatively good hedge against Foreign consumption risk, and would have a low autarky return in the Foreign economy.

Hence, upon opening international nominal bond markets, the Home country will sell Home currency bonds to Foreign residents, and the new equilibrium nominal return will be in between the (high) Home country autarky return and the (low) Foreign country autarky return. Of course, the same mechanism works for the Foreign currency bond. With $\lambda < 0$, its equilibrium return is less than the autarky return in the Foreign economy, but greater than the autarky return in the Home economy⁹.

When $\theta = 0.5$, the risk-adjusted growth rate may be written as:

$$\alpha - \rho - \frac{1}{2}\sigma^2 \left(1 - \frac{\lambda^2}{2}\right).$$

Again, we find that this falls between that of autarky and complete Markets. When $\lambda = 0$, the risk-adjusted growth rate is identical to that under autarky. When $|\lambda| = 1$, the bond trading regime attains the risk-adjusted growth rate under complete markets.

How does the presence of nominal bonds support risk-pooling across countries? This happens because, in face of country specific risk on the real technology, each country can hold a portfolio of Home and Foreign currency bonds to hedge this risk. In the symmetric case with $\theta = 0.5$, net foreign assets are zero in each country, so that, for the Home country, for instance, we have $\omega_h^h + \omega_f^h = 0$. But in order to hedge technology risk, countries find it advantageous to hold different *gross* positions in each currency. The optimal portfolio in this case is:

$$\omega_h^h = \frac{1}{2} \frac{\lambda\sigma}{v}, \quad \omega_f^h = -\frac{1}{2} \frac{\lambda\sigma}{v}.$$

When $\lambda < 0$, the Home country takes a short position in Home currency bonds and a long position in Foreign currency bonds. Since in this case, the return on Home nominal bonds is pro-cyclical, it can use a negative gross holdings of Home currency bond as an effective hedge against consumption risk. Similarly, a positive gross holding of Foreign currency bonds allows it to share in the Foreign technology process. This portfolio structure exploits the different returns processes on Home and Foreign currency bonds to allow the risk from technology shocks to be partly pooled across countries.

Of course when $\lambda > 0$, the process works in reverse. In this case, the Home currency bond is a good hedge against Home consumption risk. Then, in the Home country, it will have a lower autarky return than the Foreign currency bond. In a symmetric bond trading equilibrium with equal wealth, Home residents will therefore hold positive quantities of Home currency bonds, and negative amounts of Foreign currency bonds.

⁹Our simplifying assumption $\sigma^2 + \lambda v\sigma > 0$ ensures this intuitive result.

3.2 Effects of Marginal Variation in θ

The results can be easily extended to general values of the relative wealth ratio $\frac{W_f}{W_h+W_f}$ or θ . First we focus on the expressions for the Home country portfolio, equations (13) and (14). Under the assumptions made so far and $\lambda < 0$, the first expression is negative, while the second is positive. Hence, for all levels of θ , the Home country issues its own currency bonds short, and holds positive quantities of the Foreign currency bonds. These solutions also confirm what we saw in the previous section; when $\theta = 0.5$, the net Foreign asset position is zero, since $\omega_h^h + \omega_f^h = 0$.

We may describe in more detail the behavior of both gross and net foreign assets as θ changes. Differentiating equations (13) and (14) at $\theta = 0.5$, we see that a rise in θ has the following effect on the Home country's portfolio:

$$\left. \frac{d\omega_h^h}{d\theta} \right|_{\theta=0.5} = \frac{\lambda\sigma(2\sigma^2 + \lambda\sigma v + v^2)}{v(2\sigma^2 + 2\lambda\sigma v + v^2)},$$

and

$$\left. \frac{d\omega_f^h}{d\theta} \right|_{\theta=0.5} = -\frac{\lambda\sigma(2\sigma^2 + 3\lambda\sigma v + v^2)}{v(2\sigma^2 + 2\lambda\sigma v + v^2)}.$$

When $\lambda < 0$, the first expression is negative, and the second is positive. Hence, beginning at $\theta = 0.5$, a rise in Foreign relative wealth will be followed by a rise in Home gross borrowing in Home currency bonds, and a rise in gross lending in Foreign currency bonds.

These two effects do not cancel out, however. It is easy to see that:

$$\left[\frac{d\omega_h^h}{d\theta} + \frac{d\omega_f^h}{d\theta} \right]_{\theta=0.5} = -\frac{2\lambda^2\sigma^2}{2\sigma^2 + 2\lambda\sigma v + v^2},$$

which is negative with $\lambda < 0$. Hence, a rise in θ above $\theta = 0.5$ will lead to a rise in net Foreign borrowing in the Home country. This Foreign borrowing will be used to invest in the domestic technology, since from (7), it must be the case that

$$\left. \frac{d\omega_T^h}{d\theta} \right|_{\theta=0.5} = - \left[\frac{d\omega_h^h}{d\theta} + \frac{d\omega_f^h}{d\theta} \right]_{\theta=0.5} > 0.$$

Conversely, the Foreign economy will increase its net foreign assets, as

$$\left[\frac{d\omega_h^f}{d\theta} + \frac{d\omega_f^f}{d\theta} \right]_{\theta=0.5} > 0,$$

and therefore it reduces its investment in its own domestic technology; that is, $\left. \frac{d\omega_f^f}{d\theta} \right|_{\theta=0.5} < 0$.

Thus, in the regions of a symmetric equilibrium, capital will flow to the less wealthy country. But this capital flow will take place through a ‘cross-hauling’ effect. When $\lambda < 0$, there will be a gross outflow to purchase Foreign currency assets, but a gross inflow for the sale of Home currency assets.

The net capital flow is reflected in the behavior of risk-free interest rates at $\theta = 0.5$. Differentiating the impact of θ on the risk-free rate, we obtain:

$$\left. \frac{dr_h}{d\theta} \right|_{\theta=0.5} = \frac{\lambda^2 \sigma^2 v (\lambda \sigma + v)}{2\sigma^2 + 2\lambda \sigma v + v^2},$$

and

$$\left. \frac{dr_f}{d\theta} \right|_{\theta=0.5} = -\frac{\lambda^2 \sigma^2 v (\lambda \sigma + v)}{2\sigma^2 + 2\lambda \sigma v + v^2}.$$

A rise in θ , evaluated at $\theta = 0.5$, leads to a rise in the Home risk-free rate, and a fall in the Foreign risk-free rate with our simplifying assumption $v^2 + \lambda v \sigma > 0$. This is associated with capital flows to the Home country.

Note however that capital flows can only be effected through movements in nominal bonds. The key feature of the model is the interaction between the portfolio position of each country and the share of aggregate world wealth held by the country, which in turn determines the net savings rate of the country. At $\theta = 0.5$, the two countries have exactly equal net wealth, and given the symmetry in the model, the current account of each country is zero. A rise in W_f , driven for instance by a positive technology shock in the Foreign country, will raise θ , and increase the Foreign country’s demand for assets. Given that the Foreign optimal portfolio involves positive holdings of Home currency bonds and negative holdings of Foreign currency bonds, the rise in its asset demand raises world demand for Home bonds, and world supply of Foreign bonds. This leads to a fall in the return on Home bonds, and a rise in the return on Foreign bonds. From the solutions for R_h and R_f , we find that:

$$\left. \frac{dR_h}{d\theta} \right|_{\theta=0.5} = \frac{\lambda \sigma v (v^2 + 2\lambda \sigma v + 2\sigma^2 - \sigma^2 \lambda^2)}{2\sigma^2 + 2\lambda \sigma v + v^2},$$

and

$$\left. \frac{dR_f}{d\theta} \right|_{\theta=0.5} = -\frac{\lambda \sigma v (v^2 + 2\lambda \sigma v + 2\sigma^2 - \sigma^2 \lambda^2)}{2\sigma^2 + 2\lambda \sigma v + v^2}.$$

The first expression is negative while the second is positive, for $\lambda < 0$ ¹⁰. Thus there is a fall in the risk premium on Home currency bonds, thereby reducing the interest burden on the liabilities of the debtor country. On the other hand, there is a rise in the risk premium on Foreign country bonds, thereby increasing the return on liabilities of the creditor country. This fall in R_h and rise in R_f leads to a portfolio gain for the Home economy, given that it is short in Home bonds and long in Foreign bonds. This reduces the effective cost of borrowing, leading it to a higher net foreign debt, and to increase investment in the domestic technology. In this manner, the original positive technology shock in the Foreign economy is shared by the Home economy.

3.3 Stability Properties

An implication of the model is that the country with a higher level of wealth is a net creditor. Using the solutions in (13) and (14) above, we can write the net foreign asset share in the Home country portfolio ($\omega_h^h + \omega_f^h$) as:

$$\omega_h^h + \omega_f^h = -\frac{2\theta(2\theta - 1)\lambda^2\sigma^2}{v^2 + 2\sigma^2 + 2\lambda\sigma v - \sigma^2\lambda^2 + 4\sigma^2\lambda^2\theta(1 - \theta)}.$$

The denominator is always positive (whatever the sign of λ). Hence, as was inferred in the discussion above, Home net foreign assets are negative (positive) whenever $\theta > 0.5$ (< 0.5).

Is the wealth distribution stable? For this to be the case, it must be that Home wealth grows faster than Foreign wealth, when $\theta > 0.5$. To answer this question, we must explicitly derive the dynamics of θ . Using Ito's lemma and equation (3), we may write the diffusion process governing θ as:

$$d\theta = \theta(1 - \theta)F(\theta)dt + \theta(1 - \theta)G(\theta)dB, \quad (15)$$

where the functional forms of $F(\theta)$, $G(\theta)$, and dB are described in the Appendix. The asymptotic distribution of θ must satisfy either; (a) $\theta \rightarrow 1$, (b) $\theta \rightarrow 0$, or (c) θ follows a stable distribution in $(0, 1)$. Given the form of (15), clearly $\theta = 1$ and $\theta = 0$ are absorbing states. But the following proposition establishes the conditions under which (c) will apply.

Proposition 1 *For $\lambda \neq 0$, θ has a symmetric ergodic distribution in $(0, 1)$ centered at $\theta = \frac{1}{2}$.*

Proof. *See Appendix.* ■

¹⁰Note that $v^2 + 2\lambda\sigma v + 2\sigma^2 - \sigma^2\lambda^2 > (v - \sigma)^2 + (1 - \lambda^2)\sigma^2 > 0$ as long as $\lambda > -1$. At this point, our simplifying assumption $\sigma^2 + \lambda v\sigma > 0$ or $v^2 + \lambda v\sigma > 0$ plays no role.

The content of this proposition can be developed by showing the dependence of risk-adjusted growth rates of wealth on the relative wealth variable θ . As before, we define the risk-adjusted growth rate for country i as:

$$g_i(\theta) = \lim_{\Delta t \rightarrow 0} \frac{\Delta \ln W_i(t + \Delta t)}{\Delta t} = \lim_{\Delta t \rightarrow 0} \frac{E_t \left(\frac{\Delta W_i(t + \Delta t)}{W_i(t)} \right) - \frac{1}{2} \text{Var}_t \left(\frac{\Delta W_i(t + \Delta t)}{W_i(t)} \right)}{\Delta t}.$$

Then, θ has an ergodic distribution if it cannot access the boundaries 0 or 1. Defining the difference between the Foreign and Home risk-adjusted growth rate as $\delta(\theta) = g_f(\theta) - g_h(\theta)$, this property holds if the probability of reaching either is zero. For the lower bound, this is the case if $\delta(0) > 0$. Likewise, the probability of reaching the upper bound is zero if $\delta(1) < 0$. This just says that as the Home country gets arbitrarily wealthy, relative to the Foreign country, the Foreign country's risk-adjusted growth rate exceeds that of the Home country. Likewise, if the Foreign country's wealth increases arbitrarily relative to that of the Home country, then the Home risk-adjusted growth rate will exceed that of the Foreign country. The Proposition establishes that, for $\lambda \neq 0$, this property always holds. We may show this directly by computing $\delta(\theta)$. The Appendix shows that $\delta(\theta)$ may be written as:

$$\delta(\theta) = \frac{\lambda^2 \sigma^2 (1 - 2\theta)(v^2 + 2\lambda\sigma v + 2\sigma^2 - \sigma^2 \lambda^2)(v^2 + 2\lambda\sigma v + 2\sigma^2)}{(4\sigma^2 \theta \lambda^2 (\theta - 1) + \sigma^2 \lambda^2 - 2\lambda\sigma v - 2\sigma^2 - v^2)^2}.$$

The denominator is always positive, and the numerator is positive (negative) for $\theta < 0.5$ (> 0.5), as long as $\lambda \neq 0$. Moreover, this satisfies the conditions

$$\delta(0) = \frac{\lambda^2 \sigma^2 (v^2 + 2\lambda\sigma v + 2\sigma^2)}{v^2 + 2\lambda\sigma v + 2\sigma^2 - \sigma^2 \lambda^2} > 0,$$

$$\delta(1) = -\frac{\lambda^2 \sigma^2 (v^2 + 2\lambda\sigma v + 2\sigma^2)}{v^2 + 2\lambda\sigma v + 2\sigma^2 - \sigma^2 \lambda^2} < 0,$$

and

$$\delta(0.5) = 0.$$

Hence, for $\theta > 0.5$, and the Foreign country is relatively wealthy, the Home risk-adjusted growth rate exceeds that of the Foreign country, and θ falls. The same dynamics occur in reverse when $\theta < 0.5$. These expressions also make clear that the distribution of θ is symmetric.

A key feature of the proof is the reliance on the parameter λ . This represents the correlation between prices and the real technology in each country. Note that stationarity

is ensured whether λ is positive or negative. In either case, agents can make use of nominal bonds to hedge, internationally, against consumption risk, holding short the Home (Foreign) currency bond if $\lambda < 0$, and conversely if $\lambda > 0$. But if $\lambda = 0$, then nominal bond returns are independent of consumption risk in either country, and they will not be held in equilibrium (i.e. $\omega_j^i = 0$, for all i and j). In this case, the stationarity result fails.

To see the relationship between the portfolio structure of international assets markets and the stationarity of the world wealth distribution, take the case $\lambda < 0$. Then when $\theta > 0.5$, the Foreign country is wealthier than the Home country. The Foreign country is also a net creditor. But the positive holdings of net international assets are based on positive holdings of Home currency bonds, and negative holdings on Foreign currency bonds. As we have seen, Home currency bonds pay a relatively low return, while Foreign currency bonds pay a relatively high return. This endogenous fall in the risk-premium on the Home portfolio reduces the effective cost of borrowing for the Home economy, encouraging it to invest more in its domestic technology. Since the expected return on the domestic technology exceeds that on its nominal asset portfolio, this increases the risk-adjusted expected growth rate for the Home country, relative to the Foreign country. As a result, θ is driven back towards 0.5 again. In effect, it is the portfolio composition and its interaction with the evolution of the global wealth distribution that represents an essential element in the stability of the wealth distribution itself. Thus, current account imbalances are naturally self-correcting when agents hold an optimal currency portfolio of international debt.

Another perspective can be given from a comparison of the movement of returns relative to their autarky values. As one country begins to dominate world wealth, it will push bond returns towards their autarky values for that country. If this is the Foreign country, for instance, this will lead Home currency bond returns to fall, and Foreign country bond returns to rise, since Foreign consumption risk is relatively well hedged by Home currency bonds, and badly hedged by Foreign currency bonds. Thus, Home bond returns will approach $\alpha + \Pi - \sigma^2$, and Foreign bond returns approach $\alpha + \Pi - \sigma^2 - v\lambda\sigma$. This process reduces the net return that the Home country must pay on its international debt; that is, a key mechanism in generating a stable wealth distribution.

While this interpretation is based on a negative value of λ , this is not necessary for the stability result. If $\lambda > 0$, then the equivalent stabilizing force takes place, but now with the Foreign country holding positive (negative) amounts of Foreign (Home) currency bonds.

But for this to occur, it is essential that $\lambda \neq 0$. If $\lambda = 0$, the portfolio composition is indeterminate, since bonds can then play no role as a hedge against technology risk. In fact, agents will hold no bonds at all. Since technologies are identical, there can be no gains from trade in international bonds at all. Any innovations to wealth are permanent. Clearly

then the wealth distribution will not be stable. In fact, θ will be characterized by hysteresis in technology shocks will give rise to an expected permanent increase in wealth without international asset trade at all.

As demonstrated in the Appendix, the model allows for an explicit solution for the distribution of wealth. Figure 1 illustrates the distribution of $\ln(\frac{W_f}{W_h}) = \ln(\frac{\theta}{1-\theta})$ for different values of λ with $\sigma = \nu = 0.02$ ¹¹. In each case, the distribution has zero mean. But the λ parameter matters substantially for the shape of the distribution. For high absolute values of λ , the distribution is tightly centered around zero. But as λ falls in absolute value, the distribution becomes substantially spread out. This means that the speed of convergence in the wealth distribution depends critically on the size of λ . For high absolute values of λ , convergence is much faster. More concretely, in the above example represented by Figure 1, the unconditional probability that θ (the Foreign wealth share) is between 40% and 60% is 34.8% for $\lambda = -0.9$ and 27.0% for $\lambda = -0.8$, but it reduces to 11.8% for $\lambda = 0.5$ and 7.6% for $\lambda = -0.3$.

3.4 Characteristics of Equilibrium

Figures 2 through 5 describe some features of the equilibrium under a set of structural parameters, $\alpha = 0.03$, $\sigma = 0.02$, $\nu = 0.02$, $\Pi = 0.02$, and $\lambda = -0.5$. The Figures illustrate the relationship between the relative wealth ratio θ , country portfolio weights, real and nominal interest rates, and risk-adjusted growth rates.

Figure 2 shows how the Home country's portfolio weights depend on θ . As θ falls towards zero, the Home country dominates the world capital market, and its bond portfolio shares in both currencies are very low. But as θ rises, it increases its holdings of Foreign currency bonds, and balances this by issuing Home currency bonds. As we saw above, for $\theta < 0.5$, ($\theta > 0.5$) the former (latter) effect dominates, and it is a net creditor (debtor).

Figure 3 illustrates the pattern of real risk-free rates as a function of θ . From the analysis at $\theta = 0.5$, we know that the Home country risk-free rate is increasing in θ at $\theta = 0.5$, and the Foreign risk-free rate is decreasing in θ at that point. But the behavior of risk-free rates away from $\theta = 0.5$ may be quite different. In the Figure, we see that risk-free rates may be non-monotonic in θ . As θ rises above 0.5, the Home country risk-free rate first rises, as income growth rises when capital flows go into Home technology. But, for relatively low ν , this also involves increasing the riskiness of the Home portfolio, which tends to push down the risk-free rate. As θ continues to increase, this second effect can dominate, and r_h may

¹¹A major reason for adopting $\ln \frac{W_f}{W_h}$ instead of $\frac{W_f}{W_h + W_f}$ is that the former definition can illuminate the behavior at tails of wealth distribution with a support of $(-\infty, +\infty)$ rather than $(0, 1)$.

fall in θ . But if monetary uncertainty is high enough (i.e. v high enough), then the Home risk-free rate will be monotonically increasing in θ . The logic is as follows. As θ rises towards unity, R_h approaches $\alpha + \Pi - \sigma^2$, while R_f approaches $\alpha + \Pi - \sigma^2 - \lambda\sigma v$. Since the Home country holds positive amounts of the Foreign currency bond, this pushes up its growth rate, and hence the Home risk-free rate.

Figure 4 shows a similar pattern but in terms of nominal returns R_h and R_f . As the Home (Foreign) country increases its share of world wealth, it pushes down the return on the Foreign (Home) currency bond, since that bond is a better hedge against Home (Foreign) consumption risk, when $\lambda < 0$. Similarly, because the Home (Foreign) country issues its own currency bond in these circumstances, the return on this bond must increase when it dominates world wealth.

Finally, Figure 5 illustrates the relationship between θ and risk-adjusted growth rates. For the reasons discussed above, risk-adjusted growth rates are monotonic in θ . As θ approaches either boundary, the risk-adjusted growth rate of the smaller country will always exceed that of the larger country.

4 Applications of the Basic Model

4.1 Current Account Adjustment

In our symmetric model, the mean of the distribution of θ is 0.5. This implies that the current account will have a zero long run mean with zero holdings of net foreign assets. How does the current account adjust when we are away from the long run mean? We may define the current account as the change in net foreign assets. Net foreign assets of the Home country is written as:

$$(\omega_h^h + \omega_f^h)W_h = \frac{2\theta(2\theta - 1)\lambda^2\sigma^2}{4\theta(\theta - 1)\sigma^2\lambda^2 + \sigma^2\lambda^2 - 2\lambda\sigma v - 2\sigma^2 - v^2}W_h.$$

Since W_h is non-stationary, the level of net foreign assets will not converge. But we may rewrite this in terms of net foreign assets, relative to world wealth $W_h + W_f$. Hence we have:

$$NFA(\theta) = (\omega_h^h + \omega_f^h)(1 - \theta) = \frac{2\theta(2\theta - 1)(1 - \theta)\lambda^2\sigma^2}{4\theta(\theta - 1)\sigma^2\lambda^2 + \sigma^2\lambda^2 - 2\lambda\sigma v - 2\sigma^2 - v^2}.$$

From what we have seen already, it is clear that the sign of normalized net foreign assets satisfies the conditions $NFA(\theta) < 0$ (> 0) for $\theta > 0.5$ (< 0.5). The current account is defined as the change in the value of net foreign assets. Therefore, we may define the

process of the normalized current account of the Home country as:

$$dNFA(\theta) = NFA'(\theta)d\theta + \frac{1}{2}NFA''(\theta)d\theta^2.$$

Then, using the solution for the Ito process for θ defined above, we have:

$$dNFA(\theta) = \left[NFA'(\theta)\theta(1-\theta)F(\theta) + \frac{1}{2}NFA''(\theta)\theta^2(1-\theta)^2G(\theta)^2 \right] dt + NFA'(\theta)\theta(1-\theta)G(\theta) dB, \quad (16)$$

where again, the expressions $F(\theta)$, $G(\theta)$, and dB are defined in the Appendix.

Equation (16) allows us to describe the behavior of the drift and diffusion of the normalized current account, as a function of θ . Using the same parameters as before ($\sigma = v = 0.02$ and $\lambda = -0.5$), we may illustrate the drift term in Figure 6, or the term $NFA'(\theta)\theta(1-\theta)F(\theta) + \frac{1}{2}NFA''(\theta)\theta^2(1-\theta)^2G(\theta)^2$.

When $\theta > 0.5$, the expected current account surplus is positive for Home country, as its relative wealth growth is higher than that of the Foreign country. But for very high values of θ , the expected current account surplus becomes negative. This is because, when θ is close to unity, the Home country actively exploits a short position in Home currency bonds, which become more and more appealing with low borrowing costs. Of course, the case when $\theta < 0.5$ is just the mirror image of the $\theta > 0.5$ case.

Figure 7 illustrates the relationship between θ and the diffusion term (or volatility) in equation (16). The volatility of the (normalized) current account is highest at $\theta = 0.5$, but volatility also increases close to the boundaries, as the smaller countries increase their borrowing more in that neighborhood.

4.2 Introduction of a Tradable Technology

This subsection relaxes the assumption that a linear technology is not tradable between the two countries at all. We here introduce another linear technology which is tradable across the border. The tradable technology of country i is characterized as

$$\frac{dQ_i^E}{Q_i^E} = \beta dt + \epsilon dB_i^E$$

for $i = h$ or f , where dB_i^E is an increment to the standard Weiner process uncorrelated with dB_i , and correlated with dM_i at the coefficient λ .¹²

Now, the Home (Foreign) country can make investment in its own tradable technology at a portfolio weight ω_{Th}^h (ω_{Tf}^f), and the tradable technology of the Foreign (Home) country at a portfolio weight ω_{Tf}^h (ω_{Th}^f), while they are not allowed to make any short position on the tradable technologies. Then, the following portfolio restrictions must be satisfied for both countries: $\omega_T^h + \omega_{Th}^h + \omega_{Tf}^h + \omega_h^h + \omega_f^h = 1$ with $\omega_T^h \geq 0$, $\omega_{Th}^h \geq 0$, and $\omega_{Tf}^h \geq 0$, and $\omega_T^f + \omega_{Tf}^f + \omega_{Th}^f + \omega_f^f + \omega_h^f = 1$ with $\omega_T^f \geq 0$, $\omega_{Tf}^f \geq 0$, and $\omega_{Th}^f \geq 0$.

It is possible to prove that a wealth distribution indicator θ (the Foreign wealth share) still has a stationary distribution in $(0, 1)$ centered at $\theta = 0.5$ under the simplifying assumption that $\alpha = \beta$, and $\sigma = \epsilon = \nu$; these assumptions are made not for any essential reason, but for convenience to simplify proof substantially.

At $\theta = 0.5$, we obtain that as long as $\lambda^2 \leq \frac{1}{2}$, then $\omega_T^h = \frac{1-\lambda^2}{3-4\lambda^2} > 0$, $\omega_{Th}^h = \frac{1-\lambda^2}{3-4\lambda^2} > 0$, and $\omega_{Tf}^h = \frac{1-2\lambda^2}{3-4\lambda^2} > 0$ in equilibrium; that is, $\omega_T^h + \omega_{Th}^h + \omega_{Tf}^h = 1$ holds with long positions on all of the three linear technologies. In nominal bond markets, $\omega_h^h = -\omega_h^f = \frac{\lambda}{2(3-4\lambda^2)}$. As in the previous case where any technology is not tradable, the Home (Foreign) country still makes a short position in the Home (Foreign) currency bond, and a long position in the Foreign (Home) currency bond, when λ is negative and $\lambda^2 \leq \frac{1}{2}$.

The Home and Foreign bond markets are cleared at $i_h = i_f = \alpha + \phi - \frac{[2+\lambda(3-3\lambda-4\lambda^2)]\sigma^2}{6-8\lambda^2}$, while the corresponding risk-free rates (r_h and r_f) are equal to $\alpha - \frac{(2-3\lambda^2)\sigma^2}{6-8\lambda^2}$. At the lower limit of $\lambda^2 = 0$, nominal bond markets do not play any role as a hedge instrument, and each country divides its own wealth equally over the three technologies. The equilibrium risk-free rate is then equal to $\alpha - \frac{1}{3}\sigma^2$. At the upper limit of $\lambda^2 = \frac{1}{2}$, on the other hand, the equilibrium risk-free rate reaches $\alpha - \frac{1}{4}\sigma^2$, which is equivalent to the risk-free rate in the complete markets case where each country divides its own wealth equally over the two domestic and two foreign technologies. Those results imply that as long as λ is non-zero, nominal bond trading can still play an effective role in sharing country-specific shocks.

Given the difference between the Foreign and Home risk-adjusted growth rate defined as $\delta(\theta) = g_f(\theta) - g_h(\theta)$, it is possible to show that $\delta(0.5) = 0$, and

$$\delta(1) = -\delta(0) = -\frac{\lambda^2(5+6\lambda)\sigma^2}{9(1+\lambda)[(1+\lambda)+4(1-2\lambda^2)]} < 0,$$

as long as $\lambda^2 \leq \frac{1}{2}$. Therefore, if the Foreign (Home) country's wealth is more dominant, then the Home (Foreign) country grows faster than the other country. A fundamental source for

¹²An indirect correlation between dB_i^E and dB_i does not show up at the variance-covariance matrix because of its lower order at $\Delta t \rightarrow 0$.

this stability property of θ is the same effect of nominal bond trading as in the previous case. The above exercise demonstrates that the introduction of tradable technology limits a role of nominal bond trading as a risk-sharing instrument to some extent, but it does not change major results discussed in Sections 2 and 3.

4.3 Asymmetry in Structural Parameters

This subsection explores effects of differences in structural parameters between the two countries in terms of impacts on net foreign asset positions ($\omega_h^h + \omega_f^h$). For this purpose, we evaluate a marginal effect of a change in a particular parameter on net foreign asset positions of the Home country, starting from $\omega_h^h + \omega_f^h = 0$ at $\theta = 0.5$ in the symmetric case ($\alpha_h = \alpha_f = \alpha$, $\sigma_h = \sigma_f = \sigma$, $v_h = v_f = v$, and $\lambda_h = \lambda_f = \lambda < 0$). A major benefit of these exercises is that we can still have ergodic properties in the neighborhood of the symmetric case we have investigated in detail. We here assume that $\sigma^2 + \lambda\sigma\nu > 0$ and $\nu^2 + \lambda\sigma\nu > 0$ respectively.

In regard to production parameters, we obtain the following results:

$$\left. \frac{\partial(\omega_h^h + \omega_f^h)}{\partial\alpha_h} \right|_{\alpha_h=\alpha_f, \sigma_h=\sigma_f, \lambda_h=\lambda_f < 0, v_h=v_f} = -\frac{1}{v^2 + 2\sigma(\sigma + \lambda v)} < 0,$$

and

$$\left. \frac{\partial(\omega_h^h + \omega_f^h)}{\partial\sigma_h} \right|_{\alpha_h=\alpha_f, \sigma_h=\sigma_f, \lambda_h=\lambda_f < 0, v_h=v_f} = \frac{1}{2} \frac{(\sigma + \lambda\nu) + (3 - \lambda^2)\sigma}{v^2 + 2\sigma(\sigma + \lambda v)} > 0.$$

A marginal increase in α_h always makes Home net foreign assets negative. A major reason for this is that more profitable opportunities attract capital from the Foreign country. A marginal increase in σ_h , on the other hand, leads to positive net foreign assets as a result of hedging production risk by long positions in Foreign currency bonds.

As shown below, a marginal increase in Home inflation risk captured by ν_h makes net foreign assets positive positive for the same reason as in an increase in σ_h .

$$\left. \frac{\partial(\omega_h^h + \omega_f^h)}{\partial\nu_h} \right|_{\alpha_h=\alpha_f, \sigma_h=\sigma_f, \lambda_h=\lambda_f < 0, v_h=v_f} = -\frac{1}{2\nu} \frac{\lambda\sigma(\nu + \lambda\sigma)}{v^2 + 2\sigma(\sigma + \lambda v)} > 0,$$

As production shocks are more negatively correlated with inflation shocks, short positions in Home currency bonds become a more effective instrument to hedge production risk.

$$\left. \frac{\partial(\omega_h^h + \omega_f^h)}{\partial\lambda_h} \right|_{\alpha_h=\alpha_f, \sigma_h=\sigma_f, \lambda_h=\lambda_f < 0, v_h=v_f} = \frac{1}{2} \frac{\sigma(\nu - \lambda\sigma)}{v^2 + 2\sigma(\sigma + \lambda v)} > 0.$$

4.4 One-way Capital Flows

We now investigate a case in which there emerge one-way capital flows from the Foreign country to the Home country; more concretely, only Home currency bonds are issued to the Foreign country by the Home country as a result of closure of Foreign currency bond markets. This case is equivalent to a situation in which the Foreign country is not allowed to hold any short position even under negative correlation between production shocks and inflation shocks.

To analyze this case, we make simplifying assumptions that $\alpha_h = \alpha_f = \alpha$, $\sigma_h = \sigma_f = \sigma$, and $\nu_h = \sigma$. Optimal portfolio rules (ω_T^h , ω_h^h , ω_T^f , and ω_h^f) are still determined by equation (4) with $\lambda_h < 0$ and $\lambda_f = 0$. Then, two portfolio restrictions ($\omega_T^h + \omega_h^h = 1$, $\omega_T^f + \omega_h^f = 1$) and a bond market clearing ($(1 - \theta)\omega_h^h + \theta\omega_h^f = 0$) constitute equilibrium nominal interest rates on Home currency bonds (R_h), and real interest rates on implicit real bonds (r_h and r_f).

Even in this case, a wealth distribution indicator θ (the Foreign wealth share) still has a stationary distribution in $(0, 1)$ centered at $\theta = \frac{-1 + \sqrt{1 + \lambda_h}}{\lambda_h}$ as long as λ_h is chosen such that $0 < \frac{-1 + \sqrt{1 + \lambda_h}}{\lambda_h} < 1$. It is possible to prove this proposition by the following reasoning. Given the difference between the Foreign and Home risk-adjusted growth rate defined as $\delta(\theta) = g_f(\theta) - g_h(\theta)$, we obtain $\delta(\frac{-1 + \sqrt{1 + \lambda_h}}{\lambda_h}) = 0$, $\delta(0) = \frac{\lambda_h^2 \sigma^2}{4} > 0$, and $\delta(1) = -\frac{\lambda_h^2 \sigma^2}{4 + 4\lambda_h} < 0$. That is, when the Foreign wealth is dominant (θ close to one), the Home country grows faster than the Foreign country, and *vice versa*. On the other hand, both countries grow at the same rate when $\theta = \frac{-1 + \sqrt{1 + \lambda_h}}{\lambda_h}$. A major source of stationary distribution is the same as before; a decrease in θ raises nominal interest rates, thereby reducing the risk-adjusted growth of the Home country as a debtor. Given $\alpha = 0.03$, $\sigma = \nu = 0.02$, and $\lambda_h = -0.5$, Figure 8 depicts the Foreign and Home risk-adjusted growth; in this case, the risk-adjusted growth is equal to each other at $\theta \approx 0.586$.

When the two countries grow equally at $\theta = \frac{-1 + \sqrt{1 + \lambda_h}}{\lambda_h}$, an equilibrium nominal interest rate on Home currency bonds (R_h) is equal to $\Pi + \alpha - \sigma^2 \sqrt{1 + \lambda_h}$. At that time, the Home country finances its domestic production by $\frac{1}{2}(\frac{1}{\sqrt{1 + \lambda_h}} - 1)W_h$ from the Foreign country, while the Foreign country holds Home currency bonds equal to $\frac{1}{2}(1 - \sqrt{1 + \lambda_h})W_f$. Under the same assumption as above, Figure 9 draws positions on Home currency bonds (ω_h^h and ω_h^f) dependent on θ . Regardless of wealth distribution θ , capital always flows from the Foreign country to the Home country.

The above example demonstrates that the stability feature concerning wealth distribution or net foreign assets is still available even in the case of one-way capital flows from one country to the other.

4.5 Monetary Policy Rules

An immediate implication of our model is that, in an economy where risk-sharing must be achieved by trade in nominal assets, monetary policy rules have direct implications for welfare. In the symmetric economy we saw that the complete markets allocation was attained in the limit as $\lambda \rightarrow \pm 1$. Absent problems of international monetary policy coordination, it then follows that a welfare optimal monetary rule would be to have prices perfectly counter-cyclical (or perfectly pro-cyclical) in each country. This guarantees that full risk sharing can be achieved through trade in nominal bonds. Moreover, the higher is λ in absolute terms, the faster will θ converge. As λ approaches one, the θ distribution collapses to its mean point of 0.5.¹³

An additional implication of the analysis is that it is important to have separate monetary policies. As in the model of Neumeier (1997), eliminating exchange rate movements by a fully pegged exchange rate or a single currency area would reduce welfare, so would the elimination of nominal assets which operate as a risk-sharing mechanism¹⁴.

5 Conclusions

This paper develops a tractable model of international capital flows in which the existence of nominal bonds and the portfolio composition of net foreign assets is an essential element in facilitating capital flows between countries. National monetary policies make domestic and Foreign currency denominated bonds differ in the degree to which they can hedge country specific consumption risk. This leads countries to have distinct composition of currency-denominated bonds in their national portfolios. By adjusting their gross positions in each currency's bonds, countries can achieve an optimally hedged change in their net foreign assets (or their current account), thus facilitating international capital flows. Moreover, the risk characteristics of optimal portfolios ensures that current account movements are sustainable

¹³Once the absolute value of λ is one, the complete markets allocation is immediately achieved with extremely large sizes of nominal bond trading, and the wealth distribution stays forever at any point of the initial distribution, not necessarily at $\theta = 0.5$. A reason for this is that if $\lambda = -1$ for example, then the real return on the Home (Foreign) technology is exactly equal to that of the Home (Foreign) currency bond, and any size of short positions in its own currency bond is perfectly offset by the same amount of investment in its domestic technology.

¹⁴It is tempting to conclude from this that a pegged exchange rate would allow no capital flows at all, because such a regime would have only a single nominal bond. But in fact this is not true. In a pegged exchange rate version of our simple model, there would be one world nominal price level (because we have continuous PPP). But if the covariance of the world price level and the home technology differs from the covariance with the foreign technology, then agents may find it advantageous to take a position in nominal international bonds, thus allowing some partial lending and borrowing. But the risk-sharing possibilities would still be inferior to those analyzed in this paper.

- net debtor countries pay lower rates of return on their gross liabilities than they receive on their gross assets. This ensures that the distribution of wealth across countries is stationary.

The modeling approach can be extended in a number of dimensions. First, we could do a more explicit welfare evaluation, comparing welfare across different bond trading regimes, as well as computing the welfare implications of alternative monetary policy rules. Secondly, we could also allow for differences in growth and volatilities of technologies across countries, as well as differences in monetary policy rules. This would allow us to calibrate the model in the direction of developing an understanding of the empirical structure of national portfolios as described by Tille (2004) and Lane and Milesi Ferretti (2004).

Appendix

Process of Wealth Distribution θ

To obtain the process of wealth distribution $\theta (= \frac{W_f}{W_h + W_f})$, we define

$$m_h(\theta) = \lim_{\Delta t \rightarrow 0} \frac{E_t \left[\frac{\Delta W_h(t+\Delta t)}{W_h(t)} \right]}{\Delta t}, \quad m_f(\theta) = \lim_{\Delta t \rightarrow 0} \frac{E_t \left[\frac{\Delta W_f(t+\Delta t)}{W_f(t)} \right]}{\Delta t},$$

$$n_h(\theta) = \lim_{\Delta t \rightarrow 0} \frac{Var_t \left[\frac{\Delta W_h(t+\Delta t)}{W_h(t)} \right]}{\Delta t}, \quad n_f(\theta) = \lim_{\Delta t \rightarrow 0} \frac{Var_t \left[\frac{\Delta W_f(t+\Delta t)}{W_f(t)} \right]}{\Delta t},$$

and

$$n_{hf}(\theta) = \lim_{\Delta t \rightarrow 0} \frac{Cov_t \left[\frac{\Delta W_h(t+\Delta t)}{W_h(t)}, \frac{\Delta W_f(t+\Delta t)}{W_f(t)} \right]}{\Delta t}.$$

Then, using Ito's lemma, we can derive the process of wealth distribution $\theta (= \frac{W_f}{W_h + W_f})$ as

$$d\theta = \theta(1 - \theta) [F(\theta)dt + G(\theta)dB], \quad (17)$$

where

$$F(\theta) = m_f(\theta) - m_h(\theta) - \theta n_f(\theta) + (1 - \theta)n_h(\theta) + (2\theta - 1)n_{hf}(\theta),$$

$$G(\theta) = \sqrt{n_h(\theta) + n_f(\theta) - 2n_{hf}(\theta)},$$

and

$$dB = \frac{1}{G(\theta)} \left[\left[\omega_T^f(\theta)\sigma dB_f - \omega_f^f(\theta)v dM_f - \omega_h^f(\theta)v dM_h \right] - \left[\omega_T^h(\theta)\sigma dB_h - \omega_h^h(\theta)v dM_h - \omega_f^h(\theta)v dM_f \right] \right].$$

$dB(t)$ is newly defined as the increment to a standard Brownian motion. Note here that

$$\lim_{\Delta t \rightarrow 0} \frac{E_t [\Delta B(t + \Delta t)]}{\Delta t} = 0, \quad \lim_{\Delta t \rightarrow 0} \frac{Var_t [\Delta B(t + \Delta t)]}{\Delta t} = 1.$$

Stationarity of Wealth Distribution θ

To make theorems 16 and 18 of Skorohod (1989) applicable, we consider the process of κ or $\ln \frac{\theta}{1-\theta}$ ($= \ln \frac{W_f}{W_h}$) instead of θ . The process of κ is derived as

$$d\kappa = \delta(\theta)dt + G(\theta)dB, \quad (18)$$

where $\theta = \frac{\exp(\kappa)}{1+\exp(\kappa)}$, and $\delta(\theta) = g_f(\theta) - g_h(\theta)$. As defined in the main text, $\delta(\theta)$ represents the difference in risk-adjusted wealth growth between the two countries. Given equilibrium asset pricing characterized by equations (9) through (12), $\delta(\theta)$ is computed as

$$\delta(\theta) = \frac{\lambda^2 \sigma^2 (1 - 2\theta)(v^2 + 2\lambda\sigma v + 2\sigma^2 - \sigma^2 \lambda^2)(v^2 + 2\lambda\sigma v + 2\sigma^2)}{(4\sigma^2 \theta^2 \lambda^2 - 4\theta \lambda^2 \sigma^2 + \sigma^2 \lambda^2 - 2\lambda\sigma v - 2\sigma^2 - v^2)^2}. \quad (19)$$

We then introduce the following integrals:

$$\begin{aligned} I_1 &= \int_{-\infty}^0 \exp \left[- \int_0^w c(u(v)) dv \right] dw, \\ I_2 &= \int_0^{\infty} \exp \left[- \int_0^w c(u(v)) dv \right] dw, \end{aligned}$$

and

$$M = \int_0^{\infty} \left[\frac{2}{G(u(w))^2} \exp \left[\int_0^w c(u(v)) dv \right] \right] dw,$$

where

$$c(u(v)) = \frac{2\delta(u(v))}{G(u(v))^2}, \quad (20)$$

and

$$u(v) = \frac{\exp(v)}{1 + \exp(v)}.$$

According to the above theorems of Skorohod (1989), if $I_1 = \infty$, $I_2 = \infty$, and $M < \infty$, then κ has a unique ergodic distribution in $(-\infty, +\infty)$; accordingly, θ has a unique ergodic distribution in $(0, 1)$.

A function $c(\cdot)$ characterized by equation (20) plays a key role in determining stationarity of κ . Saito (1997) demonstrates that if $c(0) > 0$ and $c(1) < 0$, then $\kappa(\theta)$ has a unique

ergodic distribution under some regulatory conditions. The process of κ or equation (18) always satisfies $c(0) > 0$ and $c(1) < 0$, because from equation (19),

$$\delta(0) = \frac{\lambda^2 \sigma^2 (v^2 + 2\lambda\sigma v + 2\sigma^2)}{v^2 + 2\lambda\sigma v + 2\sigma^2 - \sigma^2 \lambda^2} > 0,$$

and

$$\delta(1) = -\frac{\lambda^2 \sigma^2 (v^2 + 2\lambda\sigma v + 2\sigma^2)}{v^2 + 2\lambda\sigma v + 2\sigma^2 - \sigma^2 \lambda^2} < 0,$$

given finite $G(0)$ and $G(1)$. Note that $v^2 + 2\lambda\sigma v + 2\sigma^2 > (v - \sigma)^2 > 0$ and $v^2 + 2\lambda\sigma v + 2\sigma^2 - \sigma^2 \lambda^2 > (v - \sigma)^2 + (1 - \lambda^2)\sigma^2$ as long as $\lambda > -1$.

Density Function of Wealth Distribution $\ln \frac{W_f}{W_h}$

According to Gihman and Skorohod (1972), given the process of κ ($= \ln \frac{W_f}{W_h}$) or equation (18), a density function of κ is derived as

$$\frac{2\mu}{G(u(\kappa))^2} \exp \left[\int_0^\kappa c(u(v)) dv \right],$$

where μ is chosen such that $\mu \int_0^\infty \left[\frac{2}{G(u(w))^2} \exp \left[\int_0^w c(u(v)) dv \right] \right] dw = 1$. Figure 1 depicts density functions of κ or $\ln \frac{W_f}{W_h}$ for $\lambda = -0.9, -0.8, -0.5,$ and -0.3 when $\sigma = v = 0.02$.

References

- [1] Cooley, T. F. and G. D. Hansen, 1995, "Money and the Business Cycle," in T. H. Cooley (editor) *Frontiers of Business Cycle Research*, Princeton: Princeton University Press.
- [2] Devereux, M. and M. Saito, 1997, "Growth and Risk Sharing in a Two Country Model" *Journal of International Economics*, 42, 453-81.
- [3] Dooley, M. P. and P. Isard, 1979, "The Portfolio-balance Model of Exchange Rates," *International Finance Discussion Paper 141*, Board of Governors of the Federal Reserve System, U.S.
- [4] Gihman, I. and A. V. Skorohod, 1972, *Stochastic Differential Equations*, New York: Springer-Verlag.
- [5] Gourinchas P. O. and H. Rey, 2004 "International Financial Adjustment," mimeo., U. C. Berkeley.

- [6] Kouri, P., 1976, "The Exchange Rate and the Balance of Payments in the Short Run and the Long Run," *Scandinavian Journal of Economics*, 78, 280-304.
- [7] Kydland, F. and E. Prescott (1990) "Business Cycles: Real Facts and a Monetary Myth," *Federal Reserve Bank of Minneapolis Quarterly Review*, 3-18.
- [8] Lane P. R. and G. M. Milesi-Ferretti, 2004, "Financial Globalization and Exchange Rates," *CEP Discussion Paper DP0662*, Centre for Economic Performance, LSE.
- [9] Merton, R., 1971, "Optimal Consumption and Portfolio Rules in a Continuous Time Model," *Journal of Economic Theory*, 3, 373-413.
- [10] Neumeyer, P., 1998, "Currencies and the Allocation of Risk: The Welfare Effects of a Monetary Union," *American Economic Review*, 88, 246-59.
- [11] Obstfeld, M., 2004, "External Adjustment," *Review of World Economics*, 140, 541-568.
- [12] Obstfeld, M. and K. Rogoff, 2002, "Global Implications of Self-Oriented Monetary Policies," *Quarterly Journal of Economics*, 117, 503-536.
- [13] Obstfeld, M. and K. Rogoff, 2004, "The Unsustainable US Current Account: Revisited," *National Bureau of Economic Research Working Paper 10869*.
- [14] Skorohod, A. V., 1989, *Asymptotic Methods in the Theory of Stochastic Differential Equations*, Providence: American Mathematical Society.
- [15] Saito, M., 1997, "A Note on Ergodic Distributions in Two-Agent Economies," *Journal of Mathematical Economics*, 27, 133-41.
- [16] Tille, C., 2005, "Financial Integration and the Wealth Effect of Exchange Rate Fluctuations," mimeo., Federal Reserve Bank of New York.
- [17] Woodford, M., 2003, *Interest and Prices*, Cambridge: MIT Press.

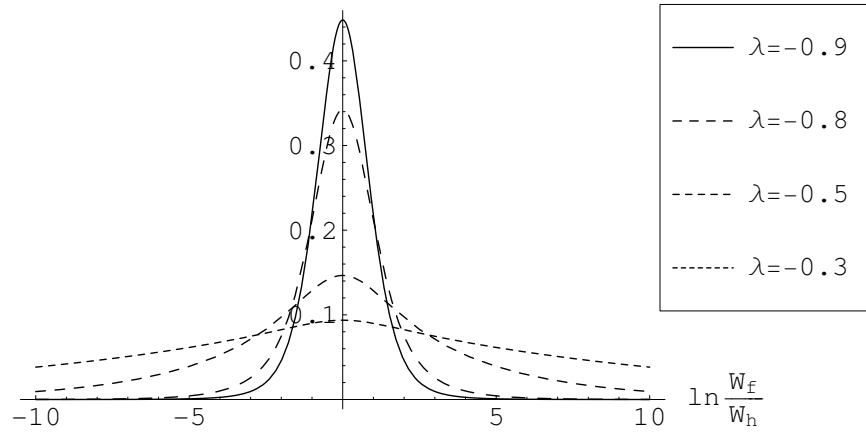


Figure 1: Density Functions of κ ($= \ln \frac{W_f}{W_h}$) for Various Correlation Coefficients λ

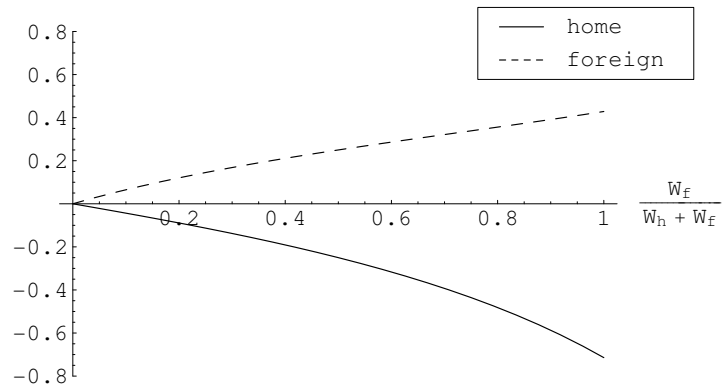


Figure 2: Portfolio Weights of Nominal Bonds for the Home Country (ω_h^h and ω_f^h)

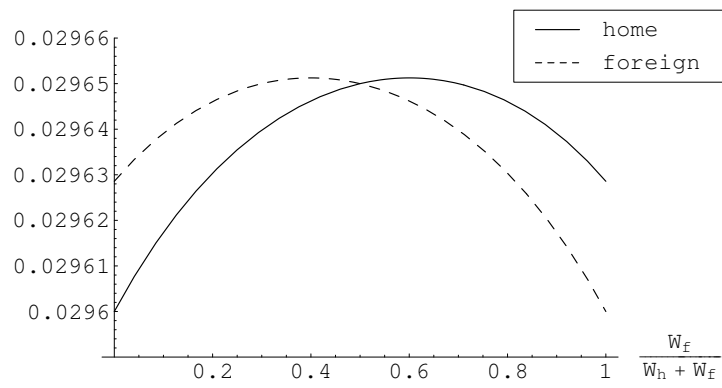


Figure 3: Real Risk-free Rates (r_h and r_f)

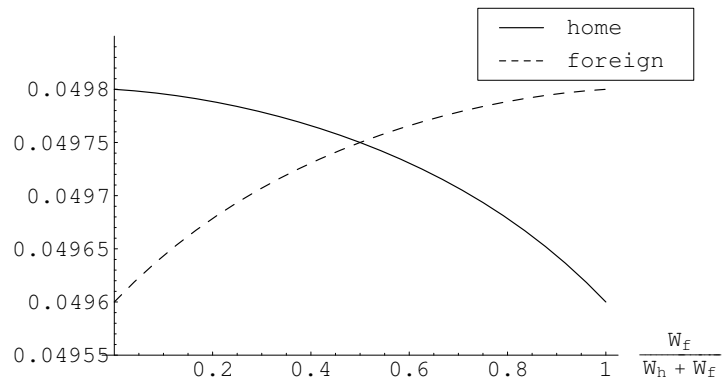


Figure 4: Nominal Interest Rates (R_h and R_f)

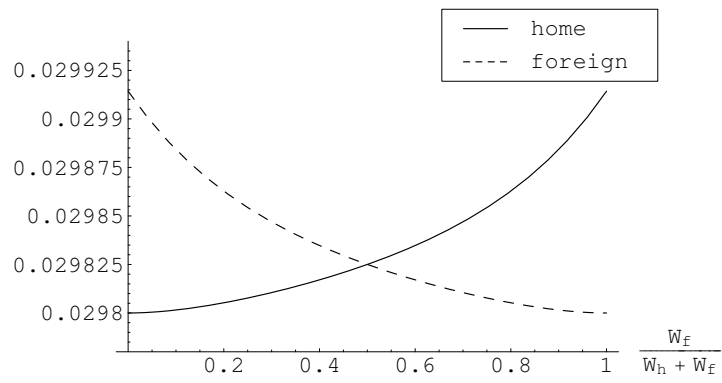


Figure 5: Risk-adjusted Growth (g_h and g_f)

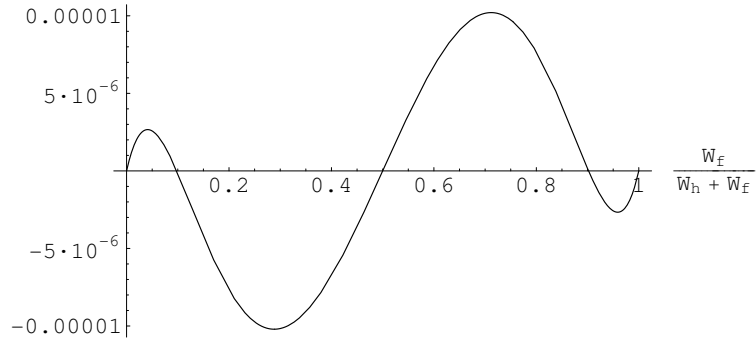


Figure 6: Drift Term of Relative Net Foreign Assets

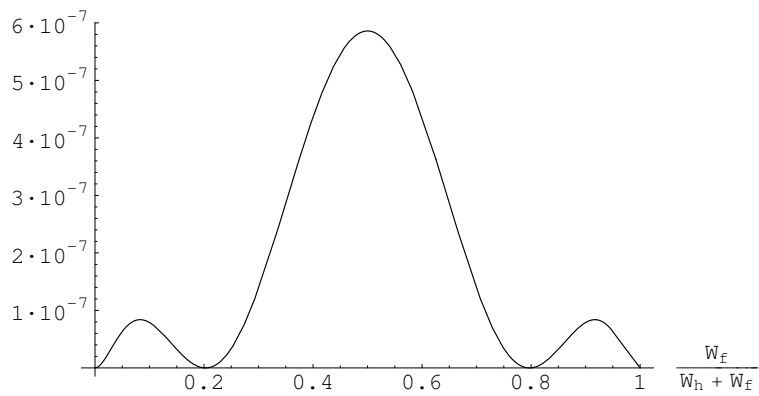


Figure 7: Diffusion Term of Relative Net Foreign Assets

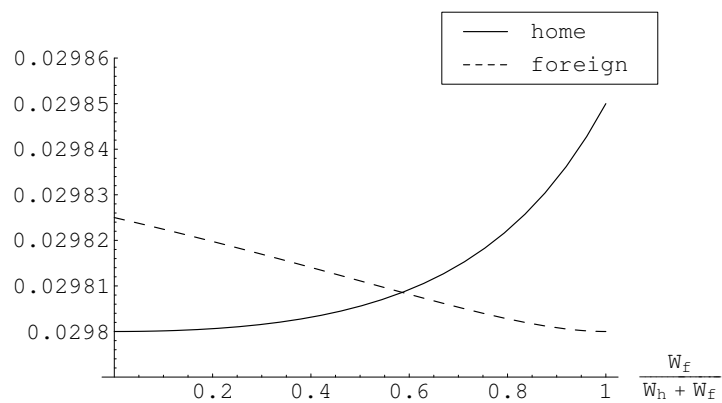


Figure 8: Risk-adjusted Growth with Short-sales Constraints (g_h and g_f)

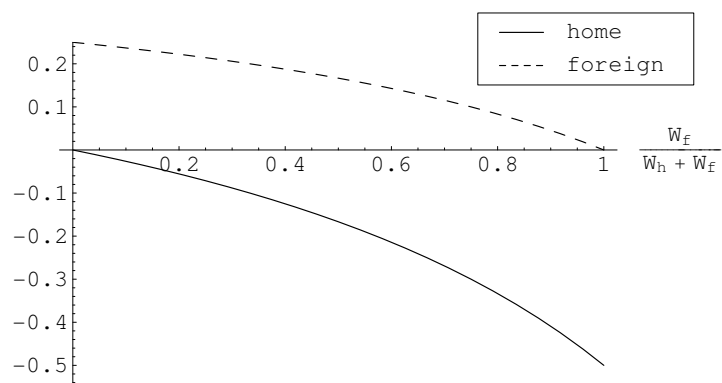


Figure 9: Positions on Home Currency Bonds with Short-sales Constraints (ω_h^h and ω_h^f)



Institute for International Integration Studies

The Sutherland Centre, Trinity College Dublin, Dublin 2, Ireland

