Home bias and globalized market

- U.S. consumers mainly buy U.S. wines and French consumers mainly buy French wine.

- A large market share for domestic products characterizes many goods markets

- A phenomenon often referred to as **home bias.**

Home bias and globalized market

- Is there a role for home bias in a globalized economy?

Globalization: a definition

- **Globalization** is the process of interaction and integration among people, companies, and governments worldwide.
- Globalization has grown due to advances in transportation and communication technology. With the increased global interactions comes the growth of international trade, ideas, and culture.
- Globalization is mainly an economic process of interaction and integration that's associated with social and cultural aspects.

Home bias in trade

- The *home bias in trade* refers to the concept that people have a strong preference for consumption of their home goods.
- Empirical evidence indicates that, within a country trade is much larger than international trade, which suggests a bias for home goods.
- This observation implies that international goods markets may be much more segmented than one usually assumes.

Home sweet home: the home bias in trade in the European Union

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The entry point

- The home bias in trade is one of the great puzzles of international economics.
- It is unsurprising that countries find it easier to engage in domestic trade than international trade.
- However, past studies have shown that the degree to which international borders hinder trade is greater than expected.

- By some estimates trade between Canadian provinces is as much as 20 times higher than trade between a Canadian province and a US state.

- This effect cannot be easily attributed to factors commonly used to explain trade flows between countries.
  - distance or
  - trade frictions.

- The study of the home bias in Europe deserves particular attention.
- Over the past 70 years a divided continent became more integrated than ever before.
- The nations of Europe formed a number of unions and agreements aimed at bringing about peace and prosperity.
- The existence of the European Union, the Eurozone and the Schengen Agreement make it seem that borders between countries are no longer relevant.

The question in this paper is….

- Do European Union countries trade domestically more than they would trade with their international clones?

The answer is:

- The findings of the paper suggest that despite years of European intergration, borders still obstruct the flow of goods and services.
- Trade in services is more biased towards the home country than trade in goods, possibly because services tend to be more localised.
- Trade in services may also encounter more intangible obstacles to trade.
- Using the newest release of the World Input Output database, available for the years 2000-2014, the trade-reducing effect of borders is estimated. The effect is found to be relevant.

As far as the trend…

- Over the period 2000 - 2014, for which the data were available, the home bias did not markedly decline for trade in goods.

- There is, however, evidence that the decline in the bias for trade in services was more pronounced.

Moreover

- The border effect is larger in Central and Eastern Europe than in other parts of the continent.

- When seeking to understand what drives these cross-country differences:

the role of European Union membership stands out.

Integration and home bias

- The effect of EU membership on the bias is not confined to the act of joining the union.

- The **depth of a country's integration** with the European Union, in this analysis, is related to the **length of time a country has been an EU member**, explains a large portion of the differences in the home bias across Europe.

Integration and home bias (ii)

- The longer a country has been a member of the union, the lower its home bias.
- This implies that the more closely integrated a country is with the European Union, the more likely it is to seek international trading partners, as opposed to domestic partners.
- The cycle appears to be self-reinforcing; a country with a more international outlook is also likely to seek further integration.

Home bias and trade in the literature

- The phenomenon was first described by McCallum (1995).

- He famously found that trade between two Canadian provinces is over 20 times greater than trade between a Canadian province and a US state

Home bias and trade in the literature (ii)

- The first comprehensive study of the border effect in the EU was conducted by Nitsch (2000).
- Using a sample of Western European countries he found that **the average EU country trades domestically 11 times more than with a comparable international trading partner**.
- Also, he found that **the bias was declining over time**, from roughly 15 in the 1980s to 10 in the 1990s

Home bias and trade in the literature (iii)

- The most comprehensive study up to date was conducted by Cheptea (2013), who was the first to document that the study of the home bias in Europe is the study of **European integration**.

- She argued that greater integration is expected to result in a decline of the home bias

In a different approach

HOME BIAS IN ONLINE INVESTMENTS: AN EMPIRICAL STUDY OF AN ONLINE CROWDFUNDING MARKET

MANAGEMENT SCIENCE

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Home Bias in Online Investments: An Empirical Study of an Online Crowdfunding Market

- The paper considers whether investors in online financial investment platforms such as crowdfunding exhibit home bias, as is common among investors and businesses in off-line contexts.

Home bias on line

- Home bias refers to the phenomenon wherein agents (businesses, funds, etc.) are more likely to conduct transactions with parties who are geographically closer to them, either in the same country or the same state, rather than those outside.

- Since French and Poterba (1991), a long and growing literature has documented this phenomenon in many contexts, and it bears important implications for market structure, policy making, and social welfare.

- Within a country, transactions are also more likely to occur within a particular area rather than across boundaries (Hillberry and Hummels 2003,Wolf 2000).

- Home bias is also observed in financial investments in terms of the asset holdings and investment decisions (Ahearne et al. 2004, Dziuda and Mondria 2012, Graham et al. 2009, Karlsson and Nordén 2007)

As far as e-commerce…

- It seems promising that the recent growth of electronic commerce should render home bias less relevant.
- Interestingly and surprisingly, Hortaçsu et al. (2009) show that on the online products market eBay.com, transactions are still more likely to occur between buyers and sellers from the same area.
- Even though the market is virtual, geography can still play a role because of shipping charges, localized consumption of the goods (e.g., event tickets), and the possibility of direct contract enforcement.

- If investors favor home state borrowers, as suggested by the home bias hypothesis, then they should observe that **after borrowers move**, there should be **fewer investors from their origination state** that bid on their loan requests and **more investors from their destination state**.

- This is confirmed by the analysis.

- Once the existence of home bias in this market is confirmed, the second research question:

What is the mechanism that drives home bias in this market?

- Since this is a financial market where investors receive returns for their investments, it is highly unlikely that economic reasons have no bearing on their decisions.
- Thus, a more intriguing and important question is:

whether investors favor home state borrowers because of higher economic payoffs or behavioral reasons related to home states also play a role.

- Consistent with the literature, in this paper we use "economic" or "rational" reasons in the sense of homo economicus (Kahneman 2003),
- The argument is that investors are able to gather and evaluate all relevant information and make a decision that maximizes their economic returns.

- On the other hand, “behavioral reasons” are behavioral biases that are often the result of bounded rationality, cognitive biases (Thaler 1993) or perceptions that deviate from economic optimality (Kahneman 2003).

- Through multiple tests rational reasons alone cannot fully explain home bias.

- Specifically, investments on home state borrowers tend to have lower returns, are likely to default sooner, and lose more on their principal than their out-of-state counterparts.

- Moreover, loans with more texts in their descriptions that repeat the “state of residence” information—which are more likely to evoke geography-based sentiments but provide no additional economic value beyond state of residence—are likely to attract more home state bids.

- Furthermore, when lenders move to a new state, they increase their investments in their new state, contrary to predictions based on informational advantage explanations for home bias.
- These findings all suggest that behavioral motivations, rather than economic reasons alone, play a role in driving home bias in this market.