Ambiguity in a Two-Country World

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The correlation between consumption levels in different countries is much lower than what is suggested by models of efficient risk sharing with common beliefs. Relatedly, observed asset portfolios of consumers in different countries suggest a "bias" toward home-country securities, even for countries where financial markets are quite well developed. This paper examines a mechanism that can generate these observations by considering preferences that allow ambiguity aversion of the sort illustrated by the Ellsberg Paradox. A key assumption is that the home consumer is more ambiguous about the process generating uncertainty in the foreign country than about that in the home country. This permits formalization of a statement like "I don't hold foreign stocks because I don't know much about them." The specific context here is that of a two-country dynamic general equilibrium model. It is shown that the model generates low consumption correlations, higher output correlations, biased financial portfolios, and biased real investment flows.