ESSAYS ON CAPITAL FLOWS AND FINANCIAL EXCLUSION

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Abstract

This thesis seeks to understand two related issues: the welfare effects of international capital flows and the equity home bias puzzle, when some agents are financially excluded. The impact of exclusion occurs through commodity price changes - a relatively under-researched channel in the international finance context. In Chapter 2, we study the asset pricing and welfare consequences of capital flows for a small open economy, some of whose residents face financial exclusion. We formulate a simple two date, two good model under certainty. Under autarky, we find that domestic risk free rate is influenced by financial exclusion and, in turn, whether exclusion is effectively a constraint on borrowing, or a constraint on lending, depends on characteristics of included agents. Financially excluded agents are impacted by opening the economy to international capital flows, through changes in domestic spot commodity prices, despite the fact that they can neither borrow nor lend. The degree to which the exclusion constraint binds depends on the world interest rate; i.e. capital flows can ameliorate or exacerbate exclusion. Financial integration improves (reduces) welfare if capital flows in (out) when the excluded agent would like to borrow (lend) in autarky. Any negative impact on welfare diminishes as the differential between the domestic and global interest rates increase. In Chapter 3, we study the hedging of non-marketable income as an explanation for the well-known "home bias puzzle" in the context of domestic financial exclusion. We employ a two-country, two-good, single period general equilibrium model. Asset markets consist of two country-specific stocks and an international bond, which provide full spanning. A subset of domestic agents are excluded from financial market. In this set-up, the goods spot price and hence, the non-marketable income depends on the endowment distribution across domestic agents (and hence on the level of exclusion). We demonstrate that, in equilibrium, a relative correlation of the excluded agent's (traded good) endowment with the returns from the two stocks governs the bias in the domestic investor's portfolio. We also derive empirically testable implications from our model: (i) A higher exclusion leads to a higher home bias; (ii) Effect of exclusion on home bias is lower at higher average non-marketable income; and (iii) Higher average non-marketable income is associated with a lower home bias. In Chapter 4, we empirically examine the impact of financial exclusion on home bias. Our motivation is based on the results of Essay 2 where it was shown, theoretically, that financial exclusion, through its impact on equilibrium spot goods prices, alters the magnitude of home bias. Those results lead to the following empirical hypotheses: home bias is decreasing in financial inclusion; non-marketable income (proxied for by labour income per capita) has a negative iv association with home bias; and that the impact of inclusion on home bias decreases at higher levels of labour income. We conduct panel regression tests on a sample of 73 countries over 2001-2014. Overall, our empirical results offer some support for our hypotheses. We contribute to the literature by empirically examining a new explanatory variable for home bias.