International Risk-Sharing and Inequality Transmission: An Application to the Euro Area

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Abstract :
Bilateral holdings of financial assets serve as a smoothing mechanism, aiming to alleviate the correlation between fluctuations in consumption and national output for both countries in the case of country-specific shocks. However, within countries, households exhibit unequal access to diversification opportunities, with financial assets, and particularly foreign assets, concentrated among the wealthiest households. Furthermore, asymmetric portfolios and cross-border capital holdings result in different intensity of diversification and, consequently, differing spillover effects from country-specific shocks. These two channels highlight the heterogeneous impact of portfolio diversification within and across countries, with important implications for inequality. This paper examines the interaction between inequality and portfolio diversification in the context of how country-specific shocks affect inequality in the euro area. While theoretical models assume full home bias in equity by restricting investment to domestic capital, I provide empirical evidence of portfolio heterogeneity both within and between countries. This evidence demonstrates differences in access to and intensity of diversification, using household-level and country-level data. To analyze these dynamics, I develop a two-country Two-Agent New Keynesian (TANK) model within a monetary union, calibrated to represent the Core and Periphery of the euro area. The model incorporates the ability to invest in both domestic and foreign capital through a risk-neutral mutual fund. I focus on the consumption responses of households within a country and among similar agents across countries when subjected to a country-specific shock. The results reveal that incorporating realistic portfolio structures significantly alters aggregate and individual consumption responses. Notably, the costs and benefits of such shocks are unequally distributed across households and countries. In the next steps, I aim to extend the model to a Heterogeneous-Agent New Keynesian (HANK) framework to quantify the mechanisms and provide deeper insights into various dimensions of inequality.