Comments on Philip Lane, "Global Imbalances and Financial Globalization"

Presentation for conference on
"The Euro and the Dollar in a Globalized Economy"
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It is a genuine pleasure to share some of my thoughts on global imbalances and global adjustment with such a distinguished audience. The comments I will be offering are, of course, my own and do not necessarily reflect the views of the Federal Reserve or its staff.

As indicated by Chart 1, which I've borrowed from Philip's presentation, a key feature of the global economy at present is the widening of global imbalances. A substantial increase in U.S. deficits has been matched by counterpart surpluses in many other economies, but especially Japan, developing Asia, and the oil exporting nations.

There are at least two reasons why we should care about these imbalances. First, at least for the present, these imbalances are very good things. At a time when domestic demand in many foreign economies is not strong enough to maintain the pace of aggregate production, excess domestic demand in the United States is taking up the slack and supporting global growth.

The second reason why we should care about these imbalances is less felicitous. As indicated in Chart 2, which I've also borrowed from Philip's presentation, the imbalances are

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[1]I would like to thank Carol Bertaut and Charles Thomas for their contributions and guidance, and Alexander Rothenberg and Christine Uhlmansiek for superb research assistance.

leading to divergent trends in net foreign asset positions–in particular, to a trend deterioration in the U.S. position, or, put another way, to a trend rise in U.S. net external debt. If this trend continues without interruption, at some point, the United States will face increasing difficulties in servicing its debt, and investors will no longer want to finance it. This will require a reduction in the U.S. deficit and counterpart reductions in foreign surpluses. If the foreign economies cannot replace external demand with higher internal demand, their economic growth will suffer accordingly.

From this perspective, therefore, the evolution of net foreign asset positions is an important determinant of how long current account imbalances can be sustained and when they will have to adjust. Philip's research, much of it done with his co-author Gian Maria Milesi-Ferretti, has made many important contributions to our understanding of the evolution of external financial positions. First, their work has provided an invaluable database of foreign asset positions of many countries over many years–many researchers, including myself, have benefitted from this data. Second, they have documented that the dispersion of NFA positions has grown over time, consistent with increases in international financial integration. Third, they have documented that gross foreign asset positions–not just the net positions–have grown larger over time, also consistent with a trend toward greater financial integration. Finally, they have argued convincingly that because gross positions are becoming larger, the effects on net foreign asset positions of changes in the valuation of foreign assets and liabilities is growing larger as well. Most notably, the U.S. net foreign asset position has deteriorated much less than its current account deficit would suggest.

In addition to reviewing these findings, Philip's presentation today has extended past research by looking at trends in European international finances. He usefully reminds us that European countries are far from uniform both in their current account balances and their net foreign asset positions. Moreover, these asset positions may influence the effects of an adjustment of global external imbalances on wealth and economic activity.

I found Philip's points to be generally useful and insightful. What I would like to do in the remainder of this talk is offer a methodological quibble, and then to address some broader issues involving external adjustment: the timing of adjustment, and its prospective effects on economic activity.

My methodological quibble involves the way Philip characterizes rates of return on international assets and liabilities. In Table 1, taken from Philip's presentation, the rates of return on assets and liabilities incorporate not only interest earnings and profits that are accounted for in the balance on investment income–and therefore are in the current account–but also capital gains on foreign assets and liabilities reflecting changes in exchange rates, stock prices, and other asset valuations. The objective of these "total return" calculations is to explain why the net foreign asset position may move in a different manner than the cumulative trade balance. However, the current income part of the total return may exhibit very different behavior than the capital gains part, and I think it may be more informative to analyze the two parts separately.

For example, the total rates of return incorporate movements in the dollar–thus, if one looks at the 2002-2004 period for the United States in Table 1, the falling dollar (along with some differential returns on equities here and abroad) contributes importantly to the much higher return on U.S. assets than liabilities. Yet the dollar moves up and down fairly randomly, and should not be thought of as something that, at least to date, makes a systematic and persistent contribution to the rate of return differential between U.S. foreign assets and liabilities. This may be seen in the Chart 3, which plots the U.S. cumulative current account balance against the net foreign asset position (labeled the NIIP, or Net International Investment Position)–the distance between them measures valuation effects. These valuation effects tend to widen and narrow over time, indicating that during some periods capital gains favor U.S.-owned assets abroad and during other periods foreign-owned assets in the United States.

Conversely, there appear to be some more genuinely persistent aspects to the differential on current income earned by U.S.-owned foreign assets and foreign-owned U.S. assets. This differential has allowed our balance on net investment income to remain close to zero, as shown in Chart 4, even as the net foreign asset position has declined to roughly a quarter of U.S. GDP. Chart 5 indicates that the rate-of-return differential importantly is centered on earnings on direct investment, as the rate-of-return differential on portfolio investment is negligible.

Now that I've put that quibble out of the way, I'd like to amplify on an issue that Philip discussed – how soon is the U.S. current account deficit, and the counterpart foreign surpluses, likely to adjust? Obviously, no one can predict the timing of this adjustment, any more than one can predict the path of the dollar. At the same time, however, I'd like to argue that, looking at the data, it doesn't seem that economic forces will require adjustment to take place right away.

First, I don't think there is anything in the recent pattern of capital flows, shown in Table 2, that indicates adjustment of the current account deficit is imminent. Let's focus on 2003 and 2004. It is clear that net private inflows, line 3, were falling, and that the financing shortfall was being made up by official inflows, line 2. Yet, in 2005, private inflows surged while official inflows fell off. We don't have comprehensive balance of payments data for 2006. However, partial data indicate that although official inflows in the first quarter moved back up a bit, private foreign purchases of U.S. securities, line 5, strengthened further.

Another point observers have made is that foreign direct investment inflows into the United States are well below their peaks in 2000 and 2001 (not shown). That is true, but those peaks were more the exception than the rule. If you look at line 7, you can see that foreign direct investment in the United States in 2005 was on par with its average for the 1990s.

Moving beyond the pattern of capital inflows, consider the U.S. external debt, measured in Chart 6 as the net international investment position (NIIP). As you can see, the U.S. international position, at about -25 percent of GDP, is hardly extreme. Several other industrial countries have much larger negative positions. Perhaps more tellingly, our debt-service burden, as measured by the balance on our investment income in Chart 7, is very close to zero. As has already been discussed, this reflects the fact that the rate of return on the assets the U.S. holds abroad–even excluding valuation effects–exceeds that on the assets that foreigners hold in this country.

But might our continuing current account deficits drive U.S. debt and debt-service measures into the danger zone in the near future? To examine this, I'd like to show you some simulations of the Federal Reserve's partial equilibrium model of the U.S. balance of payments. For these simulations, we assume that U.S. GDP growth converges to 3 percent annually, foreign growth converges to 3½ percent, and the trade-weighted value of the dollar holds flat at its value in the first quarter of this year (Chart 8). These are merely plausible assumptions for illustrative projections–they are not the Federal Reserve staff's actual forecasts.

Notice that with the flat dollar, the U.S. current account continues to widen (Chart 9). Yet, as shown in Chart 10, the implications for U.S. indebtedness are less stark than one might think. The negative NIIP does not hit New Zealand's roughly 90 percent level until after 2014. The deterioration of the balance on investment income is fairly modest, with the negative balance reaching only 3 percent of GDP under the flat dollar by 2014 (Chart 11). Thus, from the standpoint of the capacity of the United States to service and repay its external debts, adjustment of the current account does not appear urgent.

Now, another reason for external adjustment is not so much because of concerns about the debt growing too large, but instead because foreign investors may fear that the share of U.S. assets in their portfolios is becoming too large. Chart 12 shows the amounts of total U.S. equities and bonds outstanding, calculated as share in total world stocks and bonds outstanding. Clearly, by this metric, the United States does not seem to be expanding its liabilities at a greater rate than in the rest of the world. Chart 13 focuses on the equity portfolios held by foreigners: the blue bars show that the share of U.S. equities in the portfolios of foreigners has been quite stable over the past few years–a similar result holds when we look at bond portfolios (Chart 14).

The bottom line is that it does not look like the United States is rapidly approaching the limits to its ability to finance its deficit. Obviously, a shift in investor sentiment could lead the current account balance to start adjusting very soon. Nevertheless, the evidence suggests that, alternatively, adjustment could take place much later and much slower than many observers are speculating.

The second broad issue I'd like to address is the consequence of external adjustment for growth, once adjustment begins, and how economic policies here and abroad will need to respond. To begin with, I interpret Philip's results as suggesting that, ultimately, the valuation effects of adjustment are not likely to be all that great. I agree with this view, which is consistent with some rough back-of-the-envelope calculations of my own. I estimated the effects on gross foreign claims on the United States of a hypothetical 20 percent dollar depreciation against all foreign currencies–this is the same amount of depreciation mentioned by Philip in his presentation. Such a depreciation would induce a loss of wealth equal to about 6 percent of GDP for all foreigners; the loss to the euro area would be around 5 percent of its GDP, and to the United Kingdom around 15 percent of GDP. These are high-end estimates, too. The impact on wealth would be cushioned by the fact that some dollar-denominated liabilities of foreigners would decline in value, and foreigners would enjoy improved terms of trade. (Moreover, many of the claims on the United States attributed to the United Kingdom may in reality be owned by residents of other countries.) Finally, valuation losses from a 20 percent depreciation would be much smaller than the 33 percent-of-GDP hit that foreigners took from equity losses at the start of the decade.

Thus, I would think that the trade effects of external adjustment would likely be more important than the valuation and wealth effects. How large might those trade effects be? Much depends on the policies they are combined with. To explore the impact of current account adjustment, my colleagues at the Federal Reserve used our general equilibrium international macro model, FRB/Global, to simulate the effects of a hypothetical, market-driven 20 percent decline in the trade-weighted real dollar.[2] The results are presented in the form of deviations from their projected values.

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[2]These simulations were implemented by Luca Guerrieri and Christopher Gust.

As shown on Chart 15, a dollar depreciation, by reducing the trade deficit, boosts U.S. GDP relative to baseline. Now, some may view this as something of a free lunch–not only does the United States get to spend beyond its means for a decade, but when adjustment finally comes, it gets to grow even more. But, as you can see, this isn't the whole story–while U.S. GDP rises above baseline, consumption falls below. This occurs because, in reaction to higher economic activity, interest rates rise, as shown in Chart 16.

So far, this is a benign picture of adjustment. It is our trading partners that face greater difficulties. Their trade surpluses decline (Chart 17) and, accordingly, their output falls below baseline (Chart 18). In the model, their output would fall even more, but for the action of their monetary authorities, who react to slowing activity by cutting interest rates (Chart 19). These results underscores a key message: in the event of external adjustment, U.S. economic policy must be prepared to tighten and foreign economic policy to loosen.

To underscore the importance of policy moves, I'd like to show you a second simulation. In this simulation, the market-driven decline in the dollar described above is augmented by a policy package: U.S. fiscal contraction equal to 5 percent of GDP, increases in foreign domestic demand of 3½ percent of GDP, and an additional 10 percent appreciation of the Asian currencies. This scenario leaves U.S. GDP and consumption, and hence monetary policy, little changed from baseline (Charts 20, 21). Short-term interest rates still decline abroad, but with the exception of developing Asia for a limited period, real GDP remains generally close to baseline (Charts 22, 23). This simulation underscores the point that external adjustment is likely to least disturb the balance between supply and demand when combined with policies that restrain demand in the United States and stimulate demand abroad.

In conclusion, let me reiterate that international financial positions clearly will play a role in the initiation and effects of external adjustment. Philip's earlier and more recent research represent important contributions to our understanding of the role of international asset positions and valuations. Nevertheless, the financial effects of external adjustment probably will not be the whole story, and trade effects of adjustment will doubtless have important effects of economic activity in the United States and abroad. Moreover, economic policy responses will play a critical role in conditioning the output effects of adjustment. All that said, when the process of narrowing the current account deficit will begin is anyone's guess.

Chart 1

Current account positions: a world view

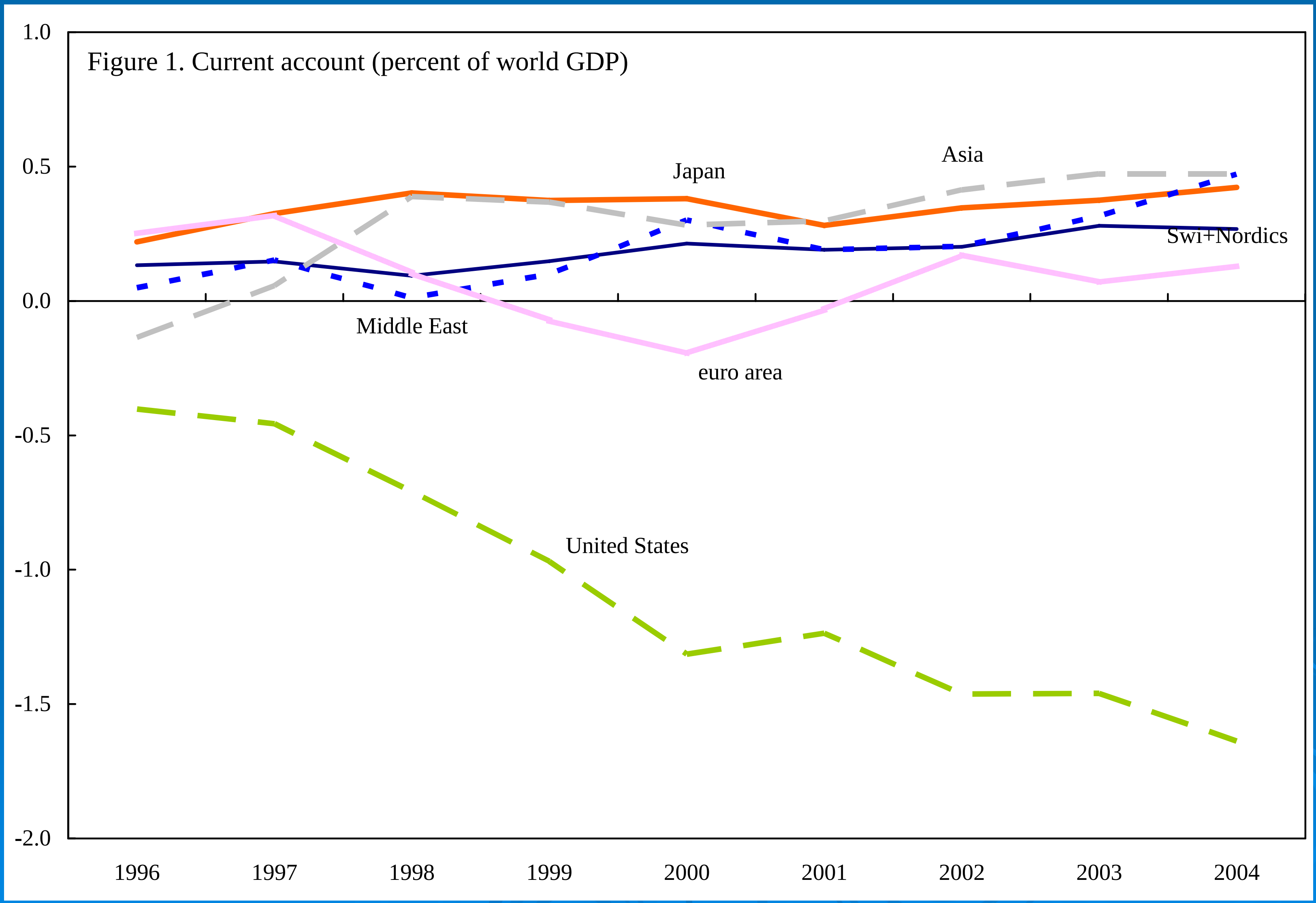


Chart 2

NFA positions: a world view

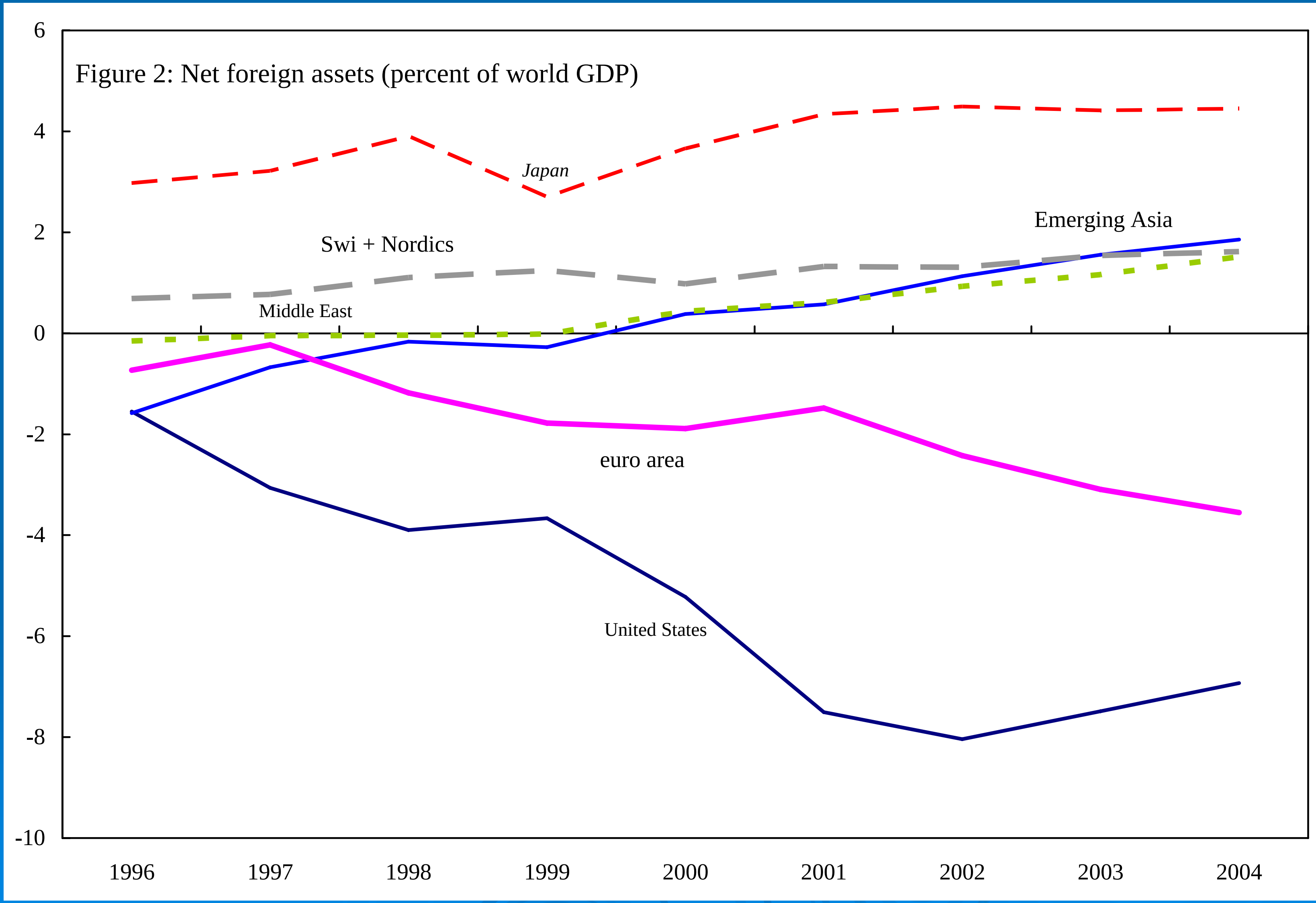
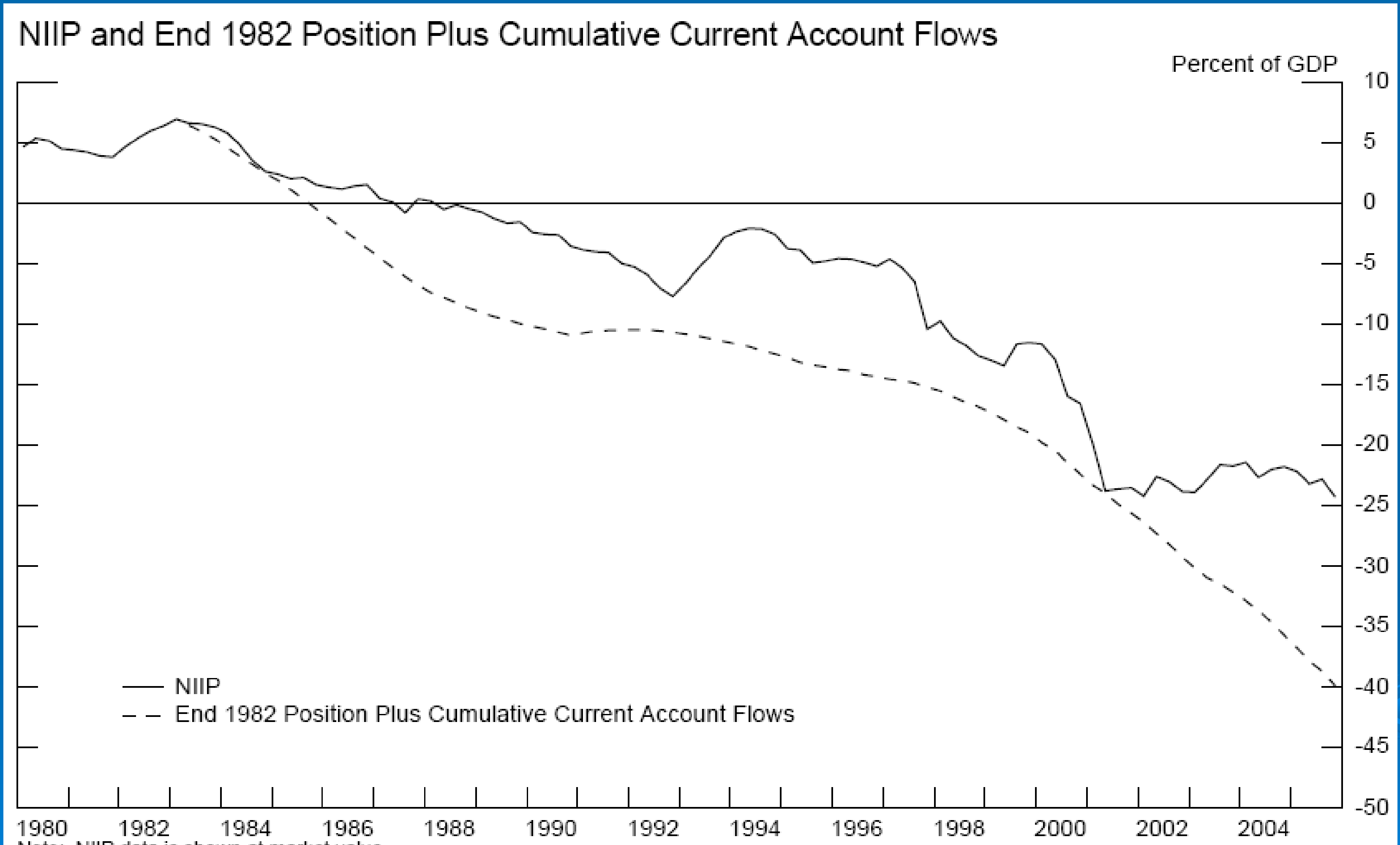


Table 1

Real returns on external assets and liabilities

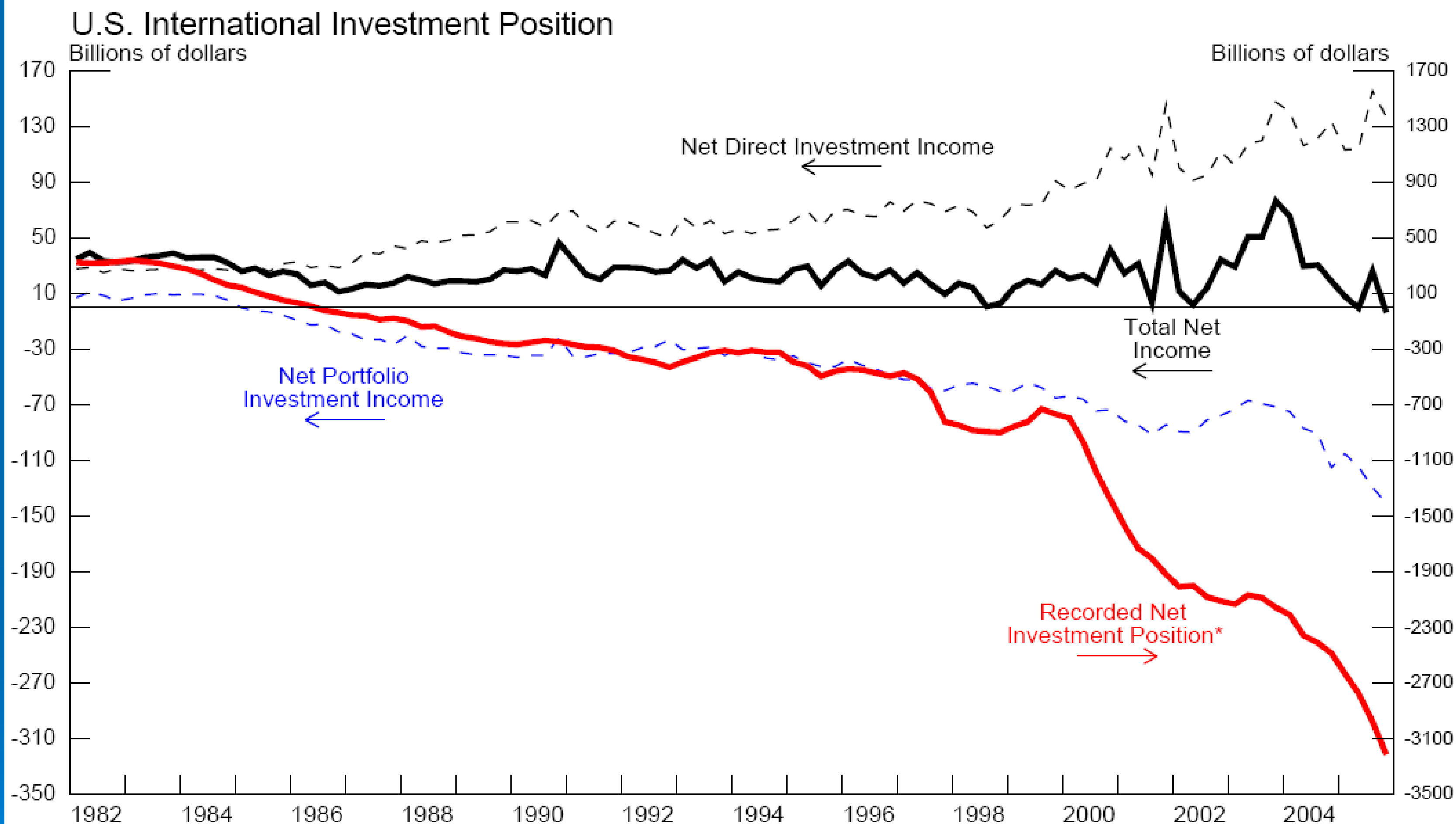
	Asset returns			Share of equity in total assets	Returns on liabilities			Share of equity in total liabilities
	Total	Equity	Debt		Total	Equity	Debt	
United States								
1995-1999	11.8	17.8	3.4	59	10.5	22.9	2.4	42
2000-2001	-8.1	-14.4	3.1	60	-5.5	-13.7	3.2	47
2002-2004	7.6	13.6	1.2	58	0.5	2.6	0.7	37
Japan								
1995-1999	6.2	3.1	3.7	16	10.1	22.1	2.5	22
2000-2001	13.7	6.8	10.2	18	0.7	-24.4	5.3	31
2002-2004	2.8	-7.1	-0.2	17	5.8	7.3	-0.8	32

Chart 3



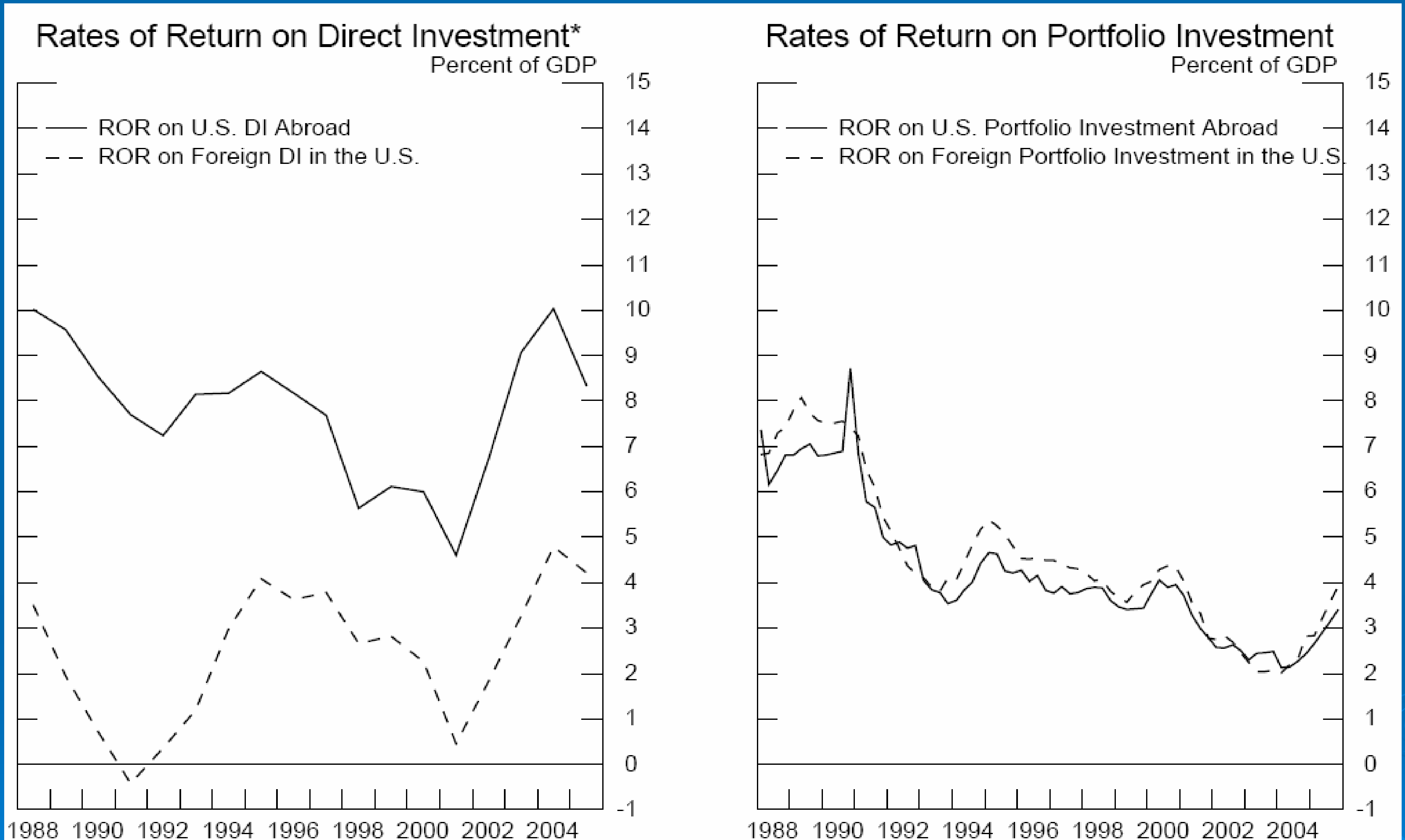
Note: NIIP data is shown at market value.

Chart 4



* with direct investment at current cost. Portfolio valuation adjustments subsequent to 2005 are assumed to be zero.

Chart 5



* Based on market value measure of DI.

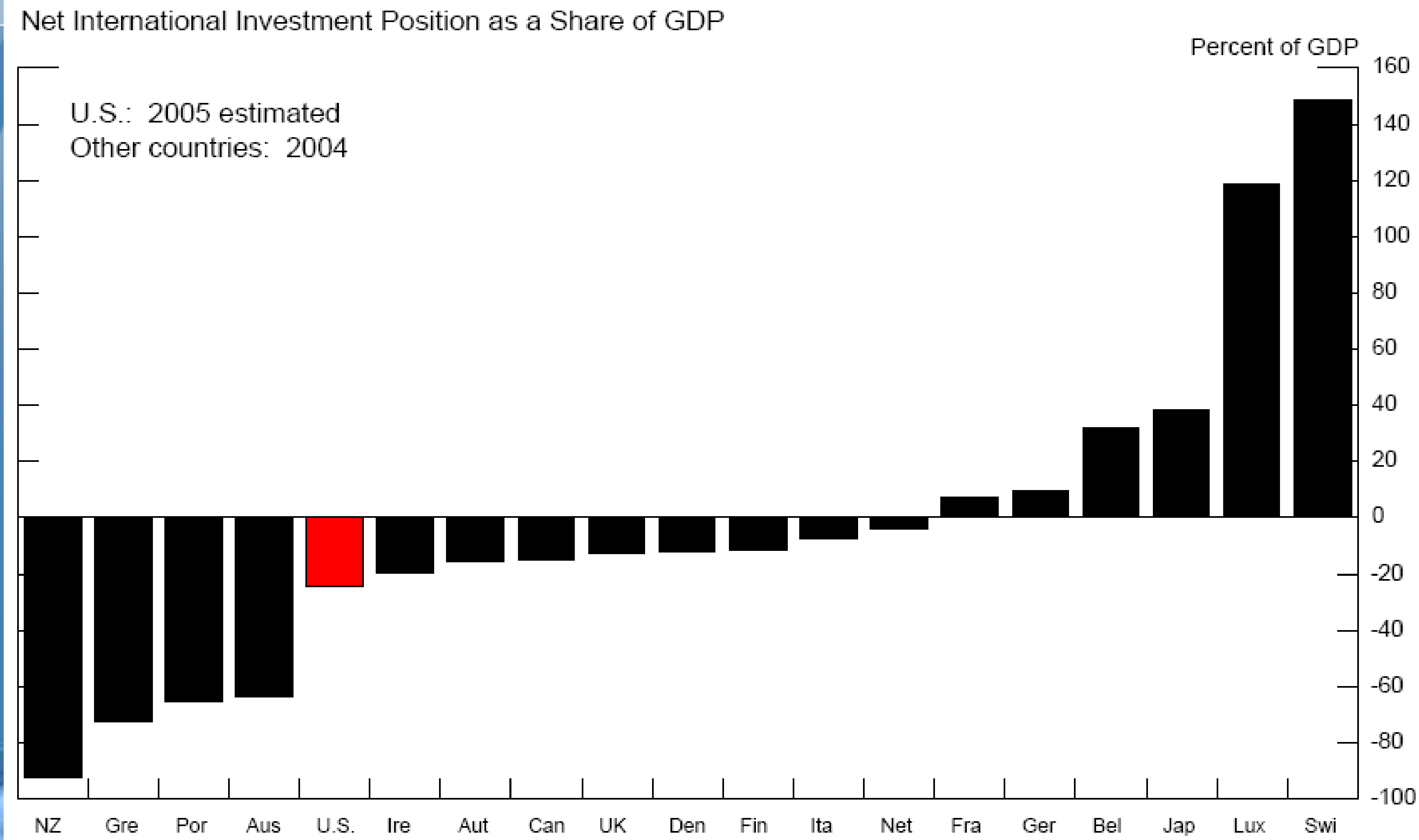
Table 2

Composition of U.S. Financial Flows ($ billions)

		1991-2001 Average	2002	2003	2004	2005	2006 Q1 (a.r.)
1.	**Current Account Balance**	**-178**	**-475**	**-520**	**-688**	**-805**	**...**
2.	**Official Financial Flows, net**	**48**	**113**	**280**	**399**	**242**	**306***
3.	**Private Financial Flows, net**	**133**	**388**	**280**	**186**	**559**	**...**
4.	Net Inflow Reported by U.S. Banking Offices	3	58	87	-34	-42	...
5.	Foreign Net Purchases of U.S. Securities	210	384	331	477	686	774*
6.	U.S Net Purchases of Foreign Securities	-106	-49	-156	-102	-155	-220*
	of which stock swaps	-33	-3	-17	12	-4	...
7.	Foreign Direct Investment in the U.S.	122	81	67	107	129	...
8.	U.S. Direct Investment Abroad	-110	-154	-141	-252	-22	...
9.	Currency and Other	20	68	92	-10	-37	...
10.	**Statistical Discrepancy**	**-2**	**-24**	**-38**	**85**	**10**	**...**

* Estimates based on TIC data and historical pattern of adjustments by BEA.

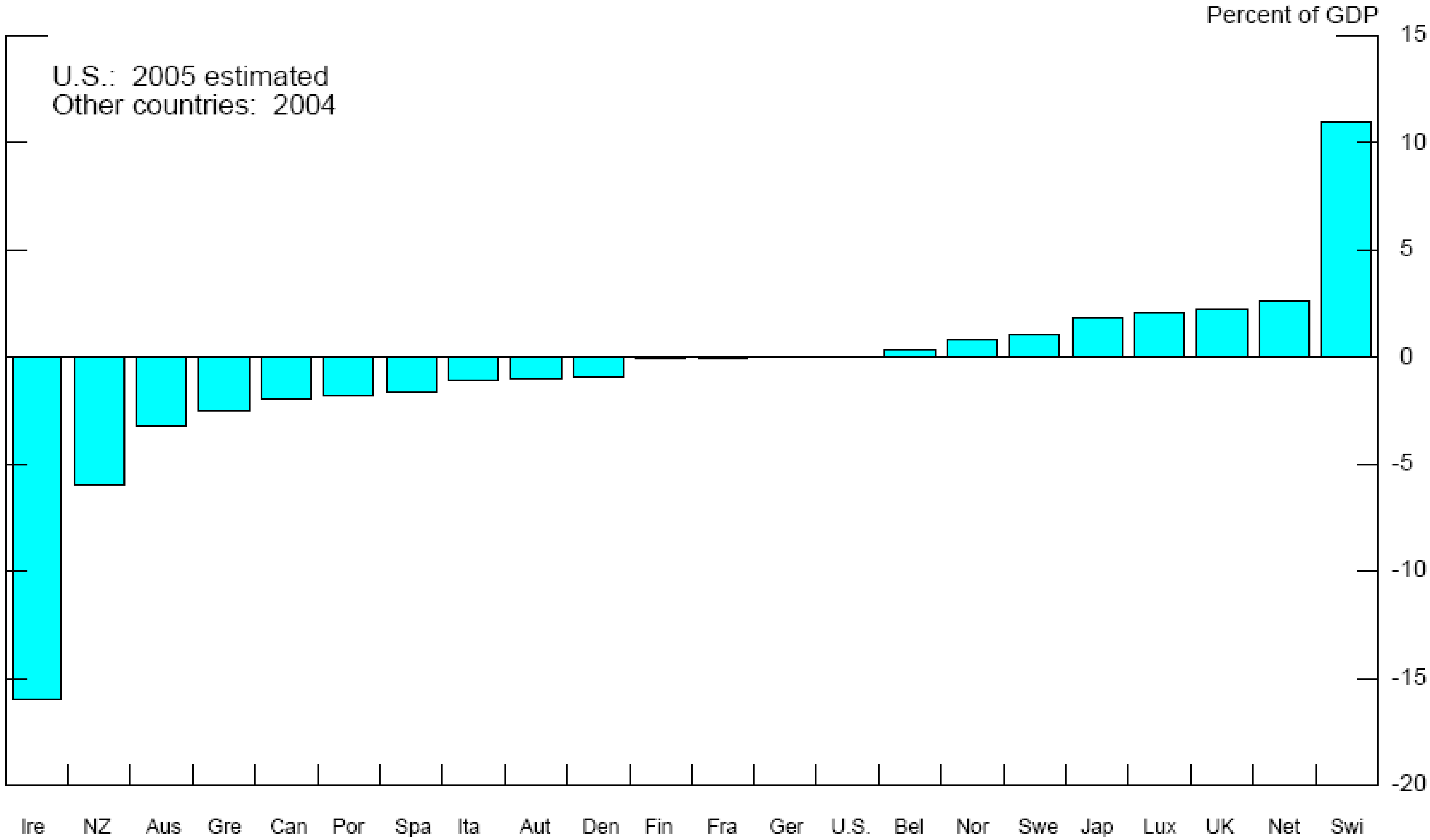
Chart 6



Source: IMF International Financial Statistics.

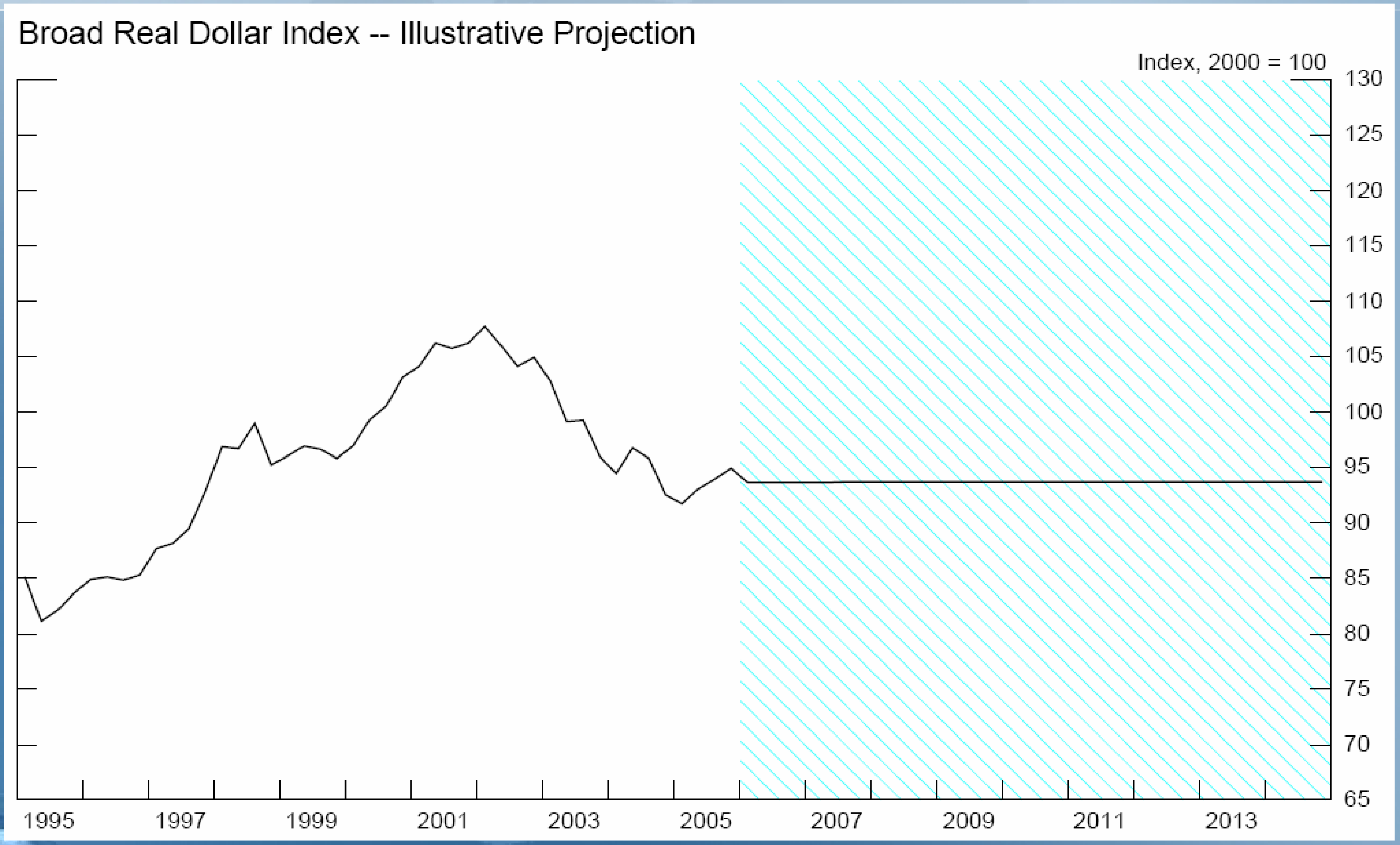
Chart 7

Net Investment Income as a Share of GDP



Source: IMF Balance of Payments Statistics.

Chart 8



Broad Real Dollar Index -- Illustrative Projection
Index, 2000 = 100
130
125
120
115
110
105
100
95
90
85
80
75
70
65
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013

Chart 9

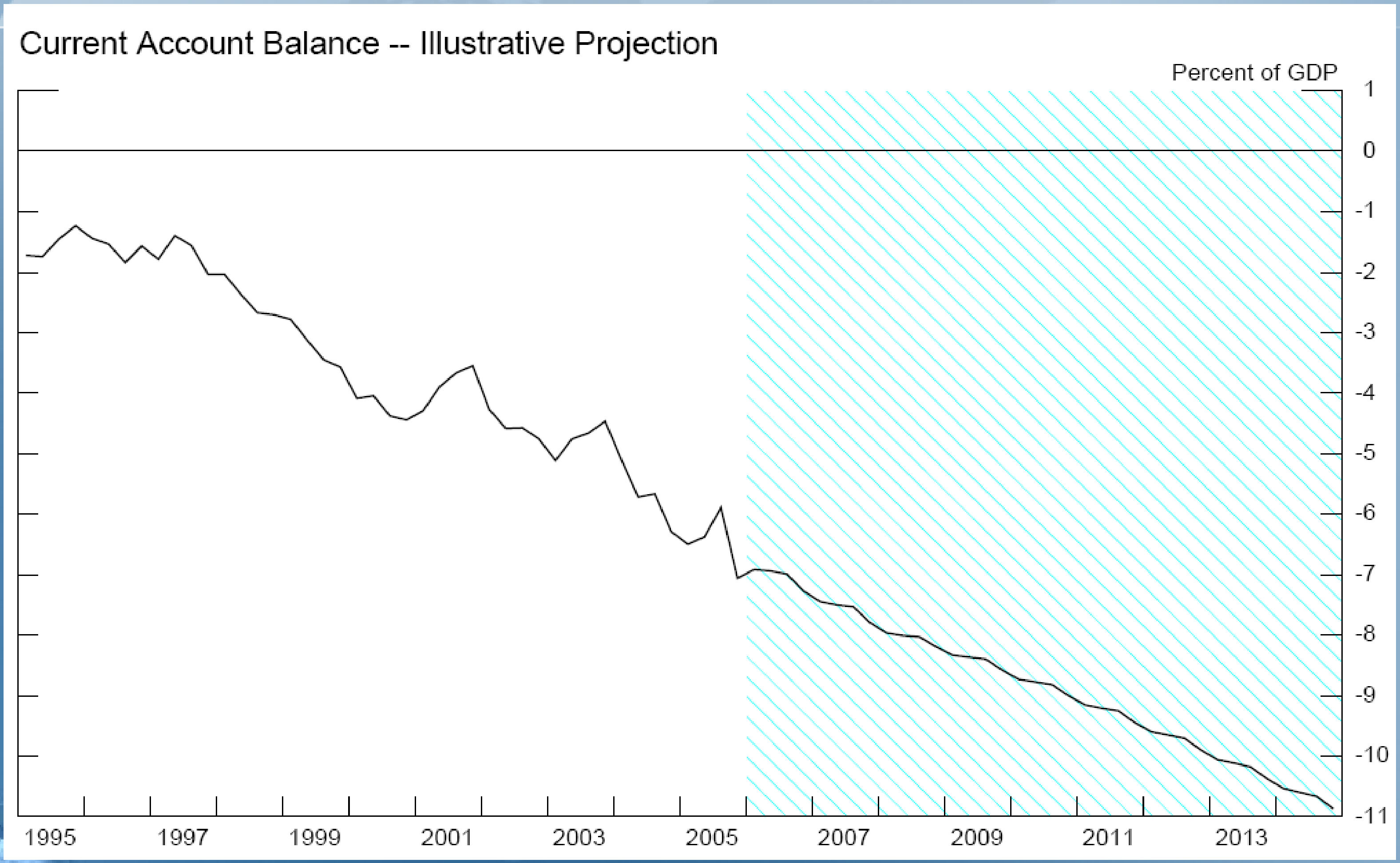

Current Account Balance -- Illustrative Projection
Percent of GDP
1
0
-1
-2
-3
-4
-5
-6
-7
-8
-9
-10
-11
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013

Chart 10

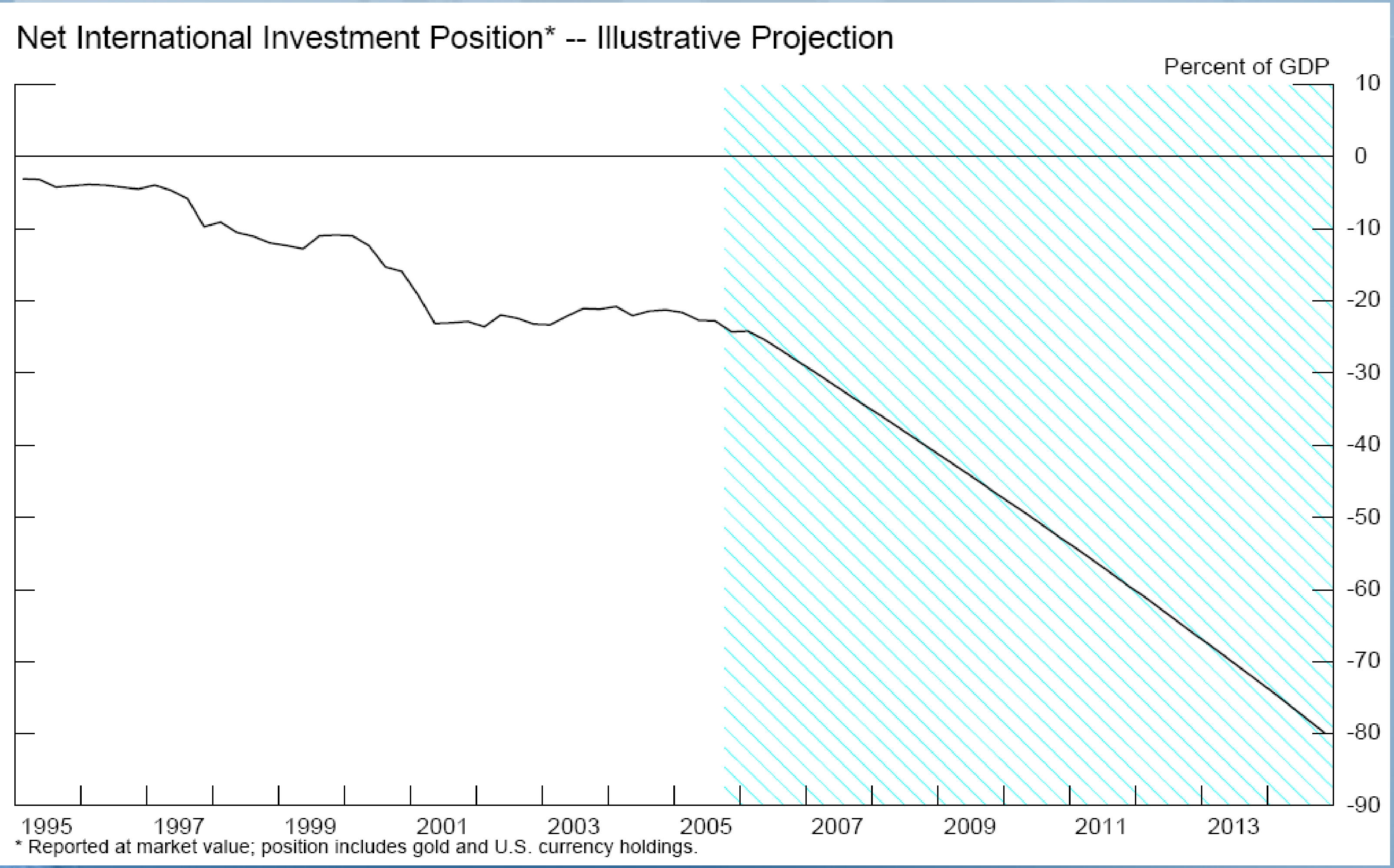

Net International Investment Position* -- Illustrative Projection
Percent of GDP
10
0
-10
-20
-30
-40
-50
-60
-70
-80
-90
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
* Reported at market value; position includes gold and U.S. currency holdings.

Chart 11

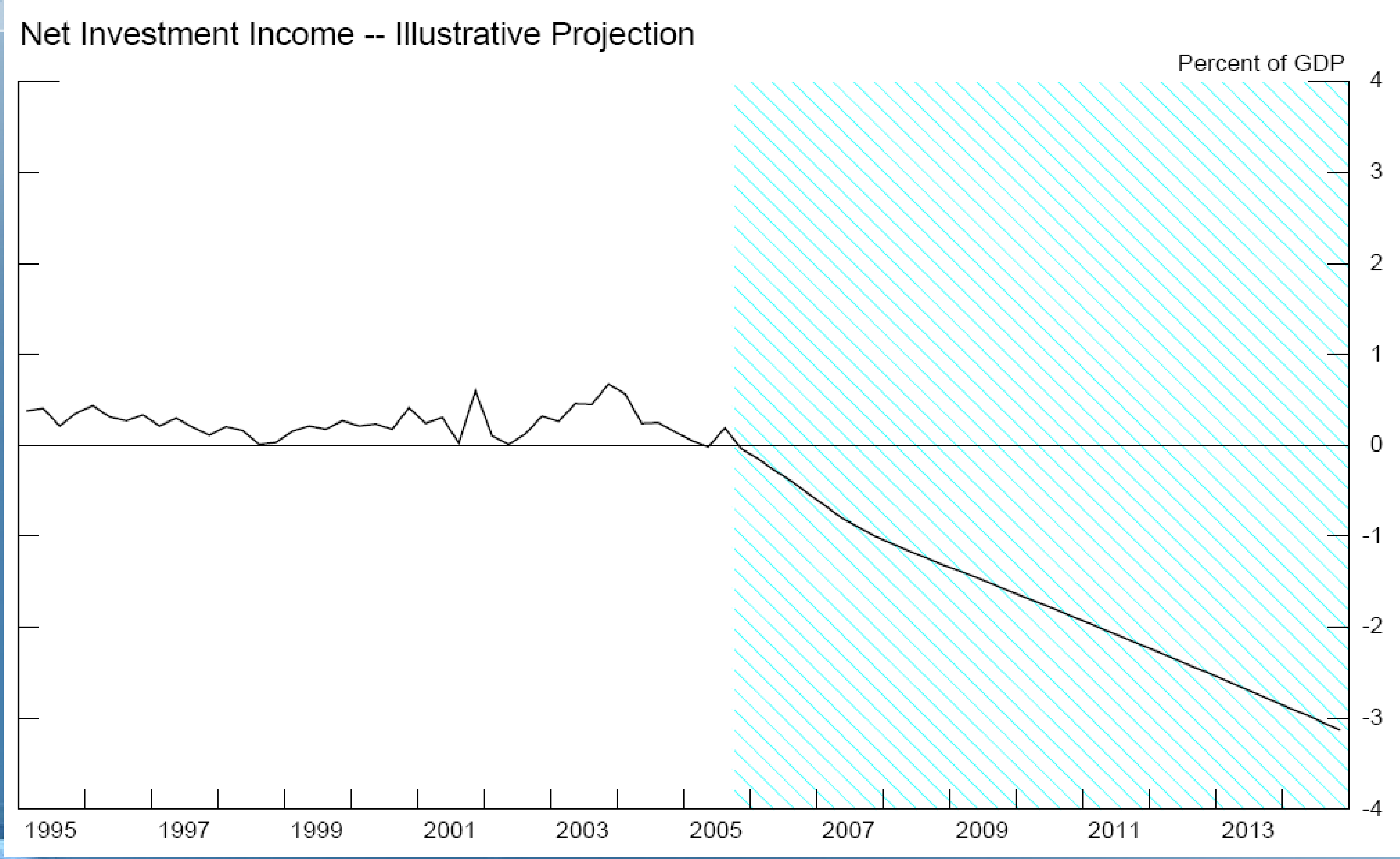
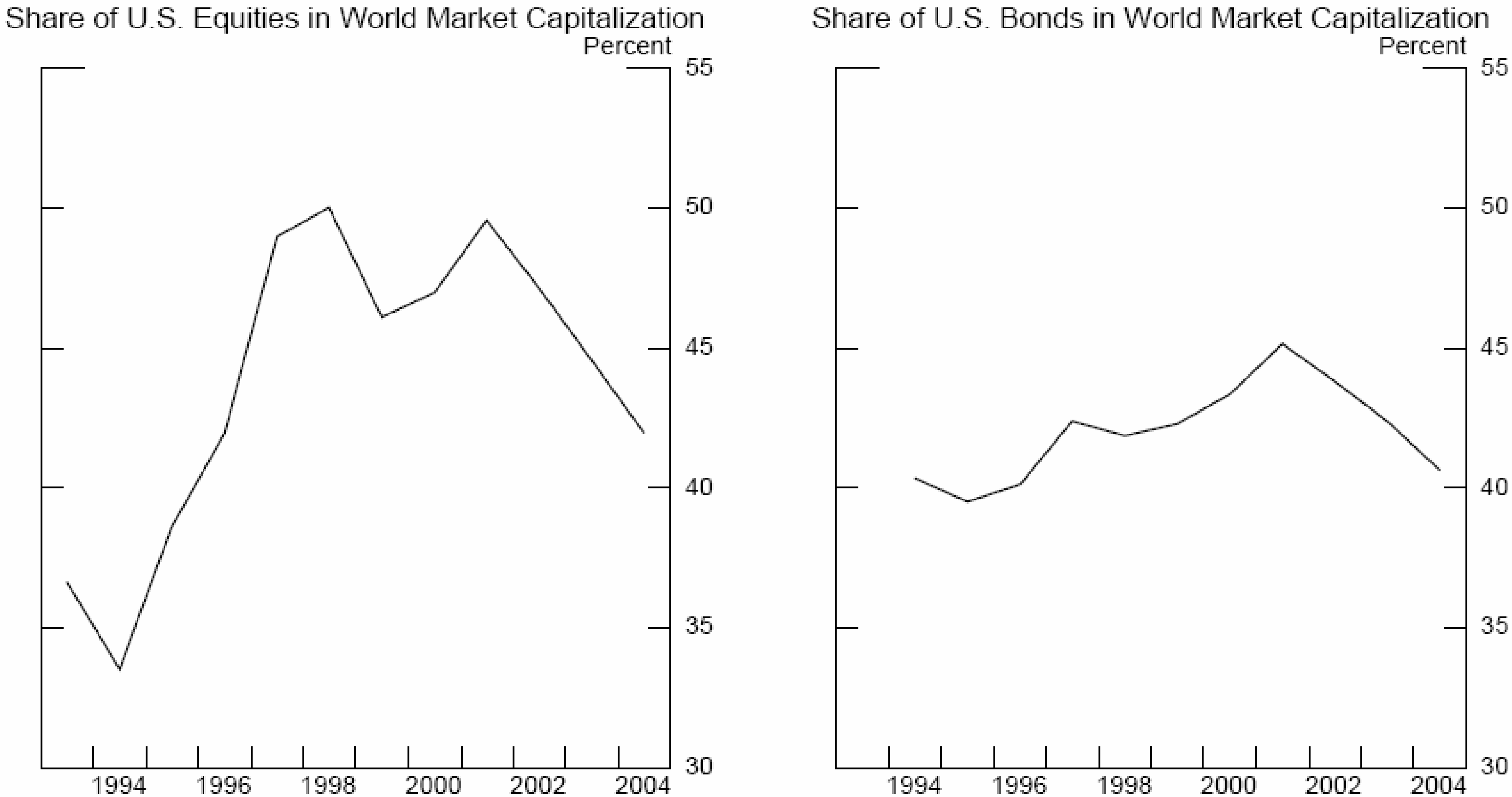

Net Investment Income -- Illustrative Projection
Percent of GDP
4
3
2
1
0
-1
-2
-3
-4
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013

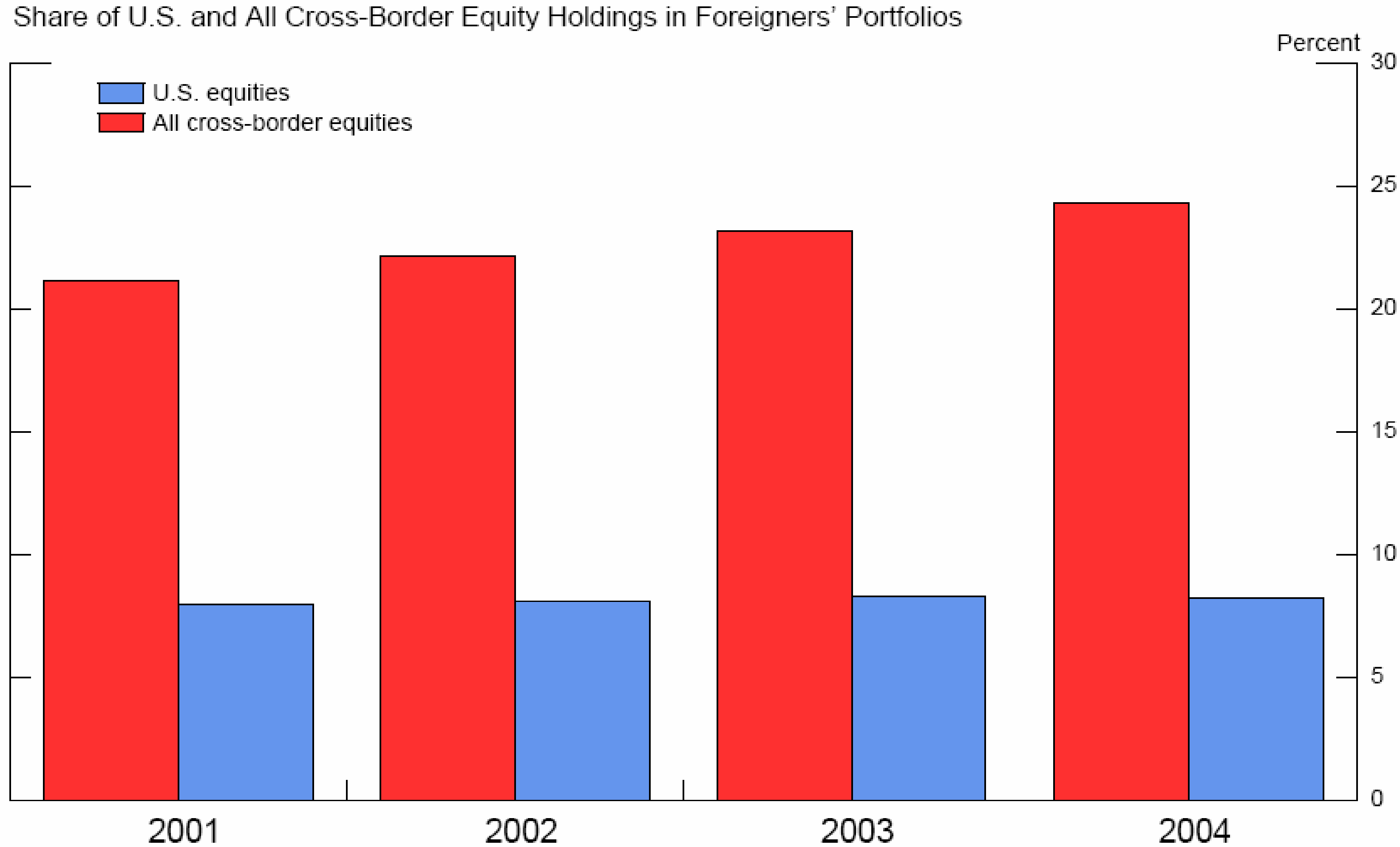
Chart 12



Source: S&P's Global Markets Factbook 2004.

Source: BIS data, adjusted for Brady bonds outstanding.

Chart 13



Source: Staff estimates based on IMF Coordinated Portfolio Asset Surveys.

Chart 14

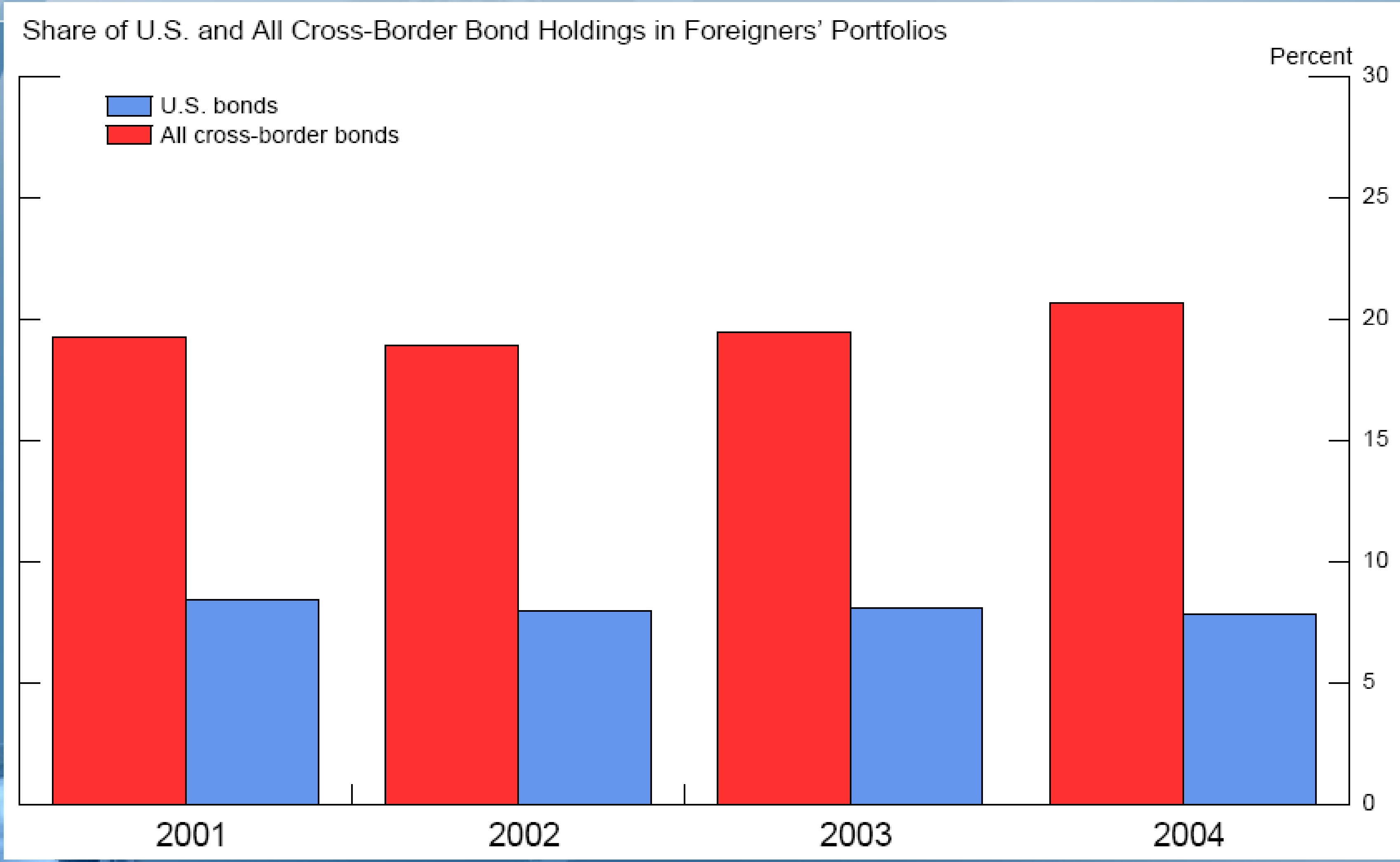
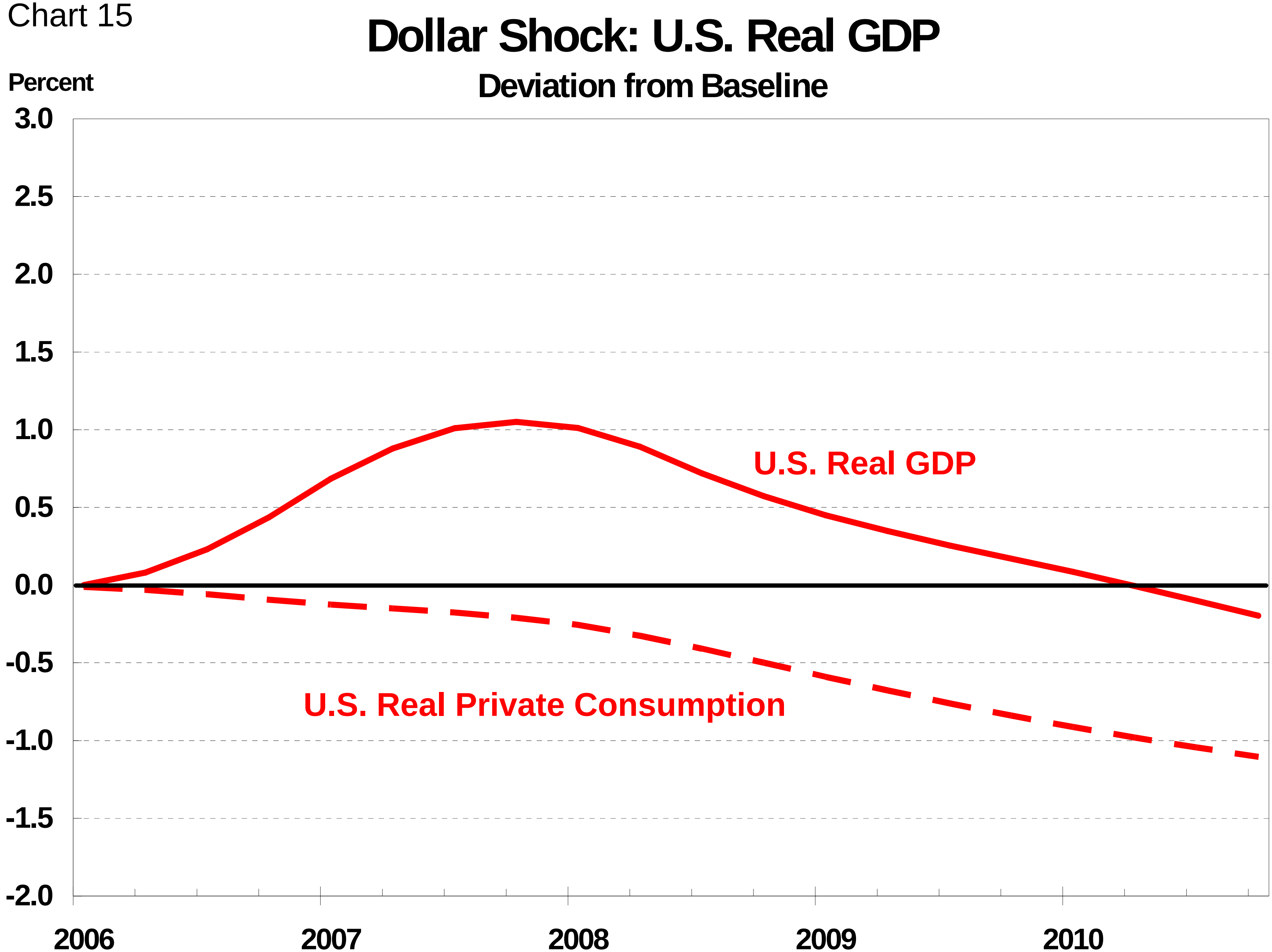

Share of U.S. and All Cross-Border Bond Holdings in Foreigners' Portfolios
Percent
U.S. bonds
All cross-border bonds
30
25
20
15
10
5
0
2001
2002
2003
2004

Chart 15



Dollar Shock: U.S. Real GDP
Deviation from Baseline
Percent
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-2.0
U.S. Real GDP
U.S. Real Private Consumption
2006
2007
2008
2009
2010

Chart 16

Dollar Shock: U.S. Federal Funds Rate

Deviation from Baseline

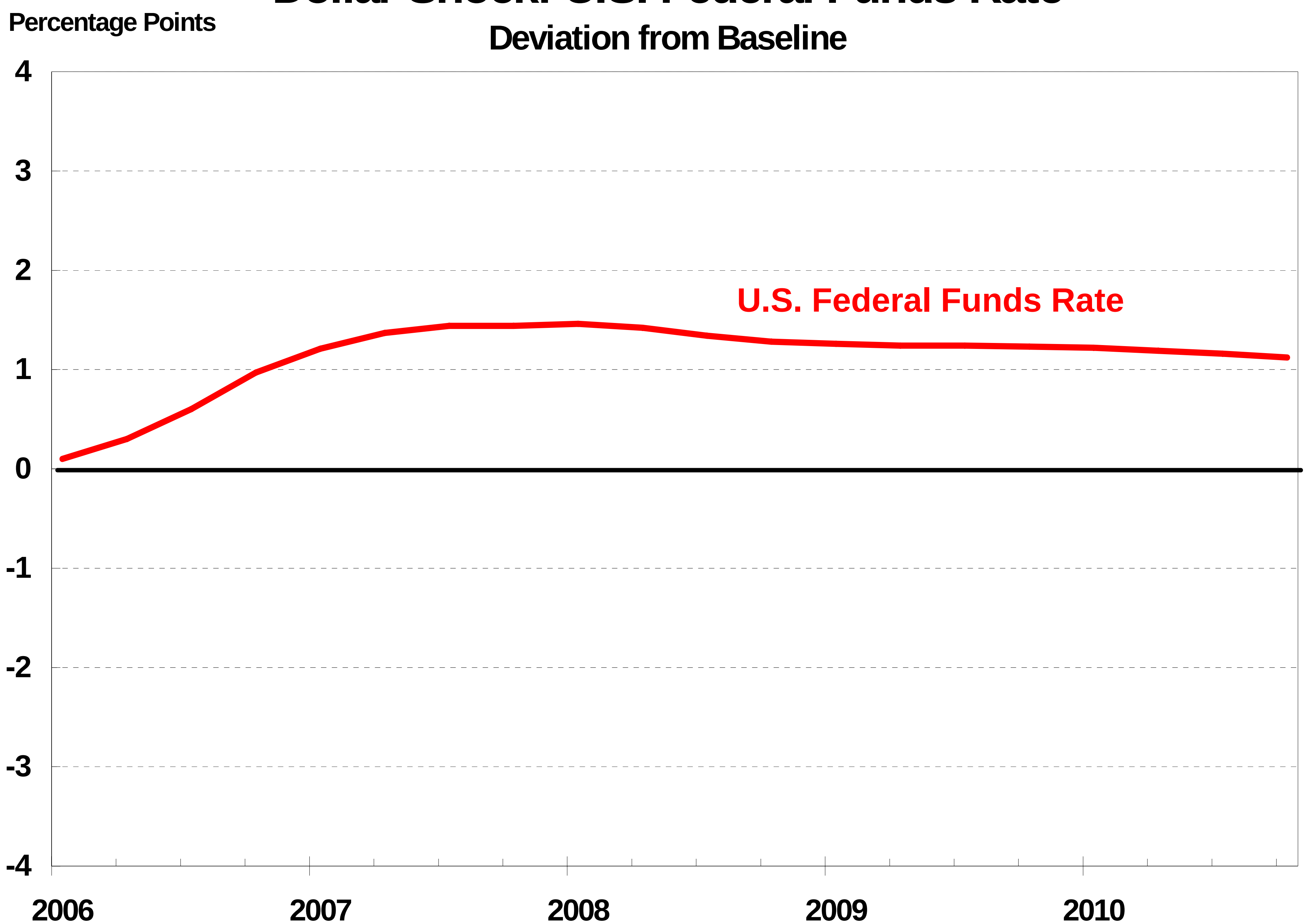
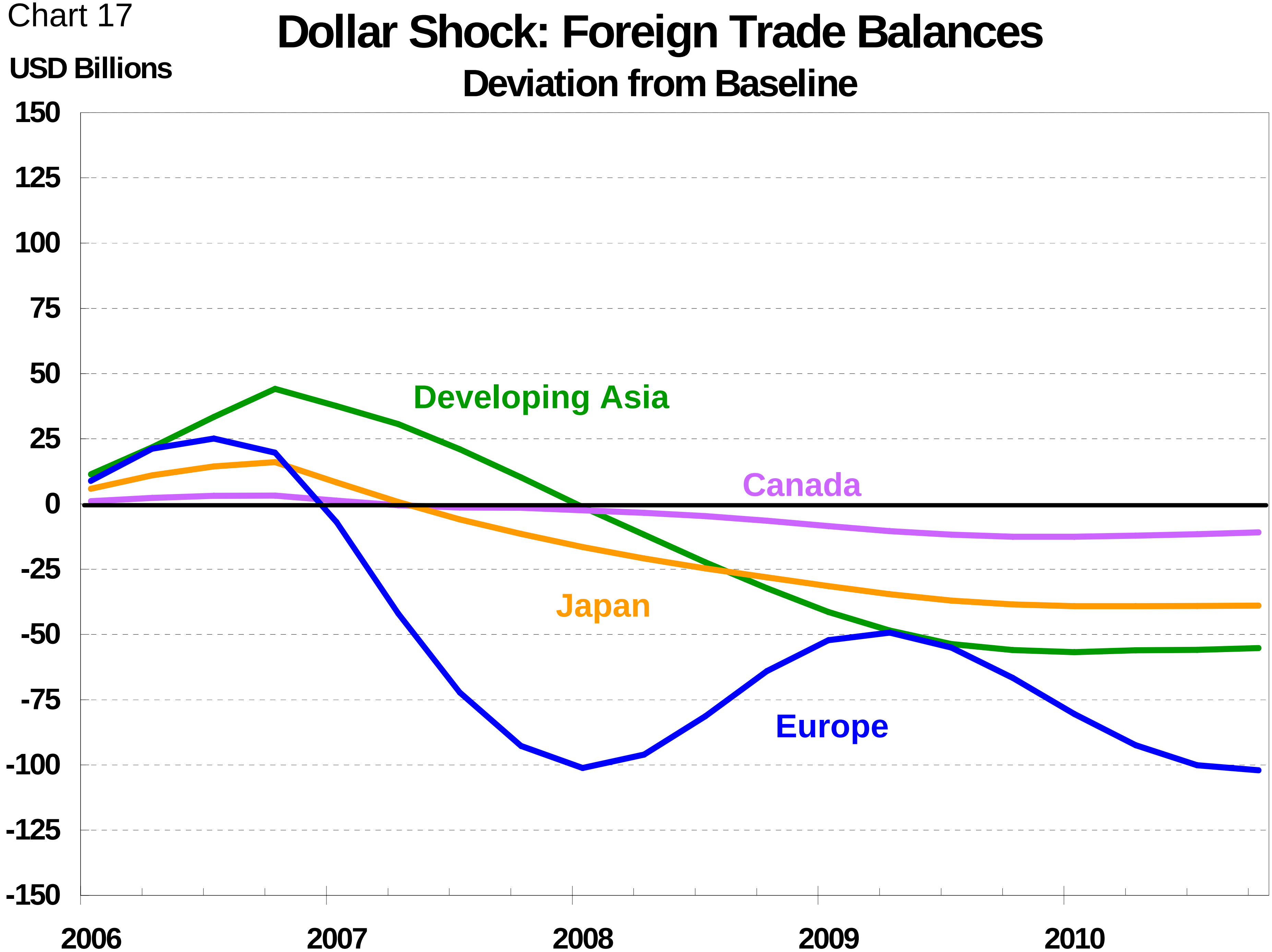


Chart 17



Dollar Shock: Foreign Trade Balances
Deviation from Baseline
USD Billions
150
125
100
75
50
25
0
-25
-50
-75
-100
-125
-150
2006
2007
2008
2009
2010
Developing Asia
Canada
Japan
Europe

Chart 18

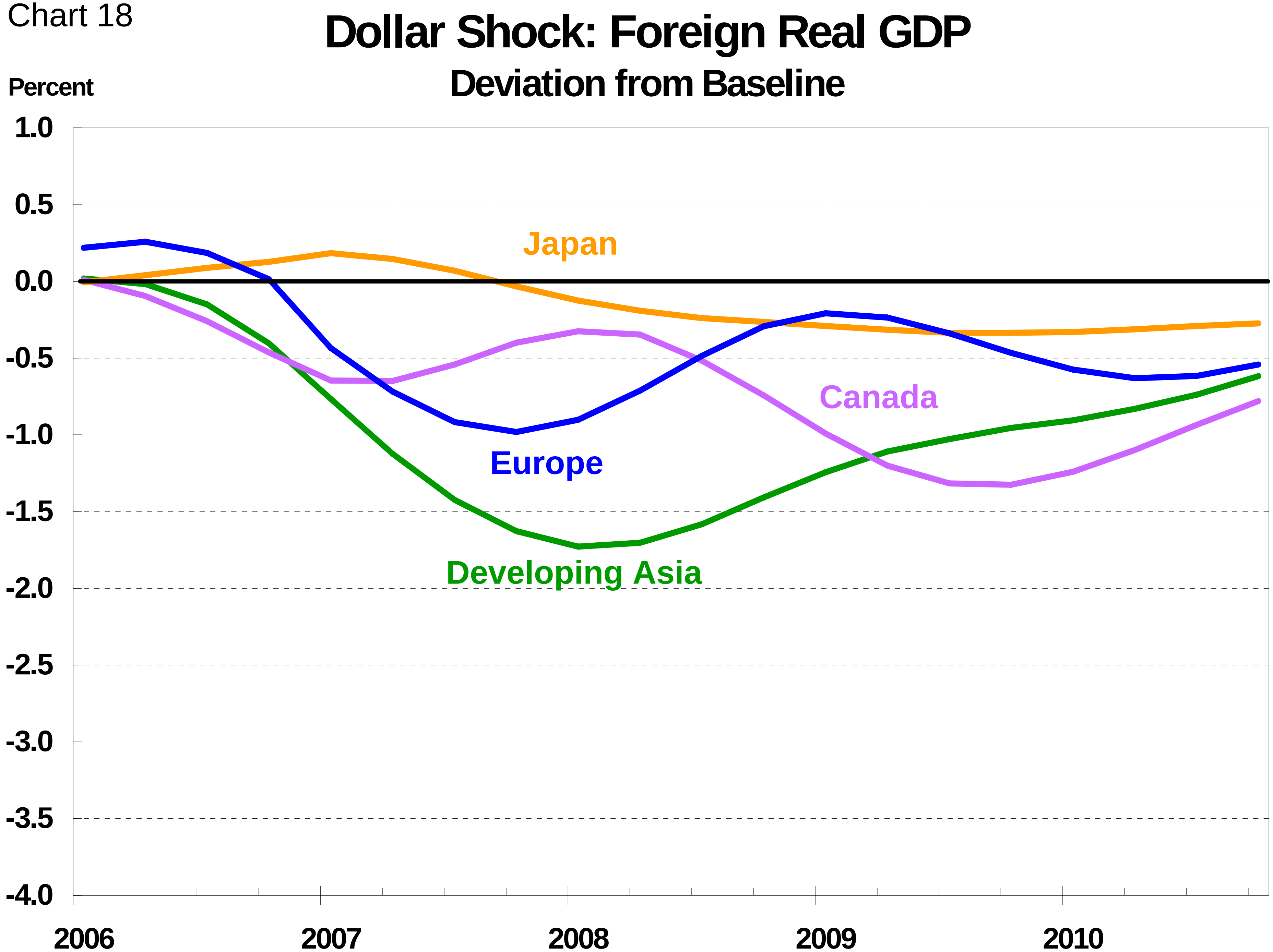

Dollar Shock: Foreign Real GDP
Deviation from Baseline
Percent
1.0
0.5
0.0
-0.5
-1.0
-1.5
-2.0
-2.5
-3.0
-3.5
-4.0
Japan
Canada
Europe
Developing Asia
2006
2007
2008
2009
2010

Chart 19

Dollar Shock: Foreign Short-Term Interest Rates

Deviation from Baseline

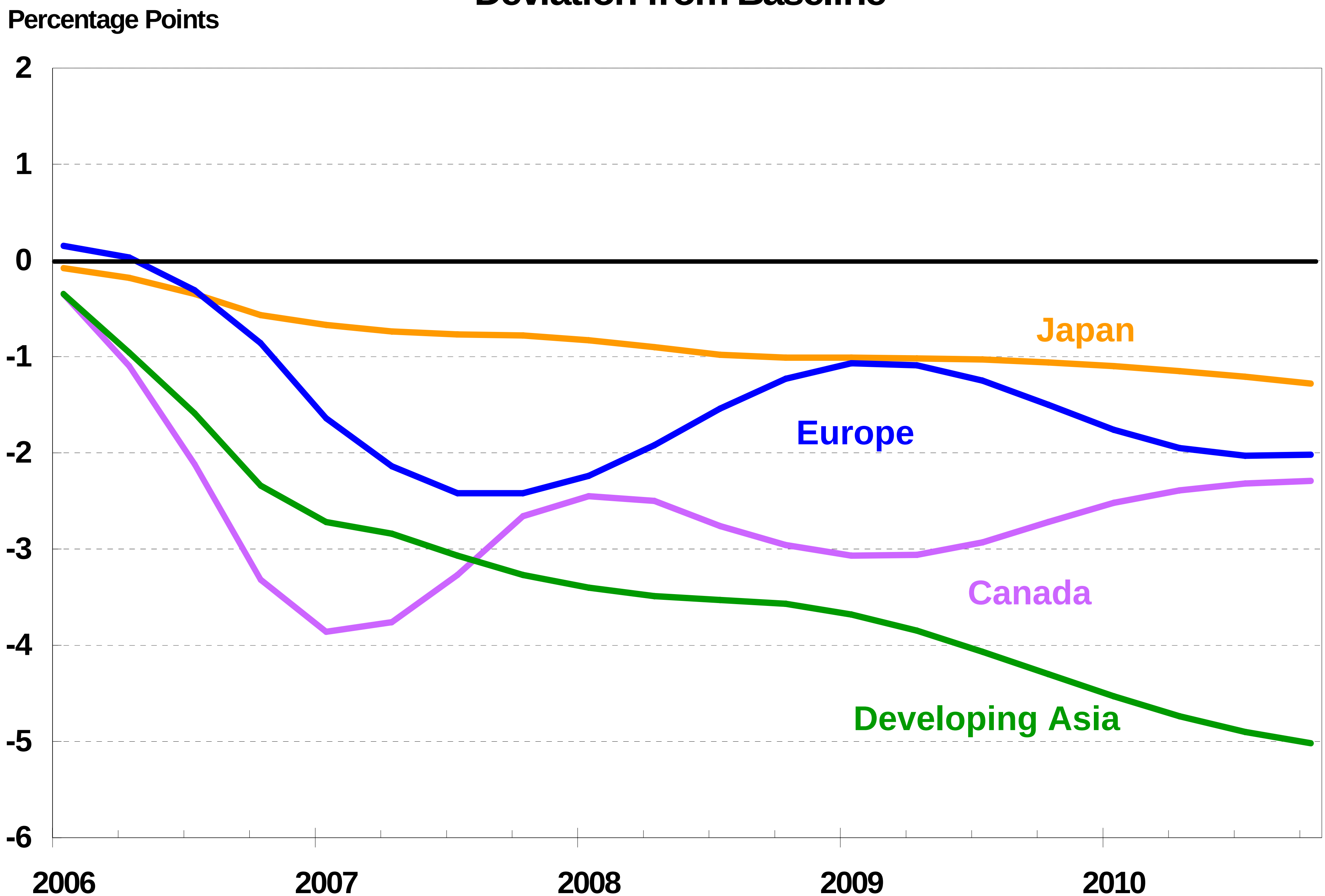


Chart 20

Policy Package + Market-Decline: U.S. Real GDP

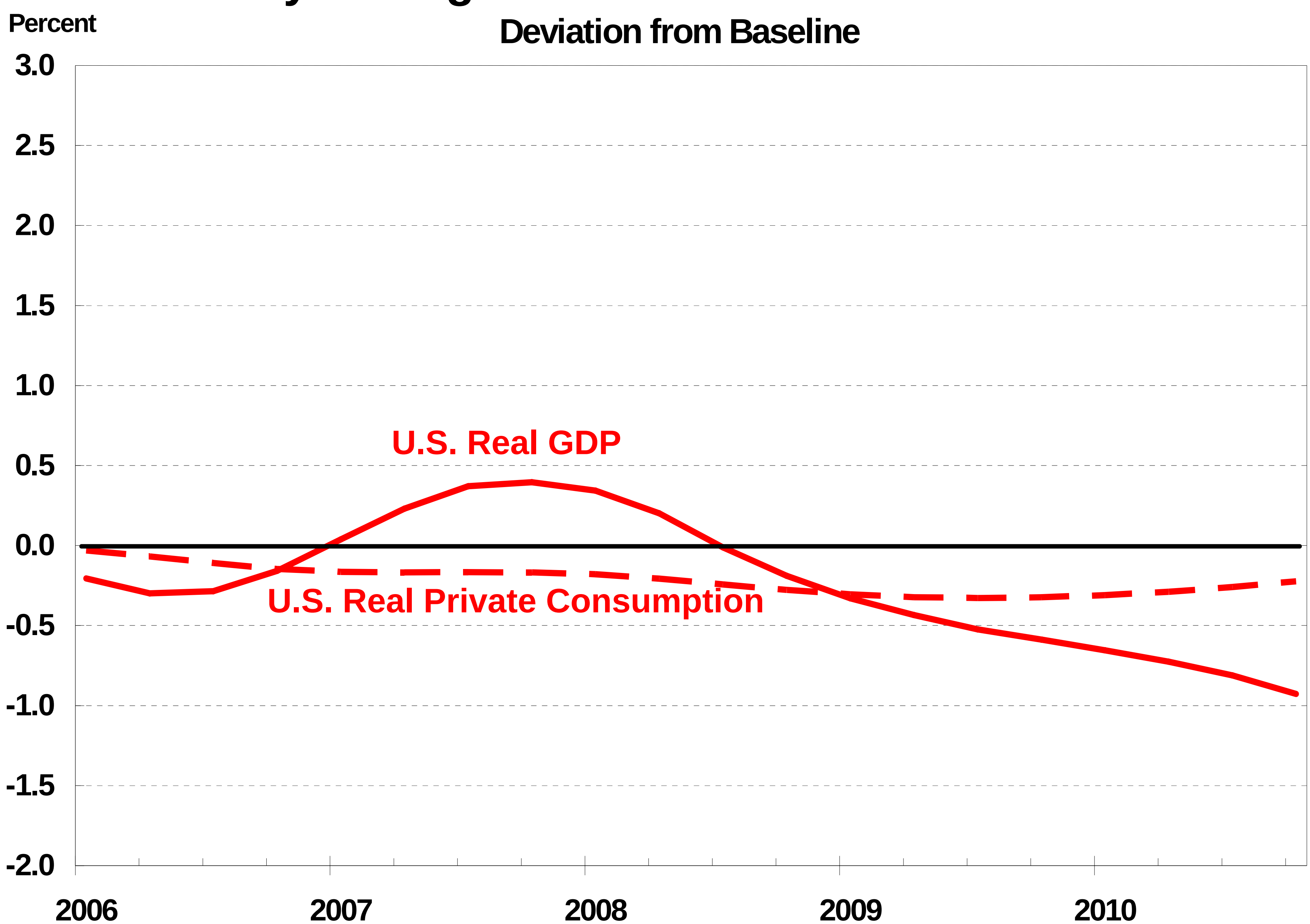


Chart 21

Policy Package + Market-Decline: U.S. Federal Funds Rate

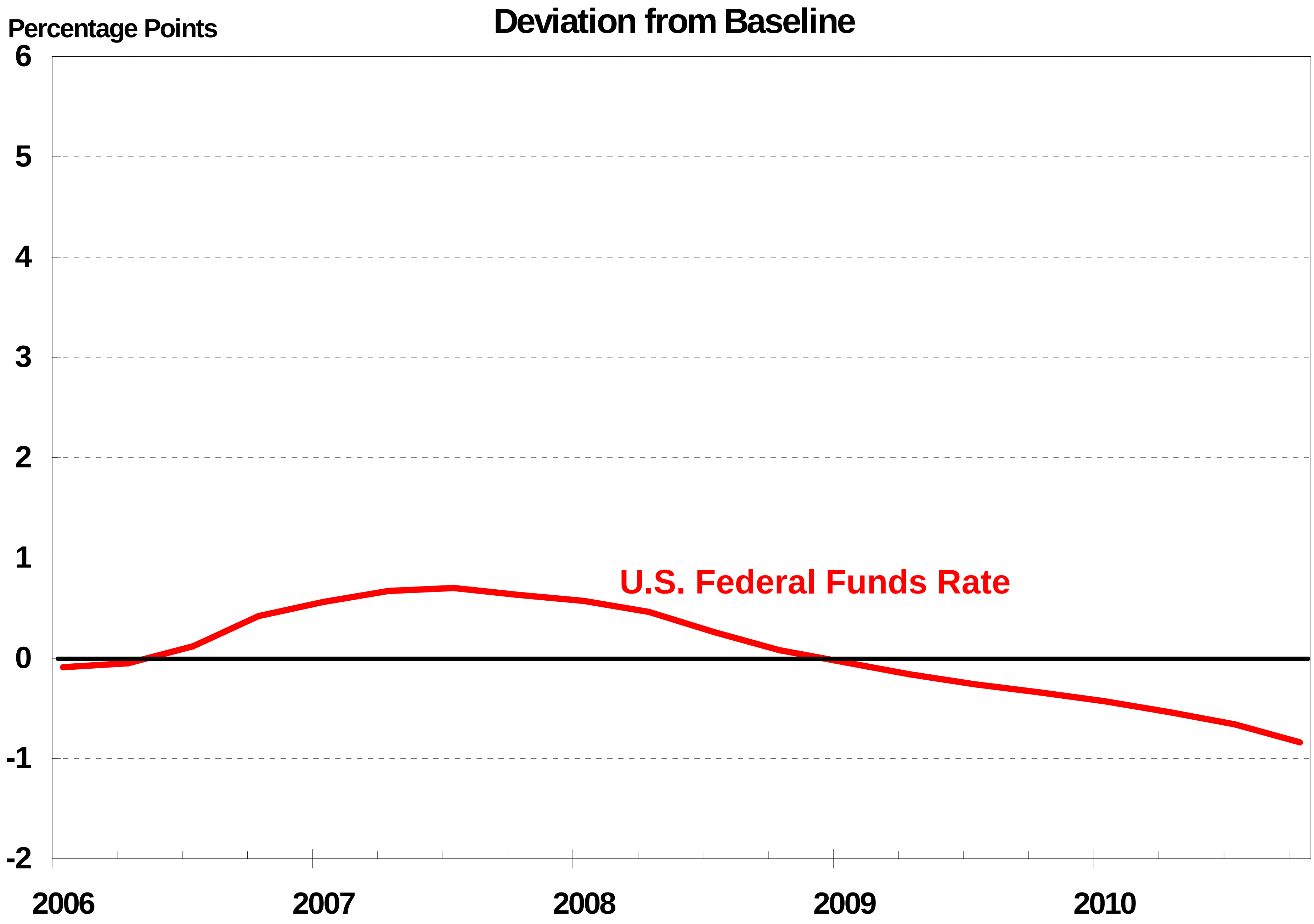


Chart 22

Policy Package + Market-Decline: Foreign Real GDP

Deviation from Baseline

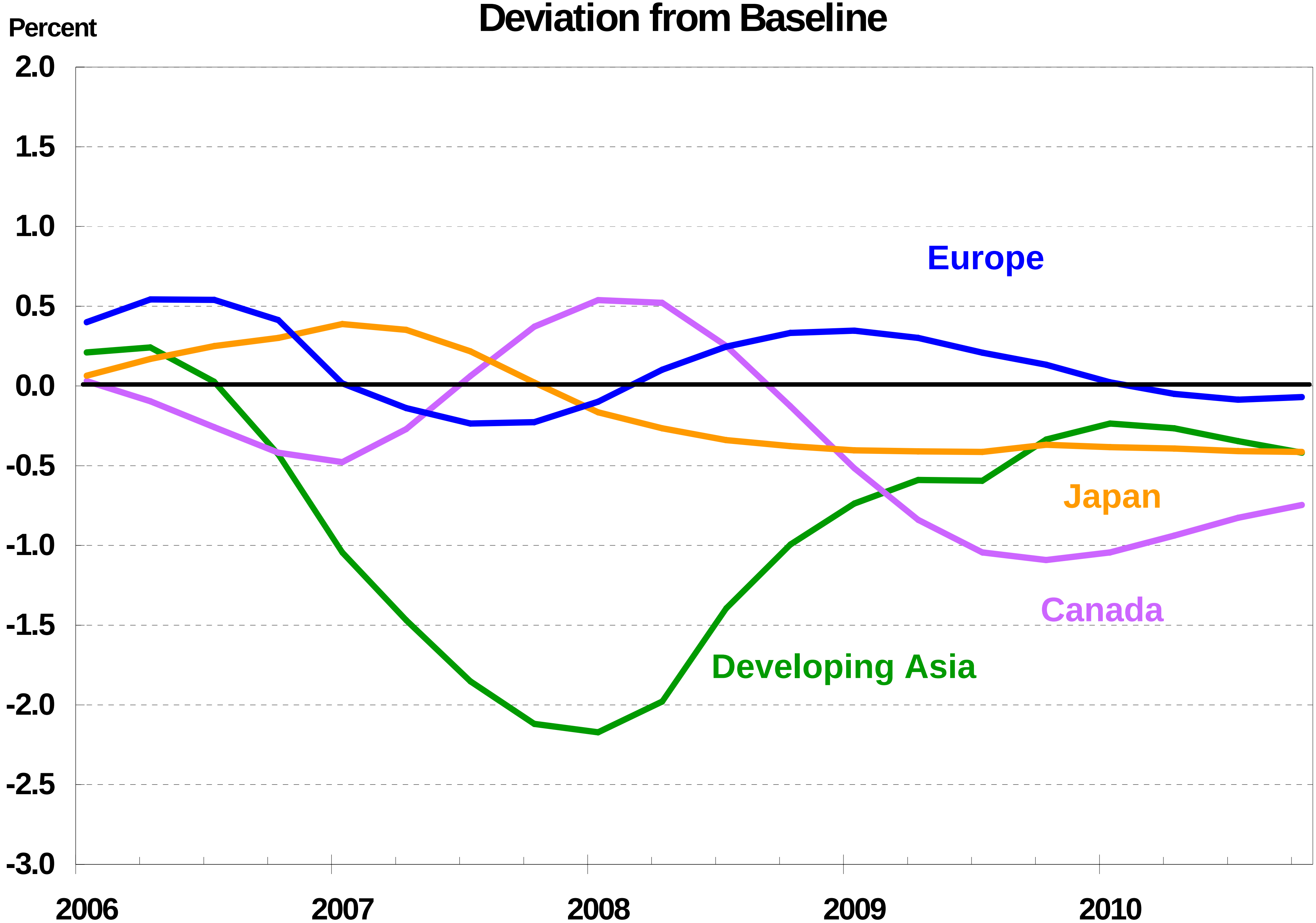


Chart 23 **Policy Package + Market-Decline: Foreign Short-Term Interest Rates**

Deviation from Baseline