



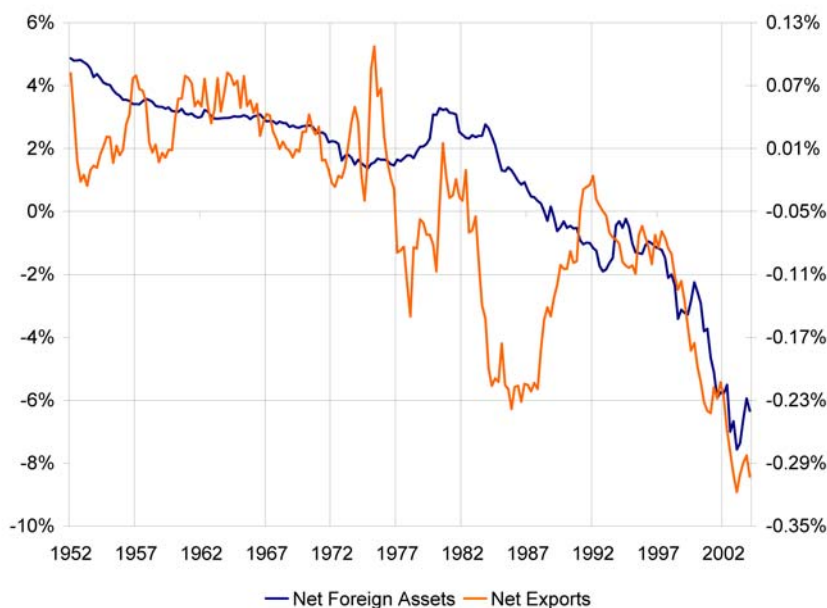
## US External Liability Imbalance Is Now Much Less Than Early 1980s

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Understanding the dynamic process of adjustment of a country's external balance is one of the most important questions for international economists. The recent wave of financial globalization has led to a sharp increase in cross-holdings of foreign assets and liabilities. The upsurge in cross border holdings has therefore opened the door to potentially large wealth transfers across countries. In **CEPR Discussion Paper No.4923** Pierre-Olivier Gourinchas and H el ene Rey argue that to fully explain the dynamics of the current account, economic analysis must incorporate capital gains and losses on the net foreign asset position.

Using a newly constructed dataset, the authors find that 30% of the short-run adjustment towards long-run external debt sustainability of the US is realized through financial valuation effects on average. The effect of a fall in the dollar on the current account is a longer-run phenomenon and does 70% of the work. They find that contrary to the perceived wisdom about the extent of the US external imbalance, the large revaluation of US assets that has taken place since early 2002 through the fall in the dollar has meant the imbalance is now much less than in the 1980s. This is shown in the graph below:



While standard economic theory suggests that the United States will need to run trade surpluses to reduce its current account deficits, the authors show that part of the adjustment can take place through a change in the returns on US assets held by foreigners relative to the return on foreign assets held by the US. Importantly, this previously unexplored 'financial adjustment channel' may transfer wealth via a depreciation of the dollar. At the moment, almost all foreign liabilities are in dollars and approximately 70% of US foreign assets are in foreign currencies. This means that a 10% fall in the dollar would transfer 5% of US GDP from the rest of the world to the US. In comparison, the trade deficit, on goods and services amounted to 'only' 4.4% of US GDP in 2003. The large transfers of wealth that may take place on external liabilities through the financial adjustment channel therefore significantly alter the need to run future trade surpluses or deficits.

Gourinchas and Rey also use their framework to predict exchange rate depreciations. Their model consistently and decisively beats the 'random walk' model that is the generally accepted benchmark in economics and states that the best predict of the future exchange rate is the current exchange rate. Therefore, the results of this paper show that the conventional wisdom – that exchange rate modelling cannot do better than the random walk – is overthrown.

#### **Notes for editors:**

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