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Financial Globalization and the U.S. Current Account Deficit

Matthew Higgins and Thomas Klitgaard

Despite heavy borrowing in recent years, the United States has financed its large current account deficits without experiencing an unusual buildup in foreign investors' holdings of U.S. assets. A new analysis suggests that this somewhat surprising development is attributable largely to rapid financial globalization, with cross-border flows worldwide rising as fast as flows into the United States. However, it could be harder for the country to sustain large deficits on favorable terms if the current wave of globalization subsided or the rate at which U.S. investors buy foreign assets increased.

To finance its large current account deficit, the United States must attract the equivalent amount of surplus foreign savings. In recent years, the U.S. deficit has been large enough to absorb the lion's share of surpluses generated abroad. Indeed, from 1999 through 2006, the cumulative U.S. borrowing of $4.4 trillion amounted to some 85 percent of the net external financing provided by countries with surplus saving.

Despite this heavy borrowing, however, the United States has been the destination for little more than 30 percent of total gross cross-border investments by other countries, a figure that only slightly exceeds the U.S. share of global GDP and is below the U.S. weight in global financial portfolios. As a result, the United States has been able to finance its large current account deficits without laying claim to a disproportionate share of global foreign investment or causing foreign external portfolios to become dominated by U.S. assets.

This edition of *Current Issues* sheds light on these seemingly incompatible developments by examining the financing of the U.S. current account deficit from a global perspective. We find that the recent period of large U.S. current account deficits has also been one of rapid financial globalization, with surplus and deficit countries alike investing a record fraction of their saving abroad. This sharp increase in cross-border investments has made it possible for the United States to emerge as the world's principal *net* borrower while receiving an unremarkable share of other countries' *gross* external investments. Facilitating this development is the fact that the rise in U.S. cross-border investment has lagged the rise in global investment by other countries.

These findings have important implications for the sustainability of the U.S. current account deficit. In our view, it might be harder to finance continued large current account deficits on favorable terms if the recent wave of financial globalization were to subside: The United States would then have to attract a larger share of other countries' foreign investments. It might also be harder to finance the deficit on favorable terms were U.S. investors to participate more fully in financial globalization by investing a larger fraction of domestic saving abroad.

Global Saving and Global Capital Flows

A country's current account balance is equal to the difference between domestic saving and domestic investment spending. A country that saves more than it invests at home sends its surplus abroad to purchase foreign assets. One that saves less than it invests finances the shortfall by issuing liabilities to foreign investors. The accumulated history of current account surpluses or deficits, along with capital gains and losses on past investments, determines a country's net international investment position.

However, the *net* flow of capital across international borders often comes alongside much larger *gross* flows. After all, even countries running current account surpluses receive foreign investment inflows, and even countries running deficits invest abroad. Thus, the current account balance also obeys the accounting identity:

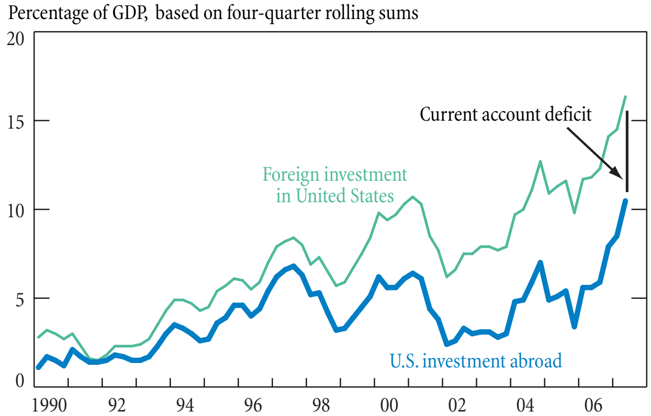
CA balance = domestic purchases of foreign assets – foreign purchases of domestic assets.[1]

Analysis of the sustainability of large U.S. current account deficits generally focuses on the implied behavior of U.S. net international liabilities. There is good reason for this emphasis. Formally, sustainability requires a path for the deficit that keeps net liabilities from rising indefinitely as a share of GDP. More concretely, continued deficits of the recent scale would likely push U.S. net liabilities as a share of GDP to an unprecedented level for a large advanced economy—a prospect that naturally raises concerns about whether such a trajectory would be compatible with economic and financial stability.[2] Moreover, investors' knowledge or belief that a substantially weaker dollar may be required to hold U.S. net liabilities to a sustainable path could lead to a general attempt to reduce U.S. exposures in advance of the dollar's fall, potentially setting off sudden and disruptive dollar adjustment.

However, the behavior of *gross* foreign claims on the United States is also important for sustainability analysis. After all, the capital losses that foreign investors might suffer from potential dollar weakness depend on the scale of gross rather than net claims. So too do the incentive for and potential magnitude of portfolio repositioning given a reassessment of risk and return on dollar assets.

In this connection, concerns about U.S. current account sustainability have often been based on the premise that the U.S. deficit is causing foreign portfolios to become increasingly tilted toward dollar assets. If so, while large deficits continue, foreign investors' reluctance to see portfolios grow even more unbalanced should exert ongoing downward pressure on the dollar and other U.S. asset prices. Some see that risk-tolerance limits for dollar exposure might be close at hand. As former Federal Reserve Chairman Paul Volker (2005) colorfully put it, "At some point, both central banks and private institutions will have their fill of dollars."[3] Even many who take a more benign view of U.S. and global imbalances argue that foreign investors' desire to keep exposure to U.S. financial assets from climbing higher will act as the ultimate check on the capacity of the United States to sustain large current account deficits.[4]

Chart 1
Financial Flows to and from the United States



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Note: The statistical discrepancy in balance-of-payments accounts is attributed equally to outflows and inflows.

In fact, foreign purchases of U.S. assets have recently been well in excess of the U.S. current account deficit (Chart 1). Since 2002, the additional foreign investment in the United States has averaged roughly 5 percent of U.S. GDP. The counterpart to this additional inflow has been a continuing flow of U.S. investment abroad. Indeed, despite considerable year-to-year volatility, outflows from the United States have generally

[1]Gross domestic and foreign purchases are measured net of purchases and sales of foreign assets by domestic residents and net of purchases and sales of U.S. assets by foreign residents, respectively.

[2]Higgins, Klitgaard, and Tille (2007) explain how favorable exchange rate and other valuation changes have held U.S. net liabilities as a share of GDP relatively steady in recent years, despite large current account deficits.

[3]Similarly, discussing U.S. current account sustainability, Lawrence Summers (2006) remarked that "There are surely limits on the tolerance of foreign investors for increased claims on the U.S."

[4]Alan Greenspan (2003) summarized the portfolio balance view as follows: "In the end, it will likely be the reluctance of foreign country residents to accumulate additional debt and equity claims against U.S. residents that will serve as the restraint on the size of tolerable U.S. imbalances in the global arena." Commenting on U.S. current account sustainability, Congressional Budget Office Director Peter Orszag (2007) observed that "Foreign investors will not be willing to purchase U.S. claims at current rates of return indefinitely as their portfolios become more and more concentrated in such assets."

been higher than they were before the period of large deficits. Last year saw outflows, inflows, and the current account deficit all reach record highs as shares of GDP.

The fact that foreign investment in the United States has been outpacing the U.S. current account deficit might appear to support concerns about foreign portfolios growing increasingly lopsided: Perhaps foreign investors will bump up against tolerance limits for dollar exposure that much sooner.

However, rising foreign investment in the United States does not necessarily imply a rising dollar weight in global portfolios: Flows to the United States must be rising *more rapidly* than flows to other countries (abstracting from valuation changes). To determine whether this has in fact occurred, we consider financial flows involving the United States from a global perspective. Our findings overturn the widespread presumption that global portfolios are tilting more toward claims on the United States. Rather, rising investment in the country has occurred during a period of rapid financial globalization, in the form of surging cross-border investment worldwide.

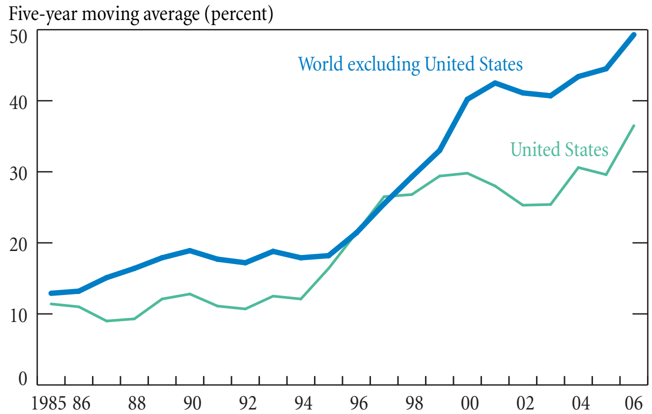
Taking the Measure of Financial Globalization

Financial globalization refers to the ongoing integration of once poorly connected national financial markets. A key aspect of globalization is a decline in financial *home bias*—the tendency for domestic saving to be invested predominantly at home, with domestic portfolios tilted heavily toward home-country assets.

Recent years have in fact seen a pronounced decline in home bias, with a record fraction of global saving going to cross-border investments (Chart 2).[5] Indeed, in 2005 and 2006, the share of global saving invested abroad climbed past 50 percent for the first time. (Chart 2 shows five-year averages, to smooth out business cycle fluctuations; thus, the values shown for 2005 and 2006 are a bit below 50 percent.) The trend toward greater cross-border investment has been worldwide, with the United States, other advanced economies, and emerging economies all investing a markedly higher fraction of saving abroad.

Significantly, U.S. external investment as a share of saving has risen less dramatically than the share for other countries. Comparing the mid-1990s with the middle of the current decade, we see that U.S. outflows as a share of domestic saving have risen by roughly 20 percentage points; the increase abroad has been close to 35 percentage points. As a result, the United States now lags the rest of the world by a considerable margin in the share of national saving invested abroad.

Chart 2
Cross-Border Investment Share of Global Saving



Source: International Monetary Fund, *International Financial Statistics* and *World Economic Outlook*.

It is instructive to consider the smaller scale of outflows from the United States in light of the current account balance-of-payments accounting identity described earlier. In particular, had outflows from the United States risen in line with the global trend, the country would have required that much more inward investment to finance an *unchanged* sequence of current account deficits. In turn, more robust U.S. demand for foreign assets, and the consequent need to attract additional inflows, would have placed downward pressure on the dollar, leading to at least somewhat *smaller* deficits.

This scenario illustrates a more general point: developments that lead to shifts in gross capital flows have important feedback effects on *net* flows.

U.S. Assets in Global Portfolios

Has the United States been receiving a disproportionate share of global cross-border investments? To answer this question, we compare the share of capital flows going to the United States with the relative size of the U.S. economy or, where possible, the size of the relevant capital market. In particular, portfolio equity and fixed-income flows are assessed relative to the U.S. share of the global equity and fixed-income markets: This is the metric Wall Street equity and fixed-income strategists use to determine whether a recommended portfolio allocation is underweight, neutral, or overweight in a given national market.[6] Unfortunately, there is no clear measure of the size of the relevant market for foreign

[5]The data in Chart 2 contain a series break that reflects the creation of the euro area in 1999. Pre-1999, our measure of cross-border investment includes investment by one euro area country in another; beginning in 1999, it excludes such flows. As a result, measured outflows before 1999 are higher than they would be under a consistent series. While it would be possible to construct a consistent series that includes intra-EMU (European Economic and Monetary Union) flows after 1999, we believe that it is more appropriate to treat the EMU as a single financial market.

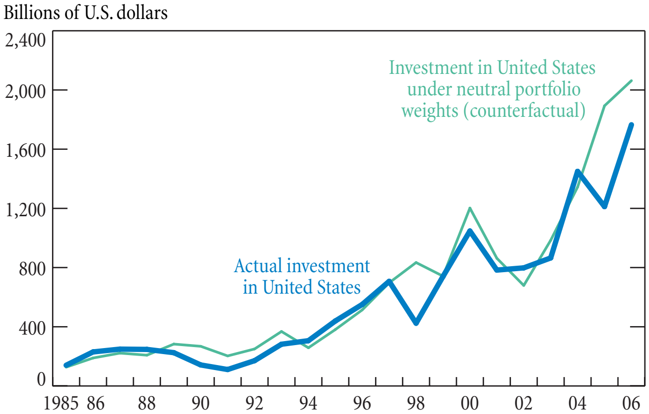
Table 1
Foreign Investment in the United States
Trillions of U.S. dollars and ratio-to-neutral allocation

	2002-06	1997-2001	1992-96
All investments	6.1	3.7	1.7
Ratio-to-neutral	0.87	0.85	0.99
Foreign direct investment	0.6	1.1	0.3
Ratio-to-neutral	0.64	0.93	1.10
Portfolio equity	0.4	0.5	0.0
Ratio-to-neutral	0.46	0.64	0.35
Bonds	3.2	1.1	0.8
Ratio-to-neutral	1.11	0.81	0.97
Banking and other	2.0	1.0	0.6
Ratio-to-neutral	0.82	1.01	1.11

Sources: International Monetary Fund, *International Financial Statistics* and *World Economic Outlook* database; Datastream global equity indexes; Bank for International Settlements global bond database; authors' estimates.

Note: Ratio-to-neutral refers to foreign investment in the United States relative to an investment allocation proportional to country weights in global GDP or the relevant global capital market. A figure above 1.00 indicates that foreign investors have been investing relatively heavily in the United States.

Chart 3
Foreign Investment in the United States



Sources: International Monetary Fund; Bank for International Settlements; U.S. Department of Commerce, Bureau of Economic Analysis; authors' calculations.

Notes: The calculation for market-neutral investment takes total outflows from other countries as given. The calculation shows the funds that would go to the United States given portfolio weights based on the U.S. weight in the global capital markets (for equity and fixed-income securities) or the U.S. weight in global GDP (for foreign direct investment and banking and other investments).

direct investment (FDI) or banking and miscellaneous investments. However, international portfolios based on relative economic output or GDP seem a sensible choice.[7] In an investment strategy with a neutral U.S. weight, the share of cross-border investment placed in the United States would be equal to the relevant scaling factor. For example, since the United States accounts for 28 percent of global GDP, a neutral investment allocation would have the United States receiving 28 percent of the flow of global FDI investments.[8]

Using our neutral benchmark, we find that, from 2002 to 2006, foreign investors placed a total of $6.1 trillion in new investments in the United States, or slightly more than 30 percent of total outflows from countries other than the United States (Table 1). Our calculations show that a neutral investment allocation based on country GDP and market capitalization weights would have resulted in the United States receiving $7.0 trillion in foreign capital. Thus, global cross-border investments were tilted *away from* the United States, by a factor of 0.87 (that is, 6.1/7.0). Significantly, a similar tilt ratio prevailed during 1997-2001, when the U.S. current account deficit was considerably smaller, and a *higher* tilt ratio prevailed during 1992-96, when the deficit was far smaller.[9] Indeed, over the last twenty years, foreign external investments have never displayed any discernible tilt toward U.S. assets (Chart 3). Simply put, the proliferation of cross-border investment worldwide has enabled the United States to finance its growing current account deficits while receiving a stable or even declining fraction of other countries' overall external investments.

A broadly similar pattern is evident across asset categories. In particular, for FDI, portfolio equity investments, and banking and other investments, investment in the United States

[6]These calculations may understate the neutral rate of investment flows to the United States because a significant share of foreign debt and equity securities is not readily available for purchase. In some foreign markets, a sizable fraction of market capitalization is locked up in rarely traded corporate cross-shareholding or government accounts. In others, there are significant restrictions on portfolio equity inflows. Several private investment banks have constructed indexes based on free float: the value of shares actually available for purchase. According to the MSCI Barra global index, as of March 31, 2006, the United States accounted for almost 45 percent of the investable equity market, compared with 38 percent of global market capitalization. By coincidence, the numbers are the same for fixed-income debt securities.

[7]This measure is viewed in the macro markets literature as a benchmark for all investments. See, for example, Anthanasoulis, Shiller, and Van Wincoop (1999).

[8]For brevity, the discussion omits some details of our procedure. In particular, for the largest economies, we scale investment in the United States by the U.S. share in the rest of the world. This includes the EMU, the United Kingdom, and Japan; before the creation of the EMU, it includes Germany, France, and Italy. (China and India account for a very small fraction of the global equity and bond markets; while the two countries account for a larger fraction of GDP, they make insignificant outbound FDI and miscellaneous investments.) For example, while the United States now accounts for 28 percent of global GDP, from the perspective of the euro area, the United States accounts for some 35 percent of rest-of-the-world GDP.

[9]Recall that our measure of global cross-border investment includes intra-EMU flows for the early part of 1997-2001 and for all of 1992-2006. The measured tilt toward the United States during these earlier periods would have been even higher had intra-EMU flows been excluded consistently.

Table 2
Foreign Claims on the United States
Trillions of U.S. dollars and ratio-to-neutral allocation

	2006	1999
Total claims	16.2	8.4
Ratio-to-neutral	0.94	1.08
Foreign direct investment	3.2	2.8
Ratio-to-neutral	0.77	1.56
Portfolio equity	2.5	1.5
Ratio-to-neutral	0.96	1.05
Bonds	5.7	2.1
Ratio-to-neutral	1.03	0.88
Banking and other	4.8	2.0
Ratio-to-neutral	1.00	0.86

Sources: U.S. Department of Commerce, Bureau of Economic Analysis; International Monetary Fund, *International Financial Statistics* and *World Economic Outlook* database; Datastream global equity indexes; Bank for International Settlements global bond database; authors' estimates.

Notes: Ratio-to-neutral refers to foreign claims on the United States relative to a portfolio allocation proportional to country weights in global GDP or the relevant global capital market. A figure above 1.00 indicates that other countries' external portfolios are tilted toward claims on the United States. U.S. derivative liabilities are not counted because their economic value is a small fraction of the quoted notional value.

during the 2002-06 period was below our neutral benchmark, and down relative to those benchmarks from 1997 to 2001. Only fixed-income investments have recently exceeded our neutral benchmark and, even here, only slightly.

International Investment Positions

A look at international investment positions—the dollar value of external assets, rather than the flow of new external investments—supports the results of our flow analysis (Table 2).[10] In particular, other countries' external portfolios were tilted slightly toward claims on the United States in 1999, but are now tilted slightly away (1999 provides a convenient reference point, as it is the first year the data allow us to exclude from global external assets the claims of one European Economic and Monetary Union [EMU] country on another). The tilt away from the United States comes despite a near doubling of foreign ownership of U.S. assets, from \$8.4 trillion to \$16.2 trillion. The reason is that other countries' total cross-border asset holdings rose in even greater proportion, from \$17.9 trillion to \$47.5 trillion.[11]

By asset category, other countries' stocks of foreign direct investments, once sharply tilted toward the United States, now show a clear tilt away. Portfolio equity investments have shifted from being tilted slightly toward the United States to slightly away. The shift away from the country in FDI and portfolio equity holdings reflects the similar trend in flows described above as well as the relatively weak performance of the U.S. equity markets.[12] Meanwhile, foreign investors have shifted from a somewhat underweight position in U.S. debt securities and banking and other assets to a more balanced position. The relatively modest current tilt in debt securities toward the United States reflects the explosive growth of cross-border debt security claims worldwide. While debt security claims on the United States roughly tripled over the period, so did all global cross-border holdings.

Alternative Metrics

Our analysis of foreign portfolio exposure to the United States is based on investment in the country as a fraction of global *cross-border* investments. In our view, this approach illustrates underlying trends while controlling for the ongoing progress of financial globalization. Still, a look at how exposure to the United States has evolved relative to global saving and global wealth might shed additional light on the sustainability of the U.S. current account deficit.

Since 2002, investment in the United States has absorbed 16.5 percent of the rest of the world's saving, up from 14.3 percent during 1997-2001 and up substantially from 7.0 percent during 1992-96. Is the recent figure high or low? If such investment were sustained, assuming stable exchange rates and similar asset price behavior in the United States and abroad, claims on U.S. assets would trend toward 16.5 percent of total foreign wealth. We cannot know the potential limits on desired foreign exposure to the United States; the limits depend, in part, on how far the recent wave of financial globalization can progress. That said, a 16.5 percent figure would not be out of line with the U.S. weight in the global economy and the global financial markets.

It is important to understand what fraction of foreign wealth today is in the form of claims on the United States. Unfortunately, no comprehensive measure of foreign wealth exists.[13] The best approach we can take, then, is to consider

[10] Lane and Milesi-Ferretti (2007) have developed similar metrics for assessing foreign exposure to the United States.

[11] The latter figure is an estimate based on incomplete data, as some smaller countries have not yet reported their 2006 international balance sheets.

[12] In dollar terms, non-U.S. equity prices rose by 95 percent from year-end 1999 through year-end 2006; U.S. equity prices were up less than 4 percent. As a result, cross-border equity and FDI claims on countries outside the United States were swelled by capital gains; claims on the United States were not. That said, the statistical authorities in a number of countries make only limited valuation adjustments to FDI claims, or even assess them at book value.

Note, too, that caution is warranted when drawing welfare conclusions from shifts in a country's net international investment position. After all, a U.S. equity price boom would raise U.S. household wealth, but by raising the value of foreign claims on the United States, it would worsen the U.S. net position.

Table 3
Foreign Financial Assets and Claims on the United States
Trillions of U.S. dollars

	2006	1999
Total financial assets	132.1	65.1
Percentage of claims on the United States	12.3	13.0
Equity securities	25.4	16.3
Percentage of claims on the United States	10.0	9.3
Debt securities	46.9	21.6
Percentage of claims on the United States	12.1	9.7

Sources: U.S. Department of Commerce, Bureau of Economic Analysis; International Monetary Fund, *International Financial Statistics* and *World Economic Outlook* database; Datastream global equity indexes; Bank for International Settlements global bond database; authors' estimates.

Notes: Total financial assets are the sum of portfolio equity holdings, debt security holdings, and commercial bank assets. Percentage of claims on the United States includes a correction for rest-of-the-world liabilities to the United States. The figures for equity securities represent a lower bound; see footnote 14 in the text.

claims on the United States relative to a measure of foreign capital market size.[14]

As an indicator of total capital market size, we take the sum of equity market capitalization, bond market capitalization, and commercial bank assets. (This approach follows the measure used in the International Monetary Fund's *Global Financial Stability Report* [2007].) We define a proxy for non-U.S. financial wealth as

Non-U.S. wealth = non-U.S. capital market size + claims on U.S. – liabilities to U.S.

According to our calculations, the share of non-U.S. financial wealth held as U.S. assets has *declined* very slightly in recent years, to just 12.3 percent at year-end 2006 (Table 3). We consider this small decline to be well within the margin of measurement error. In essence, growth in foreign financial market size has kept pace with growth in foreign claims on the United States. In dollar terms, non-U.S. equity market capitalization has increased by a factor of 1.6 since year-end 1999, bond market capitalization by a factor of 2.1, and commercial bank assets by a factor of 2.2. These figures also illustrate a more general point: growth in non-U.S. financial markets widens the scope for diversification into U.S. assets.

Turning to tradable securities, we observe that the fraction of foreign fixed-income wealth held in claims on the United States has increased slightly in recent years, to a still-low 12 percent at year-end 2006. Given the scale of reserve accumulation by foreign central banks, the share of foreign *private* fixed-income wealth held as claims on the United States must have declined. The fraction of portfolio equity wealth held as claims on the United States has also increased slightly in recent years, to almost 10 percent. Again, while we cannot know the amount of exposure to U.S. securities that foreign investors will eventually take on, these figures are hardly out of line with the size of the United States in the global markets.[15]

Our results should assuage concerns about large U.S. current account deficits leading to a potentially destabilizing increase in foreign exposure to U.S. assets. In fact, foreign investment in the United States has remained broadly in line with the relative size of the U.S. economy and U.S. capital markets. Moreover, foreign claims on the United States have not risen relative to cross-border claims generally or relative to the size of foreign capital markets. Of course, as we have already indicated, there may be other good reasons for concerns about the sustainability of large, ongoing U.S. current account deficits.

Financial Globalization and U.S. Current Account Adjustment

Rapid growth in cross-border investments worldwide has left room for the United States to take in large net flows while receiving an unremarkable fraction of other countries' total cross-border investments. But what if the recent wave of financial globalization were to crest? To address this question, we consider a hypothetical scenario.

In recent years, about 50 percent of non-U.S. saving has been invested abroad, and the United States has received about one-third of those outflows. Suppose that outflows were to fall back to 35 percent of saving, roughly the share of U.S. saving recently recorded for U.S. outflows. The United States would then have to receive more than 45 percent of the rest of the world's foreign investments (assuming that the U.S. current account deficit and U.S. outflows remain constant as shares of GDP and that the foreign saving rate and the relative size of U.S. and foreign economies are also constant). Under

[13] Although we have measures of global equity and bond market capitalization, a significant fraction of foreign wealth consists of nonsecuritized stakes in business enterprises.

[14] The metrics used here were developed in Higgins and Steinberg (2002).

[15] The figures for the share of non-U.S. equity wealth owing to claims on the United States should be considered a lower bound. After all, the bulk of foreign FDI assets in the United States is held by foreign multinationals listed on their own domestic exchanges. As such, the market value of those companies on the domestic exchanges should embody the value of their U.S. subsidiaries or affiliates. (As a secondary matter, a small part of market capitalization for companies listed outside the United States reflects minority FDI claims by the United States.) A back-of-the-envelope calculation suggests that more than 20 percent of non-U.S. portfolio equity wealth might come from claims on the United States, a figure that approaches the U.S. weight in the global economy. However, that figure appears to have been closer to 25 percent in 1999.

such a scenario, foreign investors would most likely require added compensation for shifting toward an overweight U.S. position in the form of higher U.S. interest rates, or more favorable entry prices via a weaker dollar or lower U.S. asset prices. (One limitation of this scenario is that it does not allow for such interest rate and asset price changes to promote a narrowing of U.S. and global imbalances.)

Fuller participation by U.S. investors in the financial globalization process could also make it more challenging to finance large current account deficits on favorable terms. Suppose that outflows from the United States were to rise to 50 percent of saving: the recent average for the rest of the world. (Given the anemic U.S. saving rate, this amount would still leave outflows from the United States unusually low as a share of GDP.) Again assuming an unchanged current account deficit, the United States would then have to receive roughly 40 percent of total outflows from the rest of the world, up from the 30 percent currently coming to the United States.

Conclusion

Perhaps surprisingly, large U.S. current account deficits have not led to an unusual buildup in foreign investors' holdings of U.S. assets; in fact, foreign investment in the United States has remained broadly in line with the relative size of the U.S. economy and the U.S. capital markets. The key reason for this outcome has been rapid financial globalization, with cross-border flows worldwide rising as fast as flows into the United States. Our results suggest that such globalization has allowed the United States to finance large current account deficits without experiencing sharper downward pressures on the dollar and U.S. asset prices. However, a retreat from the recent pace of financial globalization by foreign investors or an increase in the rate at which U.S. investors buy foreign assets could make it more difficult for the country to sustain a large current account deficit on favorable terms.

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