Corporate Debt, Capital Flows, and International Business Cycles*

PRELIMINARY AND INCOMPLETE. PLEASE DO NOT CITE.

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Abstract

Aiming at shedding some light on the role of the capital structure of firms on international portfolios, we develop a two-country model with trade in both equities and corporate bonds, whereas existing models of a similar kind generally embed bonds traded among investors such that their global net supply is zero. The capital structure of firms is relevant because: 1) the debt contracts are imperfectly enforceable; 2) corporate income taxation creates a tax shield between competing sources of external funds. Driven by productivity and investment-specific technology shocks and calibrated on data for the 67 countries, the model can predict home bias in all types of assets. Conducting various sensitivity exercises, we find that increasing levels of corporate leverage are negatively associated with home bias in assets and that trade in bonds matter to assess the effect of the discrepancy of substitution between goods on equity home bias. Finally, we stress the importance of investors’ preferences which abstract from wealth effects.

JEL classification: F21, F41, F44, G11, G15

Keywords: international portfolios, substitutability between assets, working capital, financing constraints

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