Abstract
We present a model of international portfolio choice based on cross-country differences in relative factor abundance. Countries have varying degrees of similarity in their factor endowment ratios, and are subject to aggregate productivity shocks. Risk averse consumers can insure against these shocks by investing their wealth at home and abroad. In a many-good setup, the change in factor prices after a positive shock in a particular country provides insurance to countries that have dissimilar factor endowment ratios, but is bad news for countries with similar factor endowment ratios, since their incomes will worsen. Therefore countries with similar relative factor endowments have a stronger incentive to invest in one another for insurance purposes than countries with dissimilar endowments. The importance of this effect depends on the size of countries. Empirical evidence linking bilateral international equity investment positions to a proxy for relative factor endowments supports our theory: the similarity of host and source countries in their relative capital-labor ratios has a positive effect on the source country’s investment position in the host country. The effect of similarity is enhanced by the size of host countries. (JEL: F21, F34, G11)