

Box 1

EXPLAINING THE US INCOME BALANCE

In 1980, the US was a net creditor towards the rest of the world to the tune of USD 360 billion. However, by the end of 2004 the US owed foreigners USD 2.5 trillion, or around 22% of US GDP. Despite this marked deterioration of the US international investment position (i.i.p.) over the past quarter century, the US income balance has consistently recorded surpluses ranging between 0.1 and 0.5% of GDP, although in 2005 this surplus dramatically shrank to an estimated USD 1 billion because of rising debt service obligations. One way of interpreting this is that the US has been earning a negative rate of return on its net foreign liabilities. This Box discusses some of the reasons why the US income balance has been in surplus despite the fact that the US has a net foreign liability position vis-à-vis the rest of the world, and it additionally examines the implications this may have for global financial stability.

The most common explanation given for positive US income balances is that the US has effectively behaved as if it was a “leveraged investor”, by issuing low-yielding debt securities and making high-yielding direct investments abroad.¹ In this vein, the asset composition of the US i.i.p. does show a strong asymmetry between a relatively large negative net position in debt securities (-28% of GDP in 2004) and a relatively small surplus in the direct investment position (+5% of GDP in 2004), each generating approximately the same income flow in absolute

¹ See P. O. Gourinchas and H. Rey (2005), “From world banker to world venture capitalist: US external adjustment and the exorbitant privilege”, *NBER Working Paper*, No 11563, August.

amounts of around 1% of GDP in 2005. These two income flows roughly offset one another and, once additional minor flows such as other portfolio income and compensation of employees are taken into account, this results in a small surplus in the income balance. However, when returns on foreign direct investment (FDI) and debt securities for both assets and liabilities are disaggregated, the picture becomes more complex. In recent years the yields on US debt securities have been very low, well below the returns on US direct investment abroad, thereby lowering the net servicing of the rising debt burden (see Chart B1.1). However, at least before 2002, the difference between the rate of return that the US “received” from direct investment abroad and the rate of return the US “paid” on its debt was not so large as to produce a positive income balance (and was even slightly negative in 2000-2001) (see Charts B1.1 and B1.2). Instead, the persistence of a positive balance on income is mainly due to the very low average returns received by foreign investors on their direct investments in the US compared to US direct investment earned abroad (see Chart B1.2). Moreover, the increase in the gross size of direct investment stocks in both directions over time amplified the impact of this excess return on US FDI on the net income flows. All in all, the US’s positive income balance appears to be mainly due to excess returns from US direct investment abroad relative to returns from FDI made in the US, and not to the US’s leveraged portfolio.

Three tentative explanations can be advanced as to why returns on US direct investment abroad tend to be much higher than returns on FDI made in the US. First, US direct investment abroad may enjoy a seniority or maturity premium with respect to relatively younger FDI in the US. Start-up costs and more competitive pressure in the US market may depress the rate of return of foreign subsidiaries in the US. Mataloni (2000) provides some supporting evidence that factors such as firm age and market share may have accounted for the low rates of return earned by foreign-owned companies in the US in the past.² Second, around one-third of US direct investment abroad is directed towards emerging markets. The rates of return of these investments most likely include higher risk premia than on FDI made in the US. Supporting this hypothesis, the Congressional Budget Office (CBO) has recently noted that the weighted average Standard

² See R. J. Mataloni (2000), “An examination of the low rates of return of foreign-owned U.S. companies”, U.S. Bureau of Economic Analysis, *Survey of Current Business*, March.

Chart B1.1 Rates of return on debt securities held abroad and on US debt held by foreigners

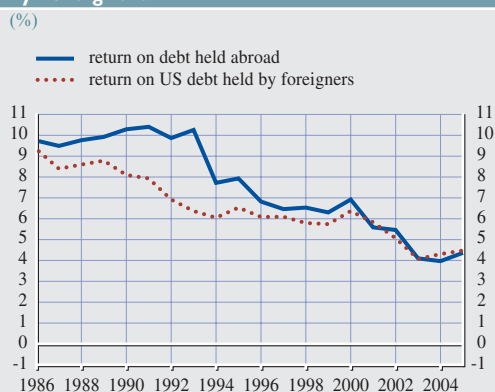
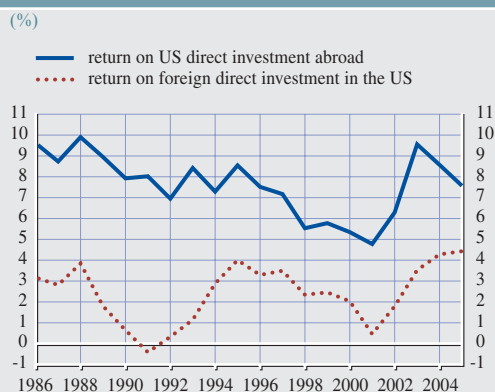


Chart B1.2 Rates of return on US direct investment abroad and on FDI in the US



Sources: IMF (BPS and IFS) and ECB calculations.

Note: For each asset class, returns are calculated dividing the respective flow in the income balance by the relevant stock from the i.i.p. in the previous year. These returns do not include capital gains.

& Poor's rating for countries which receive US direct investment abroad is equal to BBB+, eight notches lower than the US rating (AAA).³ Third, the excess return on US direct investment abroad may be the result of transfer pricing activities of multinational corporations, with US companies shifting profits to low-tax countries and foreign subsidiaries operating in the US shifting profits back to the parent company or to low-tax countries. There is indeed some indirect evidence that US-controlled multinationals tend to shift their profits into low-tax countries. For instance, an examination of the country breakdown of the rate of return on inward and outward US direct investment reveals that the US records significant positive excess returns on FDI vis-à-vis most other economies, obtaining particularly high excess returns versus low-tax countries such as Ireland, Bermuda and the Caribbean islands, as well as financial centres such as Switzerland and Luxembourg.⁴

The apparent puzzle of a positive US income balance vis-à-vis a negative i.i.p. has prompted some economists to question how net foreign assets are accounted for, and to gauge instead their value through the income streams that they generate.⁵ For instance, Hausmann and Sturzenegger (2006) draw a parallel between net foreign assets and the fair share price of a firm. Using this insight, they compute a fair value for US net assets of USD 600 billion, and from this conclude that the US is in fact a net international creditor rather than a net debtor.⁶ They label the difference between this fair value and the statistical reporting of USD -2.5 trillion at the end of 2004 "dark matter", referring to invisible assets that nevertheless generate revenues. According to Hausmann and Sturzenegger, there are three possible explanations for this large discrepancy. First, the stock of US FDI abroad could be more valuable than the market value reported by official statistics because it entails a substantial amount of brand recognition, expertise and R&D, all of which are not properly measured in official statistics. Second, while foreigners hold US currency as a store of value and as a liquid asset, for the US this represents a non-interest-bearing liability which can be used to buy profitable assets abroad, generating so-called dollar seigniorage which is not accounted for in the statistics. Third, foreigners are also likely to pay an insurance premium in order to buy relatively safe assets (US Treasuries), thereby financing the US current account with funds which are then transformed into foreign financing of risky assets (e.g. emerging market debt or equity). Of these three explanations, only the first appears to be significant in terms of explaining the characteristics of the US income balance and, hence, Hausmann's "dark matter".

It is worth noting that in 1991, the US Bureau of Economic Analysis had already discarded the capitalisation of earnings as a method for the valuation of US net foreign assets "because of the large uncertainties involved in choosing an appropriate rate of discount".⁷ Moreover, some of Hausmann and Sturzenegger's findings are open to debate because their analysis does not account for the fact that US debt has been increasing, thereby generating rising debt servicing obligations that are likely to undermine the ability of the US to generate positive earnings in the future (i.e. a positive income balance). Following the fair valuation approach, the most

3 Congressional Budget Office of the United States (CBO) (2005), "Why does U.S. investment abroad earn higher returns than foreign investment in the United States?", *Economic and Budget Issue Brief*, 30 November.

4 See M. Higgins, T. Klitgaard and C. Tille (2005), "The income implications of rising U.S. international liabilities", Federal Reserve Bank of New York, *Current Issues in Economics and Finance*, Vol. 11, No 12, December.

5 See R. Hausmann and F. Sturzenegger (2006), "Global imbalances or bad accounting? The missing dark matter in the wealth of nations", *CID Working Paper*, No 124, Harvard University, January.

6 Hausmann and Sturzenegger (2006) multiply the average US net income over the past 25 years (USD 30 billion) by a somewhat arbitrary price-earnings ratio (set at 20, implying a return on assets of 5%). Hence, this valuation corresponds to the capitalisation of an infinite future annual stream of income of USD 30 billion at a 5% discount rate.

7 See J. S. Landefeld and A. M. Lawson (1991), "Valuation of the US net international investment position", US Bureau of Economic Analysis, *Survey of Current Business*, May.

important variable for assessing the fair valuation of net assets is their expected economic earnings, rather than past reported earnings, which may be a relatively poor indicator of future earnings performance. This notwithstanding, an important point implicit in Hausmann and Sturzenegger's analysis is that the sustainable level of US net foreign liabilities may be larger than that of other countries because of the ability of US residents to earn high returns on their assets while paying relatively low yields on their liabilities.

To sum up, on the one hand, the unwinding of global imbalances could be complicated by the potential deterioration of the US investment income balance, owing to rising debt servicing obligations, which would in turn imply a smaller sustainable trade deficit over the long run. On the other hand, as long as the US is paying a relatively low rate of return on its net foreign liabilities, its position as the world's largest debtor should not generate any real cause for concern.