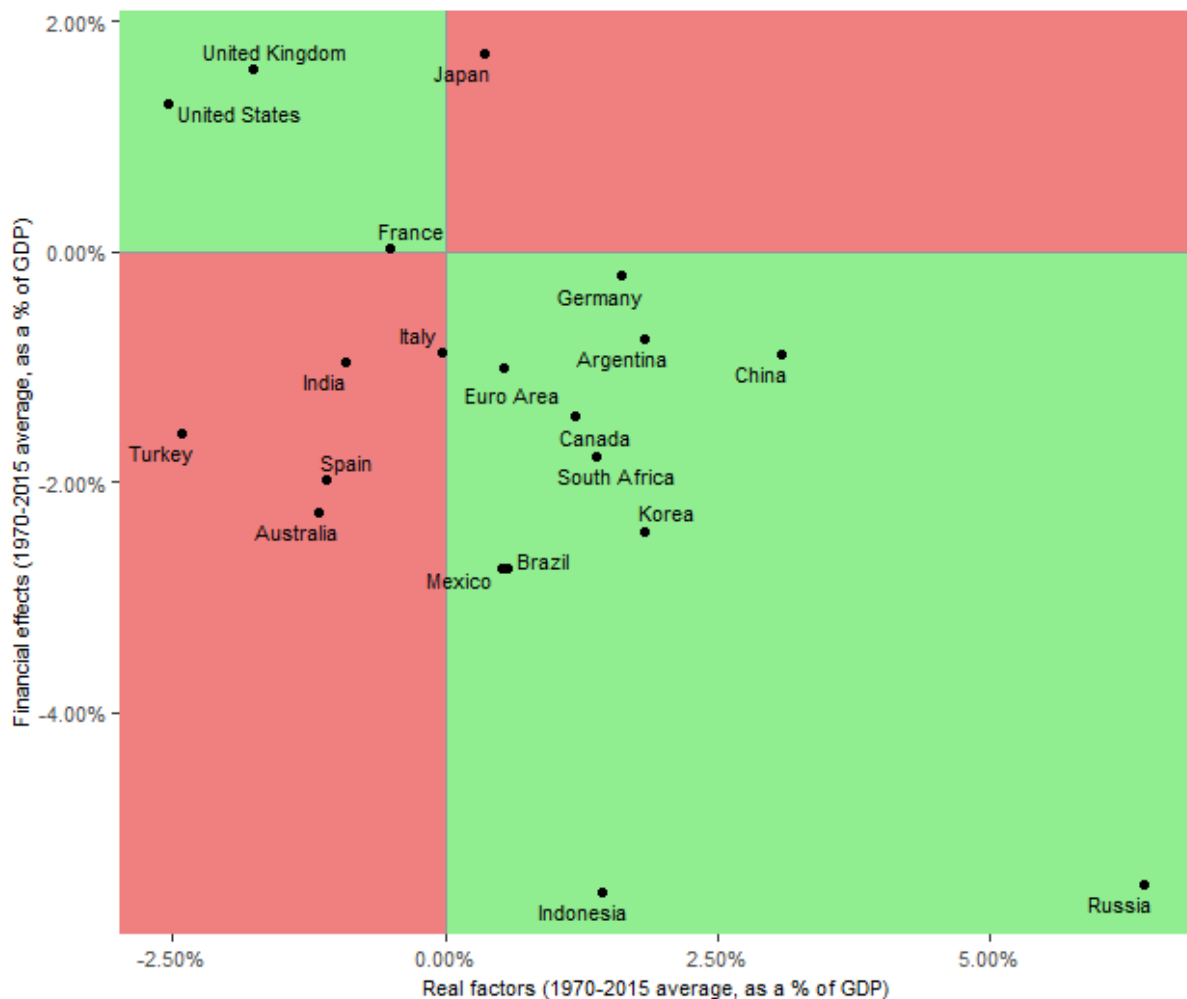


Divergence of net international investment positions: a snowball effect?

By [Bruno Cabrillac](#) and Baptiste Meunier

The net international investment positions (NIIP) of the G20 countries have diverged since 1990. While this divergence results partly from persistent imbalances in goods and services, NIIPs have their own dynamics: the portfolio generates income and capital gains or losses. These dynamics have had a stabilising effect at the cost of financial risks for some debtors, i.e. the United States, and an excessive accumulation of safe assets by some creditors.

Chart 1 – Financial effects and real factors



Sources: Lane and Milesi-Ferretti (2017), authors' calculations

The NIIP results from two factors: financial effects and real factors

The NIIP represents the net balance of claims and liabilities vis-à-vis non-residents. The NIIPs of G20 countries have diverged since 1990: from a situation of near-equilibrium for all countries, they have become polarised and have shown strong liability or asset positions depending on the country.

In accounting terms, the NIIP of a country results from real determinants (trade balance, labour income, etc.) on the one hand, and from two financial determinants (valuation effects, i.e. capital gains or losses on portfolios related to changes in the price of financial assets or the exchange rate for portfolios denominated in foreign currency, net investment income, i.e. dividends and interest from net assets) on the other. These financial determinants depend solely on the NIIP itself, on its asset structure and on the amount of net assets; they are therefore comparable to a NIIP's internal dynamics.

It is key for the study of global imbalances to understand the impact of these financial effects, especially as the exacerbation of IIPs has greatly increased their magnitude over the past 30 years. If the impacts of financial effects and real factors have the same sign, the divergence of the NIIP is self-sustaining with a "snowball" effect. A negative (positive) NIIP due to the accumulation of real factors would be impacted by negative (positive) financial effects that would polarise it even more. Such a situation would be a source of concern as it would make resolving global imbalances in G20 countries more difficult.

Financial effects generally have a stabilising effect, linked to the structure of the portfolio

On average, over the period 1970-2015, financial effects had a rather stabilising long-term impact. In most G20 countries (14 in the green areas on Chart 1), they had an opposite sign to that of real factors: the financial dynamics offset the impact of real factors. In other words, the divergence of their NIIPs would have been greater without these financial effects. This was not the case for the countries in the red areas (6) whose financial effects exacerbated the polarisation of their NIIP.

This stabilising effect results from investment income and the market effect (see Chart 2) and concerns mainly two types of countries:

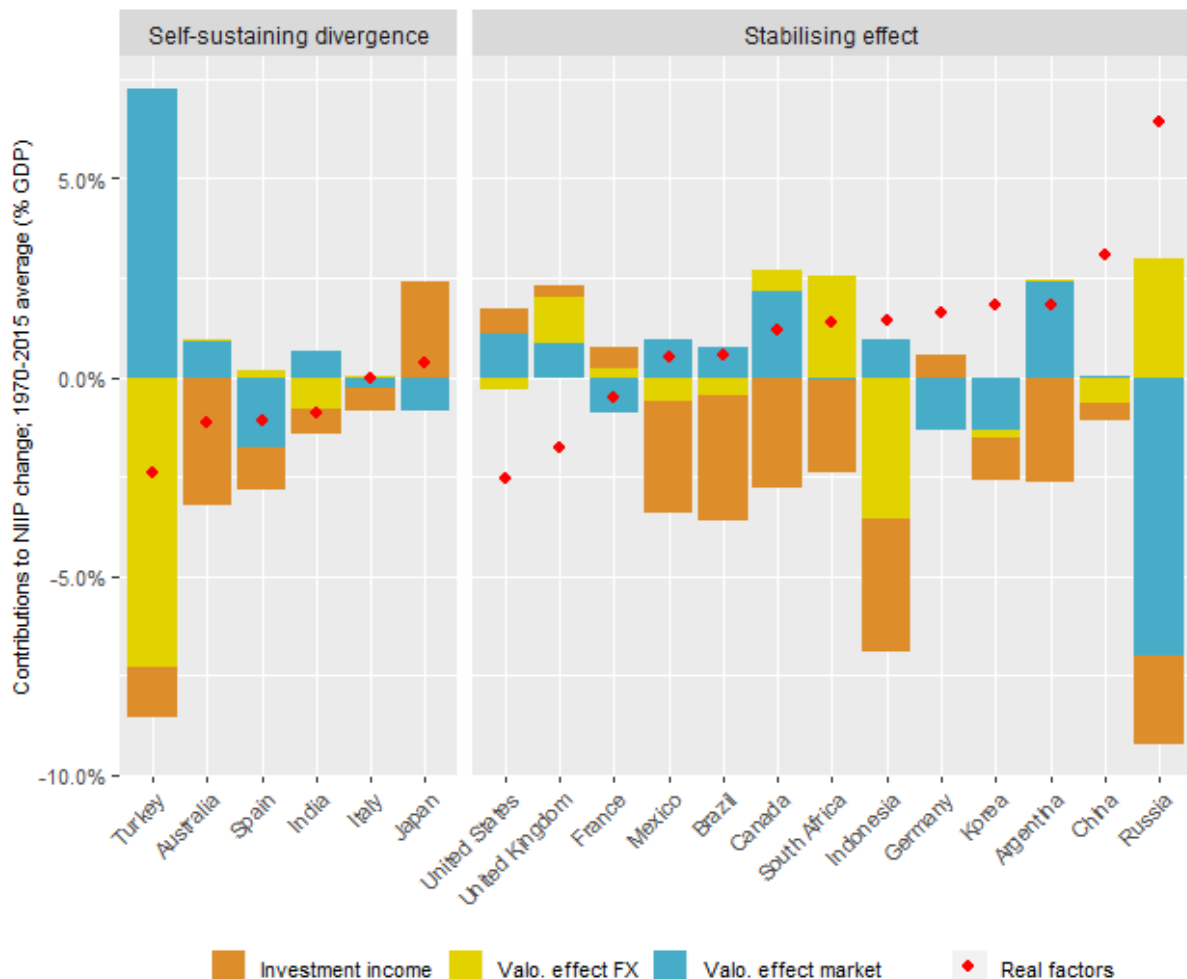
- Deficit advanced countries that issue a reserve currency backed by a global financial centre (United States, United Kingdom). These countries finance their deficits in the form of debt securities and make outward equity investments and FDI: because of the differences in yields between these asset classes, they derive a higher average yield on the assets side than what they pay on the liabilities side. This is heightened by the differences in yields, within the same asset class, with claims being less remunerative than liabilities – e.g. in the United States, a higher yield on outward FDI

than on inward FDI, see [Bosworth et al. \(2007\)](#). Financial effects have a positive impact, offsetting the goods and services deficit;

- Surplus emerging countries (Argentina, China, South Africa, Mexico, Brazil, Korea, Indonesia, Russia) which invest in debt securities for a liabilities side composed of equities and FDI. Financial effects, which are negative, offset the persistent surplus on other items.

Conversely, deficit emerging countries (India and Turkey) are faced with a snowball effect: their NIIP, which consists of debt securities on the assets side and equities and FDI on the liabilities side, generates negative income and valuation effects, which exacerbate the effect of the trade deficit.

Chart 2 – Average contributions to NIIP changes



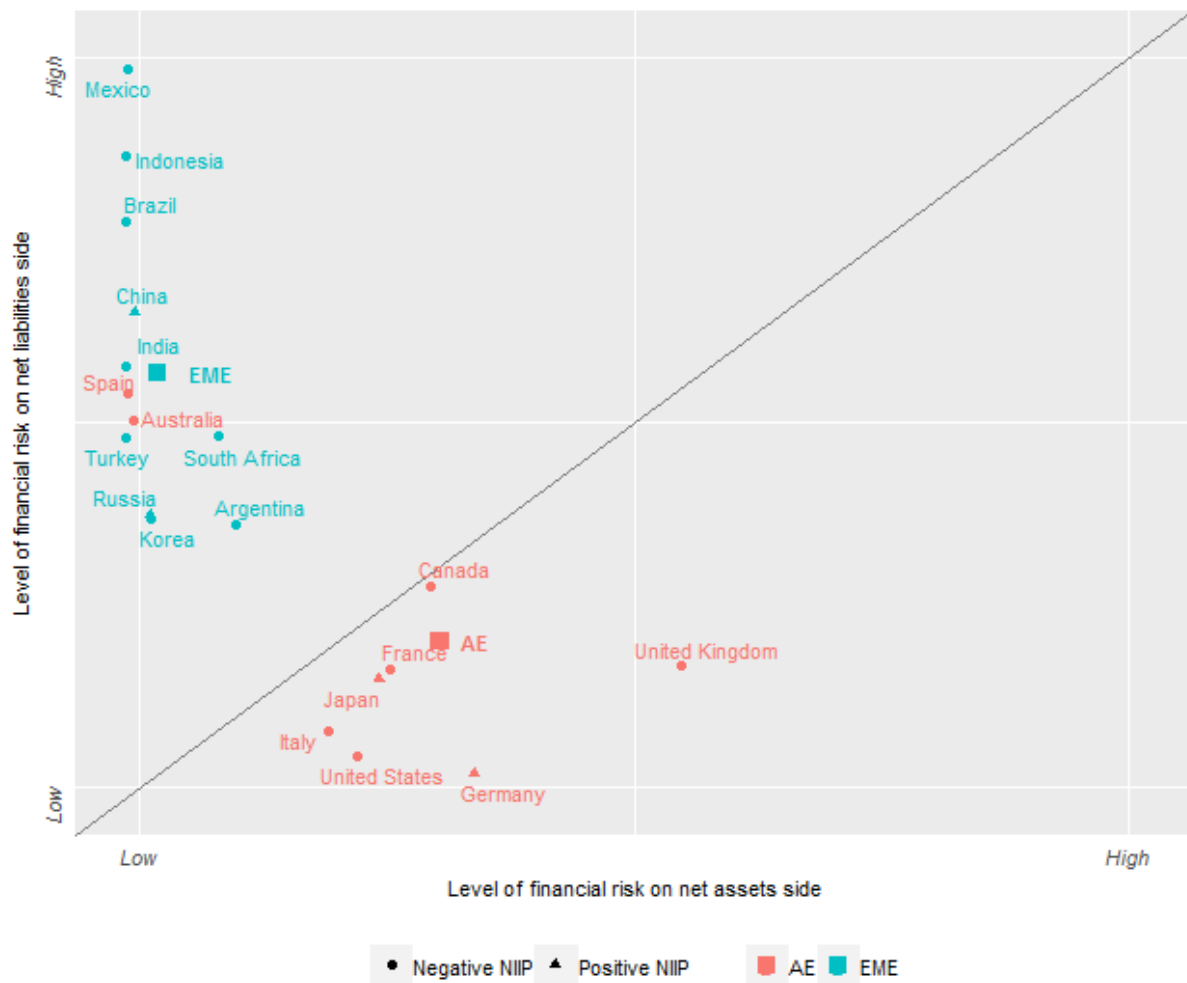
Sources: Lane and Milesi-Ferretti (2017), Benetrix, Lane and Shambaugh (2015), authors' calculations

On average, exchange rate effects had no long-term stabilising impact. A country with a positive NIIP should, however, see its exchange rate appreciate, producing a negative valuation effect. Indeed, an appreciation implies that assets denominated in foreign currencies are worth less in local currency; since all countries have more assets than liabilities denominated in foreign currencies, the net impact of an appreciation is negative.

The NIIP's composition reflects a risk taking approach that may be destabilising during a crisis

The financial effects are the consequence of risk taking exposing the NIIP to the financial cycle. Having more high-risk financial products on the assets side than on the liabilities side results in positive yields during market upswings but exposes the NIIP to a sharp deterioration in the event of a crisis: the fall in assets (equities, FDI) will be stronger than that of liabilities (debt securities whose value may increase as a result of lower rates and the safe haven effect). In countries whose currency is a safe haven currency, the deterioration will be exacerbated by the exchange rate appreciation. In the United States, this mechanism is analysed as a corollary of the exorbitant privilege of the dollar in [Gourinchas, Rey and Govillot \(2010\)](#): in times of growth, the United States provides risk-free assets and achieves positive valuation effects; in times of crisis, the negative effects are comparable to the payment of an insurance premium.

To measure this risk, we calculate a weighted risk on the net assets and liabilities sides (see Chart 3). Each asset class is assigned a weight: the average of the Basel III RWA coefficients in investment grade. Reserves have a weight of zero, FDI has the same weight as equities. The diagonal represents a neutral risk: a country below (above) will have a higher (lower) risk. The further away a country is from the diagonal, the greater the effect. The asymmetry between advanced and emerging countries is observed by a significantly higher average risk of the former.

Chart 3 – Financial risk of the NIIP (1970-2015 average)

Sources: Lane and Milesi-Ferretti (2017), authors' calculations

Overall and over the long term, the financial effects of the NIIP have a rather stabilising impact. This does not correspond to a natural mechanism, but to a state of the world – and of the international monetary system – characterised by deficit advanced countries, but with higher risk assets than their higher-yielding liabilities, and surplus emerging countries, but with lower risk assets than their lower-yielding liabilities. These effects are therefore a long-term consequence of the Lucas paradox – capital flows from emerging to advanced countries – and of the exorbitant privilege of international currencies which implies, among other things, an accumulation of risk-free assets by emerging countries.