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ECONOMIC Synopses

The United States as a Global Financial Intermediary and Insurer

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The press, politicians, and academics have focused attention on the large and sustained negative U.S. trade and current account imbalances since their inception in the 1970s. Much of this attention has cast blame on protectionist practices of foreign countries, especially Japan in the 1980s and China most recently. Two important considerations are often ignored: First, the counterpart of a deficit in the current account is a positive net capital inflow. That is, any country with a current account deficit must also be getting capital inflows to finance either domestic investments or consumption. Shutting down those inflows would require a reduction in domestic investments and consumption or possibly both. Second, and more interestingly, American investors can use capital inflows from the rest of the world to finance their own investments abroad. In other words, Americans can be investing in the rest of the world at the same time that foreigners are investing in the United States. This allows both sides to diversify their asset holdings.

Over long periods, American investors have obtained rates of return from their foreign assets that exceed the rates of return on foreign holdings of U.S. assets. The first column of the table shows estimates from Gourinchas, Rey, and Govillot (2017), who find that from 1952 to 2015, American investors obtained a 5.8 percent rate of return on their foreign investments, while foreign investors obtained only 3.3 percent on their U.S. assets. Hence, U.S. investors could earn positive net income while holding a lower level of assets abroad than foreigners hold in the United States. Indeed, back-of-the envelope calculations suggest large leverage ratios (liabilities-to-asset) ratios, on the order of 1.75, could be sustainable for the United States. More elaborate estimates find lower numbers, but all of them are well above 1.[1]

> In times of global crisis, the rest of the world gains from investing in U.S. assets.

The table also shows that U.S. investors hold foreign assets that are riskier than U.S. foreign liabilities: Returns to the former have a higher standard deviation than returns to the latter, 15.2 percent versus 11.8 percent. This finding is consistent with the fact that U.S. liabilities are largely in the form of equity and foreign direct investment (FDI), while much of the U.S. foreign liabilities are in the form of bonds and bank deposits, which have more stable market values. These asymmetries explain the differences in average returns and risks (standard deviations).

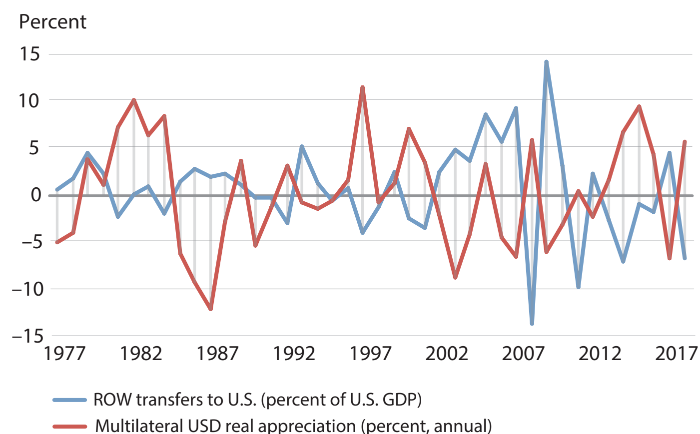
These portfolio asymmetries have implications for the global allocation of risk. Indeed, Gourinchas, Rey, and Govillot (2017) argue that the United States is working as a global insurer. That is, in exchange for collecting positive

U.S. External Portfolio: Quarterly Returns (annualized, %)

	Overall 1952:Q1-2015:Q4		Bretton Woods 1952:Q1-1972:Q4		Post Bretton Woods 1973:Q1-2015:Q4	
Returns	**Average**	**SD**	**Average**	**SD**	**Average**	**SD**
Assets	5.8	15.2	6.2	9.5	5.6	17.4
Liabilities	3.3	11.8	3.6	10.8	3.2	12.3
Difference	2.5	10.2	2.6	6.7	2.5	11.5

NOTE: SD, standard deviation.
SOURCE: Gourinchas, Rey, and Govillot (2017, Panel C of Table 1).

Implied Transfers from the Rest of the World to the United States (percent of U.S. GDP)



NOTE: ROW, rest of the world. USD, U.S. dollar.
SOURCE: Author's calculations using data from FRED®, Federal Reserve Bank of St. Louis.

net returns during normal times, the United States transfers resources to the rest of the world during global downturns and crises. Collecting positive returns in normal times and paying out during bad times is what an insurance company does. During global crises the market value of most assets, including U.S.-owned foreign equity and FDI, falls relative to the value of U.S. Treasury bonds. Moreover, during global crises, investments "fly to quality," typically leading to an appreciation of the U.S. dollar. As a result, during a crisis the value of the U.S. international investment position (IIP) falls; that is, the amount of U.S. resources owned by foreigners increases. Net of the balance in the current account of the period, these changes in the U.S. IIP represent a transfer of resources between the United States and the rest of the world. Indeed, the red line in the figure shows the annual valuation of the U.S. IIP, net of the current account of the period, as a fraction of U.S. gross domestic product (GDP) each year. On average, the value is positive (around 0.84 percent per year); that is, the United States is paid by the rest of the world. But the value becomes negative during global turmoil, most notably during the Great Recession of 2007-09, when it reaches 13 percent of U.S. GDP[2]; that is, the United States implicitly transfers resources to the rest of the world during these times—partly because the U.S. dollar (the blue line, measured by the real multilateral rate) tends to appreciate during these times. This appreciation increases the net debt of the United States with the rest of the world because most U.S. liabilities are denominated in U.S. dollars, while a large share of U.S. foreign assets are denominated in foreign currency. This association partly explains why the transfers are not persistent over time. ■

Notes

[1] See Gourinchas and Rey (2007); Chien and Naknoi (2015); and Wang, Wen, and Zhiwei (2015) among others.

[2] It also turns negative during the early 1980s, the Tequila Crisis of 1994, the Asian financial crisis of 1997-98, and the European debt crisis of 2012-14.

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