**Foreign Direct Investment as a Determinant of Cross-Country Stock Market Comovement**

In the post WW2 period, the cross-country correlations of the stock markets in developed economies were fairly low, implying significant potential benefits from diversification. Beginning in the mid 1990s, stock market correlations started increasing and continued to do so up until the aftermath of the Great Recession. These increases have been quantitative large; for example the correlation of US equity prices with the equity prices in an aggregate of 22 other developed economies has risen from below 0:40 in the 1980s to above 0:80 in the 2010s. Although the size and timing of this increase varies to some extent, a similar pattern can be found when looking at bilateral country pairs. The increase in stock market correlations has largely coincided with a concurrent strengthening in foreign direct investment (FDI) linkages between the largest economies with developed equity markets. The aim of this project is to explore the relationship between these two facts. We first document these two phenomena and establish an empirical relation between them that survives after controlling for other potentially important factors such as increased trade, and business cycles synchronization. We subsequently provide a theoretical framework that can be used to clarify the mechanism that links the two phenomena, but also to quantify the contribution of FDI changes to the increase in stock market correlations. We find that the increase in FDI positions can explain approximately one third of the increase in the cross-country stock market comovements.

We develop a two-country production-based asset pricing model which, crucially, incorporates multinational firms investing in technology capital. The mechanism we propose is simple. Multinational corporations operate plants in both countries and that implies that they are exposed to shocks in both the home and foreign country. In an environment with increased FDI, firms generate a larger fraction of their earnings abroad. In turn, this implies stronger incentives to increase investment in response to shocks in the foreign country. Increased investment in technology capital also spills over to investment at home, due to the complementarity between tangible and technology capital. The end result is that investment and capital are more synchronized across multinationals and this implies their equity values are also more correlated.

The structure of international financial markets can be important for the extent to which equity prices are synchronized. In our benchmark model we assume markets are incomplete, but we also consider the implications of complete markets and, at the other extreme, financial autarky. We show that the level of stock market correlations increases as markets become more complete, as expected.

However, the increase in stock market correlations when FDI linkages increase is present regardless of the asset market structure. Importantly, this is despite very different implications for the correlation of dividends across market structures. The model allows us to separate and explore different channels via which stock markets may comove.

**In the last months we have concentrated our efforts to incorporate the trade channel in the model. We have introduced two goods that have different degrees of substitutability produced at home and abroad following McGratten and Waddle (*AEJ Macro* 2020). The results of the new model confirm the empirical results. Trade has not contributed to the increase of stock market comovements and regardless of the asset structure of the economy trade has stayed flat after the positive FDI shock. This result is an important step forward understanding the mechanisms and to get closer to the data.**