

“Valuation Effects” Stabilizing Changes in Net External Assets

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Masaaki Kawagoe

Senior Economist, Japan Center for Economic Research

Ikuko Fueda

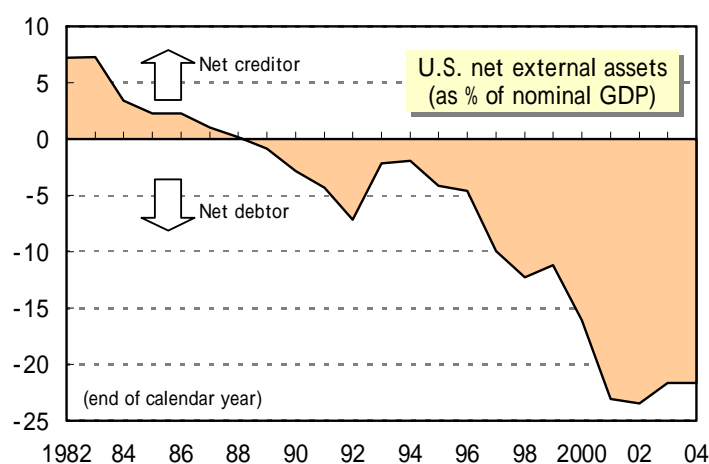
Associate Senior Economist, Japan Center for Economic Research

Current Account Deficit Does Not Always Increase External Liabilities

The arrival of the current decade was greeted by a further deterioration of the continued U.S. current account deficit. In 2004, the deficit reached 5.7 per cent of the nominal gross domestic product (GDP), a record level. While the continued current account deficit should accumulate external debts, the actual situation is not that simple.

The movements in the “net external asset position” (relative to the nominal GDP) for the U.S., a figure computed by subtracting external debts from external assets, are on a long-term downward trend. In fact, the U.S. slipped into the ranks of debtor nations toward the end of the 1980s (Chart 1; the negative figures show net external debt position). The decline accelerated sharply in the mid-1990s: a decline by 20 percentage points during the eight-year period of 1994 to 2002 reaching minus 23.4 per cent.

Chart 1 The U.S. External Position Has Levelled Off



Source: BEA “Survey of Current Business.”

A change in the trend in 2002 is noteworthy. Despite the continued current account deficits, net external assets started to show a sign of leveling off. Just why has the turnaround come to pass?

Curbing Expanding Debts Held by Deficit Countries

The difference between the stock value (i.e. net external assets) at the end of the current year and the previous year counterpart is not the sole result of this year's flow (i.e. current account balance). A fluctuation in the stock value is also caused by the gains or losses due to revaluating the previous year-end stock at current prices. For example, the value of external assets (or debts) can change as a result of changes in stock or real estate prices, foreign exchange rate fluctuations or other factors. The point is shown by the following identity:

$$\begin{aligned} \text{Changes in net external asset balance} \\ = \text{Current account balance for year in question} + \text{Valuation effects} \end{aligned}$$

Accordingly, the halt in the declining U.S. net external assets can be interpreted to result from "positive" valuation effects, which offset the "negative" effect due to the current account deficits. That is, in the case of the United States, the valuation effects function as a "stabilizer" to prevent a further deterioration in the nation's net external position.

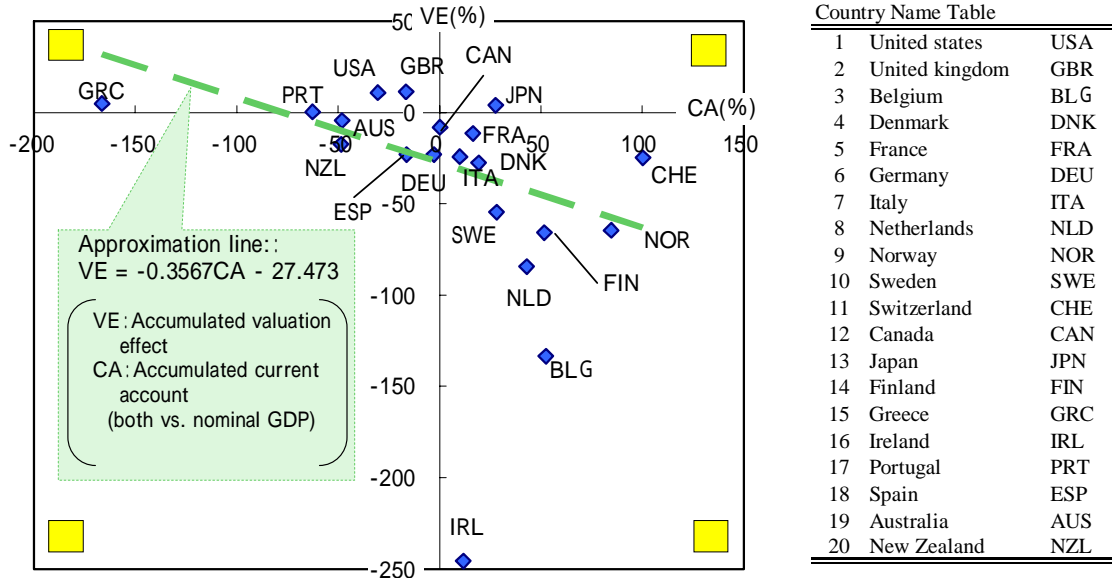
This stabilizing function provides an interesting perspective in the debate on sustainability of the current account deficit. The conventional argument is that avoiding a cumulative worsening in net external assets (or a snowballing increase in net external debt) requires a certain amount of goods and services account surplus sometime in the future. The valuation effects could be a channel for supplementing the improvements in these fundamentals.

Offsetting A Third of the Cumulative Current Account Balance

Here, let's examine to what extent the stabilizing function of the valuation effects observed in the U.S. affect external asset position in other countries. Following the IMF (2005), we calculate the valuation effects from the data of 1993 to 2003 on the net external assets and current account balance in 20 developed countries, using the aforementioned identity. Chart 2 presents a scatter plot of accumulated current account (CA) and accumulated valuation effects (VE) for each country.

In Chart 2, the stabilizing effects can be considered to be functioning for countries falling into either (1) Domain II (in which the CA is negative while the VE is positive) or (2) Domain IV (in which the CA is positive while the VE is negative). The number of the developed countries belonging to these domains (which includes the United States and the United Kingdom) counts to fifteen, which is judged to be statistically significant. The slope of the approximation line is -0.35 , indicating that approximately a third of the accumulated current account is offset by the valuation effects.

Chart 2 A “Stabilizing Function” Observed in Many Countries
 ~ A tests in 20 Developed Country Data (1993-2003) ~



Note: The added approximation line calculated with 19 countries (excluding Ireland).
 Source: IMF *International Financial Statistics*, OECD *Economic Outlook*.

Dangerous Heavy Dependence on Valuation Effects

A next question is how the valuation effects actually function. In the case of developed countries, assets are generally denominated in foreign currencies, while debts are in their own currencies. Therefore, when the current account worsens and the foreign exchange rates depreciate, the value of external assets rises. This directly improves the external position even without any changes in the trade balance.

We must bear in mind, however, that this “stabilizing function” due to the valuation effects is a phenomenon observed *ex post*. Obviously, no one would lend money, realizing in advance that the asset values are destined to decline. For that reason, if the United States or other debtor nations heavily depend on the valuation effect, this must be a risky strategy. It remains true, therefore, that sooner or later fundamentals should be improved so as to produce surplus in the goods and services account.

Reference

IMF (2005) “Globalization and External Imbalances,” *World Economic Outlook* Chapter III, pp. 109-156. April.