A Portfolio Theory of International Capital Flows

Michael B. Devereux
University of British Columbia
Hong Kong Institute for Monetary Research

and

Makoto Saito
Hitotsubashi University

September 2006

Summary

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.