

Changing Fortunes

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THE ongoing financial crisis has caused dramatic changes in asset prices and exchange rates across the globe. Stock markets have lost 40 percent or more of their value in both advanced economies and emerging markets. Interest rate spreads on corporate and sovereign bonds have widened dramatically. Exchange rates have been very volatile: the currencies of most emerging markets and some advanced economies (such as the United Kingdom) have seen steep declines, while the yen has appreciated very sharply. In addition to their impact on macroeconomic activity, these changes have significantly affected the external assets and liabilities of the main creditor and debtor countries.

Take, for example, the world's largest external borrower—the United States. How did the crisis affect its position vis-à-vis the rest of the world? Preliminary estimates suggest that the U.S. net external position—meaning the difference between U.S. residents' financial claims on the rest of the world and the rest of the world's financial claims on the United States—saw in 2008 its most serious deterioration in history: more than \$2 trillion. This deterioration occurred despite substantial declines in the market value of U.S. wealth—which inflicted losses on foreign holders of U.S. assets, and significantly exceeded net borrowing by the United States (the current account deficit) that amounted to “only” some \$650 billion. Similarly, changes in asset prices and exchange rates seriously affected the net external positions of countries that ran large current account surpluses in 2008, such as China, Japan, and the oil exporters.

This article explores the ways in which the ongoing crisis is affecting the net external positions of the borrowing and lending countries and the likely consequences of these developments. It starts out by explaining how economists measure a country's net exter-

nal position, discusses in detail the changing external position of the United States as well as of creditor nations, and concludes with some thoughts about how these and related developments could affect the unwinding of global imbalances.

Gauging net external positions

Explaining the worries about persistent “global imbalances”—that is, large current account deficits and the associated external borrowing in countries such as the United States, and large current account surpluses and associated external lending by countries such as China and the major oil exporters—is relatively straightforward. Consider, for example, a deficit country. Over time, it will accumulate large external liabilities, which need to be serviced (and thus require a trade surplus). Its ability to attract foreign capital may also decline as its external position deteriorates, causing the exchange rate to depreciate and its cost of external borrowing to increase.

The risk associated with large external liabilities will clearly depend on the international environment. During periods of growing international financial integration, residents of a country increase the share of their wealth invested overseas, thus making it easier to borrow and lend internationally. In periods of financial turmoil, of which the current one is an extreme case, the risks associated with a large recourse to external borrowing can rise dramatically, as is vividly illustrated by cases such as Hungary and Latvia.

To measure a country's net external position, economists typically focus on the so-called net international investment position (NIIP—the difference between a country's residents' financial claims on the rest of the world and the rest of the world's financial claims on a country's residents). A country's NIIP can change for two reasons: net external borrowing or lending (the mirror image of

Battered by the financial crisis, the world's lenders and borrowers see dramatic shifts in their external accounts

current account deficits or surpluses) and changes in the value of the country's assets and liabilities due to fluctuations in exchange rates and asset prices. For example, if China holds a large stock of U.S. Treasury bonds and the value of these bonds increases because U.S. interest rates decline, then China's NIIP will improve. Conversely, an appreciation of the renminbi vis-à-vis the U.S. dollar will tend to reduce the renminbi value of China's dollar-denominated assets and hence worsen the NIIP. The NIIP should not be confused with a measure of the country's overall wealth: for example, if the productivity of a country's firms increases, the market value of these firms will rise, and so will the country's wealth. However, if foreigners own some of the shares of these firms, the country's NIIP may well deteriorate, because some of the wealth gains will accrue to the rest of the world.

Developments in the U.S.

Why then did the U.S. NIIP deteriorate so much? And what consequences will that have?

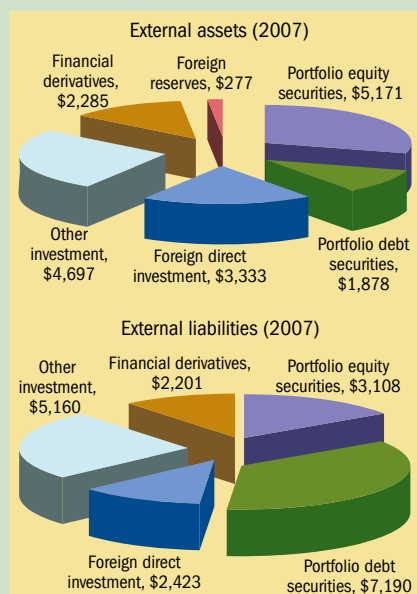
To understand these developments, it is useful to start by characterizing the U.S. position at end-2007, which was negative to the tune of \$2.2 trillion (see Chart 1). The U.S. external assets were characterized by large holdings of portfolio equity and foreign direct investment (FDI), while U.S. external liabilities were predominantly in debt instruments (such as treasury and corporate bonds). The net equity position (the sum of portfolio equity assets and FDI assets minus the sum of portfolio equity and FDI liabilities) was positive at about \$3 trillion, and the net debt position negative, at more than \$5 trillion. In terms of currency composition, U.S. external assets are predominantly denominated in foreign currency, whereas U.S. liabilities are almost entirely denominated in dollars.

After posting strong gains for several years, stock market valuations in 2008 plummeted worldwide, battered by the financial crisis. Because the United States is substantially "long" on equity instruments vis-à-vis the rest of the world, this has inflicted severe net capital losses on U.S. residents. These net losses were further boosted by the fact that the stock market decline was larger in non-U.S. stock markets than in the United States, also reflecting some dollar appre-

Chart 1
Net negative

The U.S. net equity position at the end of 2007 was positive (\$3 trillion), but the net debt position was negative (over \$5 trillion).

(billion dollars)

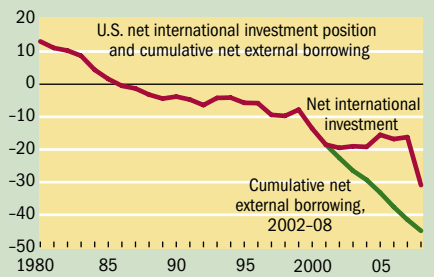


Source: Bureau of Economic Analysis.

Chart 2
Trend reversal

The U.S. net capital gains from 2002–07 were reversed in 2008.

(percent of GDP)



Source: Bureau of Economic Analysis; author's estimates.

ciation. All told, stock price declines have likely worsened the U.S. portfolio equity position by some \$1.3 trillion. In addition, the dollar value of U.S. FDI abroad has been negatively affected by the dollar appreciation, implying a further deterioration in the U.S. net equity position.

Although the global financial crisis originated in a segment of the U.S. debt securities market and gave rise to very large changes in bond prices, the net impact of these fluctuations on the U.S. debt position is likely to be modest. At the end of 2007, foreigners held significant amounts of U.S. Treasury bonds and bills (\$2.4 trillion), agency bonds (\$1.6 trillion), and corporate bonds (\$2.8 trillion). Both treasury and agency bonds rose in value with the decline in interest rates, while corporate bonds (which include privately issued mortgage-backed securities) declined in value. Net losses on corporate bonds likely exceeded the gains on treasury and agency bonds.

At the same time, however, U.S. residents incurred losses on their holdings of bonds issued overseas, for various reasons: declining emerging-market dollar bond prices; the impact of the dollar's appreciation on the value of U.S.-held local-currency bonds; the decline in corporate bond prices in Europe; and declining values of asset-backed securities (bonds issued by entities in the Cayman Islands but backed by U.S. mortgages, and bought by U.S. residents). The net valuation losses incurred by U.S. residents on these debt instruments may well exceed those incurred by foreign residents on U.S. bonds.

All told, the net loss on the U.S. external portfolio is likely to be in the range of \$1.5 trillion—and would be even higher if FDI were estimated at market value. This very large figure once again illustrates how, in a world with large cross-border holdings of financial instruments, fluctuations in the value of these instruments can swamp the effect of net borrowing or lending. It also illustrates the danger of extrapolating a systematic overperformance of asset returns as an alternative to current account adjustment: as Chart 2 illustrates, the United States had experienced very large net capital gains during 2002–07 that allowed it to maintain a broadly stable

NIIP, despite relying heavily on external borrowing. These capital gains originated from very high returns on foreign equity holdings by U.S. investors, which increased in value much more rapidly than the U.S. equity holdings held by foreign investors, as well as from significant dollar depreciation, which increased the dollar value of U.S. foreign-currency holdings. Both trends were reversed in 2008.

Developments in creditor countries

Which countries experienced the corresponding net gains on their net external position during 2008? And, more generally, what have been the implications of the dramatic changes in exchange rates and asset prices on global asset and liability holdings? The first point to note is that the decline in stock prices across the globe has reduced considerably the market value of financial wealth in virtually all countries, a shock compounded in a number of countries by declining values of residential and commercial real estate. Countries where foreign holdings of domestic stocks substantially exceed their residents' holdings of foreign stocks (a country group that includes most emerging markets, as well as the euro area) experienced net capital gains on their external position, even though their aggregate wealth declined. My rough preliminary estimates suggest that the improvement in the net external position arising from equity price changes could be on the order of \$1 trillion for the euro area, and on the order of \$200 billion for several large emerging markets, such as Brazil, China, India, Korea, and Russia.

More generally, how did the changes in asset prices and exchange rates affect the external position of the largest creditor countries: China, Japan, and the oil exporters? All these economies ran large current account surpluses in 2008, which, other things equal, further increased their NIIP. But of course changes in asset prices and exchange rates also had a significant impact. Specifically,

- In market-value terms, China likely experienced significant capital gains on its holdings of U.S. Treasury and agency bonds, whose value increased because of the decline in U.S. interest rates. These net gains should be added to those on the net portfolio equity position mentioned above (foreigners own more shares of Chinese companies—including American depository receipts—than Chinese residents own foreign shares). On the other hand, the appreciation of the renminbi vis-à-vis the U.S. dollar and other currencies has increased the dollar value of FDI in China. On balance, net capital gains were likely positive, so at market value the Chinese NIIP is likely to have increased by more than the current account surplus would suggest.

- Japan instead likely experienced net capital losses on its NIIP, which may well have declined despite the current account surplus. The main reason for this development is the behavior of the exchange rate: the yen appreciated dramatically in 2008 (more than 30 percent in nominal effective terms), and because Japan's external assets are predominantly denominated in foreign currency and its liabilities in domestic currency, the yen value of assets has declined relative to liabilities.

- Calculating the impact of asset price changes on the value of external assets in oil exporters is a daunting task, in light of the paucity of information on the size and composition of their assets. Some decline in the value of their external assets is likely, in light of the global decline in equity prices, but the extent of this decline cannot be pinpointed accurately (for an estimate of losses by sovereign wealth funds in Gulf Cooperation Council countries, see Setser and Ziemba, 2009).

Impact on global imbalances

How do these developments, and the ongoing economic and financial crisis more generally, relate to prospects for an unwinding of global imbalances? Although one cannot do justice to this issue in a few paragraphs, here are a few general points:

- The external adjustment process was—at least partially—under way before the crisis: excluding oil imports, affected by record-high energy prices, the U.S. current account deficit had been declining since the end of 2005, helped by a significant weakening of the dollar since its 2002 peak.

- With a much reduced equity cushion, the large negative debt position of the United States now looks more vulnerable, underscoring the importance of a further reduction in the current account deficit.

- IMF *World Economic Outlook* projections suggest that such a reduction will occur, helped by the dramatic decline in oil prices, which could reduce the U.S. current account deficit by \$150 billion or more in 2009, as well as by the very sharp decline in U.S. demand.

- More generally, international trade volumes are plummeting with the large declines in output and demand across the globe, and the evolution of trade and current account balances in the United States and elsewhere will depend on the relative severity and duration of the downturn in each country relative to its trading partners—something on which there is clearly great uncertainty.

As for the main creditor regions and countries:

- Among oil-exporting countries, the decline in the value of external assets is compounded by the very large reduction in oil revenues—indeed, their \$600 billion current account surplus in 2008 may disappear altogether in 2009.

- In Japan, lower commodity prices would tend to cushion the decline in the current account surplus driven by the significant yen appreciation and lower external demand.

- In China, whose external accounts will benefit from lower commodity prices, a sizable boost to domestic demand would be key to countering the risk of a severe slowdown domestically, and help the process of external rebalancing. ■

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Reference:

Setser, Brad, and Rachel Ziemba, 2009, "GCC Sovereign Wealth Funds: Reversals of Fortune," *Council on Foreign Relations Working Paper* (Washington); see www.cfr.org/content/publications/attachments/CGS_WorkingPaper_5.pdf.