EUROPEAN CENTRAL BANK
EUROSYSTEM

Discussion of paper by Philip Lane & Gian Maria Milesi-Ferretti on

"Where Did All The Borrowing Go? A Forensic Analysis of the U.S. External Position "

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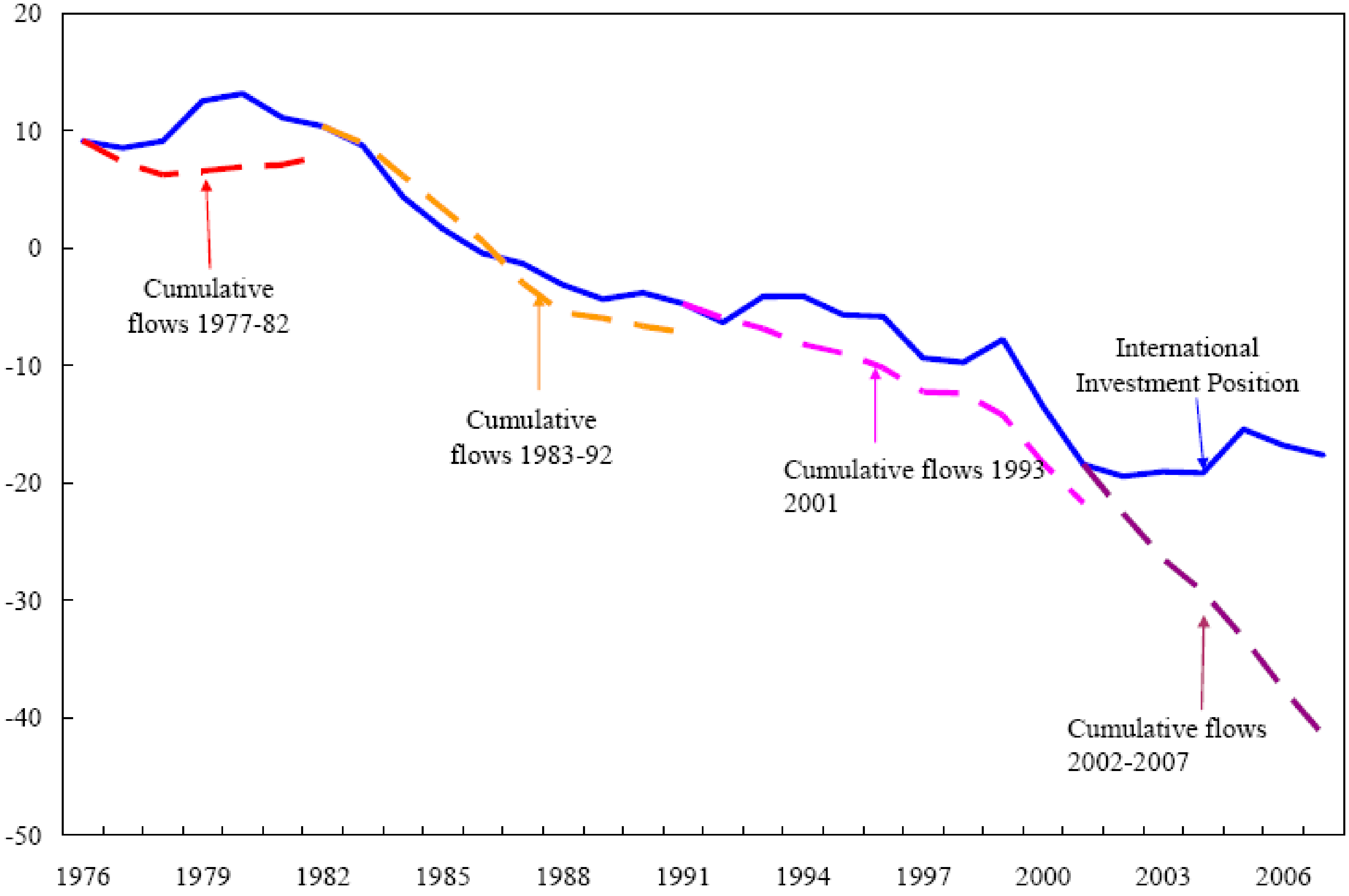
The usual disclaimers apply.

1. Main points

- Stock-flow discrepancy in the U.S. balance of payments
  - US IIP relatively stable despite large US CA deficit
  - What is source of discrepancy: role of "residual adjustments", i.e. past measurement errors in (a) financial flows, (b) capital gains, and/or (c) initial positions ?
- Three key points of paper
  - Residual adjustments contributed to improve US external position: due to under-reported capital (portfolio) outflows and initial positions (in OI); and *not* capital gains …

Stock-flow discrepancy (Fig. 1.A)

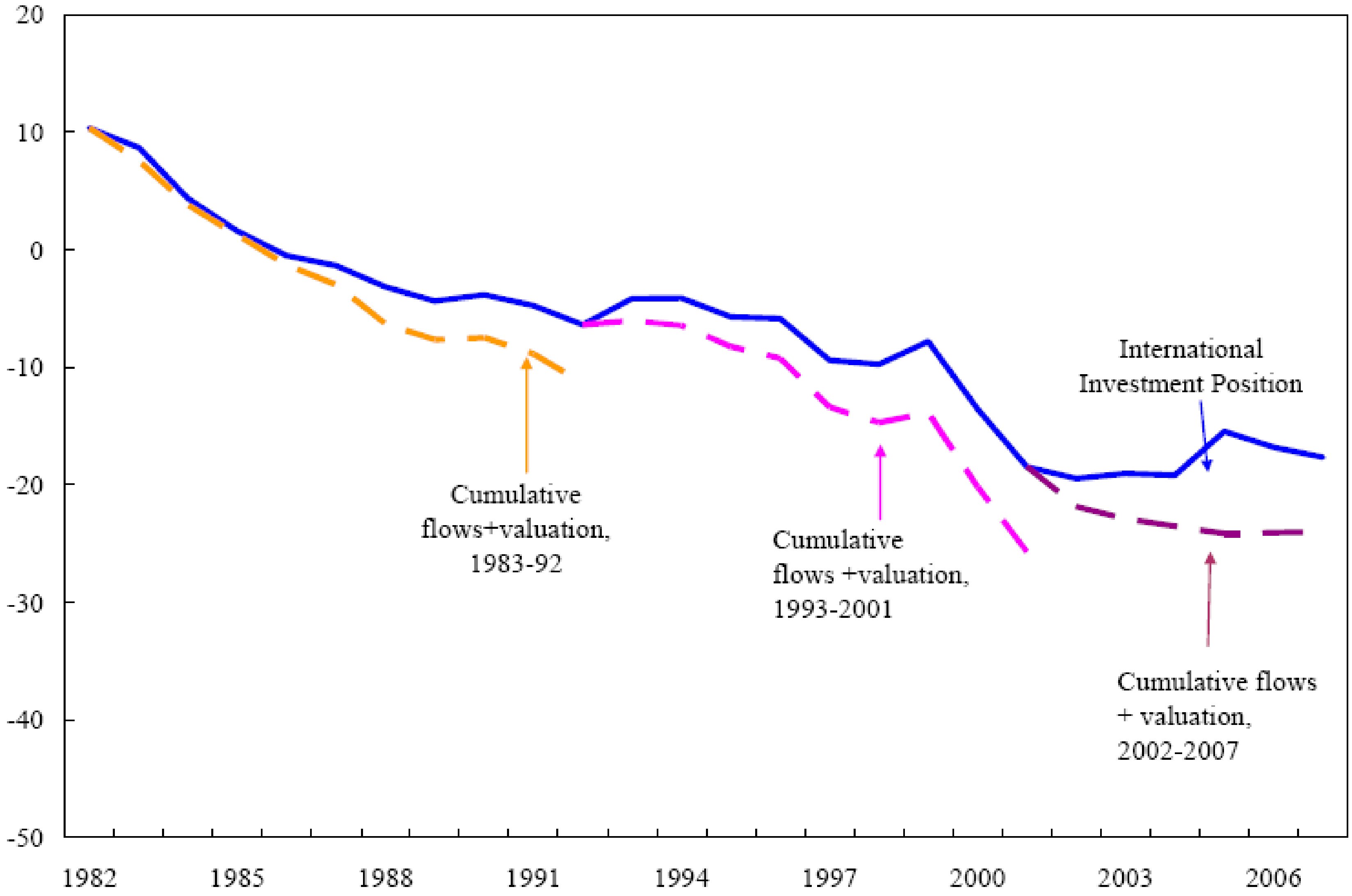


Main points

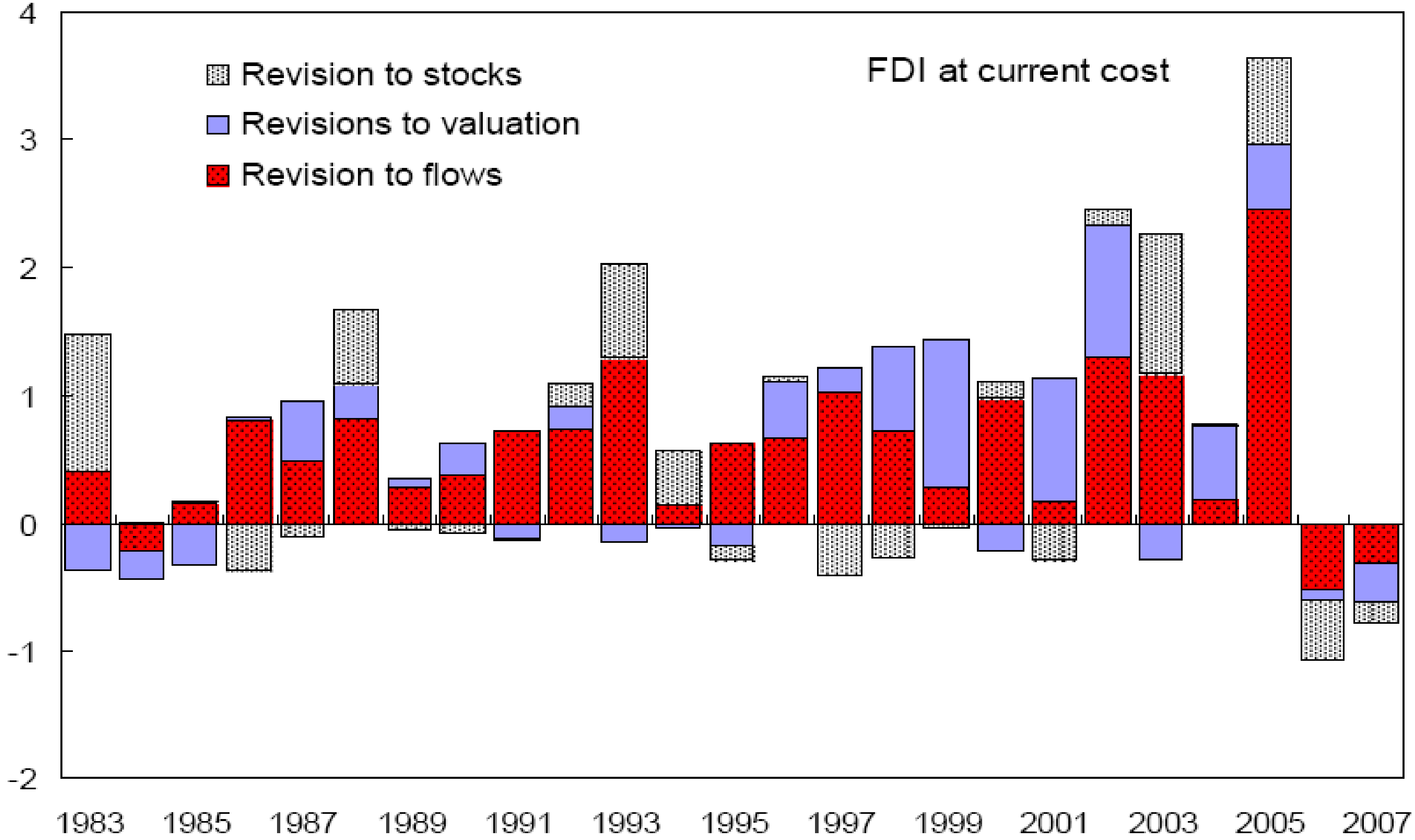
- Three key points of paper
  - Residual adjustments contributed to improve US external position: due to under-reported capital (portfolio) outflows and initial positions (in OI); and *not* capital gains
  - Magnitude sizeable: 0.6-0.7% of GDP
  - New puzzle: how can US current account deficit exceed net capital flows to US by 0.6-0.7% of GDP?

$$RESID_{it}^{rev} = (POS_{it}^{rev} - POS_{it-1}^{rev}) - F_{it}^{rev} - VAL_{it}^{P,rev}$$

Stock-flow discrep. – valuation adj. (Fig. 2.A)



Sources of residual adjustment (Fig. 4.A)



Contribution

- Gourinchas & Rey (2007) Lane & Milesi-Ferretti (2007)
  - Attribute discrepancy to (relative) capital gains between US and foreign investors
- Curcuru, Dvorak and Warnock (2008)
  - Rates of return are similar for US and foreign residents
  - Data revisions are key: upward revisions of US financial assets (capital outflows) over time

Contribution

- Present paper
  - In vein of CDW 2008, but focus (a) on residual adjustment;
  - (b) alternative scenarios for attributing residuals;
  - (c) new puzzle: mismatch US current account position and outflows
- Interpretation of residual adjustment
  - Puzzle of (c) possibly due to *both* under-reporting of US exports *and* under-reporting of US external liabilities
  - Also Curcuru, Thomas and Warnock (2008)

2. First comment: forensic nature

- Forensic nature of analysis – find the culprit from circumstantial evidence – how sure can we be?
- Key are the underlying *assumptions* of scenarios:
    - What are they precisely (e.g. currency composition; type of investment; maturity; timing of flows, etc.)?
    - How plausible are they?
    - Can we say something about range of assumed parameters, and thus distribution of possible scenarios?

First comment: forensic nature

- Why make inferences based on assumptions?
- Could one follow traces to identify the culprit directly?
  - Look at micro evidence of US investors versus foreign investors
  - This would be a much more direct test for the most contentious of all issues – importance of valuation effects:
  - Are rates of return on US assets really not (much) higher than those on US liabilities?

Aggregate evidence on return differentials

	Actual Portfolios (1994-2005)	BEA original (1994-2005)	BEA revised (1994-2005)	Gourinchas and Rey (1994-2004)	Gourinchas and Rey (1973-2004)
Equity					
Claims	9.56	9.73	13.57	12.32	19.84
Liabilities	11.88	12.50	14.53	14.24	13.73
Differential	-2.32	-2.77	-0.96	-1.92	6.11
Bonds					
Claims	6.08	6.47	10.69	5.25	8.35
Liabilities	5.89	5.81	3.97	1.89	4.62
Differential	0.19	0.66	6.72	3.36	3.73

Source: Table V of Curcuru, Dvorak and Warnock (2008)

Micro evidence on individual fund returns

Annualised equity returns for investment funds, 2003-08

	mean return	std. dev.	assets USD billion	number of funds
US funds in US	8.6	30.9	4,017	4961
Non-US funds in US	7.0	35.9	106	896
US funds in non-US	15.1	36.2	1,974	2051
advanced econ.	15.5	37.6	93	143
emerging econ.	15.1	36.3	1,880	1908
Non-US funds in non-US	18.0	48.0	1,539	5599
advanced econ.	12.8	43.2	539	2040
emerging econ.	20.4	52.1	1,000	3559

Source: Fratzscher (2008)

Micro evidence on individual fund returns

- Monthly equity returns for large set of funds:
  - Returns on US assets much higher than on US liabilities
  - More similar to original Gourinchas-Rey differentials
  - Higher risk of US assets than US liabilities
  - i.e. US investors should be earning higher returns in the long-run to compensate for risk differentials
- The debate on the importance of capital gains seems far from resolved

3. Second comment: CA sustainability

- Policy relevance of paper's argument: implications for sustainability of US current account deficit
- Concept/definition of sustainability:
  - Ability to record "large" current account deficits or surpluses for a sustained period of time
  - Key question: how much of a net debtor can the US become (e.g. same as, say, Australia)?
  - → we know little about what sustainable IIP could be, but probably much larger than current US IIP

3. Second comment: CA sustainability

- How “sustainable” or stable has US CA been in past?
  - Also in present paper, much of the stock-flow discrepancy occurs in the 2002-07 sub-period

CA sustainability

Current account adjustment (in % of GDP)

	current account (in % of GDP)						
	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Advanced economies	-0.6	-1.1	-1.3	-0.9	-1.0	-0.6	-0.6
United States	-5.3	-5.9	-6.0	-5.3	-4.6	-3.3	-3.2
Euro area	0.8	0.2	0.0	0.3	-0.5	-0.5	-0.5
Japan	3.7	3.6	3.9	4.8	4.0	3.7	3.3
United Kingdom	-2.1	-2.6	-3.4	-3.8	-3.6	-3.4	-2.9
EMEs and developing	2.4	4.1	4.9	4.1	4.1	2.9	2.8
Developing Asia	2.6	4.0	5.9	7.0	5.4	5.2	5.7
China	3.6	7.2	9.4	11.3	9.5	9.2	10.0
Western Hemisphere	0.9	1.3	1.5	0.4	-0.8	-1.6	-1.6
Central & Eastern Europe	-5.0	-4.3	-5.6	-6.0	-6.7	-7.1	-7.0
Oil exporters	10.0	15.2	15.6	12.2	14.5	10.2	8.7

Source: World Economic Outlook, October 2008.

4. Ongoing CA adjustment

- What may happen in future – esp. after financial crisis?
  - Residual adjustment has turned negative in 2006-07 (Fig. 4)
  - Sharp adjustment in US CA deficit already occurring…
  - … and this despite huge USD exchange rate fluctuations
  - See latest WEO projections – possibly still not fully reflecting all of US CA deficit reduction

5. Conclusions

- Neat paper on debated issue
  - Focus on residual adjustments and allocation to various financial account categories
  - Key result: Residual adjustments due to under-reported capital (portfolio) outflows and initial positions (in OI); and *not* capital gains; Magnitude sizeable: 0.6-0.7% of GDP
  - New puzzle: how can US current account deficit exceed net capital flows to US by 0.6-0.7% of GDP?
  - Suggestions to focus on assumptions and implications for policy