

External Adjustment, Global Imbalances, Valuation Effects*

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Abstract

We provide an overview of the recent developments of the literature on the determinants of long-term capital flows, global imbalances, and valuation effects. We present the main stylized facts of the new international financial landscape in which external balance sheets of countries have grown in size and discuss implications for the international monetary and financial system.

Keywords

Exchange rates, Current account, International capital flows, International monetary system

JEL classification codes

F21, F3, F33, F36, F4, F41, G01, G15

1. INTRODUCTION

The question of external adjustment is a central issue in international macroeconomics. Early approaches such as Hume's (1752) price specie flow mechanism emphasized the self-regulating nature of international exchanges through settlements in hard currency. Following the disruptions of the interwar period, the early Keynesian analyses of Machlup (1943), Meade (1951), or Metzler (1960) focused instead on the role of monetary and fiscal policy in achieving a desired level of internal and external balance. These static models focused on nominal price and wage rigidity and did not feature any self-correcting force that would ensure long-term stability. When Mundell (1968) asked "To what extent

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should surplus countries expand; to what extent should deficit countries contract?” the debate was about the relative merits of expenditure-switching and expenditure-reducing policies, that is, policies that would alter the composition of demand between domestic and foreign goods, versus policies that would directly affect patterns of aggregate demand. Subsequent research, started by Hamada (1969) and Bruno (1970) and summarized in Obstfeld and Rogoff (1995) borrowed from the optimal growth theory of Ramsey (1928), Cass (1965), and Koopmans (1965). Since the current account measures the difference between national saving and domestic investment, both forward-looking decisions, proper modeling of the external adjustment requires an explicit theory of economic agents’ consumption/saving and investment decisions. The resulting synthesis, in the form of the “intertemporal approach to the current account” characterized the dynamics of the current account as the result of forward-looking decisions by households and investment decisions by firms, set in market structures of varying degrees of complexity. This was the focus of Obstfeld and Rogoff (1995) in the previous volume of the handbook, and constitutes a natural starting point for this chapter. Conceptually, the intertemporal approach ascribes movements in a country’s current account to the difference between the current situation of a country, and its long run circumstances. Formally, it states that countries should borrow whenever their current income is below their permanent income, or whenever the return to domestic capital is higher than the cost of borrowing. The precise amount of borrowing is then pinned down by the requirement that debts be repaid, and returns to capital be equated across locations.²

From a conceptual point of view, this approach constitutes a giant leap forward. From an empirical perspective, however, the theory has yielded mixed results and its key empirical predictions have often been rejected by the data, a point already noted by Obstfeld and Rogoff (1995).³ We emphasize here two particularly relevant empirical shortcomings, which we document in Section 2: first, the model performs particularly poorly in explaining the empirical pattern of *net* long-term capital movements, both between developing and mature economies and across developing countries. Second, the model does not take into account that the current account represents an increasingly imperfect measure of the change in a country's net foreign asset position since the latter also reflects changes in the market value of cross-border claims and liabilities. The relative importance of these “*valuation effects*” is particularly high for advanced economies, but increasingly

² This chapter does not deal with situations where countries may decide not to repay their debts. For a discussion of the specific issue of sovereign debt, see [Chapter 11](#) by Mark Aguiar and Manuel Amador in this handbook.

³ For instance, [Nason and Rogers \(2006\)](#) found that the present-value-model of the current account was soundly rejected for Canada over the post-war period. In general, the current account balances ascribed by the theory tend to be much smaller and less variable than their empirical counterpart. Put another way, output fluctuations appear much more persistent to the econometrician's eyes than actual current account movements suggest. There are some important exceptions. For instance, [Aguilar et al. \(2007\)](#) find that the current account fluctuations of small emerging economies are consistent with the theory precisely once one takes into account that productivity shocks appear much more persistent in emerging economies. [Obstfeld and Rogoff \(2000\)](#) show that introducing transportation costs in an otherwise standard model helps understanding [Feldstein and Horioka's \(1980\)](#) puzzle of small current account imbalances and allows to make progress on other important international macroeconomics puzzles.

so too for emerging ones. The growing empirical importance of these valuation effects requires that we look more closely at the determinants of international portfolios.

We explore these two dimensions in turn. Understanding the source of “global imbalances”—deficits in advanced countries, surpluses in rapidly growing emerging ones—constitutes the principal objective of [Sections 3 and 4](#). [Section 3](#) lays out a simple model of long-term capital flows. The starting point is the neoclassical growth model in continuous time under perfect foresight, a standard framework which allows us to derive many key results without having to spend too much time on the necessary machinery. The model’s predictions regarding capital flows rest on two key elements. First, capital will tend to flow from countries with low autarky returns to countries with high autarky returns. Second, the model identifies two key determinants of a country’s autarky returns: capital scarcity and long run growth prospects both taken as exogenous and country-specific. Putting both things together, the theory unambiguously points to advanced economies as countries with low autarky interest rates, and emerging ones as countries with high autarky interest rates. Hence capital should flow “downstream” from rich to poor countries.

Existing attempts to explain the observed pattern of global imbalances introduce additional determinants of autarky interest rates. The various models put forward in the literature, surveyed in [Section 4](#), all share the feature that advanced economies—chiefly the U.S.—can exhibit *higher* autarky real returns than the rest of the world, especially emerging economies. Equivalently, these countries have high *desired* saving (or low *desired* investment) relative to the U.S. Hence, these theories predict that capital should flow from South to North, as observed in the data. Most of these theories rely on asymmetries between financial and economic development in advanced and emerging countries. [Caballero et al. \(2008a\)](#), for instance, assume that developing countries face a shortage of stores of value. This shortage depresses the autarky rates of returns of these countries, and rapid growth in this part of the world can exacerbate global imbalances. Other theories, such as [Mendoza et al. \(2009\)](#) or [Angeletos and Panousi \(2011\)](#), emphasize cross-country differences in the ability to insure away idiosyncratic risk. In a Bewley-type model, these differences translate into different strength of the precautionary saving motive. Less financially developed countries, faced with higher residual levels of idiosyncratic risk will save more, depressing autarky rates of return. Yet other theories, such as [Antràs and Caballero \(2009\)](#), emphasize the interactions between financial frictions and international trade.

Most of these models do not feature aggregate uncertainty and do not have an international diversification motive. They make predictions about *net* capital flows, that is, about the intertemporal transfer of resources across countries. [Section 5](#) follows a different track. It starts by observing that the current account does not, in general, coincide with the change in a country’s net foreign asset position. The latter also reflects changes in the *market value* of claims and liabilities underlying a country’s net position, including exchange rate movements. As documented in [Section 2](#) and by [Lane and Milesi-Ferretti \(2001\)](#) these *valuation changes*, ignored in much of the earlier literature, have

grown tremendously in importance since the 1980s, to the point where over a given period, their fluctuations can easily dominate the current account balance. Obtaining precise estimates of these valuation changes is not an easy task, and we discuss the empirical methodological advances that have allowed researchers to make progress on that front. Valuation changes would not matter much for the underlying process of external adjustment if they were purely unexpected and random. We present a simple framework to analyze the structure of total external returns and their predictability. We discuss how such returns can be constructed from the underlying balance sheet position, with a particular attention to the relevant empirical caveats that are involved in any exercise of this nature. [Section 5](#) also focuses more specifically on the U.S. external balance sheet and presents updated estimates of the excess return the U.S. enjoys on its external balance sheet. We discuss the origin of what has sometimes been called an “exorbitant privilege.” We show how the predictable component of this excess return contributes to relaxing the external constraint of the United States. A legitimate question to ask then is to what extent existing theories and in particular to what extent the new stream of literature featuring dynamic stochastic general equilibrium models can accommodate the valuation channel of adjustment in their dynamics of the net foreign asset positions.

Finally, our discussion on the structure of external balance sheets of countries has a bearing on the functioning of the International Monetary and Financial System which we take up in [Section 6](#). Traditionally the country at the center of the system—the U.K. in the 19th century and before the First World War or the U.S. after the Second World War—has been described as a global liquidity provider. The center country issues the currency used in most international exchanges whether on goods markets or on financial markets. By emphasizing the heterogeneity in risk profiles of the different countries, the role of the center country can be reinterpreted as one not only of a liquidity provider but also one of a global insurer. After all, the U.S. dollar is not merely a very liquid international mean of exchange but it is also the currency denomination of U.S. Treasuries, which are held as reserve assets all over the globe. We discuss how the endogenous structures of portfolios of countries affects net returns on the external asset position and leads to potentially very large wealth transfers in crisis times.

We conclude with a review of intriguing research questions left open by the literature.

2. STYLIZED FACTS

We begin by highlighting some important stylized facts characterizing recent developments in international capital markets.

2.1. Global Imbalances, World Interest Rates, and Allocation Puzzle

Over the last twenty years capital has flown from South to North, and especially toward the United States, arguably among the most advanced economies in the world. The large current account deficits of the United States have started to expand after the

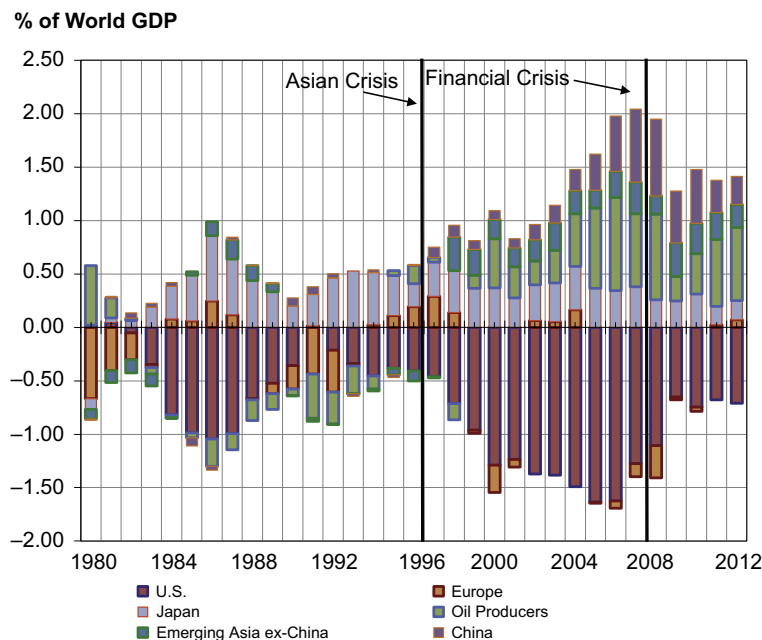


Figure 10.1 Global Imbalances: Current Accounts. *Notes:* Oil Producers: Bahrain, Canada, Kuwait, Iran, Libya, Nigeria, Norway, Mexico, Oman, Russia, Venezuela, Saudi Arabia. Emerging Asia ex-China: Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand. Europe: European Union. *Data Source:* IMF World Economic Outlook Database, Various Issues

Asian Crisis to reach 5.3% of U.S. GDP in 2004, 5.8% in 2005, and about 6% in 2006. Figure 10.1 illustrates this pattern by reporting the current account balances of various groups of countries, as a fraction of world output between 1980 and 2012. Table 10.1 reports average ratios of current accounts to world output for three periods: between 1980 and 1996 (before the Asian financial crisis); from 1997 to 2006 (between the Asian and global financial crises); and since 2007.⁴ U.S. current account deficits have been financed by a broad array of creditors, mostly Japan in the 1980s and early 1990s, oil producing economies and emerging Asia since 1996, and especially China over the recent period.⁵ These massive net capital flows into the world's dominant capital market have been referred to as “global imbalances.”

Figure 10.2 reports the world real interest rate over the same period.⁶ We observe a dramatic decline in the world real interest rate, from 5% to 6% at the beginning of the 1980s, to -2% by the end of 2011. As Bernanke (2005) observed in his early and

⁴ Current account balances in Table 10.1 do not sum to zero because of the discrepancy between global saving and investment. The missing surplus (or deficit in recent years) averages about 0.5% of world output.

⁵ See Blanchard and Milesi-Ferretti (2009) for a detailed account of the evolution of global external deficits.

⁶ The world real interest rate is defined as the GDP-weighted average of 3-months nominal interest rates minus realized inflation, for the countries of the G-7. The figure also reports two measures of ex-ante long-term U.S. rates.

Table 10.1 Current Account Balances, Fraction of World GDP

Region	Period		
	1980–1996	1997–2006	2007–2012
United States	−0.44	−1.17	−0.86
Japan	0.32	0.36	0.26
European Union	−0.10	0.04	−0.07
Oil producers	−0.06	0.28	0.57
China	0.01	0.15	0.49
Emerging Asia ex-China	−0.01	0.19	0.26
Latin American and Caribbean	−0.13	−0.10	−0.07
Rest of the World	−0.08	−0.02	−0.14

Source: IMF World Economic Outlook, April 2012. Oil producers consist of Canada, Norway, Mexico, Russia, Venezuela, Saudi Arabia, Iran, Kuwait, Libya, Oman, and Bahrain. Emerging Asia ex-China consists of Taiwan, Korea, Malaysia, Indonesia, Philippines, Singapore, and Thailand.

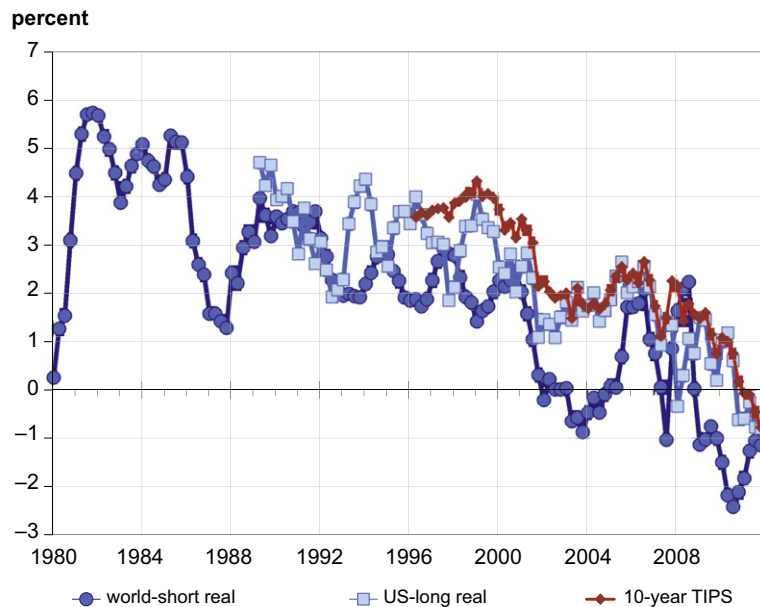


Figure 10.2 Global Imbalances: World Interest Rates. *Notes:* world-short real: ex-post 3-month real interest rate for the G-7 countries (GDP weighted). U.S.-long real: 10-year yield on U.S. Treasuries minus 10-year expected inflation. 10-year TIPS: yield on inflation indexed 10-year Treasuries. *Source:* Global Financial Database, IMF International Statistics, OECD Economic Outlook, Survey of Professional Forecasters

influential piece on the “savings glut,” any account for the pattern of global imbalances needs also to be consistent with the evidence on real interest rates.

Stylized Fact 1 (Global Imbalances). *The largest and arguably most advanced world economy, the United States, has been a net capital importer since 1982 and has been increasingly financed*

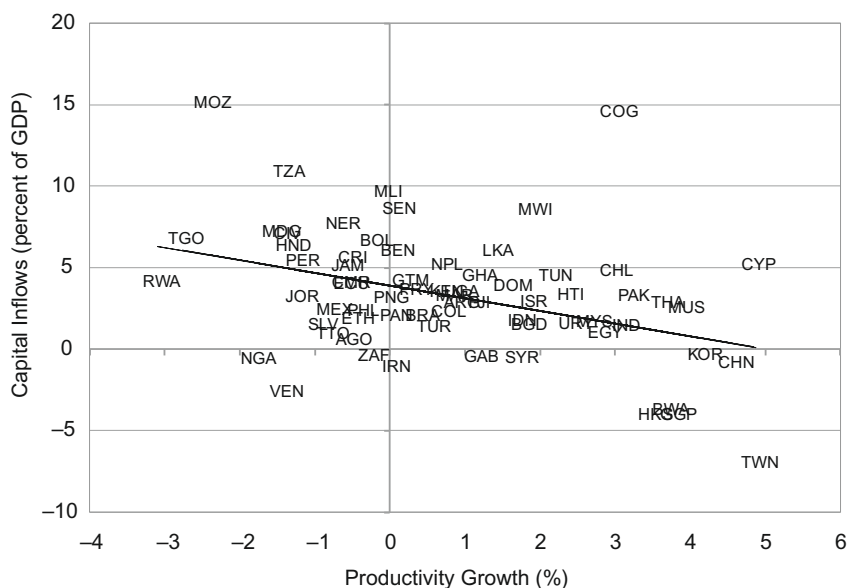


Figure 10.3 Average Productivity Growth and Capital Inflows Between 1980 and 2000. *Note:* Sample of 68 developing economies. *Source:* [Gourinchas and Jeanne \(2013\)](#)

by fast-growing emerging economies. The absolute value of world current account balances scaled by world GDP, the “global imbalances,” have been increasing starting in 1996—with a short dip at the time of the 2001–2002 recession and a more sustained one since 2008. The emergence of these global imbalances coincides with a general decline in world real interest rates.

Moreover, the pattern of *total* net capital inflows to developing countries stands also in contradiction with the basic theory. [Figure 10.3](#), reproduced from [Gourinchas and Jeanne \(2013\)](#), plots average productivity growth between 1980 and 2000 (horizontal axis) against the average net capital inflows relative to GDP. According to the theory, the relationship should be strongly positive. Instead, the figure exhibits a strong negative correlation, which the authors label the “allocation puzzle.” [Gourinchas and Jeanne \(2013\)](#), [Aguiar and Manuel \(2011\)](#), and [Alfaro et al. \(2011\)](#) find that this negative correlation between growth and capital flows is mostly driven by public flows, while private capital inflows appear positively correlated with productivity fundamentals.

Stylized Fact 2 (Allocation Puzzle). *Aggregate net capital inflows tend to be negatively correlated with productivity growth across developing countries. This pattern is largely driven by public sector capital flows.*

2.2. The Growth of Cross-Border Gross Positions

Another key stylized fact in international economics since the 1990s has been the massive increase in *gross* capital flows. As capital controls were taken down, as financial regulation and transaction costs decreased, the gross external asset positions of countries underwent

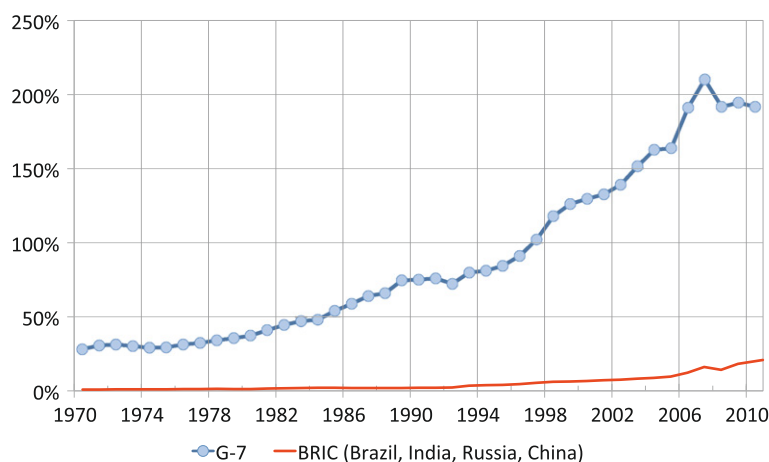


Figure 10.4 G-7 and BRIC Cross-Border Assets and Liabilities (Percent of World GDP). Cross-Border Assets and Liabilities Defined as the Sum of Gross External Assets and Liabilities. Source: Lane and Milesi-Ferretti (2007a) updated to 2010

5%, Indonesia 5%, Russia 18%, China 9%, Brazil 21%), as these economies tend to invest in safer securities such as government bonds.¹⁰ Interestingly, and in particular since the 1990s, the BRICs (Brazil, Russia, India, China) have taken increasingly net short positions in risky assets while the G-7 economies, which often double up as important financial centers (the U.S., the U.K., large euro area countries) are increasingly long in risky assets.¹¹ Figure 10.5 reports the net risky position of these two groups of countries as a fraction of the groups' annual GDP. Starting in the 1990s, the expansion of the external balance sheet of countries has been accompanied by a marked heterogeneity in their structure across countries, with advanced economies increasingly involved in international maturity and liquidity transformation.

Stylized Fact 4 (Heterogeneity in Gross Flows and Positions). *The asset composition of the external balance sheet of countries is heterogeneous with advanced economies tending to be long in risky assets and emerging markets short in risky assets.*

¹⁰ The share of risky assets is calculated as the sum of FDI assets and equity assets as a ratio of total assets. The average is taken between 1970 and 2010 except for Russia (1993–2010) and China (1981–2010).

¹¹ The net risky position is defined as the difference between portfolio equity and direct investment assets and liabilities. Other components of the external balance sheet also include risky assets: portfolio debt includes long-term corporate and sovereign bonds. Cross-border banking positions also involves long-term syndicated loans. However, these asset categories also include shorter-term or safer fixed-income assets, such as official reserves, government securities or short-term loans. It is possible that some of the asymmetries we now observe across asset categories were present in the past within asset categories. For instance, Despres et al. (1966) argue that the United States was providing liquidity to the rest of the world by lending long term and borrowing short term, transactions that would both be recorded in the “other” categories of the international investment position. The observed asymmetry coupled with the increase in the size of the external balance sheet leaves little doubt that these activities have, if anything, increased over time.

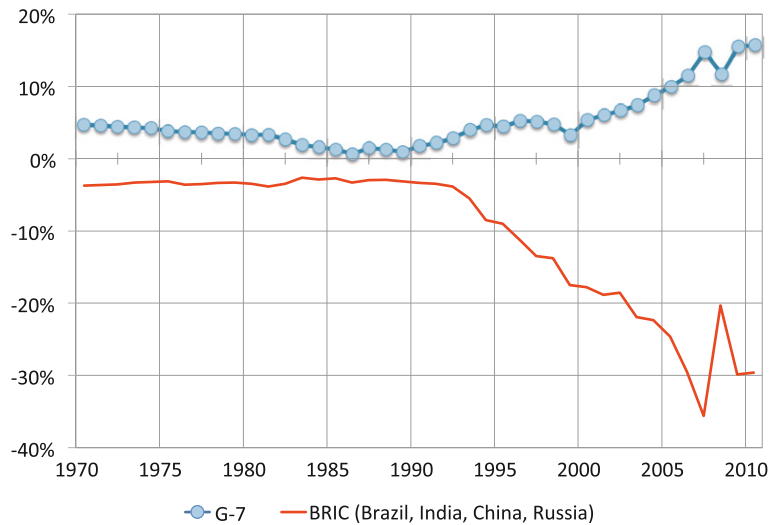


Figure 10.5 Net Risky Position Defined as Equity and Direct Investment Assets, Minus Equity and Direct Investment Liabilities. *Source:* Lane and Milesi-Ferretti (2007a) updated to 2010

2.3. The Importance of Valuations for the External Balance Sheet

Large and heterogeneous leveraged portfolios open the door to potentially important wealth transfers across countries when asset prices and exchange rate fluctuate. In turn, these capital gains and losses are bound to affect the external asset positions of countries. To illustrate, [Figures 10.6 and 10.7](#) compare [Lane and Milesi-Ferretti's \(2007a\)](#) measure of a country's net external position with a measure obtained simply by cumulating current account balances for a group of advanced economies ([Figure 10.6](#)) and a group of emerging ones ([Figure 10.7](#)). Since the current account does not—by definition—incorporate fluctuations in the value of existing assets and liabilities, the two measures differ from one another in theory by the cumulated value of capital gains and losses on the country's external position.¹² As [Figure 10.6\(a\)](#) shows for the United States, simply cumulating the balance on the U.S. current account since 1970 would lead to a severe underestimate of the U.S. external position, by about 36% of U.S. GDP in 2010. *A contrario*, this suggests that the U.S. has enjoyed important net capital gains on its net external asset positions over this period. These *valuation effects* are economically quite sizable: they represent the equivalent of an additional surplus of the U.S. current account of about 2% of output, for every year between 1970 and 2010. [Figures 10.6\(b\) and \(d\)](#) show smaller cumulated

¹² In practice, data discrepancies between the Balance of Payments and the International Position surveys can also account for the gap between the two series. We revisit this issue at length in [Section 5](#).

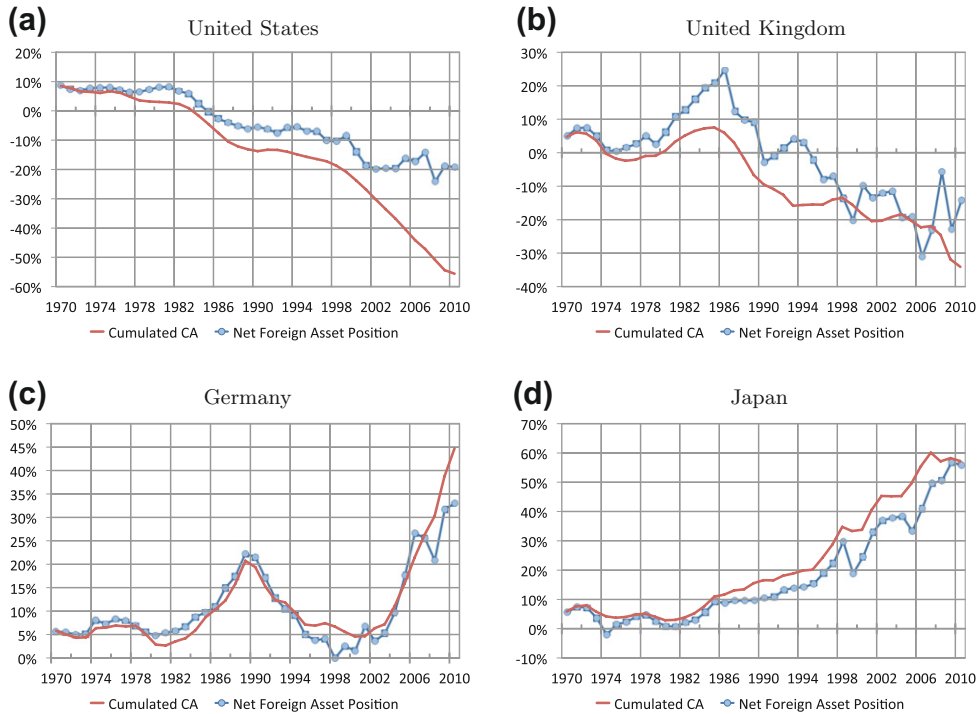


Figure 10.6 Cumulated Current Account and Net Foreign Asset Position: U.S., U.K., Germany, and Japan, 1970–2010. Percent of GDP. Source: Lane and Milesi-Ferretti (2007a) updated to 2010.

valuation gains for the other advanced economies we consider.¹³ Figure 10.7 shows that the BRIC economies tended to experience significant cumulated valuation losses since 2000, between 10% of output for China and 40% for Russia. Figures 10.6 and 10.7 illustrate the asymmetry between the U.S. (large positive valuation gains) and emerging economies (large valuation losses). By contrast, Figures 10.6(b) and (d) show that cumulated current accounts provide a roughly accurate guide to the low frequency movements in the net external position of other advanced economies, although the valuation component can be large in any given year. Table 10.2 documents the average magnitude of absolute valuation effects (as a percentage of GDP), as well as the average of the absolute value of current accounts of a number of countries over four periods.¹⁴ For most countries, including emerging economies, the importance of valuation effects has been increasing

¹³ The U.K. external position is underestimated by about 20% of GDP in 2010 while the German and Japanese positions are overestimated by 11% and 1.5% of GDP, respectively.

¹⁴ Specifically, we calculate $\bar{VA} = 1/T \sum_t \left| \frac{NA_t - NA_{t-1} - CA_t}{GDP_t} \right|$ and $\bar{CA} = 1/T \sum_t \left| \frac{CA_t}{GDP_t} \right|$ over the four periods 1971–1980, 1981–1990, 1991–2000, and 2001–2010 where NA_t denotes the net foreign asset position and CA_t the current account.

Table 10.2 Valuations and Current Accounts (Average p.a., % GDP)

Period	U.S. (%)	U.K. (%)	Ireland (%)	Germany (%)	Japan (%)	Brazil (%)	Russia (%)	China (%)	India (%)	Switzerland (%)
Valuations										
1971–1980	0.84	1.29	3.12	0.67	1.3	0.97	N/A	0.00	0.44	10.74
1981–1990	0.93	3.59	3.73	0.75	0.83	2.02	N/A	1.47	0.98	9.76
1991–2000	1.79	4.71	18.67	1.42	2.03	2.11	4.26	2.95	1.16	9.39
2001–2010	4.75	7.57	13.29	3.91	2.67	8.38	13.71	2.22	6.08	11.84
Current accounts										
1971–1980	0.40	1.16	5.75	1.00	1.15	5.74	N/A	0.00	0.82	2.16
1981–1990	1.95	2.16	4.23	2.71	2.32	2.32	N/A	1.52	1.68	3.72
1991–2000	2.12	2.21	0.48	1.48	2.26	2.05	9.02	1.94	1.13	8.55
2001–2010	4.56	2.24	2.37	4.50	3.39	1.67	7.94	5.43	1.41	10.96

The table reports the average valuation and current account components, as a share of GDP, for each sub period, where the average valuation and current account components are defined as $VA = 1/T \sum_t \left| \frac{NA_t - NA_{t-1} - CA_t}{GDP_t} \right|$ and $CA = 1/T \sum_t \left| \frac{CA_t}{GDP_t} \right|$.

where “tilde” denotes variables expressed in efficient units per capita: $\tilde{x} = X/(\xi N)$. Equation (5) states that consumption per capita grows if the *autarky real interest rate* $r_t^a = \alpha \tilde{k}_t^{\alpha-1} - \delta_k$ exceeds the rate of time preference ρ . In that case, along the optimal plan, the representative household prefers to reduce consumption in order to benefit from the high return delivered by the additional unit of saving. The strength of that effect on consumption growth is controlled by the willingness of the household to shift consumption across periods, that is, by the elasticity of intertemporal substitution $1/\gamma$.¹⁷

Different countries with the same technology parameters α and δ_k will face different autarky interest rates only to the extent that they have different *levels* of capital per efficient unit. That is, if we consider two countries i and j : $r_t^{a,i} > r_t^{a,j}$ if and only if $\tilde{k}_t^i < \tilde{k}_t^j$: autarky rates are high if countries are *capital-scarce*.

3.2.1. Relation to the Lucas Puzzle

This argument forms the basis for the well-known Lucas (1990) puzzle. Lucas observed that if countries had access to the same technology α and ξ , then the ratio of their marginal product of capital $MP_k = \alpha \tilde{k}^{\alpha-1}$ can be expressed simply as a function of relative output per worker: $MP_k^i/MP_k^j = (y^i/y^j)^{1-1/\alpha}$.

Applying this calculation to India and the U.S., where Lucas estimated a 15-fold difference in output-per-worker and assuming $\alpha = 0.4$, the ratio of marginal products equals a whopping $(1/15)^{1-1/0.4} = 58!$ Of course, the assumption that technology ξ is the same in India and the U.S. is a strong one, and a “trivial” way to solve the Lucas puzzle is to allow for differences in productivity levels.¹⁸ There is no puzzle if differences in productivity entirely offset differences in output per worker: $\xi^i/\xi^j = y^i/y^j$. Indeed, the literature on development accounting has found significant differences in productivity or social infrastructure across countries. For instance, Gourinchas and Jeanne (2006) using data for 1995, estimate an average sixfold difference in labor-augmenting productivity for 65 non-OECD economies relative to the U.S.¹⁹ Clearly, cross-country differences in productivity levels are important.

Other factors can also account for the Lucas puzzle. Most prominently, Caselli and Feyrer (2007) find that, despite large differences in capital-output, marginal products of capital $MP_k = \alpha Y/K$ are remarkably close across countries, after properly adjusting the effective share of capital α for differences in the share of reproducible capital and the

¹⁷ The rate of growth of population n does not affect consumption growth under our choice of preferences. With faster population growth, a unit of output saved today yields fewer units of consumption per capita tomorrow. But because flow utility is scaled by population, future consumption per capita is also valued more and the two effects cancel exactly.

¹⁸ One of Lucas’s proposed explanations for the puzzle was to take into account how external effects of human capital accumulation translate into differences in productivity.

¹⁹ Gourinchas and Jeanne (2006, Table 9 p.736) report a development accounting gap of 0.11 and a contribution of 0.58 and 0.2, respectively for exogenous labor-augmenting productivity and human capital (in log-share). We obtain the number reported in the text as $\exp(-(0.58 + 0.2) \ln(0.11))$. Hall and Jones (1999) and Caselli (2005) document similar results. Alfaro et al. (2008) also confirm that controlling for institutional quality differences removes the puzzle for direct and portfolio equity investments.

This pins down the stock of capital per efficient units at $\tilde{k}(r) = (\alpha / (r + \delta_k))^{1/(1-\alpha)}$, a decreasing function of the world interest rate. Denote the financial wealth of the country by $W = K + B$ where B represents net foreign claims. Along the optimal plan, consumption and wealth evolve according to:

$$\frac{d \ln c_t}{dt} = \frac{1}{\gamma} (r - \rho); \quad \frac{d\tilde{w}_t}{dt} = (r - n - g) \tilde{w}_t + (1 - \alpha) \tilde{y}(r) - \tilde{c}_t, \quad (8)$$

where $\tilde{y}(r) = \tilde{k}(r)^\alpha$ represents the constant level of output and $(1 - \alpha)\tilde{y}(r)$ represents the part of output that is not paid out as capital income. According to (8), the growth rate of consumption per capita is constant and equal to:

$$g_c = \frac{1}{\gamma} (r - \rho - \gamma g) + g = \frac{1}{\gamma} (r - r_{ss}^a) + g. \quad (9)$$

Consumption per capita grows faster (respectively slower) than the rate of domestic productivity growth if the world interest rate is higher (resp. lower) than the autarky interest rate.

To fix ideas further, we can think of the rest of the world as a closed economy that has reached its steady state. In that case, the world interest rate r satisfies $r = \rho + \gamma \bar{g}$, where \bar{g} is the growth rate of world productivity. Substituting into equation (9), we obtain $g_c = \bar{g}$: the rate of growth of consumption per capita equals the world's growth rate of productivity, regardless of domestic output growth per capita g .

Under the assumption that $r > n + \max(g, \bar{g})$ and after a few tedious but elementary steps of algebra, we can substitute back into the dynamic budget constraint (8) and integrate to obtain:

$$\tilde{c}_t = (r - n - \bar{g}) \left[\tilde{w}_t + \frac{(1 - \alpha) \tilde{y}(r)}{r - n - g} \right]. \quad (10)$$

The consumption rule is linear in total wealth with a propensity to consume equal to the interest rate minus the growth rate of aggregate consumption $n + \bar{g}$. Total wealth consists of financial wealth \tilde{w}_t and the present value of labor income $(1 - \alpha)\tilde{y}(r)/(r - n - g)$. After a few extra steps, one can also solve for the path of external wealth and the current account (noting that $CA_t = \dot{B}_t$)²¹:

$$\tilde{b}_t = \left(\tilde{w}_0 + \frac{(1 - \alpha) \tilde{y}(r)}{r - n - g} \right) e^{(r - r_{ss}^a)t/\gamma} - \frac{(1 - \alpha) \tilde{y}(r)}{r - n - g} - \tilde{k}(r). \quad (11a)$$

²¹ In this expression, $\tilde{w}_0 = \tilde{k}_{0-} + \tilde{b}_{0-} = \tilde{b}_0 + \tilde{k}(r)$, where \tilde{k}_{0-} and \tilde{b}_{0-} denote the stock of capital and the net external position immediately before the financial account opening at time $t = 0$. At the time of the opening, initial external debt positions are rolled over and the country finances any capital shortfall through external borrowing: $\tilde{b}_0 = \tilde{b}_{0-} + \tilde{k}_{0-} - \tilde{k}(r)$.

$$\begin{aligned} c\tilde{a}_t = & (n + \bar{g}) \left(\tilde{w}_0 + \frac{(1 - \alpha) \tilde{\gamma}(r)}{r - n - g} \right) e^{(r - r_{ss}^a)t/\gamma} \\ & - (n + g) \left(\frac{(1 - \alpha) \tilde{\gamma}(r)}{r - n - g} + \tilde{k}(r) \right). \end{aligned} \quad (11b)$$

Inspection of these expressions reveals that the long-term external position depends on the gap between the world and autarky interest rates $r - r_{ss}^a$, proportional to the gap between world and country productivity growth, $\bar{g} - g$. We can distinguish three cases:

- Case 1: $r_{ss}^a < r$. From the preceding discussion, this occurs when $g < \bar{g}$. The first term in the expression for $\tilde{c}\tilde{a}_t$ and \tilde{b}_t asymptotically dominates the dynamics. Eventually the country runs a *current account surplus* and holds a positive net foreign position. Because optimal consumption grows at a higher rate than output, the country needs to accumulate growing claims against the rest of the world.²²
- Case 2: $r_{ss}^a = r$. In that case $g = \bar{g}$ and the current account and net foreign asset positions are driven by initial capital scarcity and external claims: $\tilde{c}\tilde{a}_t = (g+n)(\tilde{w}_0 - \tilde{k}_{ss})$ and $\tilde{b}_t = \tilde{w}_0 - \tilde{k}_{ss}$. The country runs a permanent current account deficit if it is initially capital scarce or has initial external liabilities. If initial capital scarcities and external claims are small, so that $\tilde{w}_0 \approx \tilde{k}_{ss}$, then $\tilde{c}\tilde{a} = \tilde{b} = 0$.
- Case 3: $r < r_{ss}^a$. From the preceding discussion, this corresponds to $\bar{g} < g$. The first term in (11a) and (11b) disappear asymptotically and the economy becomes a *net borrower* and runs a *current account deficit*. Since the country's output grows faster than the rest of the world, foreigners want to invest domestically.²³

The preceding analysis reveals that countries export (resp. import) capital when the autarky interest rate is below (resp. above) the world interest rate. The determinants of *intertemporal* trade are thus similar to those of *intra-temporal* trade and dictated by the principles of comparative advantage: just as countries export goods that are relatively abundant (i.e. with low autarky prices), countries export capital when capital is relatively abundant, i.e. when autarky real interest rates are relatively low.²⁴

3.3.2. Large Open Economy

Consider now the case of two economies (home and foreign), not necessarily small, with open financial accounts. One can characterize the pattern of capital flows and net foreign positions by following the same steps as above, now with the condition that $B_t + B_t^* = 0$ at any instant where $*$ denotes foreign variables. Assuming that the technology parameters

²² Expressed in *world* efficient units, B stabilizes at $B/\bar{\xi}N = \tilde{w}_0 + (1 - \alpha)\tilde{y}(r)/(r - n - g) \geq 0$.

²³ In that case, the country will not permanently remain small relative to the rest of the world. Eventually, the world interest rate will have to converge to the domestic autarky rate r_{ss}^a . The country will still run a current account deficit $\tilde{c}_{ss} = (n + g)\tilde{b}_{ss}$ since it will have accumulated large net foreign liabilities $\tilde{b}_{ss} < 0$ along the way to the steady state.

²⁴ Obstfeld and Rogoff (1996, Chapter 2) present a similar analysis in a two-period model.

δ_k and α are the same in both countries, free capital mobility ensures that $\tilde{k}_t = \tilde{k}_t^*$, so that the world interest rate satisfies $r_t = \alpha \tilde{k}_t^{\alpha-1} - \delta_k$. Faced with a common real return to capital, optimal consumption plans in both countries satisfy:

$$\gamma \frac{d \ln c_t}{dt} + \rho = \gamma^* \frac{d \ln c_t^*}{dt} + \rho^* = r_t, \quad (12)$$

so that with common preferences (γ and ρ) the rate of growth of consumption per capita g_c is the same in both countries and $r = \rho + \gamma g_c$.

Without lack of generality, assume that home has a higher growth rate of productivity than foreign: $g > g^*$. Equation (6) then implies that home has a higher autarky interest rate: $r_{ss}^a > r_{ss}^{a*}$. Assume further that there are no initial capital scarcities, so that we focus on differences in productivity growth. It is easy (but tedious) to show that the world interest rate r is located somewhere between home and foreign interest rates: $r_{ss}^{a*} \leq r \leq r_{ss}^a$. Since $r = \rho + \gamma g_c$, one can equivalently show that the growth rate of consumption per capita is located between the domestic and foreign productivity growth rates $g^* \leq g_c \leq g$. Countries with an autarky interest rate above the equilibrium world interest rate will experience capital inflows; those with autarky interest rates below the world interest rate will experience capital outflows.²⁵

3.4. Current Account Movements and Productivity Differentials

For the preceding theory to account for the empirical evidence on capital flows from emerging economies to advanced ones, two conditions need to be met. First, initial capital scarcities must not be too large for the developing world: $\tilde{k}_0 \approx \tilde{k}_{ss}$. This will be the case if productivity levels are lower or if capital market distortions (τ) are higher in poorer countries. Second, productivity growth must be higher in advanced economies than in developing ones.

This interpretation of the theory would be relatively bad news for developing countries: the direction of capital flows would simply reflect a broader pattern of economic *divergence* that would see advanced economies pulling further and further away from developing ones.²⁶ Fortunately, it does not survive careful empirical scrutiny. Instead, the empirical evidence indicates that it is precisely the (developing) countries with the strongest productivity growth that also experienced the strongest capital *outflows* (stylized Fact 2).

Large net capital inflows in the eurozone's periphery (Blanchard and Giavazzi, 2002) or in Eastern European economies (Alfaro et al., 2011) in the early 2000s were held as strong examples of the validity of the neoclassical theory. However, given the ongoing eurozone crisis, the deep structural adjustment in many Eastern European economies, and

²⁵ A source of global imbalances in that model arises from differences in impatience ρ . More patient countries will have lower autarky rates, and run current account surpluses. See Ghironi et al. (2008) for a model along these lines.

²⁶ Although, under financial integration and common preferences, the rate of growth of consumption per capita would remain equal in advanced and developing economies. See equation (12).

the fact that many of these capital inflows appear to have fueled ultimately unsustainable residential housing and financial booms, the argument that net capital flows in both regions were triggered by strong productivity growth as predicted by the neoclassical growth model is not so clear cut anymore.

If differences in productivity growth are not the main driver of capital flows over long periods of time, what is? The next section of this chapter reviews recent theoretical advances that help us understand the pattern of “global imbalances” (stylized Facts 1 and 2).

4. MODELS OF GLOBAL IMBALANCES

The previous section established two results. First, capital flows to countries with high autarky returns to capital, until returns are equalized. Second, productivity growth is one of the main determinants of autarky returns in the neoclassical growth model. Existing attempts to explain the pattern of observed external imbalances maintain the first element but relax the second. They all share the feature that some other ingredient depresses autarky interest rates in emerging economies relative to advanced ones. Equivalently, these countries feature a high *desired* saving (or low *desired* investment) relative to the U.S. As first analyzed by [Bernanke \(2005\)](#), this can account simultaneously for the external deficits of the U.S. and the observed low world real interest rates ([stylized Fact 1](#)). Bernanke identified a number of potential culprits for the increase in global desired savings: the increased savings and reserve accumulation in emerging economies following the East Asian financial crisis of 1997–1998; the rapidly aging population in many advanced economies (and some emerging ones), requiring additional saving to provide for an increasingly large retired population; and the sharp increases in oil prices and the corresponding swing toward current account surpluses of oil exporting economies (see [Figure 10.1](#)). Contemporaneously, [Dooley et al. \(2004a,b\)](#) emphasized the role of export-led growth development strategies in developing Asia, with an undervalued currency and the accumulation of official claims on the center country.

We begin with a review of theories relying on asymmetries in financial development between countries at different stages of development. The form that these financial frictions takes does matter. For instance, consider the capital wedge τ introduced in [Section 3.2.1](#). In the steady state of the neoclassical model, this capital wedge does not affect the private rate of return to capital, still equal to $\rho + \gamma g$: the effect of the financial friction τ falls entirely on the marginal product of capital, $MP_k = (\rho + \gamma g)/(1 - \tau) + \delta_k$. Instead, we emphasize below financial frictions that also influence the autarky interest rate. In the model we consider, these financial frictions simultaneously drive up the equilibrium marginal product of capital and drive down the autarky risk-free rate. The first such model argues that developing countries suffer from a shortage of “stores of value.” This shortage tends to drive up the price of financial assets, that is, to drive down the equilibrium

interest rate. We use that framework to also explore the role of demographic factors, in particular population aging, and the interaction between demographic forces and financial frictions. The second model borrows from [Bewley \(1987\)](#) and [Aiyagari \(1994\)](#) and emphasizes the general equilibrium effects of precautionary saving. In that model, agents try to self insure against idiosyncratic risk. In equilibrium this depresses autarky interest rates below the riskless rates of the neoclassical model. The stronger the precautionary saving motive, the lower the autarky interest rate. Differences in idiosyncratic risk then translate into differences in autarky interest rates. The third class of models focuses on the interaction between financial frictions and international trade. Lastly, we discuss the role of public vs. private capital flows and reserve accumulation.

4.1. Asset Shortages

We begin with a model of asset shortage. The model captures the notion that financial markets in many emerging economies are not sufficiently developed and that these countries suffer from a shortage in stores of value. It generalizes [Caballero et al. \(2008a\)](#) to a production economy with overlapping generations. In the model, the demand for stores of value arises from the asynchronicity between income and consumption decisions.²⁷ That idea is implemented in a perpetual youth model à la [Blanchard \(1985\)](#) and [Weil \(1987\)](#). The model exhibits an essential *non-Ricardian* feature: households currently alive are unable to trade in claims on the resources of yet unborn generations. The lower the share of total income that accrues to the financial assets, the more acute is the resulting *shortage of stores of value*. Under financial autarky, this depresses equilibrium real interest rates. The model provides a link between levels of financial development, measured by the capacity of a country's financial system to capitalize streams of future income into real assets, and global imbalances.

4.1.1. The Individual Problem and Aggregate Dynamics

At every instant, households face an i.i.d instantaneous probability of dying θ . Since θ is common to all households, it represents the fraction of the population that dies every instant. A fraction θ of the population is also born every instant, so that total population remains constant, normalized to 1.²⁸ Since mortality risk is idiosyncratic, it is perfectly insurable: a competitive market for life-insurance will offer a rate of return θ per unit of wealth, in exchange for a claim on the household's estate when it dies.²⁹ Denote by

²⁷ The focus on consumption-saving decisions is done mostly for modeling simplicity. One could equivalently focus on the asynchronicity between sales and investment decisions in a production economy, or on a precautionary motive due to liquidity shocks.

²⁸ It is straightforward to introduce population growth. One could simply assume that the fraction of the population that is born every instant is $n + \theta$. Alternatively, one could follow [Weil \(1987\)](#) and assume that each cohort is an infinitely lived dynasty, but new cohorts are born every period.

²⁹ The life-insurance company breaks even under this scheme. If assets under management are W_t , it pays out θW_t per unit of time, and receives θW_t from households that just died.

In this expression H_t represents the present discounted value of non-financial income of all *currently alive* cohorts, but does not include the present discounted value of non-financial income accruing to yet unborn cohorts. This *non-Ricardian* feature is essential for the results.³¹

To fix ideas, assume, as in Blanchard (1985) that cross-section income profiles decrease with age:

$$z(s, t) = \frac{\phi + \theta}{\theta} Z_t e^{-\phi(t-s)}, \quad \phi \geq 0. \quad (19)$$

Equation (19) states that, at any given time t , older workers (lower s) receive lower income with a slope controlled by ϕ . In the limit of $\phi \rightarrow \infty$, all non-financial income is received by the newborn generation: $z(t, t) = Z_t$, $z(s, t) = 0$ for $s < t$, and $H_t = 0$. This case maximizes the asynchronicity between income and consumption decisions since all income is received at birth, but consumption decisions need to be sequenced over a (random) lifetime. Conversely, when $\phi = 0$, all households receive the same income, regardless of age, which mitigates the need for saving. Under assumption (19), H_t satisfies:

$$\dot{H}_t = (r_t + \theta + \phi) H_t - Z_t. \quad (20)$$

4.1.2. Financial Autarky

We close the model by specifying the market structure and technology available to the household. As in the previous section, suppose that output is produced with the aggregate production function $Y_t = K_t^\alpha (\xi_t N_t)^{1-\alpha}$, where $\dot{\xi}_t/\xi_t = g$. Under financial autarky, physical capital K is the only asset available, so $W_t = K_t$. We make two simplifying assumptions. First, we assume that there is no depreciation of capital: $\delta_k = 0$.³² Second, we assume that the share of aggregate non-financial income in total income is constant: $Z_t = (1 - \delta)Y_t$. δ is a key parameter, it controls the *supply of stores of value*. To see this, observe that the payments to capital rK equal δY since there is no depreciation. It follows trivially that the value of the capital-output ratio is:

$$K/Y = \delta/r. \quad (21)$$

For a given interest rate r , the market value of the capital stock (the supply of stores of value under financial autarky) varies one-to-one with δ .³³ Under these two assumptions, it is simple but tedious to combine (18) and the equilibrium condition $W_t = K_t$ to show that the steady-state autarky interest rate satisfies:

$$[r_{ss}^a - \delta(g + \rho + \theta)](r_{ss}^a + \theta + \phi - g) = (1 - \delta)r_{ss}^a(\rho + \theta). \quad (22)$$

³¹ If we define $\bar{H}_t = \int_t^\infty Z_u \exp(-\int_t^u r_v dv) du$ as the non-financial wealth of current and future generations, where Z_t denotes aggregate non-financial income. It is easy to check that $H_t \leq \bar{H}_t$ with equality when $\theta = 0$.

³² This assumption is innocuous but simplifies the algebra.

³³ One can also verify that δ maps directly into the capital wedge τ introduced at the beginning of Section 4: $\delta = \alpha(1 - \tau)$.

The first equation expresses domestic wealth, i.e. the domestic *demand for stores of value* per unit of output, W/Y , as a function of the world interest rate. A higher interest rate increases the demand for stores of value since wealth accumulates at a higher rate. The second equation expresses the *domestic supply of stores of value* (here capital) as a function of the interest rate. A higher interest rate depresses the present discounted value of the payments to capital δY , which lowers the equilibrium capital–output ratio. The difference between W and K represents the net foreign asset position of the country, B . With some simple manipulations, it is easy to express the net foreign asset position and the current account as a function of the autarky and world interest rates, as in the preceding section³⁶:

$$\frac{B_t}{Y_t} = \frac{W_t - K_t}{Y_t} = \frac{\delta(r - r_{ss}^a)}{r(r_{ss}^a - \delta r)}; \quad \frac{CA_t}{Y_t} = g \frac{\delta(r - r_{ss}^a)}{r(r_{ss}^a - \delta r)}. \quad (25)$$

This expression makes clear that the net foreign asset position is positive (resp. negative) depending on whether the world interest rate is higher (resp. lower) than the autarky interest rate. From the previous discussion, we infer that it is now possible for capital to flow out of emerging countries, provided that they have a sufficiently low autarky interest rate, i.e. a sufficiently low supply of stores of value.

Asymptotic Metzler Diagram. The previous results can be summarized in a version of the celebrated [Metzler \(1960\)](#) diagram. The vertical axis in [Figure 10.8](#) reports the real interest rate while the horizontal axis reports either the long run domestic financial wealth

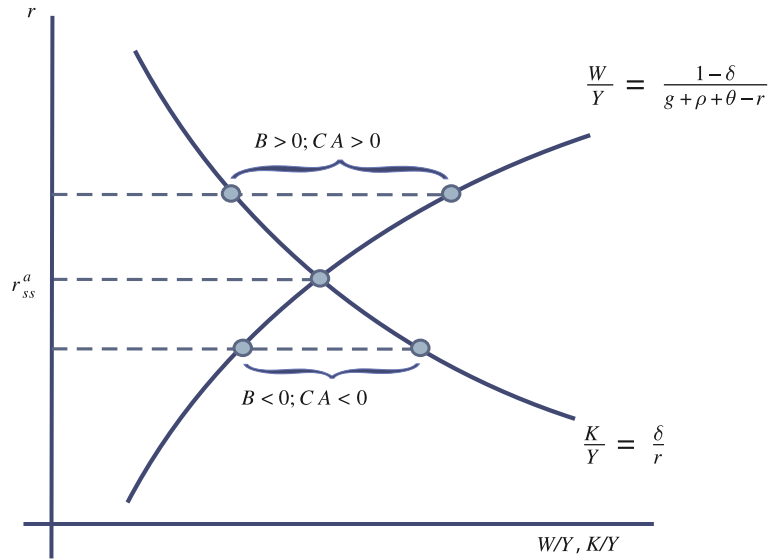


Figure 10.8 The Metzler Diagram

³⁶ The current account satisfies $NA_t = CA_t$.

instance, [Gruber and Kamin \(2009\)](#) find that quantity measures of financial development, such as the ratio of credit to GDP, do not systematically predict larger current account deficits. One issue is whether quantity measures such as credit to GDP accurately capture the level of a country's financial development when some countries' financial systems are bank-based, while others are market based. [Gruber and Kamin \(2009\)](#) also find that real long-term interest rates are similar in the U.S. and other industrial countries. But the model predicts that under integration the risk-free rates should be equalized, so differences in observed long-term interest rates should simply reflect risk characteristics, and not differences in autarky interest rates. A deeper question is why excess savings from emerging markets should flow disproportionately toward the United States, and not other industrial countries. One answer is that external balances worsened in other industrial economies too, such as the United Kingdom and Australia, or many peripheral eurozone economies such as Spain, Ireland, or Portugal. But this was offset by growing current account surpluses in Germany and Japan. Another possible answer is that even if the U.S. offers similar levels of financial development (high δ) as other industrialized economies as a whole, it experiences more robust growth (high g) and therefore should have higher autarky interest rates.³⁷ Another part of the answer, to which we return later in this chapter, is that the U.S. dollar remains the leading international reserve currency.

4.1.4. Productivity and Financial Frictions

In the model of the previous section, external imbalances arising from differences in levels of financial development, as measured by δ , are amplified by differences in productivity growth. To see why, consider the two-country model from the previous section, but now suppose country b grows faster: $g^b > g^a$. The world interest rate is still the output weighted average of the two autarky rates: $r_{ss,t}^a = \omega_t^a r_{ss}^{a,a} + (1 - \omega_t^a) r_{ss}^{a,b}$. The difference is that ω_t^a tends to zero so the world interest rate converges to $r_{ss}^{a,b}$. As long as g^b is not too high, so that $r_{ss}^{a,b} < r_{ss}^{a,a}$, this leads to *larger* capital flows from b to a , unlike the neoclassical growth model where $g^b > g^a$ leads to capital flows from a to b . A similar mechanism is at work in [Buera and Shin \(2009\)](#). That paper models an emerging economy that experiences a growth acceleration. In the model individuals choose between supplying labor (worker) or becoming entrepreneurs. In an efficient allocation, low productivity individuals choose to become workers and high productivity ones become entrepreneurs. The economy, however, suffers from two frictions: idiosyncratic wedges that distort the allocation of factors away from efficiency, and financial frictions. Both frictions lower total factor productivity (TFP). The paper then considers the effect of a program of structural reforms that increases TFP, while keeping the financial friction unchanged. This is similar to an increase in g while keeping δ low in our model. Initially, this reform lowers investment and increases savings. Investment decreases due to the exit of low-productivity firms, while

³⁷ [Engel and Rogers \(2006\)](#) argue along those lines that the U.S. current account deficit can be explained by the country's higher growth relative to other industrial countries.

high productivity ones are constrained by the financial friction. The response of aggregate saving is more complex. Workers face an upward wage profile due to the rise in TFP. This tends to decrease savings. On the other hand, incumbent entrepreneurs experience temporarily high profits, since wages are initially low. In addition, individuals with high productivity but little wealth will choose a high saving rate to overcome the financial frictions. The net effect is an increase in saving, and net capital outflows. [Song et al. \(2011\)](#) present a similar model tailored specifically to the experience of China after the economic reforms of 1978. At the beginning of the reform process, the economy features high productivity private firms with limited access to credit markets, and inefficient state owned firms with better access to credit. The paper shows that the financial frictions slow down the reallocation of factors toward efficient private firms, while sustaining high returns to capital during the transition. It can also lead high productivity firms to specialize initially in labor intensive activities, where the financial frictions are less relevant. In these papers, it is the *interaction* between financial friction and productivity growth that triggers external surpluses in emerging economies.

4.2. Demographics and Global Imbalances

As noted by [Bernanke \(2005\)](#), demographic characteristics can also explain global imbalances. In general, demographics can have complex effects on net savings. A faster rate of population growth increases investment as a larger workforce increases the marginal return to capital, increasing autarky rates. Faster population growth also increases the fraction of young (savers) relative to old (dissavers), increasing aggregate saving and reducing the autarky rate.³⁸ In general, the impact of demographic factors on the autarky rate and capital flows depends on the age-structure of the working age population and the age-profile of income. Aging countries should save more to provide sufficient resources in retirement for the increasing number of retirees per worker. [Lane and Milesi-Ferretti \(2001\)](#) find strong empirical support for this claim when studying the determinants of net foreign asset position, with a negative impact of the share of younger age cohorts and a positive effect of the share of workers near retirement. [Domeij and Flodén \(2006\)](#), in a calibrated overlapping generation model, find that demographic variables account for a small but significant fraction of capital flows for OECD countries between 1960 and 2002. [Ferrero \(2010\)](#) explores the effect of population aging in a two-country extension of [Gertler's \(1999\)](#) model of “perpetual youth and perpetual retirement,” calibrated to the U.S. and the G-6. The model allows for differences in fiscal policy, as well as productivity growth and finds that the more pronounced aging of the population in the G-6 (relative to the U.S.) accounts for a significant share of the deterioration in the U.S. trade balance and the decline in global real interest rates. We illustrate the basic mechanism with a simple extension of our model. Households evolve through two distinct stages

³⁸ See Obstfeld and Rogoff (1996).

of life: work and retirement. While working, households earn labor income. With some instantaneous probability λ , i.i.d. across workers, they retire. Once in retirement, they do not earn income any longer and die with instantaneous probability θ , as before. We maintain total population constant, so that the dependency ratio—the ratio of retirees to workers—is equal to λ/θ . A decline in mortality rate (a decline in θ) will increase the dependency ratio for a given length of the working life (equal to $1/\lambda$). To simplify further the analysis, suppose that households only consume when they are about to die. Aggregate consumption must then equal θW_t^r where W_t^r denotes the aggregate financial wealth of retirees. Since aggregate output is given by Y_t , this pins down the aggregate wealth of retirees: $W_t^r = Y_t/\theta$. Consider now the wealth accumulation dynamics of retirees and workers respectively:

$$\dot{W}_t^r = r_t W_t^r - \theta W_t^r + \lambda W_t^w. \quad (28a)$$

$$\dot{W}_t^w = r_t W_t^w + (1 - \delta) Y_t - \lambda W_t^w. \quad (28b)$$

Equation (28a) states that the retirees' wealth increases with the interest rate r_t , decreases with consumption, and increases with the arrival of newly retired workers. Equation (28b) states that the aggregate wealth of workers W_t^w increases with savings (equal to non-financial income) and decreases when workers retire. In steady state, the aggregate wealth of both groups must increase at rate g . Substituting the expression for W^r and W^w , it follows that the autarky interest rate satisfies:

$$(1 - \delta) \lambda \theta = (g + \theta - r_{ss}^a) (g + \lambda - r_{ss}^a). \quad (29)$$

It is easy to verify that $r_{ss}^a < g + \delta \lambda < g + \lambda$ and that $\partial r_{ss}^a / \partial \theta > 0$: population aging lowers the autarky interest rate. This result allows us to understand why economies with rapidly aging populations, such as Germany, Japan, or China, run sizable external surpluses.³⁹

In a recent paper, Coeurdacier et al. (2012) explore further the interaction of demographic characteristic and financial frictions for an emerging economy such as China. In their three-period overlapping generation models, young workers in emerging economies (the South) face tighter credit constraints, preventing them from borrowing against their middle-age income. As a result, autarky interest rates are lower and following financial integration, capital flows to industrial countries (the North). The model also features higher growth in the South, so that the world interest rate declines over time—a consequence of the rising share of the South in global output, as discussed above. The model can explain why a decline in global interest rates leads to a decrease in saving rates in the North and an increase in the South. The reason is twofold. First, the substitution effect

³⁹ According to United Nations projections, the dependency ratio, defined as the ratio of population aged 65 or over to population aged 20–64, was 21.8% in the U.S. in 2010. For Germany, Japan, and China, the corresponding numbers are 33.4%, 38.3%, and 12.7%. By 2050, the dependency ratio will have increased to 39.5% for the U.S., and 62%, 76.4%, and 45.4% for Germany, Japan, and China, respectively.

follows [Angeletos and Panousi \(2011\)](#) which allows for investment risk in a continuous time setting similar to that of the previous section.⁴³

4.3.1. The Set-Up

Consider a country populated with a continuum of infinitely lived households uniformly distributed over $[0, 1]$. Each household supplies one unit of labor inelastically to a competitive labor market, so that the aggregate labor supply is constant and equal to 1. In addition, each household runs a “privately-held” firm. This firm operates with capital k_{it} and labor n_{it} and produces $y_{it} = k_{it}^\alpha (\xi_t n_{it})^{1-\alpha}$, where productivity ξ_t is common to all firms and grows at a constant rate g . In addition to capital invested in their own firm, households can trade a riskless bond in zero net supply. Denote $w_{it} = k_{it} + b_{it}$ the domestic financial wealth of household i , composed of holdings of physical capital k_{it} , and bond holdings b_{it} . The budget constraint for household i is:

$$dw_{it} = d\pi_{it} + [r_t b_{it} + z_t - c_{it}] dt, \quad (30)$$

where z_t denotes labor income, equal to the wage since each household supplies one unit of labor, r_t is the equilibrium risk-free rate, and $d\pi_{it}$ denotes the household’s capital income. Labor income and the interest rate are deterministic due to the absence of aggregate risk. Household capital income $d\pi_{it}$ is subject to idiosyncratic and uninsurable risk:

$$d\pi_{it} = [\gamma_{it} - z_t n_{it} - \delta_k k_{it}] dt + \sigma k_{it} d\omega_{it}. \quad (31)$$

The first term in brackets represents the deterministic part of the capital income, equal to output minus labor costs and depreciation. The second part represents the stochastic component. $d\omega_{it}$ is a standard Wiener process, i.i.d. across agents and time, akin to an obsolescence shock. Importantly, while the shock is idiosyncratic—and therefore perfectly insurable with complete markets—we assume that markets remain incomplete. More specifically, σ measures the *residual idiosyncratic risk* faced by households, after all available formal and informal domestic risk sharing opportunities have been exhausted. The case of complete markets then corresponds to $\sigma = 0$. A country with a higher level of financial development—and therefore more opportunities to diversify risk domestically—will have a lower σ .⁴⁴

⁴³ See also [Corneli \(2009\)](#). [Mendoza et al. \(2009\)](#) allow for both investment and income risk. The case with investment risk only is more tractable and delivers as an additional result that the capital-output ratio is low (and hence the marginal product of capital is high) when the level of financial development is low. Instead, in the [Aiyagari \(1994\)](#) set-up with labor income risk, there is no risk premium and precautionary saving increases the capital stock above its complete market level. This would imply the counterfactual result that capital-output is high (and marginal product of capital low) in less financially developed countries.

⁴⁴ Of course, this interpretation may not be warranted. For instance, one could imagine situations where higher levels of financial sophistication allow for better sharing of idiosyncratic risk, at the expense of a higher exposure to aggregate risk. Since the model does not feature aggregate risk, this is not a feature we explore here.

Solving the aggregate Euler equation for the risk-adjusted return $\hat{\rho}$, one obtains:

$$r = \hat{\rho} - \frac{\gamma}{2}\phi^2\sigma^2 \leq \hat{\rho} = \rho + \gamma g - \frac{\gamma^2}{2}\phi^2\sigma^2 \leq \rho + \gamma g. \quad (33)$$

This condition states that in equilibrium the precautionary motive depresses both the riskless rate r and the risk-adjusted return $\hat{\rho}$ below the benchmark return in the riskless economy, $\rho + \gamma g$. Investing in capital is risky, so the precautionary motive increases the demand for riskless bonds. In equilibrium these bonds are in zero net supply so the risk-free rate has to decrease up to the point where households decide not to hold them. This is the same logic as in [Aiyagari \(1994\)](#). The precautionary motive also tends to depress the demand for capital, since it is the source of risk. Therefore, capital has to offer a premium in equilibrium. Substituting the definition of $\hat{\rho}$ and ϕ , and after simple manipulations, we obtain⁴⁶:

$$\phi(r) = \left(\frac{2(\rho + \gamma g - r)}{\gamma\sigma^2(1 + \gamma)} \right)^{1/2}. \quad (34a)$$

$$\bar{r} = \alpha\tilde{k}^{\alpha-1} - \delta_k = r + \gamma\sigma^2\phi(r) \geq r. \quad (34b)$$

The first equation expresses the share of wealth invested in the risky asset as a function of the riskless rate r . The second equation expresses the expected return to capital as a function of the riskless rate. It is immediate that in the riskless case $\sigma^2 = 0$, $\bar{r} = r$. It can be solved implicitly for the level of capital as a function of the riskless rate: $\tilde{k}(r)$. As [Angeletos and Panousi \(2011\)](#) show, $\tilde{k}(r)$ is not monotonously decreasing with the interest rate. Instead, it is U-shaped, decreasing only if $r \leq \underline{r} \equiv \rho + \gamma g - (\gamma/(1 + \gamma))\sigma^2/2$. The intuition is that a higher interest rate allows households to accumulate more wealth, making them more willing to take risks, and reducing the risk premium required by households to hold capital. It follows that for $r > \underline{r}$, an *increase* in the riskless rate is associated with a *decrease* in the marginal product of capital as the decline in the risk premium more than offsets the increase in the riskless rate.

One solves for the autarky interest rate by substituting $\tilde{k}(r)$ into the asset market equilibrium condition: $\phi(\tilde{k}(r) + \tilde{h}(r)) = \tilde{k}(r)$ where $\tilde{h}(r) = (1 - \alpha)\tilde{k}(r)^\alpha/(r - g)$. This yields the implicit expression:

$$1 = \phi(r_{ss}^a) \left(1 + \frac{(1 - \alpha)\tilde{k}(r_{ss}^a)^{\alpha-1}}{r_{ss}^a - g} \right). \quad (35)$$

It is immediate to check that $r_{ss}^a = \rho + \gamma g$ when $\sigma = 0$, and that $\partial r_{ss}^a / \partial \sigma < 0$: more uninsurable idiosyncratic risk depresses autarky rates.

⁴⁶ Where we use our notation $\tilde{x} = X/(\xi N)$.

4.3.4. Open Economy

Small Open Economy. Consider now the case of a small open economy facing a constant riskless interest rate r . From the previous derivations, the domestic capital stock (per efficient unit) will be given by $\tilde{k}(r)$ that solves (34b) while the portfolio share will be $\phi(r)$ that solves (34a). The demand for stores of value is $\tilde{w}(r) = \tilde{k}(r)/\phi(r) - \tilde{h}(r)$. The supply is $\tilde{k}(r)$, and the difference between the two determines the net foreign asset position $\tilde{b}(r) = \tilde{w}(r) - \tilde{k}(r)$. One can check that $\tilde{b}(r)/\tilde{k}(r)$ is always *increasing* with the interest rate: as the interest rate increases, the propensity to save in the riskless bond increases, relative to saving in the risky capital. If $r > r_{ss}^a$ (resp. $r < r_{ss}^a$), the small open economy is a net creditor (resp. borrower).

Following [Kraay and Ventura \(2000\)](#), we can use the model to ask how the current account should respond to transitory income shocks. To do so, rewrite [equations \(34\)](#) as:

$$\frac{\tilde{k}}{\tilde{x}} = \frac{\alpha \tilde{k}^{\alpha-1} - \delta_k - r}{\gamma \sigma^2} \quad (36)$$

and solve for the response of domestic capital \tilde{k} to a change in domestic wealth \tilde{x} :

$$\frac{\partial \tilde{k}}{\partial \tilde{x}} = \frac{\gamma \sigma^2}{\gamma \sigma^2 + \alpha(1 - \alpha)\tilde{k}^{\alpha-2}\tilde{x}} \frac{\tilde{k}}{\tilde{x}} \geq 0. \quad (37)$$

When σ^2 is close to 0 (full risk sharing), the marginal increase in domestic wealth is invested in international riskless bonds ($\partial \tilde{k}/\partial \tilde{x} \approx 0$). In this case, countries run current account surpluses in response to transitory positive shocks. Conversely, when $\alpha \approx 1$, so that $\partial \tilde{k}/\partial \tilde{x} \approx \tilde{k}/(\tilde{k} + \tilde{b})$, the marginal increase in wealth is invested like the average unit.⁴⁷ The implication is that net creditor countries (for which $\tilde{b} > 0$) run current account surpluses in response to a transitory positive income shock, while net debtor countries (for which $\tilde{b} < 0$) run current account deficits. In a panel of 13 industrial countries between 1973 and 1995, [Kraay and Ventura \(2000\)](#) find that the interaction term between the share of gross national saving in GDP and the ratio of foreign assets to total assets is highly significant, with an R^2 of 0.37.

Large Open Economy. Following the now familiar steps, suppose a world economy is composed of two otherwise identical countries facing different levels of residual uninsurable risks with $0 < \sigma < \sigma^*$ where $*$ denotes the foreign, less financially developed, economy. Assuming that the conditions are satisfied for $r_{ss}^{a,i} \geq \underline{r}^i$ in each country i , the equilibrium satisfies:

$$r_{ss}^a \leq r \leq r_{ss}^{a*} < \rho + \gamma g. \quad (38a)$$

$$\tilde{k}(r_{ss}^{a*}) < \tilde{k}^* < \tilde{k} < \tilde{k}(r_{ss}^a). \quad (38b)$$

$$\tilde{b} < 0 < \tilde{b}^*. \quad (38c)$$

⁴⁷ We use the fact that $\tilde{h} \approx 0$ when $\alpha \approx 1$.

The integrated risk-free rate settles somewhere between the two autarky rates, as usual. Moreover, the capital stock in the riskier economy is lower than in the safer one. This is because the risk premium effect dominates. This has two interesting implications. First, the capital stock increases in the less developed economy upon financial integration: $\tilde{k}(r_{ss}^a) < \tilde{k}(r)$, the increase in interest rates in the less financially developed economy makes them richer and willing to take more risk. Second, the marginal product of capital is higher—and the capital-output ratio is lower—in less financially developed economies, something that accords well with the empirical evidence.

Cross-Border Flows as Safe Asset Flows. Finally, this model predicts that the advanced economy is a net borrower while the less financially developed economy is a net creditor: $\tilde{b} < 0 < \tilde{b}^*$. In the model, all cross-border flows take the form of *riskless loans*: there is no cross-border investment in risky projects. This provides a way to re-interpret the results: faced with larger uninsurable risks, households in the foreign country want to invest in *safe assets*. The domestic country faces lower uninsurable risks, so it has less need for insurance and is willing to *supply* these safe assets to foreigners. Stated differently, the domestic economy has a *comparative advantage* in supplying safe assets. In turn, it earns a premium that allows it to consume more than it produces along the transition to the new steady state (i.e. it runs a trade deficit). This result parallels [Gourinchas et al. \(2010\)](#) whom we will discuss later in this chapter.⁴⁸

4.3.5. Aggregate Uncertainty

The models considered so far only feature idiosyncratic uncertainty. Some recent models consider instead the impact of aggregate uncertainty.⁴⁹ In a business cycle framework, [Fogli and Perri \(2006\)](#) consider the effect of the Great Moderation (the decline in the volatility of the U.S. business cycle between the mid-1980s and the onset of the 2007 financial crisis). Faced with a decline in aggregate volatility, the U.S. representative household would reduce its precautionary holdings. This would result in a deterioration of the U.S. external balance. In a calibration of their model, they find that the Great Moderation can account for around 20% of the U.S. external imbalance. Note however, that the decline in precautionary saving would be associated with an *increase* in global interest rates, in contradiction with [stylized Fact 1](#). In a recent paper, [Coeurdacier et al. \(2013\)](#) study jointly the gains from capital accumulation and risk sharing in a model with aggregate uncertainty. Using global numerical methods they study the dynamics of the model along the transition path from autarky to financial integration. They find that aggregate uncertainty interacts with the classical determinants of capital flows explored in [Section 3](#) and that the precautionary motive can overturn the direction of net capital flows as in the models explored in this section.

⁴⁸ [Mendoza et al. \(2009\)](#) also allow for investment risk. In their model, agents can invest in risky assets in foreign countries. As a result, in equilibrium, the financially developed country still runs a negative net foreign position, but holds a long position in foreign risky assets and earns excess returns on its external portfolio.

⁴⁹ These models abstract from idiosyncratic uncertainty. As mentioned earlier, in models with both idiosyncratic and aggregate uncertainty the wealth distribution varies over time and becomes a state variable.

4.4. Financial Frictions and International Trade

Two recent papers focus on the interaction between trade flows and capital flows. [Jin \(2012\)](#) presents a stochastic two-country overlapping generations model with production and capital accumulation in which factor intensities are (exogenously) different across countries. The paper combines insights from the factor proportions trade literature with those of the standard neoclassical open economy growth model. In her model, there is both an intertemporal motive for capital flows and an intratemporal motive since capital will tend to flow to countries that are more specialized in capital intensive industries. Hence two competing effects determine the direction of net capital flows: the composition effect (linked to asymmetries in specialization across countries) and the standard efficiency effect (stemming from capital scarcity). A country hit by a positive productivity shock, or experiencing a relative increase in its labor force—as was the case for many emerging economies since 1990—can nevertheless become a capital exporters if it specializes in labor intensive industries. Hence specialization is the key mechanism through which [Jin \(2012\)](#) may account for global imbalances.

Antràs and Caballero (2009) present a model where financial frictions determine patterns of capital flows and trade flows. Countries are heterogeneous in terms of financial development and sectors differ in their degree of financial dependence. They feature a two-country (North and South, where South is financially underdeveloped), two-factor (capital and labor), two-sector general equilibrium model where a homogeneous good is internationally traded. Under trade *and* financial autarky, South invests disproportionately in the sector without financial frictions. This depresses wages and rental rates of capital. If capital is now allowed to move freely, but international trade in goods remains restricted, capital will flow out of the financially underdeveloped economy toward the financially developed one, as in the models presented in this section. By contrast, if international trade in goods is *also* liberalized, countries will specialize along the lines of comparative advantage: the financially underdeveloped South specializes (incompletely) in the sector unaffected by the financial friction. This raises the rental rate of capital in the South because of good price equalization, while domestic wages remain depressed, and this can reverse the direction of capital flows. Hence it is the difference in production structures due to the pattern of specialization induced by comparative advantage that interacts with financial liberalization to shape the direction of net capital flows. The pattern of specialization is thus endogenously determined by cross-country differences in financial development, echoing the main theme of this section.

4.5. Global Imbalances and Financial Fragility

An important theme developed in [Bernanke \(2005\)](#) is that other asset prices may adjust beside the global interest rates to a shortage of stores of value. In [Caballero et al. \(2008b\)](#), the decline in world interest rates can be so strong as to make the economy dynamically inefficient, opening the door to rational bubbles. While the financial bubble increases

asset supply endogenously, it is also prone to crashes. More generally, low world interest rates can fuel search for yield, or inefficient investments (e.g. [Rajan, 2005](#)). A number of observers noted the close connection between current account deficits and housing booms ([Bernanke, 2010](#); [Ferrero, 2012](#)). Lower global interest rates, and in particular mortgage rates, can account for part of the increase in housing prices. As [Ferrero \(2012\)](#) observes, a gradual relaxation of borrowing constraints for households, or a favorable change in property taxes would lead to a simultaneous current account deficit and housing boom, as observed in the data, but would also lead to an increase in interest rates. In the same vein, [Adam et al. \(2011\)](#) use a small open economy model with endogenous housing and learning. In their model, bullish agents about the housing market respond strongly to a decline in world interest rates, triggering a housing boom and a current account deficit.

4.6. Private Flows, Public Flows, and Reserve Accumulation

A number of papers have pointed out that private and public flows behave quite differently, and that most of the net accumulation of foreign assets by emerging economies is in the form of public flows, especially through official reserve accumulation by central banks (see [Aguar and Manuel, 2011](#); [Gourinchas and Jeanne, 2013](#); [Alfaro et al., 2011](#)). Indeed, a large share of emerging markets' gross external asset holdings takes the form of central bank reserves or other official holdings. The distinction between private and public capital flows becomes relevant once we depart from the—admittedly extreme—case of full Ricardian equivalence. In that class of models, any change in public flows is offset one-for-one by a corresponding change in private sector capital flows so the model pins down total net capital flows but not their composition. It is quite reasonable to depart from full Ricardian equivalence and the stringent assumptions it requires (non-distortionary taxation, perfect capital markets, infinitely lived dynasties). But the precise channels by which models depart from Ricardian equivalence matters greatly for the predictions of the model about the *joint fluctuations* in private and public flows. It is not in general a good idea to simply assume private flows behave as if there were *no* public flows. Spelling out the right model of public and private flows is an active area of ongoing research. At one extreme, some models assume that there are no private capital flows and governments provide the only form of intermediation of domestic resources into foreign stores of value (semi-open economy). For instance, one may see governments as financial intermediaries for the domestic private sector, intermediating domestic savings into global uses, as pointed out by [Song et al. \(2011\)](#). Similarly, in [Aguar and Manuel \(2011\)](#) a government that has access to international capital markets faces a commitment problem. It accumulates international reserves as a way to post collateral, and limit the temptation to expropriate investors in the future. In [Jeanne and Rancière \(2011\)](#), the domestic government faces instead the possibility of a sudden loss of access

to external credit and accumulates reserves for precautionary reasons.⁵⁰ [Bacchetta et al. \(2012\)](#) present a model where households face borrowing constraints and where the planner may choose to impose capital controls and accumulate reserves. In steady state, when financial constraints don't bind, it is optimal to replicate the open economy, and the central bank is simply a shell for international financial intermediation. Along the transition, binding financial constraints may lead the planner to choose an interest rate different from the world interest rate, through reserve accumulation and capital control policy, as in [Jeanne \(2012\)](#). Many of these models emphasize the strong demand from emerging market economies for liquid and safe global assets. Indeed, as [Bernanke \(2011\)](#) show, surplus emerging market economies concentrated their reserve accumulation on the safest U.S. securities: U.S. Treasuries and agency debt. To understand this pattern, one needs to go beyond models with no aggregate risk and no diversification motive.

5. EXTERNAL BALANCE SHEETS, VALUATION EFFECTS, AND ADJUSTMENT

Many of the models of the previous section, with no aggregate uncertainty or no diversification motive, make predictions about *net* capital flows, that is, about the intertemporal transfer of resources across countries. However, as emphasized in [Section 2](#), one key stylized facts in international economics since the 1990s has been the massive increase in gross capital flows. The properties of the international balance sheet of countries determine how different shocks propagate across countries and how countries adjust to their long run solvency constraint.

5.1. International Adjustment

This section highlights the quantitative importance of valuation effects and the financial channel of external adjustment. To do so, we explore the implications of the external solvency constraint. Unlike [Sections 3](#) and [4](#), we present derivations in discrete time for two reasons. First, it allows for an easier mapping between the theoretical objects of analysis and their empirical counterpart. Second, many of the issues discussed in this section have a business cycle dimension, for which a discrete time set-up is better adapted.

5.1.1. External Solvency Constraint

We begin by writing down the external budget constraint of a country and deriving some implications for the process of international adjustment. Define $NA_t = A_t - L_t$ as the net foreign asset position (at market value) of a country at the end of period t , where A_t and

⁵⁰ Bacchetta and Benhima (2012) present a model where the demand for precautionary liquid reserves arises from the corporate sector. In the model, credit-constrained firms face liquidity shocks and their demand for liquid assets (foreign bonds) increases with investment. Therefore, a more rapidly growing economy will invest more and demand more foreign bonds.

L_t denote respectively gross external assets and liabilities.⁵¹ The change in net foreign asset position from one period to the next is given by the following accumulation equation:

$$NA_t = R_t NA_{t-1} + NX_t, \quad (39)$$

where $NX_t = X_t - M_t$ denotes the balance on goods, services, and net transfers during period t , and R_t represents the gross portfolio return on the net foreign portfolio between the end of period $t-1$ and the end of period t . Adding and subtracting the net investment income balance NI_t , we can write:

$$NA_t - NA_{t-1} = [(R_t - 1) NA_{t-1} - NI_t] + CA_t = VA_t + CA_t \quad (40)$$

using the definition of the current account as the sum of the trade balance NX_t and the net factor payment: $CA_t = NX_t + NI_t$. The change in the net foreign position equals the current account, CA_t , plus the valuation adjustment VA_t . This valuation adjustment equals the *capital gain* on the net foreign asset portfolio, i.e. the net return $(R_t - 1)$ minus income, dividends, and earnings distributed.⁵² Traditionally, this valuation term has been omitted and the net external position of a country has been calculated as the cumulated sum of past current accounts. This is in keeping with the National Income and Product Accounts (NIPA) and the Balance of Payments methodology that focuses on produced transactions and ignores capital gains and losses. But cumulated current accounts will give a very approximate and potentially misleading reflection of a country's net foreign asset position—the object of interest in most of our economic models—unless the cumulated valuation gain is correspondingly small. While this assumption may have been reasonably accurate in eras of limited levels of financial integration, it is not one we can maintain in the face of large cross-border gross positions, as seen in [stylized Fact 5](#). We now turn to the empirical methodology allowing us to value assets and liabilities at market prices.

5.1.2. Valuation Effects: Empirical Methodology

Obtaining precise estimates of these valuation changes is not an easy task. We start with a discussion of the empirical methodological advances that have allowed researchers to focus on valuation changes with a particular attention to the relevant empirical caveats that are involved in any exercise of this nature.

⁵¹ Note that this definition of the net foreign asset position coincides with the one presented in the previous section since domestic wealth W consists of domestic holdings of domestic assets V^d and gross external claims A , while domestic assets V can be held either by domestic residents (V^d) or by foreigners in the form of gross external liabilities ($V^f = L$). It follows that $NA = A - L = (W - V^d) - (V - V^d) = W - V$.

⁵² To be complete, the accumulation equation should also include the capital account KA_t , unilateral transfers UT_t , and the statistical discrepancy SD_t . We abstract from these components in this discussion and will bring them back when necessary. For many countries, especially industrialized ones, capital account transactions and unilateral transfers are typically small. Errors and omissions are also excluded from the financial account in the U.S. Bureau of Economic Analysis estimates of the U.S. international investment position.

Stocks and Flows. The relatively recent availability of periodic surveys of cross-border assets and liabilities has it made possible to investigate empirically the channels of adjustments of a country's external balance sheet.⁵³ Constructing external balance sheets of countries *at market value* involves reconciling data on stocks and balance of payment data on flows.⁵⁴

For each asset class, we can write a general law of motion as follows:

$$PX_{t+1}^i = PX_t^i + FX_{t+1}^i + VX_{t+1}^i + OX_{t+1}^i, \quad (41)$$

where PX_t^i represents the position at the *end of period* t for asset class i reported in the disaggregated net international investment position for gross claims ($X = A$) or gross liabilities ($X = L$), FX_t^i denotes the corresponding flow during period t as recorded in the balance of payments, VX_t^i is the valuation gain that can be attributed to currency and asset price movements, while OX_t^i ("other changes") represents an error term due to changes in coverage or mismeasurements of various kinds. Summing across all the series and using a simplified version of the balance of payment identity $FA_t = CA_t + SD_t$, where SD_t denotes the statistical discrepancy of the balance of payment, we obtain the international investment position at the end of period $t + 1$ ⁵⁵:

$$NA_{t+1} = NA_t + CA_{t+1} + VAL_{t+1} + OC_{t+1} + SD_{t+1}, \quad (42)$$

where $VAL_t = \sum_j VA_t^j - \sum_i VL_t^i$, is the sum of the valuation effects across asset classes, and $OC_t = \sum_j OA_t^j - \sum_i OL_t^i$ is the corresponding sum of the "other changes."

These simple accounting relations allow in principle researchers to construct time series of estimates of cross-border positions at market values which are consistent with flow data and with the periodic surveys. In practice, of course, the exercise is rarely straightforward and a number of assumptions are needed to ensure everything "adds up."

Lane and Milesi-Ferretti (2001, 2007a) in pioneering work constructed and updated annual estimates of external assets and liabilities for over 178 countries and the euro area over the period 1970–2007 (data release August 2009). Gourinchas and Rey (2007a) and Gourinchas et al. (2010) focused on the United States and provided quarterly estimates for the period 1952–2010. Bertaut and Tryon (2007), building on Thomas et al. (2004) perform a number of refinements to the data and provide monthly estimates of U.S. cross-border securities positions from 1994. Stoffels and Tille (2009) constructed data on

⁵³ For example, the Coordinated Portfolio Investment Surveys of the IMF, covering external holdings of securities of 73 countries (in 2010) started in 1997 and became annual from 2001. The CPIS surveys are complemented by the surveys on Securities Held as Foreign Exchange Reserves (SEFER), and Securities Held by International Organizations (SSIO). The Coordinated Direct Investment Survey (CDIS) of the IMF covering 97 countries started in 2009. The U.S. Treasury has performed very occasional surveys of external assets or liabilities since at least the Second World War but has done so on a more regular (annual) basis only since 2002 for the liability side and 2003 for the claim side.

⁵⁴ In the case of the U.S., data on stocks comes from surveys performed infrequently by the Treasury and reported by the Bureau of Economic Analysis.

⁵⁵ As before, we ignore the capital account and unilateral transfers in this derivation.

the Swiss external investment position. In more conjectural work given the data limitations, Kubelec and Sá (1980) provide estimates of *bilateral* holdings among 18 advanced economies and emerging markets, Milesi-Ferretti et al. (2010) estimated a snapshot of bilateral holdings in a sample of 70 countries at end year 2007 while Gourinchas et al. (2012) extended this sample to 2009. Lane and Shambaugh (2010) present *currency compositions* of external claims and liabilities for a large panel of countries over 1990–2004. Finally, exploiting a unique Swiss database, Zucman (2013) shows that non recorded assets held in offshore accounts can explain the discrepancy between assets and liabilities at the world level.

5.1.3. The Case of the United States

A World's Banker Balance Sheet. The case of the United States is particularly interesting. We have already noted the very sizeable gap between the reported U.S. net international position and cumulated current account deficits (*stylized Fact 5*). This suggests possible important roles played by valuation effects in the dynamics of the net foreign asset position of the U.S. Along the same line, Tille (2008) observed the potential important stabilizing effects of a dollar depreciation on the external balance sheet of the United States due to a large asymmetry in currency composition between liabilities (all in dollars) and assets (mostly in foreign currency): when the dollar depreciates, the value of liabilities in dollars is unchanged while the value of external claims goes up.

As a number of papers noted, the structure of the U.S. external balance sheet is also asymmetric in other ways. Writing in the 1960s while the U.S. was the center country of the Bretton Wood system of fixed exchange rates, Kindleberger (1965) and Despres et al. (1966) observed that the U.S. was the “Banker of the World,” lending mostly at long and intermediate terms, and borrowing short, thereby supplying loans and investment funds to foreign enterprises and liquidity to foreign asset holders. Figure 10.9 presents the decomposition of the U.S. external accounts by asset classes (FDI, bank—which includes trade credits, debt, equity). In the wake of the Second World War, the United States was a creditor country, with a positive Net International Investment Position (NIIP) of about 12% of U.S. output. More importantly, U.S. gross external claims and liabilities were small, reflecting the large direct and indirect costs of cross-border financial transactions. Most of the external claims of the U.S. were direct investment or bank loans, while a sizeable share of its external liabilities were foreign holdings of U.S. government securities. Fast forward to the beginning of the 21st century, after an unprecedented period of deregulation of cross-border financial flows. By then, the U.S. has become a sizable debtor country, with a negative NIIP of about 22% of output in 2010. More dramatically, gross external claims and liabilities soared, to more than 100% of output in recent years. Figure 10.10 presents the evolution of net portfolio equity and FDI position of the U.S. (its risky asset position) and its net debt and bank asset position (as a proxy for its safe asset position). The risky position skyrocketed upwards in the run up to the crisis while the U.S. was increasingly

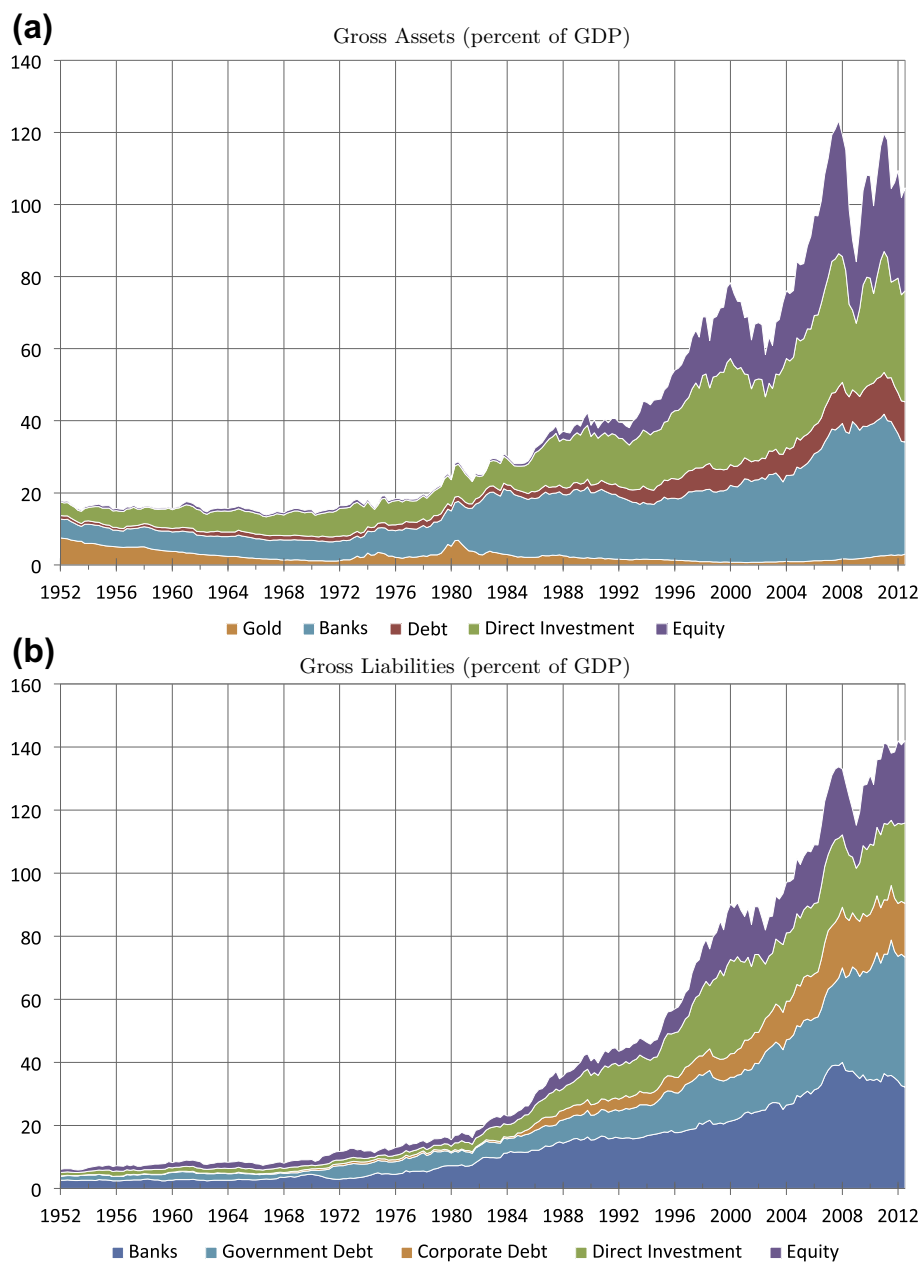


Figure 10.9 U.S. Gross Asset and Liabilities, by Asset Class, 1952–2012. *Source:* [Gourinchas et al. \(2010\)](#)

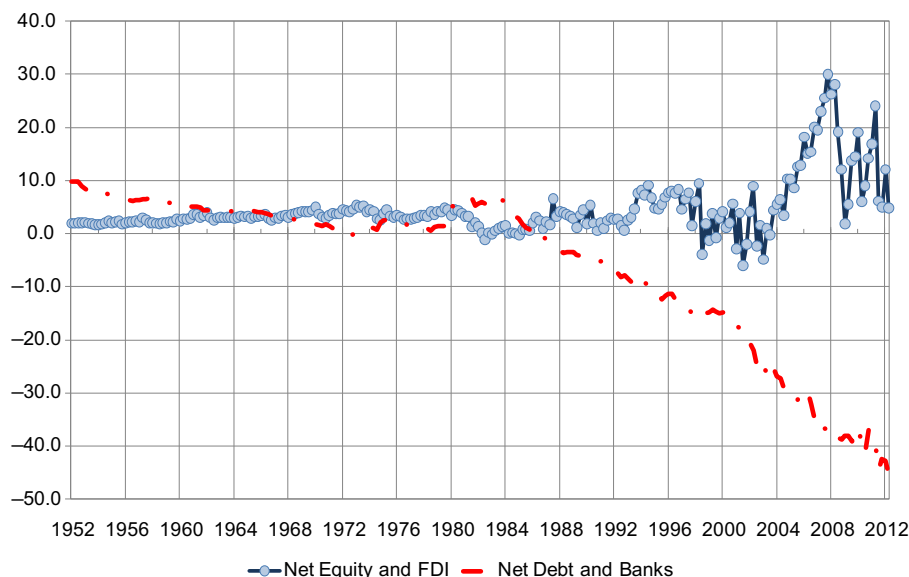


Figure 10.10 U.S. Net Portfolio Equity and Direct Investment (Percent of GDP) and Net Portfolio Debt and Other Assets (Percent GDP). Source: [Gourinchas et al. \(2010\)](#) Updated to 2012

short in safe and liquid assets: as noted by [Gourinchas and Rey \(2007a\)](#), the U.S. became an increasingly leveraged global financial intermediary. The pattern of *liquidity and maturity transformation* already noted by observers in the 1960s is still a characteristic of the U.S. balance sheet. This is all the more surprising if one puts this stylized fact in parallel with the evolution of the banking sector in recent years. In a series of thought provoking papers, Shin argues that European global banks have become intermediaries for U.S. savings, financing themselves in the United States, in particular via the wholesale market (money market funds) and channeling the liquidity worldwide including back into the U.S. markets (see for example [Shin, 2012](#)). Shin points out that U.S.-dollar denominated assets of banks outside the United States amounted to about \$10 trillion prior to the 2007 crisis. This pattern of banking investment flows whereby global banks are liquidity providers to the United States goes against the previously described role of the U.S. as a World Banker. In the aggregate balance sheet of the country though, it is still dominated by the overall pattern of *liquidity and maturity transformation* performed by the United States as a whole.

Computing Returns on the U.S. External Asset Position. The particular structure of the external balance sheet of the United States has been shown to generate an “Exorbitant Privilege”: the United States is able to earn higher returns on its external

assets than on its external liabilities (see [Gourinchas and Rey, 2007a](#)).⁵⁶ This French claim has been under intense scrutiny in the literature, igniting a lively debate, which we now briefly summarize.

From [equation \(42\)](#), the formula linking the change in net foreign asset position and the return is:

$$NA_{t+1} = R_{t+1}NA_t + NX_{t+1} + SD_{t+1} + OC_{t+1}. \quad (43)$$

When computing the returns on the net foreign asset position of a country, the researcher is immediately faced with a problem: where should OC_{t+1} , the residual term whose *raison d'  tre* is to reconcile stock and flow data coming from different sources be allocated?⁵⁷ Different authors have taken different (time varying) views on this question and obtained estimates of external returns on samples of different lengths, resulting in a debate which may look confusing for the lay person. But the underlying issue is quite simple and easy to summarize: as a residual item, OC_{t+1} can only represent mismeasured valuations, mismeasured flows, mismeasured initial positions, or some combination of the three. Let's consider each possibility in turn.

- OC_{t+1} represents mismeasured capital gains. This is a plausible assumption for some asset categories, such as direct investment, where capital gains are notoriously hard to measure. This was the assumption adopted in the first wave of papers of the literature. In that case, the total return is given by $(R_{t+1} - 1)NA_t = NI_{t+1} + VAL_{t+1} + OC_{t+1}$. This set of papers tends to find that the U.S. enjoys a strong excess returns on its overall external position. [Gourinchas and Rey \(2007a\)](#) report a real excess return of 2.1% per year on the 1952–2004 period; [Lane and Milesi-Ferretti \(2007b\)](#) report 3.9% per year for the shorter 1980–2004 period; similarly [Obstfeld and Rogoff \(2005\)](#) find a 3.1% per year excess return for 1983–2003; and [Meissner and Taylor \(2008\)](#) 3.7% per year on 1981–2003.
- OC_{t+1} represents mismeasured financial flows as pointed out in a second wave of papers ([Curcuru et al., 2008b](#); [Lane and Milesi-Ferretti, 2009](#)).⁵⁸ In that case, the dynamics of net assets is given by $NA_{t+1} = NA_t + F\hat{A}_{t+1} + VAL_{t+1}$ with the “corrected” flow term defined as $F\hat{A}_t = FA_t + OC_t$. Such an adjustment must have a counterpart in the Balance of Payments identity $F\hat{A}_t = CA_t + KA_t + SD_t - OC_t = 0$. By definition, if $F\hat{A}$ measures the correct financial flows, then the residual term $SD - OC$ must correspond to mismeasured current account transactions:

⁵⁶ [Giscard d'Estaing \(February 16, 1965\)](#), then finance Minister of President Charles De Gaulle coined the term “exorbitant privilege.”

⁵⁷ OC_{t+1} can also reflect some reclassification. For example when a portfolio investor has a position in a firm and then acquires more equity such that total holdings exceed 10%, his/her entire holdings are classified as direct investment, including those that were held prior to meeting the 10% threshold. This results in OC for both portfolio and FDI. A similar reclassification occurs when a U.S. firm reincorporates offshore or onshore.

⁵⁸ Their argument relies on the difference in revision policies between the stock and the flow data for equity and bond portfolio investment.

$\hat{CA}_t = CA_t + (SD_t - OC_t)$.⁵⁹ Hence, if flow adjustments are large, this implies that trade flows are also *de facto* grossly misrecorded for the United States, especially in the recent period (for a discussion on the implications for the balance of payments see Lane and Milesi-Ferretti (2009) and Curcuru et al. (2008a)). Adding residuals to flows, Curcuru et al. (2008b) find *no* excess returns on the portfolio component nor on the overall net foreign asset position of the U.S. for the 1990–2005 period.⁶⁰ Forbes (2010) implements the Curcuru et al. (2008b) methodology and, in contrast, estimates very large excess returns of about 6.9% per year during 2002–2006.⁶¹ Curcuru et al. (2013) find excess returns of 1.9% on the total net foreign asset position of the U.S. for the 1990–2011 period and show that direct investment yield differentials play an important role in their sample.

- OC_{t+1} represents mismeasured positions as advocated by Lane and Milesi-Ferretti (2009) for non-portfolio positions of banks and non-banks. For these categories covering bank loans, deposits, short-term paper and trade credits, capital gains are unlikely to be large. However the scope of the surveys has progressively expanded over time and the methodology has improved making it plausible that initial positions were mismeasured.

Lane and Milesi-Ferretti (2009) offer a detailed and careful discussion of these different options, indicating where mismeasurements are likely to be more severe. They end up recommending that for portfolio assets and liabilities, the residual be partly reallocated to financial flows; for FDI that it be reallocated to capital gains; and for non-portfolio positions of banks and non-banks that it be reallocated to mismeasured initial positions.

How Large is the “Exorbitant Privilege”? We follow an agnostic approach and allocate the residual term in different ways to assess quantitatively whether the results change substantially. As pointed out already by Lane and Milesi-Ferretti (2009) allocating the residual term to valuations increases the excess returns on the net foreign asset position, while allocating it to flows decreases it. Table 10.3 presents in (a) the most conservative results regarding the excess returns (following Curcuru et al. (2008b)—whose own estimates are presented in row (e) for the shorter period analyzed in their paper—we allocate *all* the residuals to flows); in (b) we allocate all the residuals to flows except for FDI where they are allocated to valuations as argued by Lane and Milesi-Ferretti (2009); in (c) we present an upper bound for the excess returns as all the other changes are allocated to valuations. In rows (d)–(h) we present earlier estimates of the literature pertaining to

⁵⁹ Capital account transactions are well measured if they correspond mostly to official aid and grants. However, we note that the capital account also includes transactions in non-produced, non-financial assets, such as patents and trademarks which should be included in direct investment returns and are unlikely to be measured with great precision.

⁶⁰ For the return on the overall position, they use BEA original data releases instead of revised data to compute their estimates, arguing this corrects the problem of disparate revision policies between stocks and flows.

⁶¹ As we show below, the difference in estimates comes from the short sample period and volatility of underlying returns.

5.1.4. Intertemporal Approach to the Current Account

We now go back to the external solvency constraint (39), and iterate it forward, imposing a no-Ponzi condition and taking conditional expectations⁶²:

$$NA_t = -E_t \left[\sum_{i=1}^{+\infty} \left[\prod_{j=1}^i R_{t+j} \right]^{-1} NX_{t+i} \right]. \quad (44)$$

This expression states that the net foreign asset position of a country should equal the (opposite of) the expected present discounted value of future trade balances, discounted at the cumulated return on the net foreign asset position. Hence the current value of a country's net foreign asset position reflects both the expected future path of net exports and of returns on the net foreign asset position. Equation (44) is very generic: it has to hold, regardless of the details of the economic model, provided Ponzi schemes are ruled out. To illustrate the economic intuition behind this intertemporal constraint, imagine that some news leads agents to update upwards their estimates of future net exports. That same news would either decrease the value of current net foreign assets (either by movements in the exchange rate or by increasing consumption and current indebtedness for example) or would affect expectations of future returns on the net foreign asset position (or both).

In a world where internationally traded assets consist only in riskless government bonds whose gross rates of returns are R_t^f , the rate of return on the net foreign asset positions R_t simplifies to R^f . In such a world, which may not be so different from the pre-1980s international capital markets, equation (44) takes the familiar form $NA_t = -E_t \sum_{i=1}^{+\infty} (1+r)^{-i} NX_{t+i}$ where we also assumed that $R_t^f = (1+r)$ is constant. Hence in this “relatively non-financially globalized world”, any movements in the net foreign asset position has to be made up in the future by net exports. The international adjustment process of countries relies exclusively on *quantity* adjustments through the classical *trade channel*.⁶³ Furthermore, since there are no capital gains or losses on net riskless bond positions, it is immediate from (40) that there is no valuation effect either and the change in the net foreign asset position $NA_{t+1} - NA_t$ coincides with the current account CA_t . From there, the simplest version of the *intertemporal approach to the current account* assumes an infinite-horizon certainty-equivalent representative consumer, with a

⁶² The no-Ponzi condition is: $\lim_{k \rightarrow \infty} \left(\prod_{j=1}^k R_{t+j} \right) NA_{t+k} = 0$.

⁶³ Whether this adjustment requires movements in the real exchange rate and/or the terms of trade, is a debated issue. Obstfeld and Rogoff (2005) present estimates of the adjustment in relative prices needed to close the U.S. current account. Corsetti et al. (2013) argue that some of the adjustment can come from adjustments at the extensive margin, i.e. through the export/import of new varieties, without much adjustment in terms of trade. Faruquee et al. (2007) present a richer simulation based on four regional blocs.

stationary along a balanced-growth path, even a cursory look at the data shows in contrast, that the stock of gross assets and gross liabilities, exports and imports are on a transition path. Looking at international financial integration from a historical perspective (see for example [Obstfeld and Taylor, 2004](#)), capital mobility increased between 1880 and 1914, decreased between the First World War and the end of the Second World War, and has been increasing until the advent of the global financial crisis. Many of these long run structural shifts are driven by exogenous forces, chief among them technological innovations in the shipping and communication industries. Hence a natural approach consists in modeling the world economy as a stochastic economy around a slow-moving deterministic trend. The variables of interest are the fluctuations of the net asset, and net export variables *in deviation from these trends*.⁶⁸ The derivation of the loglinearized solvency constraint requires several steps and some ancillary assumptions, which are relegated to the appendix available on the authors' websites. Denote by nxa_t a linear combination of the stationary components of exports, imports, assets and liabilities (the weights are constant given by the loglinearization). The loglinearized approximation of (46) takes the following form:

$$nxa_{t+1} \approx \frac{1}{\rho} nxa_t + r_{t+1} + \Delta nx_{t+1}, \quad (47)$$

where r_t are the loglinearized returns on the net foreign asset position, the variable nxa_t is a measure of *cyclical external imbalances*, and Δnx_{t+1} measures the cyclical net export growth. Unlike the current account, this expression incorporates information both from the trade balance (the flow) and the foreign asset position (the stock). It increases with assets and exports and decreases with imports and liabilities. Finally, the constant ρ equals the ratio of the long-term growth rate of the economy to the long-term gross return on the net foreign asset position, assuming the economy eventually settles in a balanced-growth path. Assuming a no-Ponzi condition and taking expectations, one obtains:

$$nxa_t \approx -E_t \sum_{j=1}^{+\infty} \rho^j [r_{t+j} + \Delta nx_{t+j}], \quad (48)$$

where we assume $\rho < 1$, i.e. that the long-term growth rate of the economy is lower than the steady-state rate of return, a plausible restriction.⁶⁹

[Equation \(48\)](#), which is the loglinearized equivalent of (44), is central to the analysis of external adjustment dynamics in a world of integrated financial markets. It shows that movements in net exports and the net foreign asset position must forecast either future

⁶⁸ In that sense the exercise is similar to the one performed in the business cycle literature, which separates trend growth from medium frequency fluctuations and focuses exclusively on the latter. It differs from it though, in that the trends considered here have considerably lower frequency. [Evans \(2012\)](#) proposes a variation that keeps the trend component. It requires that the ratio of gross assets to gross liabilities be stationary.

⁶⁹ This also implies that the steady-state mean ratio of net exports to net foreign assets NX/NA satisfies $NX/NA = \rho - 1 < 0$. In other words, countries with long run creditor positions ($NA > 0$) should run trade deficits ($NX < 0$) while countries with steady-state debtor positions ($NA < 0$) should run trade surpluses ($NX > 0$).

portfolio returns, or future net export growth, or both. Consider the case of a country with a negative value for nx_a , either because of a deficit in the cyclical component of the trade balance, or a cyclical net debt position, or both. If returns on net foreign assets are expected to be constant: $E_t r_{t+j} = r$. In that case, [equation \(48\)](#) implies that any adjustment *must* come through future increases in net exports: $E_t \Delta nx_{t+j} > 0$. As above, this is the standard implication of the intertemporal approach to the current account, where adjustment is done by quantities. This is the *trade channel of adjustment*.

But instead, the adjustment may also come from high *expected* net foreign portfolio returns: $E_t r_{t+j} > 0$. This is the *valuation channel of adjustment*. Such movements in predictable returns can occur via a depreciation of the domestic currency which induces a predictable wealth transfer from foreigners to domestic residents. The role of the exchange rate can be illustrated by considering the case—relevant for the U.S., the U.K., and generally advanced economies—where foreign liabilities are mostly denominated in domestic currency while foreign assets are mostly denominated in foreign currency. Holding local currency returns constant, a currency depreciation helps stabilize the net external asset position as it increases the domestic return on foreign assets, an effect that can be magnified by the degree of leverage of the net foreign asset portfolio. If we consider emerging markets, external liabilities are likely to be at least partly denominated in foreign currency (U.S. dollar or euro). A domestic currency depreciation might then lead to sizable losses on the net foreign asset position for these countries and be destabilizing, as in the Asian financial crisis of 1997–1998.⁷⁰

Quantifying the Trade and the Valuation Channels of Adjustment. It is possible that some of today's fluctuations in the cyclical net foreign asset position come from *unexpected* changes in asset prices or net exports. These unexpected changes would be reflected simultaneously in the left- and right-hand side of [equation \(48\)](#). If valuation changes were mostly unexpected and had a white noise structure, they would not matter much for the underlying process of external adjustment. If, on the contrary, they had a predictable component they would be potentially an important component of the process of international adjustment, just like the trade channel.

We can decompose the cyclical imbalance nx_a into a valuation and a net export component $nx_a = nx_a^r + nx_a^{\Delta nx}$ where nx_a^r is the component of nx_a that forecasts future returns, while $nx_a^{\Delta nx}$ is the component that forecasts future net exports growth. We construct empirical estimates of nx_a^r and $nx_a^{\Delta nx}$ using a VAR formulation. Specifically consider the VAR (p) representation for the vector $(r_{t+1}, \Delta nx_{t+1}, nx_a)'$. Appropriately stacked, this VAR has a first order companion representation: $z_{t+1} = A z_t + \epsilon_{t+1}$. We construct nx_a^r and $nx_a^{\Delta nx}$ as:

$$nx_a^r = \beta e_r' A (I - \rho A)^{-1} z_t; \quad nx_a^{\Delta nx} = -e'_{\Delta nx} A (I - \rho A)^{-1} z_t,$$

where e_r' ($e'_{\Delta nx}$) defines a vector such that $e_r' z_t = r_t'$ (resp. $e'_{\Delta nx} z_t = \Delta nx_t'$).

⁷⁰ Corsetti and Konstantinou (2012) use a similar approach to show that transitory shocks are important drivers of gross asset and liability positions while variations in aggregate consumption are dominated by permanent shocks.

We can also compute the unconditional decomposition of the variance of $nx a_t$:

$$1 = -\frac{\text{cov}\left(\sum_{j=1}^{+\infty} \rho^j r_{t+j}, nx a_t\right)}{\text{var}(nx a_t)} - \frac{\text{cov}\left(\sum_{j=1}^{+\infty} \rho^j \Delta nx_{t+j}, nx a_t\right)}{\text{var}(nx a_t)} \equiv \beta_r + \beta_{nx}.$$

The empirical study of the measure of cyclical imbalances of the United States $nx a_t$ uncovers the following stylized facts:

1. The valuation channel has historically accounted for roughly 30% of the process of adjustment of the United States toward its long run solvency constraint. The results are similar for the conditional decomposition and the unconditional variance decomposition (β_r).
2. The capital gains on the net foreign asset position are positively correlated with net exports for the United States.
3. Current imbalances help predict net exports (especially in the medium to long run), returns in the net foreign asset position (in the short to medium run), and the exchange rate from one quarter onwards, both in and out of sample.

Writing models compatible with these facts has proved to be a challenging task, as discussed in the next section.

5.2. Theoretical Models and Valuation Effects

5.2.1. Expected and Unexpected Valuation Effects

Valuation effects come in two flavors: unpredictable and predictable. The first variety does not create any particular difficulty for standard models of international finance: while we may argue over what model best characterizes international portfolio holdings, most models from our toolbox would incorporate in one form or another something akin to a parity condition. Conceptually, perhaps the simplest way to understand unpredictable valuation terms is by reference to a standard complete market model. In such a set-up, one can interpret unexpected valuation effects as the record-keeping of future payments on the contingent claims held by domestic and foreign investors, payments that implement full risk sharing. Interpreted in this light, the volatility generated by valuation adjustments could be interpreted as “good volatility” insofar as it reduces the volatility of marginal utility of consumption and improves welfare.

Consider for example a symmetric two-country, two-good endowment economy in complete markets. Imagine the domestic economy is hit by a positive output shock. As is well known (see for example Chapter 5 of [Obstfeld and Rogoff \(1995\)](#)), when current realization of domestic output is high compared to foreign's, the domestic economy is running a trade surplus, while the real exchange rate is depreciating due to the relative abundance of the domestic good. In complete markets, the home country becomes a net debtor as foreigners hold claims on current and future domestic output and domestic asset is worth more relative to foreign's. Hence foreigners realize an (unexpected) capital gain on their net asset position. So when its trade balance is in surplus, the domestic economy experiences a valuation loss on its net external asset position. This is the desired outcome

from an efficient risk sharing point of view and these valuation gains and losses tend to stabilize the external debt dynamics. External liabilities will tend to disappear over time so that the relative wealth distribution remains stationary. Hence, in that standard set-up, there are potentially strong valuation effects but these are unexpected capital gains and losses on the net foreign asset position. As such, they do not contribute to the adjustment process described in [equation \(48\)](#) which is driven by *expected* gains and losses. This is not to say that it would be impossible to get expected valuation effects in models with complete markets, but for this to happen, one would need, for example, models with time variation in the risk premia, such as external habits models (see [Campbell and Cochrane, 1999](#)).

Conversely, models with incomplete markets do not necessarily generate expected valuation effects. [Pavlova and Rigobon \(2012\)](#) present a continuous time two-country pure exchange model with incomplete markets in which stocks and a bond are traded and in which valuation effects are non-existent. There are supply shocks in both countries as well as preference shocks for the home country good. By assuming logutility, [Pavlova and Rigobon \(2012\)](#) are able to elegantly obtain closed form solutions and to gain a number of important insights. Interestingly, in their model, preference shifts can introduce enough heterogeneity to generate non-zero bond holdings in equilibrium. They show that in the absence of intertemporal hedging –which comes from the log preference specification, the net foreign asset position is exactly equal to the present value of future trade deficit. This result reflects the absence of time varying risk premia in their incomplete asset market model. In loglinearized models with more general utility specifications and incomplete markets such as for example [Tille and van Wincoop \(2010\)](#) or [Evans and Hnatkovska \(2012\)](#), similar results have been obtained as a first order approximation around the deterministic steady state. More generally, as long as the Euler condition of the model implies expected returns are equalized at the first order around the non-stochastic steady state, expected valuation effects can only be of second or higher order, a point noted by [Devereux and Sutherland \(2010\)](#). Expected valuation effects will therefore generally not be quantitatively large in this class of models, as they can only reflect changes in second or higher order moments. As a result, and despite significant methodological advances made by [Devereux and Sutherland \(2011\)](#) and [Tille and van Wincoop \(2010\)](#), the recent microfounded literature on optimal portfolios in Dynamic Stochastic General Equilibrium (DSGE) models of the open economy surveyed in [Coeurdacier and Rey \(2013\)](#) has not, so far, led to frameworks in which expected gains and losses on net foreign asset positions can be substantial.

5.2.2. Modeling Expected Valuation Effects

By contrast, the predictable valuation effects that are relevant for the U.S. adjustment along its long run solvency constraint require large deviations from standard arbitrage conditions. Some limited progress has been made toward modeling predictable valuation effects with a revival of the older portfolio-balance literature associated with the work

of Dale Henderson, Pentti Kouri, or the late Bill Branson. [Blanchard et al. \(2005\)](#) provide a very elegant presentation of the Kouri portfolio balance model and explore its implications for the joint dynamics of the U.S. current account and the dollar. In this literature, a key assumption is imperfect asset substitutability. A negative shock to the trade balance of the United States leads to a depreciation of the U.S. dollar. But this immediate unexpected depreciation does not fully offset the shock. If it did, there would be excess demand for U.S. assets since the supply of assets is assumed inelastic and in dollar terms the value of the rest of the world's wealth rises. Instead, there is a less than offsetting drop in the dollar and foreigner's demand for U.S. assets is kept in check by a further *expected* depreciation of the dollar toward its long run steady-state value. The U.S. keeps on accumulating more debt along the depreciation path so that the long run level of the dollar will be below that which would have been needed to offset the negative shock at once. If in contrast assets were perfect substitutes then the exchange rate would have immediately jumped to offset the negative shock fully. The imperfect substitutability of assets implies a slow adjustment of the portfolios together with expected exchange rate changes. Very interestingly the model does therefore predict that foreigners will be purchasing U.S. dollar assets while expecting a dollar depreciation. The model however has the drawback of assuming exogenous interest rates and ad hoc demand functions for financial assets. Microfoundations and general equilibrium effects tend to mute portfolio balance effects. For example, [Backus and Kehoe \(1989\)](#) have shown in the context of sterilized interventions on foreign exchange markets that if a general equilibrium setting is adopted, portfolio balance effects are not present any longer. Changes in the relative supplies of bonds do not matter if one takes into account the ensuing changes in monetary and fiscal variables. As [Woodford \(2012\)](#) recently remarked in his Jackson Hole address assessing the effectiveness of open market purchases, in most of our microfounded general equilibrium models, a Modigliani–Miller irrelevance result holds (see [Wallace, 1981](#)). When assets are valued “only for their pecuniary returns” (they may not be perfect substitutes from the standpoint of investors, owing to different risk characteristics, but not for any other reason) and when there are no limits to arbitrage, one of the core predictions of portfolio balance models, which is that changing the relative supply of assets has an effect on prices, goes away. This is because the market price of any asset is taken to be the present value of returns. Since changing the relative supplies of assets should not change the real quantity of resources available for consumption in each state of the world, the representative household's marginal utility of income in different states of the world should not change. Hence the pricing kernel should not change, and the market price of a given asset should not change either (see [Woodford, 2012, p. 61](#)).

The open economy literature has so far not managed to come up with a new generation of portfolio balance models microfounded and embedded in a general equilibrium set-up. In the context of closed economies some recent papers have introduced strong frictions on asset markets in order to rationalize the effect of net supply changes on prices.

Greenwood and Vayanos (2008) for example build on the idea of “preferred habitat” for bond market investors, a very strong form of non-substitutability of assets, to study the effect of open market interventions. A similar research agenda could be pursued in the open economy.

6. THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

The world banker balance sheet of the U.S. generates excess returns in normal times. But, as explained in Gourinchas et al. (2010), this “exorbitant privilege” has a counterparty in times of financial turmoil. The U.S. as the center country of the international monetary system provides insurance to the rest of the world. During a global crisis, there is a massive wealth transfer from the U.S. to the rest of the world. This insurance transfer occurs at a time where the marginal utility of consumption is high. This is the “exorbitant duty.” It is implemented very naturally by a portfolio long in risky assets—whose value goes down dramatically in crisis times—and short on government debt—whose value remains relatively stable in crisis times. This is precisely the external portfolio of the U.S., issuer of the safe asset, the reserve currency, which is held in large quantities abroad. Hence Gourinchas et al. (2010) argue that the U.S. plays the role of a *global insurer*. This interpretation of the role of the center country in the international monetary system is new. Traditional views have focused on the network externality in the use of the center country’s currency as a medium of exchange: the dollar is used in international transactions because the sheer size of the U.S. economy in the world makes it more likely that other agents use it and therefore dollar transaction costs are low (see for example Krugman, 1980).

The economic intuition of the global insurance role of the U.S. can be simply captured within a CCAPM framework.⁷¹ If we denote the net foreign asset position of the U.S. as $NA_t = A_t - L_t$, the external solvency constraint (in a world with no government consumption nor investment) is given by $NA_{t+1} = (1 + r_{t+1}^a) A_t - (1 + r_{t+1}^l) L_t + Y_t - C_t$, where r_{t+1}^a and r_{t+1}^l are the returns on gross external assets and liabilities.

Let us call r_t the risk-free rate of interest, we can then use the no arbitrage condition of a representative consumer model to get

$$(1 + r_t) E_t \left(\frac{\beta u'(C_{t+1})}{u'(C_t)} \right) = E_t \left(\frac{\beta u'(C_{t+1})}{u'(C_t)} (1 + r_t^a) \right) = E_t \left(\frac{\beta u'(C_{t+1})}{u'(C_t)} (1 + r_t^l) \right) = 1.$$

Multiplying the external constraint through by the pricing kernel and taking expectation:

$$E_t \left[\frac{\beta u'(C_{t+1})}{u'(C_t)} NA_{t+1} \right] = A_t - L_t + \frac{Y_t - C_t}{1 + r_t},$$

⁷¹ We are very grateful to Maury Obstfeld for this insight.

which is equivalent to

$$E_t (NA_{t+1}) = (1 + r_t) NA_t + Y_t - C_t - (1 + r_t) \text{cov}_t \left[\frac{\beta u' (C_{t+1})}{u' (C_t)}, NA_{t+1} \right].$$

Hence, by having a net external position which comoves negatively with the stochastic discount factor (i.e. which decreases when the marginal utility of consumption is high), the U.S. is able to increase the expected return on its net foreign asset position (this is the “exorbitant privilege”). As a mirror image, the rest of the world sees its return on its net foreign asset position decreased due to the hedge provided by the center country. Indeed during the 2007–2009 global financial crisis, the U.S. wealth transfer to the rest of the world amounted to about \$2 trillion. [Gourinchas et al. \(2012\)](#) present some empirical evidence on the geographical distribution of gains and losses. Interestingly during that period, some regional insurers such as Switzerland and the euro area also provided wealth transfers to the rest of the world alongside the U.S., albeit on a much smaller scale.

[Gourinchas et al. \(2010\)](#) provide a theoretical model of the role of the U.S. as the global insurer. The model features both business cycle and global risk. The U.S. portfolio, endogenously determined, is long equity and short in safe assets. This portfolio reflects an assumed asymmetry in risk aversion between the U.S. and the Rest of the World (more risk averse).⁷² One way of microfounding this asymmetry in risk aversion is provided by [Maggiori \(2011\)](#) who models a world in which financial development is unequal. The country whose financial intermediaries are less constrained will behave in the aggregate as if it were less risk averse. Another possible microfoundation can be found in [Mendoza et al. \(2009\)](#), where it is a better ability to share idiosyncratic risk within the U.S., which enables the U.S. to be long in risky assets internationally. Focusing on international bond markets, [Hassan \(forthcoming\)](#) emphasizes differences in country sizes to explain differences in real rates of returns. In his model, bonds of larger economies (in particular the U.S.) are better hedges because they insure against shocks that affect a larger fraction of the world economy.

This interpretation of the workings of the International Monetary System, where the U.S. is a global insurer, puts center stage the ability of the U.S. to issue safe assets (government bonds). Those are backed by the *fiscal capacity* of the United States. During times of global crisis, U.S. government bonds are the only assets able to provide insurance on a massive scale (the Swiss bond market can also be considered a safe haven but its sheer size precludes it from being the world insurer). This in turn suggests the emergence of a modern version of the Triffin dilemma. In the 1960s, Robert Triffin identified a fundamental weakness in the Bretton Woods institutions. Under that system, the currencies of member countries could be exchanged at a fixed rate against the dollar while the value of

⁷² [Stepanchuk and Tsyrennikov \(2011\)](#) also model the U.S. as a less risk averse economy and use global solution methods to solve for optimal portfolios under incomplete markets.

the dollar was fixed against gold at \$35/oz. Triffin observed that global liquidity demand grows with the global economy. As the rest of the world grew, so did the stock of dollars held abroad. In the meantime, however, the United States' gold stocks (backing the dollars held abroad) remained more or less constant. Maintaining the gold value of the dollar had to become increasingly difficult, and the crisis of the dollar unavoidable. Ten years before the end of the Bretton Woods system, Triffin had thus predicted its collapse. The gold value of the dollar is no longer fixed, but we still live in a Triffin style world. There is a growing asymmetry between the fiscal capacity of the United States (the “backing” of U.S. Treasury bills) and the stock of reserve assets held abroad, in other words, the U.S.'s external debt, thus threatening the ability of the U.S. to act as a world insurer (see [Farhi et al., 2011](#); [Obstfeld, 2011](#)).

7. CONCLUSION

The consequences of these dramatic changes in the landscape of international finance have only started to be investigated recently. A large part of the economics profession, as well as international organizations (see for example [Fischer, 1997](#)) often see financial integration as an ideal toward which economies should aspire. The belief was that by moving toward a more integrated world, the international economy would reap many of the benefits from better risk sharing. The recent crisis however, having shaken advanced economies' financial systems more deeply than emerging markets', has altered this view and put at the forefront the dangers of contagion inherent to large cross-border holdings. It has become more obvious that current accounts deficits or surpluses, linked to net capital flows, miss important dimensions of the process of international adjustment of countries and of their financial fragility in crisis times.⁷³ After all, the euro area was running a balanced current account vis-à-vis the U.S. and yet it was deeply affected by the U.S. financial crisis of 2007–2008. The properties of the international balance sheet of countries determine how different shocks propagate across countries and how countries adjust. There is a clear need for a deeper analysis of the international financial landscape.

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⁷³ See Obstfeld (2012) for a recent careful and nuanced discussion of the role of current accounts.

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