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International Portfolio Choice and Corporation Finance: A Synthesis

MICHAEL ADLER and BERNARD DUMAS*

THE STRUCTURE OF THE theory of international finance largely mirrors that of domestic financial theory. Starting from a micro-theory of individual portfolio choice one obtains, via aggregation and market clearing, equilibrium pricing relationships and risk-return tradeoffs. These provide objectives for value maximizing firms from which decision rules can be computed. This analytical sequence is the same whether there is one or more capital markets. To distinguish between the domestic and international settings, one needs an economic concept of nationhood.

Alternative approaches to international economics differ essentially in their conception of what a nation is. Ricardian theory identifies countries by their technologies and consumption preferences. The Heckscher-Ohlin theory of international trade defines nations as zones within which physical factors of production are confined.[1] In monetary economics, individual economic units holding the same currency in their portfolios as a means of payments are recognized as belonging to the same nation, and currencies are distinguished from each other by the fact that they are issued by different central banks.[2]

In portfolio theory, two avenues have so far been explored in an attempt to capture the international dimension. Most of the recent literature stemming from Solnik [179] has been devoted to models where nations are defined as zones of a common purchasing power unit or, more precisely, as subsets of investors

* The authors are Professor of Business, Columbia University and Professor, C.E.S.A. (H.E.C., I.S.A., C.F.C.), respectively. The article was begun while Dumas was Visiting Professor at Columbia and completed while he was Visiting Professor at Berkeley. We are grateful to André Saurel, who helped supply part of the data base, and to Jean-Francois Dreyfus, who contributed to the data processing. We received valuable critical comments from Professors Bradford Cornell, Jeffrey Frankel, Bruce Lehmann, David Modest, Patrice Poncet, Richard Roll, Piet Sercu, Bruno Solnik, René Stulz and, especially, Michael Brennan. Errors may remain despite their efforts: they are our responsibility. We apologize to the authors whose work is not quoted. This is no indication of the quality of their work but only of our ignorance or of the limited scope of this survey.

[1] Generalizations of the Heckscher-Ohlin theory to economies with uncertain production and securities trading may be considered as belonging to the field of international finance but they will not be reviewed here. See Helpman and Razin [85, 86, 87], Baron and Forsythe [20], and Dumas [48, 49].

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