

## With Privilege Comes...?

October 2009



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With the post-Lehman flight-to-liquidity bid waning, the US dollar exchange rate has returned to the downward trajectory in place since 2002. Notwithstanding the perfunctory rhetorical support for a Rubin-esque “strong dollar” policy by US administration officials, there is growing recognition that fundamental forces are aligned to put downward pressure on the dollar for some time to come. The forces most cited in the financial press include

- *Fed on hold at the zero lower bound for an extended period*
- *Vast expansion in the monetary base*
- *Prospects for a “W” US recovery in a New Normal world*
- *Trillions of dollars of Treasury issuance with massive budget deficits in the near term and in out years*

The key question, really, is not will the dollar downdraft resume (it has resumed and will likely continue). The key question is instead, will the pace of depreciation turn into a rout that jeopardises the reserve currency status of the dollar and the accompanying “exorbitant privilege” that accrues to the US? It is instructive to assess the

value of the “exorbitant privilege” in light of data recently released by the US Treasury on the US international investment position for the crisis years of 2007–2008 and revised data for previous years. These data suggest that an orderly decline in the dollar may help to rebalance global investment portfolios if, as expected, global investment flows – both official and private – continue to diversify away from US assets. This effect on the US international investment position is one of two complementary, but distinct, results of a dollar weakness. The better understood outcome is that a weaker dollar may serve to prevent the US current account deficit, at present less than 4% of GDP, from ballooning back to nearly 7% of GDP, as it was at the peak of the credit bubble.

Because of its “exorbitant privilege” as the provider of the global reserve currency, the

US tends to reap a capital gain when the dollar depreciates, since US assets abroad are mostly foreign currency-denominated while US liabilities owed to foreign investors are almost entirely dollar-denominated, according to data collected by the US Treasury. Therefore, an orderly decline in the dollar may facilitate global portfolio adjustment by reducing the value of the US net international liability position, *so long as the US retains the privilege*. However, there is ultimately no “free lunch” for the US from dollar depreciation. Foreign producers who export to the US may be willing to absorb the weaker dollar in their profit margins to some extent, but eventually, a weaker dollar will likely worsen the US terms of trade, potentially slowing growth of US living standards and, ultimately, US demand.

This situation is a privilege in the sense that most countries with large net international

liability positions are generally forced by the capital markets to issue liabilities in *foreign* currency. For example, think of the present situation in many central European countries where mortgage liabilities to foreign-owned banks are denominated in foreign currency. When their currencies weaken, their net international liabilities generally go up (when measured in local currency). This is destabilising, as these countries have found out.

## Background

As a matter of accounting, the current account (CA) imbalance must equal the difference between national saving and investment (I).

National saving, in turn, is the sum of private saving ( $S^{\text{private}}$ ) by households and corporations and saving by the government, or taxes (T) minus government spending (G):

$$CA = (T - G) + S^{\text{private}} - I$$

The US runs a current account deficit of roughly 3.8% of GDP, according to the US Treasury. We account for this as follows. First, the government is currently running a massive budget deficit, where  $T - G$  is negative and subtracts from national saving. The current account deficit is smaller than the budget deficit because of a surplus of private saving – both household and business saving (corporate profits) – relative to a depressed level of business and residential investment.

In textbooks, it is often assumed that the change in the net international investment position of a country is just equal to the current account balance:

$$\Delta NIIP = CA$$

This implies that if the US runs a current account deficit of  $-\$660$  billion, as it did by one measure in 2007, the first year of the crisis, the textbook would expect the US net

Components of Changes in the Net International Investment With Direct Investment at Current Cost, 2002-2008 [Millions of Dollars]							
Year	Position Beginning	Changes in Position				Total  (a+b+c+d)	Position Ending
		Attributable to			Other Changes (Incl. Changes in Coverage and Net Capital Gains of Foreign Affiliates)		
		Current Account	Valuation Adjustments				
			Asset Price Changes (Local Currency)	Exchange- rate Changes			
(a)	(b)	(c)	(d)	(a+b+c+d)			
2002	-1,868,875	-500,515	-62,273	148,321	245,372	-169,095	-2,037,970
2003	-2,037,970	-532,879	8,613	275,116	200,607	-48,543	-2,086,513
2004	-2,086,513	-532,331	94,578	197,843	81,006	-158,904	-2,245,417
2005	-2,245,417	-700,716	720,816	-220,947	521,118	320,271	-1,925,146
2006	-1,925,146	-809,150	418,394	222,496	-90,876	-259,136	-2,184,282
2007	-2,184,282	-663,556	232,361	443,699	31,862	44,366	-2,139,916
2008	-2,139,916	-505,060	-720,137	-583,040	478,907	-1,329,330	-3,469,246

Source: US Treasury – Treasury International Capital (TIC) System

international investment position to deteriorate by –\$660 billion that year. But as shown in the table above, it did not. This would only be true if asset prices in local currency terms are unchanged and if exchange rates are unchanged. In the real world, asset prices and exchange rates do change and as we see, these have a large impact on the US international investment position. Moreover,

the impact of asset price and exchange rate changes on the net international investment position depends on the size, composition and currency denomination of the gross holdings of US assets abroad and foreign claims against the US. Thus in the real world we have:

$$\Delta NIIP = CA + (\text{effect of asset price changes local currency}) + (\text{effect of currency changes})$$

In 2007 the US began the year with a net international liability position of –\$2.1 trillion. That same year, the US current account deficit was \$663 billion. But of course asset prices in local currencies changed here and abroad, as did the US dollar exchange rate. In 2007, the dollar depreciated and this represented a capital gain to US investors in foreign currency assets of \$443 billion. This capital gain was not unusual. *Indeed, for the years 2002 through 2007, the cumulative capital gain to US investors from a weaker dollar exceeded an “exorbitant” 1 trillion dollars!*

The table also illustrates that in most recent years US investors have benefited from global asset price changes (local currency) even though the US has a net international liability. How can this be? Since gross US liabilities to foreign investors exceed gross US holdings of foreign assets, in rising markets shouldn't the value of liabilities go

up by more than the value of assets? This could be the case if US and foreign investors held similar portfolios, but they don't. Data collected by the US Treasury show clearly that US investors hold a larger share of foreign direct investment (FDI) and equities in their foreign portfolios, while foreign investors in the US (including, importantly, central banks and sovereign wealth funds) have portfolios that are much more concentrated in Treasuries, other fixed income and cash equivalents. In years when FDI/equity returns are strong, the US tends to earn a net capital gain even though it has a net liability position. Nice work if you can get it! So as a result of the dollar downdraft, rising equity markets, the FDI/equity tilt in US global portfolios, and the Treasury/cash tilt in foreign holdings of US assets, *there was little change in the US net international liability position between 2002 and 2007, even though the*

*US ran cumulative current account deficits of \$3.3 trillion during those five years! Exorbitant privilege indeed!*

The data also show the impact of the crisis in 2008 on the US international investment position was the reverse of what we observed in 2007. While the dollar weakened during the first half of the year, it strengthened sharply in the fall of 2008 as global portfolios sought to rebalance in favour of the world's then most liquid asset, Treasuries. This pushed up the dollar's value and drove down Treasury yields. Equities also sold off sharply. Because foreign holdings of US assets are concentrated in Treasuries, while US investments abroad are tilted toward equities and FDI, the US international investment position deteriorated by \$720 billion in 2008 due to changes in bond and stock prices in local currencies. On top of

this, the stronger dollar delivered a capital loss to US investors abroad of nearly \$600 billion. Together, these asset price changes and the US current account deficit caused the net international investment position of the US to deteriorate substantially in 2008, with net international liabilities rising by *\$1.3 trillion* to end the year at *-\$3.5 trillion*.

### **Implications Going Forward**

As the global economy recovers, it is likely that the 2008 surge in the net US international liabilities will put downward pressure on the dollar for some time to come. In a post-crisis world the relative attractiveness of US assets has and will likely continue to decline, and global investors may seek to rebalance away from the 60% increase in their net exposure to US assets that occurred in 2008. This is negative for the dollar and, in the New Normal, also likely negative for the *relative* performance of US equities, especially

for companies without a global presence that must grind out profits in a world of 4% nominal GDP growth. For fixed income, much will likely depend on the appetite and portfolio preferences of foreign central banks and sovereign wealth funds as global private demand for sovereign debt – US Treasuries included – is eventually likely to lag behind the vast increase in sovereign debt supply which may result from current and prospective budget deficits. An orderly decline in the dollar, similar to the decline between 2002 and 2007, would likely contribute to this adjustment. For example, because of the exorbitant privilege, the decline of the dollar from 2002 to 2007 reduced net US international liabilities by \$1 trillion. While an orderly decline in the dollar is the *most likely* scenario going forward, a disorderly decline, while unlikely, cannot be ruled out. Much may depend on how history completes

the sentence which provides the title for this essay. If “with (exorbitant) privilege comes *responsibility* (on fiscal, regulatory, and monetary policy),” a disorderly decline will likely be avoided. If not...?

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