Barriers to Global Capital Allocation

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Outline

Quick overview

A few comments

A big and fascinating question

- Why capital does not flow from capital-rich to capital-poor countries? (Lucas, 1990)

- Two views:

  1. Large persistent differences in the return of capital across countries because of **frictions** (e.g., Maggiori (2021)).

  2. Return of capital is similar across countries (minor role for frictions) + lower capital ratios in poor countries related to **lower endowments of complementary factors** (e.g., human capital) (e.g., Caselli and Feyrer (2007)).

What is this paper about?

- This paper provides a **quantitative model** of international capital allocation where cross-border investment is subject to **frictions** (informational and policy related):
  - **micro-founded gravity model** (more costly to acquire information about the expected return of smaller and more *distant* countries),
  - **information frictions**: geographical, linguistic and cultural distances,
  - **policy frictions**: taxes and political (expropriation) risk.

Main results

- Current world allocation of capital is **sub-optimal**
  - *peripheral* countries penalized, *central* countries benefit from frictions
  - calibrated model reproduces (steady-state):
    - country-level portfolios
    - cross-sectional variation in the rates of return
    - degree of home bias
  - removing barriers would **increase world GDP by 5.9%** with implications for cross-country **inequality**.
  - **structural model** allows various counter-factual experiments.

Three comments and one question

Comment #1: Where is risk?

- In the model, **risk** is different from how it is often perceived in finance (i.e., a beta):
  - shocks are completely unpredictable so that there is a strong incentive—with no frictions—to completely diversify them out (in fact, in the *efficient* allocation π_{ij} is independent of j, that is of the origin country),
  - departures from the efficient allocation depend only on the frictions (e.g., cultural distance).
- What if countries with higher returns, offer higher returns because they are **riskier** (i.e., their payoffs are lower at times of higher marginal utility of rich-country-investors)?

Comment #2: Delegated investment and information frictions

- In the model, the information friction story is very well suited to describe the behavior of an individual (small) investor.
- In the presence of (persistent) large return differentials, why don't investors delegate the information seeking activity to *skilled* managers (e.g., mutual funds, hedge funds, etc.)?
- Or, why don't sophisticated investors *arbitrage out* these return differences? (maybe global macro hedge funds in part do this?).
- Can this suggest the existence of additional *barriers* (e.g., risk?).

Comment #3: Currency risk

- In the robustness section you account for currency risk by including an additional cost (friction) related to the cost of currency hedging.

- The cost proxy comes from the CIP dataset of Du and Schreger (i.e., the forward premium is obtained assuming the CIP and using their synthetic risk-free rates).

- The hedge should cover the horizon of the investment, which is unknown (and most likely different for equity, debt or FDI investment).
  - What horizon do you use for the forward premium?
  - Do you consider a long-term average for a given tenor?
  - How large is the time-variation in the currency hedging cost along the global financial cycle?

Question: Religious distance as instrument

- Religious distance is used as an instrument under the assumption that it affects financial flows only *indirectly* through its effect on contemporary *Cultural distance*.

- What is the motivation not to use alternative measures, like **ancestral distance** (e.g., genetic), that have been also used by the authors in the past?