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Gross or Net International Financial Flows

Understanding the Financial Crisis

Karen H. Johnson
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Introduction

It has been argued by many analysts, including Chairman Ben Bernanke of the Federal Reserve, that the global external imbalances, which have been a feature of the world economy for more than a decade, are an important, causal factor underlying the global financial crisis of the past two years.¹ The claim is that net financial flows, which are the counterpart of net current account balances, resulted in capital flowing from surplus countries, such as China, to the major deficit countries, especially the United States, and contributed to low dollar interest rates, unrealistic risk premia, high U.S. asset prices, and excessive expansion of credit. Once credit quality problems emerged, the bust soon followed. But it is not the net external imbalances (or net financial flows) of the surplus countries that move across borders and must be intermediated by the global financial sector; it is the gross financial flows of all countries that require this. Moreover, it is the gross stocks of assets held cross-border (far larger than any one year's gross flows) that must be managed for risk. This paper will explain in detail the differences between the net external imbalances and measured gross financial flows. This comparison will reveal that data on net external imbalances do not identify which countries are most actively involved in large cross-border financial transactions and, hence, whose behavior is most critical for global financial stability.

The data for multilateral current account balances are readily available and are most often what is meant when the term “external imbalances” is used. The multilateral nature of this concept is frequently useful because it reflects the complex and multifaceted trade links among countries in the global economy. And this concept reports the change (either positive or negative) in the net claims on the rest of the world of the country in question. Hence it cumulates to a measure of the net cross-border wealth holdings (or indebtedness) of the country.² Although current account data are most often derived from the trade side of balance-of-payments data, there is a counterpart set of financial flow accounts, which, apart from a statistical discrepancy, give an identical result for the net imbalance.

Whether the current account balance is useful or appropriate to cite depends upon the question being asked. The net balance number reflects a wide variety of offsetting pluses and minuses. With respect to the data for financial flows from abroad into a given country for a particular category of assets—say, privately held domestic equity—statisticians net the purchases and sales of that country's equity by all private foreign investors to arrive at the increase or decrease in domestic equity held by private foreigners. This same calculation is done for other securities, direct investment, currency, bank claims, and other smaller items. Calculations are also done for foreign official investors or, in some cases, just for the total of private and official investors. Some categories may show increases over the time interval being measured while others show decreases. The increases and decreases are then summed to determine the net financial inflow into the country from the rest of the world. These same calculations are done for the domestic investors to measure the net financial outflow from the country to the rest of the world for the range of asset categories covered. It is the net *difference* in these two figures that corresponds to the current account imbalance. A country with a current ac-

count deficit, such as the United States, has a corresponding financial surplus or net inflow from the rest of the world and vice versa. Hence, as measured in the net imbalance, \$100 of direct investment by a U.S. firm into its holdings in Canada is offset by an increase of \$100 of currency held by a person in Cambodia.

As is clear from the above discussion, a country could have a *zero* net external imbalance and yet have had huge gross inflows and outflows of financial capital. Why might this matter? It matters because the various assets and liabilities that comprise those flows differ in important ways and because within each country the persons, firms, or official holders of assets likely differ from those who incurred liabilities. So the foreign assets held by pension funds or university endowments are not necessarily available to pay the cross-border debt of firms who imported goods or tourists who traveled abroad on their credit cards. Moreover, with respect to the events of the recent global financial crisis, it is interesting to explore how financial capital that moved across borders was intermediated. Did it pass through a regulated financial institution or was it invested by an entity not subject to regulation? Did it add to the total of funds invested without due care as to the risks being undertaken? Was a bond purchased and so downward pressure put on interest rates? Or was a house purchased, and so upward pressure put on housing prices? In which country did the financial flow originate and what sort of investor decided to direct it to, for example, the United States?

In 2007, the U.S. current account deficit was nearly \$730 billion.³ Accordingly, the net financial inflow from the rest of the world to the United States was about that large. But the gross inflow of financial capital to buy U.S. assets was about \$2.1 trillion—nearly three times as large. Of that amount, about \$1.6 trillion were a variety of assets purchased by private foreign investors. Total net acquisition by U.S. investors of foreign assets was about \$1.5 trillion, nearly all of which was by private investors. As of year-end 2007, the net indebtedness of the United States to the rest of the world totaled \$2.4 trillion. Clearly these large figures suggest the possibility that a focus on the \$730 billion can miss most of the action in cross-border financial flows.

Do the data for gross cross-border financial flows in the recent period provide a different picture of how global capital flows contributed to the financial crisis than the data on net imbalances? This paper looks at the multilateral net external imbalance data for 2007 and its implications. Then it looks at U.S. data for gross financial inflows to see if the insights from the current account data are confirmed or challenged. Although they have been improved greatly in recent decades, the data on cross-border financial flows are less complete and accurate than are the data on cross-border flows of goods and services. This is one reason why the net current account balances are so frequently cited. With the United States perceived to be the source and locus of much of the financial crisis, data on financial flows into the United States, while only a part of global financial flows, should prove useful. Finally, the paper examines data on other gross global financial flows to judge how they influenced the financial crisis.

Insights from Multilateral External Imbalances

Table 1 provides current account balances for the major surplus and deficit countries for 2007. Although losses in U.S. subprime mortgages began to emerge in 2007, data for that year record the last full year before the crisis hit in a major way. The table contains data in U.S. dollars, so larger economies tend to be at the top of the lists of surplus or deficit countries. In analyzing the recent crisis, this approach, in contrast to expressing the balances as a share of gross domestic product (GDP), for example, reflects the potential for the given country's deficit or surplus to be of importance for global financial markets. For broad global market developments, the size of the imbalance—and counterpart net financial flow—is what matters.

Table 1: 2007 Current Account Balances (\$billions)

Deficit		Surplus	
United States	-731.2	China	371.8
United Kingdom	-80.7	Japan	211.0
Australia	-57.1	Saudi Arabia	95.8
Turkey	-37.7	Russia	76.2
South Africa	-20.7	Norway	62.0
India	-11.3	Switzerland	43.1
New Zealand	-10.6	Singapore	39.2
Mexico	-8.2	Sweden	39.1
Pakistan	-6.9	Taiwan	33.0
Iceland	-3.1	Euro area	20.4
		Thailand	14.0
		Canada	12.7
		Indonesia	10.5
		South Korea	5.9
		Argentina	4.3
		Brazil	1.6

Source: International Monetary Fund (IMF), *World Economic Outlook*, April 2009.

In order for there to be some countries experiencing deficit, there must be others with surplus, as the balance for the entire global economy must be zero. So, in general, one should look both to countries with large deficits and large surpluses for underlying factors that contributed to the global financial crisis. Those countries with current account deficits in a given year received net financial inflows

from the rest of the world; those with surpluses supplied financial capital—that is, had net financial outflows—to the rest of the world.

What can be learned from the actual data for 2007? First, the United States clearly ran the largest deficit and so absorbed the largest net inflow of financial flows from abroad. The United Kingdom was second, with a net inflow of about \$80 billion, a bit more than 10 percent of that of the United States. After these two countries, the deficits reported on the list rapidly get smaller in absolute size. Issues of absorbing sizable net inflows of capital from the rest of the world would seem to be largely confined to these two countries, with Australia running third. With respect to surplus countries, those providing net financial flows to be absorbed elsewhere, China reported the largest figure at more than \$370 billion. Japan was second, with about \$210 billion, roughly two-thirds of the Chinese surplus. Together their surpluses are almost equal to the U.S. deficit. The next three surplus countries benefited from substantial earnings from the sale of crude oil. The subsequent two, Switzerland and Singapore, are global financial centers with small domestic economies.

Based on these data, the following implications have been pointed out by many analysts:

- The large net inflows of financial capital into the United States added to the financial excesses that occurred in these markets. They exerted downward pressure on dollar interest rates and upward pressure on U.S. asset prices. Risk management practices were allowed to slacken.
- Many of the same excesses were experienced in London markets. Net inflows of foreign financial capital contributed to the excessive expansion of the financial sector, to the measurement of substantial output in the services sector of the economy despite weakness elsewhere, and to lower interest rates and higher asset prices than would otherwise have occurred.
- China, Japan, and the oil-exporting countries had high domestic saving relative to investment and sought attractive returns elsewhere in global markets. The capital markets of New York and London are the most developed and safest such markets and attracted capital inflows. The surpluses of these high-saving countries contributed (along with many other factors) to the outcome of large deficits in the United States and United Kingdom as global saving flowed into their markets. The resulting imbalances thus fed the global boom that ultimately collapsed in crisis.
- Countries that were nearly in balance had an essentially neutral effect through global financial flows on the development and then bursting of the global financial bubble/crisis. (They may have had domestic financial vulnerabilities that have succumbed to global pressures.) In particular, the euro area, with a small recorded surplus in 2007, was not a factor in adding to the pressures created by the global flow of financial capital. Similarly, Canada did not contribute importantly to these net financial flows and resulting pressures.
- A worrisome part of the story is that over time, as China, Japan, and others have accumulated surpluses for several years, they have built up large holdings of international assets (some are referred to as sovereign wealth funds), which include large dollar balances. The risk of a reallocation of these funds out of dollar assets into others adds to the uncertainty now troubling financial markets.

Insights from Gross Cross-border Financial Flows

So much for the lessons from net cross-border financial flows. What can be learned from gross financial inflows and outflows? Because the global financial crisis is seen as arising in the United States, an examination of U.S. data can provide new information and insight. Clearly, the total U.S. financial inflow in 2007 of more than \$2 trillion, shown in Table 2, was many times the U.S. current account balance of about \$730 billion. Of this total, about 75 percent were inflows from private investors.⁴

Table 2: 2007 U.S. Financial Inflows, Excluding Financial Derivatives (\$billions)

Total	2,129.5
Official	480.9
Private	1,648.5
of which	
Direct investment	275.8
Securities	672.5
U.S. Treasuries	66.8
Other	605.7
U.S. currency	-10.7
Reported by U.S. banks	509.3
Other nonbank	201.7

Source: Bureau of Economic Analysis.

The argument is often made that the economic incentives that drive direct investment inflows are quite different from those that drive the portfolio investment into securities or the flows among banks. Direct investment is seen as having a longer-term focus. The flows are often between a firm and its foreign subsidiaries or foreign partners and may be the result of earnings of the foreign subsidiary that are retained abroad. For these reasons, it probably makes sense to concentrate on private securities transactions and bank flows in looking for insights into the financial crisis.

Private inflows into U.S. securities were the largest single category and were about 40 percent of the total private inflow. U.S. Treasury security purchases were about 10 percent, with other securities such as stocks and private bonds accounting for the remaining 90 percent. These securities were traded on U.S. capital markets, rated by the major rating agencies, held by a wide range of investors, and figured prominently in the crisis. The increase in liabilities to private foreign investors reported by U.S. banks, about \$510 billion, was also large. Many bank transactions are with other banks. Such interbank transactions can result in both banks increasing their claims on each other, and hence increasing the gross flows reported in the balance of payments, for business reasons that are technical

and may not be significant. Shifting of funds by an international bank among its branches is one such example. But because the global banks are at the center of this financial crisis, it seems wise to look closely at all the data, including that of substantial increases in the liabilities of U.S. banks to foreign private investors.

A look at the changes from 2003 to 2007 in the main components of U.S. private financial inflows is enlightening. Table 3 shows that the total gross financial inflow to the United States increased \$1.3 trillion over this period, whereas the current account deficit rose in size by only \$200 billion. Of the \$1.1 trillion increase in private inflows, net private securities purchases by foreign investors increased by \$360 billion and the net increase in liabilities of U.S. banks to foreigners rose by about \$410 billion—again, much larger than the increase in the current account deficit.

Table 3: U.S. Financial Inflows, Excluding Financial Derivatives, 2003 vs. 2007 (\$billions)

	2003	2007
Total	858.3	2129.5
of which		
Private	580.2	1648.5
of which		
Securities	312.2	672.5
Reported by U.S. banks	97.2	509.3
Note: Current account deficit	521.5	726.6

Source: Bureau of Economic Analysis.

The U.S. balance-of-payments data are reported on a by-country basis. There are limitations with these data. Not all of the increase in holdings of U.S. dollar assets occurs within the United States, so the by-country data may not reflect correctly all the holdings by country of dollar-denominated claims.⁵ The attribution of country may reflect the location of the financial intermediary holding the asset, not the ultimate owner, as the reporting of portfolio flows is largely done by financial entities. Similarly, the issuer of a security may be an international financial entity and may not reveal the location of final risk underlying the security. For the purposes of analyzing the forces in the current financial crisis, knowledge of the location of the financial firms doing the transacting may be more important than knowledge of the country of the ultimate beneficial owner.

Table 4: By-Country Data on Gross Financial Inflows to the United States in 2007, Excluding Financial Derivatives (\$billions)

Total	2,129.5
Europe	1,015.9
of which	
Euro area	360.3
United Kingdom	561.0
Asia + Pacific	450.0
of which	

China	260.3
Japan	65.9
Taiwan	5.8
Singapore	20.9
Australia	-0.2
Canada	83.5
Middle East ⁶	39.8
OPEC ⁷	52.1

Source: Bureau of Economic Analysis.

Table 4 shows that Europe accounted for one-half of the gross financial inflow into the United States in 2007. About one-third of the European total was inflow from the euro area, and the total from that region exceeded that from China and greatly exceeded that from Japan. More than one-half of the European inflow is accounted for by the United Kingdom, a country experiencing a current account deficit; no doubt the large figure reflects the global role of London in financial markets. Clearly, the structure and behavior of financial institutions, the quality of financial regulation, and the skills of financial managers in London and in the euro area were critical to the course of the flows of financial capital into the United States in 2007.

The role of China as a factor in feeding the financial bubble in New York markets seems significant, but smaller, as captured in these data. Data reported by the People's Bank of China on its English webpage show that total Chinese holdings of foreign exchange reserves increased \$462 billion from December 2006 to December 2007, a total greater than the figure for China in Table 4. Not all of China's foreign exchange reserves are necessarily in dollars, and not all of their dollar reserves are held in the United States. It is probably the case that the financial pressures on dollar interest rates and asset prices from Chinese investment behavior is somewhat understated by the U.S. balance-of-payments figure for inflows from China. At the same time, data on financial flows suggest that the primacy of China with respect to global financial flows that is implied by net current account data on Table 1 is inaccurate.

The data in Table 4 also suggest that financial transactions between the United States and Canada are larger and more significant in the crisis than is indicated by the Canadian current account balance. The data for the Middle East and Organization of the Petroleum Exporting Countries (OPEC) are different perspectives on the behavior of the major oil exporters in generating inflows into U.S. asset markets. These figures indicate that dollar holdings by the countries in these aggregates may be substantially outside the United States and may, for example, be part of the reason the reported U.K. figure is so large.

Table 5: 2007 U.S. Financial Outflows, Excluding Financial Derivatives⁸ (\$billions)

Total	1,472.1
Official + government	22.4
Private	1,449.7
of which	
Direct investment	398.6

Securities	366.5
Reported by U.S. banks	644.1
Other nonbank	-40.5

Source: Bureau of Economic Analysis.

The United States also experienced large financial outflows in 2007. What insights might these data provide? Table 5 reports the overall data by category of asset. The total is large, but smaller than the gross total inflow, consistent with the United States experiencing a net current account deficit and hence net financial inflow. The outflow is almost entirely private. The direct investment figure is substantial, in fact larger than the direct investment inflow. However, the figure for direct purchases of foreign securities by U.S. investors is smaller, and the figure for the increase in bank claims on foreign entities larger, than the corresponding entries on Table 2. Comparison of tables 2 and 5 reveals that U.S. private investors acquired fewer claims on foreign countries than private foreign investors acquired claims on U.S. assets. Foreign investors tended to increase their direct exposure to U.S. securities; U.S. investors tended to increase their exposure to foreign assets through bank claims.

Table 6: By-Country Data on Gross Financial Outflows from the United States in 2007, Excluding Financial Derivatives (\$billions; outflows shown as positive)

Total	1,472.1
Europe	1,014.0
of which	
Euro area	477.2
United Kingdom	422.4
Asia + Pacific	26.8
of which	
China	-2.0
Japan	-50.0
Taiwan	-2.8
Singapore	14.0
Australia	27.3
Canada	67.9
Middle East	13.6
OPEC	19.2

Source: Bureau of Economic Analysis.

The data for U.S. financial outflows by country are in Table 6. They show that Europe accounted for an even larger share of U.S. gross financial outflows than it did inflows. The euro area and the United Kingdom each accounted for nearly one-half of the total for Europe. Canada was again a substantial counterparty, but financial outflows to Asia and the Pacific were limited, with U.S. residents actually reducing their financial claims on Japan and China. The outflows to the oil-exporting countries also seem to have been small, given the Middle East and OPEC figures.

Unfortunately, detailed data by country and by category are not always available, particularly for inflows. In 2007, for Europe as a whole, private foreign investors tended to acquire U.S. securities, particularly those other than U.S. Treasury securities. U.S. private outflows to Europe were more often intermediated by banks. For the United Kingdom, bank claims and securities acquisition were comparable for outflows, whereas inflows were greater for securities. For Japan, a large reduction in claims by U.S. banks was reported in the outflow data; the inflow data show securities acquisition and increases in U.S. bank liabilities. For Canada, the data for inflows show substantial private securities purchases and limited increase in U.S. bank liabilities, whereas the data for outflows show a large increase in U.S. bank claims on Canada.

Over time, the cross-border financial flows plus changes in the value of the holdings of these assets determine the net international investment position of a country. The United States is a net debtor country, importantly, because it has run large current account imbalances over the past several years. At year-end 2007, the U.S. net international investment position was about negative \$2.4 trillion.⁹ However, foreign-owned claims on the United States totaled \$20.1 trillion, of which about \$14.5 trillion were privately held. U.S. investors owned claims on the rest of the world totaling \$17.6 trillion, of which \$15 trillion were privately held. Among the categories of assets held, the United States is sometimes a net debtor but sometimes a net creditor. For example, the United States holds direct investment assets abroad that exceed in value the comparable claims on the United States held by foreigners. Little about the size and the characteristics of the assets held on both sides can be inferred from the net position figure.

Table 7: Foreign Holdings of U.S. Securities as of June 30, 2007 (\$billions)

Total	9,771.7
of which	
Europe	4,202.4
of which	
Euro area	2,368.8
Switzerland	329.0
United Kingdom	920.6
Asia	3,142.6
of which	
China	922.0
Japan	1,196.5
Canada	475.2
Middle East oil exporters ¹⁰	308.4

Source: U.S. Treasury, Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2007.

The Treasury International Capital (TIC) data provide a by-country listing of foreign holdings of U.S. securities. Table 7 reports these data as of June 30, 2007. These holdings are large relative to any one year's gross flows, much less relative to any year's net current account balance. Europe is a major participant in the foreign holding of U.S. securities, with the United Kingdom (a country that has recorded current account deficits each year over the past two decades) holding a larger total than

Switzerland (a country with surpluses over the same period). China and Japan both have large holdings.

The development of expanded two-way cross-border financial transactions among most countries has been labeled “financial globalization” and is largely regarded as positive. Significant inflows and outflows for a given country can indicate more efficient global diversification and hence lower risk in the portfolios of its private and official investors. Such flows can enhance the efficiency of the global allocation of capital and thus contribute to rising standards of living generally. They can also reflect the lowering of previously erected barriers that prevented investors from making their best choices and a reduction in “home bias” of investors, whereby because of lack of information and/or high transaction costs, investors showed a disproportionate preference for domestic assets.¹¹ But expanded global flows of financial capital bring about changes in the risks to which individual investors are being exposed and increase systemic risk—the risk that the interconnected system of financial markets will experience a widespread simultaneous failure of major participants. Each part of the financial network has become more vulnerable to regulatory weak spots, and the potential need for international cooperation and coordination of financial supervision has increased. Such cooperation may be particularly necessary if a major international firm, with operations in many countries, needs to be wound down.

Data on gross financial flows into and out of other countries offer similar insights to those discussed above using U.S. data. In 2007, the United Kingdom reported a current account deficit of about \$80 billion in 2007 yet had gross financial outflows of almost \$2 trillion.¹² Japan experienced a current account surplus of \$211 billion yet had gross financial inflows excluding financial derivatives of more than \$260 billion.¹³ Switzerland, with a current account surplus of \$43 billion, had gross financial inflows of about \$325 billion.¹⁴

What Can Be Learned from the Crisis About Understanding Financial Flows?

Preliminary data are available for 2008. The crisis that became intense over that year entailed two related but different developments: some asset values moved sharply, and some markets ceased to function or almost ceased to function. If the net imbalances reveal the crucial financial flows that contributed to the boom and then the bust, it would be expected that, in the subsequent changes in asset values and market disruptions that marked the crisis, dollar values and markets would show sharp changes but that euro assets and markets would not, as the euro area had recorded net balance. If, alternatively, gross flows are revealing crucial financial activity and vulnerabilities, then dollar and euro assets and markets would both be disrupted, as gross flows were predominantly between Europe and the United States.¹⁵ Moreover, which assets and markets were disrupted might confirm that the sectors that had experienced significant expansion in two-way flows were the ones that proved vulnerable.

Table 8 reports some relevant financial data for dollar and euro assets.

Table 8: Asset Price Changes during 2008

Ten-year Government Bond Rates (percent)

	End December 2007	End June 2008	End December 2008
United States	4.03	3.97	2.21
Euro area	4.42	4.81	3.41

AAA Corporate Bond Spreads (basis points)

	End December 2007	End June 2008	End December 2008
United States	122	158	343
Euro area	47	61	178

Stock Prices (percent change)

	From December 2007 to June 2008	From June 2008 to December 2008
Wilshire 5000	-12.3	-32.9
Dax	-20.4	-27.9

Sources: IMF, *World Economic Outlook*, April 2009; IMF, *Global Financial Stability Report*, April 2009.

During the crisis, long-term government bond rates fell in both the United States and the euro area, as investors sought safety and declined more for U.S. bonds. Corporate bond spreads rose in both economies, more so in the United States. But given the difference in the change in government

yields, the absolute changes in AAA corporate bond rates were about the same. Although the timing was a bit different, the overall changes in stock prices as measured by the indexes shown were about the same. These developments suggest both euro and dollar markets were affected. In addition, one would have expected dollar depreciation if the U.S. net external imbalance had been central to the causes of the crisis and its outcome. The dollar did depreciate sharply against the euro from December 2007 through July 2008, but on balance from December 2007 through December 2008, the dollar appreciated slightly against the euro.

Although during 2008, the U.S. current account deficit narrowed only slightly, by about \$20 billion to \$706 billion, gross financial inflows into the United States decreased substantially, by \$1.6 trillion; they fell to about 25 percent of their level in 2007. U.S. financial outflows similarly collapsed. Although private foreign investors continued to acquire claims on the United States, albeit at a much-reduced rate, U.S. private investors on balance actually lowered their holdings of foreign assets. It is not surprising that in the midst of a financial crisis, investors both in the United States and abroad would drastically change their behavior. Gross inflows to the United States from China and Japan continued. It was the two-way gross flows between the United States and Europe that changed; in both directions flows reversed. This development had consequences: as seen in Table 8, asset values changed sharply and some markets, such as cross-border interbank lending, were severely disrupted.

Do U.S. Gross Financial Flows Paint a Different Picture Than Net Current Account Balances?

To summarize the differences in implications for 2007:

- Current account data lead to the conclusion that the major financial flows were from China and Japan to the United States. But the data on financial flows show that in fact the two countries/currency areas with the largest gross financial inflows into the United States in 2007 were the euro area—with an essentially neutral current account position—and the United Kingdom, which had a current account deficit.
- A large amount of two-way trade in assets occurred in 2007 between the United States and the United Kingdom and between the United States and the euro area. This was not the case for China and Japan, where the U.S. balance-of-payments data record significant acquisitions by Chinese investors of U.S. assets but net reduction by U.S. investors of claims on China. In the case of Japan, acquisition of U.S. assets was limited, and again U.S. investors actually reduced their financial claims.
- The components of gross financial inflows and outflows for the United States show that the risk characteristics of U.S. and foreign investors differed. Although the detailed data are limited, foreign inflows from the other industrial countries and regions showed large acquisition of U.S. securities, including those other than U.S. Treasury securities. Foreign investors were clearly contributing to the demand for securities trading on the capital markets. The increase in U.S. claims on these counterparties tended rather to be claims reported by banks. These “mismatches” provide insight into where concentrated risks developed. They may also cast light on where regulatory differences were being exploited in a cross-border fashion.

Conclusions for the larger question of the links between external imbalances and the global financial crisis:

- Current account balances do not move over time in a predictable, stable fashion with gross cross-border financial flows.
- Current account balances may signal problems that require policy response and are the answer to some questions. But they are not a problem because they engender large cross-border financial flows. Those flows occur anyway in today’s world. Small surpluses or deficits do not signal that a country is refraining from engaging in large cross-border asset transactions that may be risky, and large surpluses or deficits do not necessarily indicate that a country is *not* managing its international portfolio well.
- Policies based on current account balances, such as ceilings that would trigger remedial policy response or IMF-enhanced surveillance, cannot be justified because of the risks posed by global financial flows to global financial stability. Current account data are too partial (because of netting in the statistics) to give useful information on the associated financial flows. The netting embed-

ded in current account data can be misleading because the assets acquired by some domestic residents are not necessarily available to meet the liabilities of other domestic residents and because the composition of claims acquired on the rest of the world, and hence their risk characteristics, may be quite different from the composition of claims on the domestic economy acquired by foreign residents.

- There is no substitute for careful supervision and regulation of the major international financial institutions and asset markets. Gross financial flow data can indicate where rapid expansion of particular forms of credit is occurring, where leverage may be becoming excessive, where regulatory inconsistencies are being exploited, and where heightened systemic linkages may be found. Although the data on gross flows may not provide a complete picture of the countries of residence of ultimate borrowers and lenders, it does provide a picture of which countries are important in the infrastructure of global finance.
- For understanding the factors behind the global financial crisis and the policy measures revealed as necessary by it, one needs to look at the role of the various countries and institutions in the financial markets, not in the markets for goods and services. Macroeconomic policies designed to narrow current account imbalances will not necessarily strengthen the global financial network.

Endnotes

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1. In his speech to the Council on Foreign Relations (CFR) on March 10, 2009, Bernanke linked the “global imbalances in trade and capital flows” that began a decade or more ago to “large capital inflows” experienced by the United States and other advanced economies that in turn contributed to the crisis. Steven Dunaway, in his Council Special Report for CFR, *Global Imbalances and the Financial Crisis* (March 2009), argues that the net external (largely trade) imbalances are a root cause of the crisis that must be addressed for sustainable global financial stability to be achieved.
 2. Data on the value of net international investment position of a country also take into account changes in the valuation of cross-border assets and liabilities over time.
 3. U.S. balance-of-payments data are from the webpage of the Bureau of Economic Analysis. There are slight differences in the U.S. data released June 17, 2009, and reported in tables 2–6 and those reported by the IMF in April 2009 and quoted in Table 1.
 4. Relative to the U.S. current account deficit, the purchases of U.S. assets by foreign officials is a much larger fraction, more than 60 percent, than the almost 25 percent it represents of the total financial inflow. It can be very misleading to compare components of the financial accounts, net or gross, to the net balance number. Because the various flow components in principle can be positive or negative and because the gross financial flow figures are much larger than the constructed net balance, several different financial components could each be labeled as “financing” the U.S. deficit. This point is often made about official inflows, but it could equally be made about other components and is misleading.
 5. It is also the case that not all dollar-denominated claims are claims on the United States. Some international borrowers issue debt in dollars, for example; many non-U.S. international banks offer deposits and loans denominated in dollars.
 6. The Middle East is composed of Bahrain, Gaza Strip, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates (UAE), West Bank, and Yemen.
 7. OPEC is composed of Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, UAE, and Venezuela.
 8. In balance-of-payments accounts financial outflows appear with a negative sign, but they are shown here as positive.
 9. Data on the U.S. international asset position are from the web site of the U.S. Treasury under the Treasury International Capital System reports. The data cited value direct investment assets and liabilities at current cost.
 10. “Middle East oil exporters” is composed of Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE.
 11. Speeches by Federal Reserve chairman Alan Greenspan on November 14, 2005, and December 2, 2005, called attention to the links between a general decline in “home bias” in the global economy and the evolution of the U.S. net current account balance.
 12. U.K. financial flow data are from the U.K. government *Pink Book: 2008 edition*.
 13. Japanese financial flow data are from the IMF Balance of Payments.
 14. Swiss financial flow data are from the website of the Swiss National Bank. Like the United Kingdom, Switzerland is the location of large international financial institutions that may hold international assets for investors elsewhere.
 15. The net imbalances themselves can change only slowly because of the general equilibrium nature of the global economy that maintains equality between the net current account balance and net financial flows and the net balance of saving and investment for every economy. The prices at which these quantities achieve this outcome give insight into where the financial pressures on markets arose.

About the Author

Karen H. Johnson is a consulting economist with interests in international finance and monetary policy. Her previous position was as director of the Division of International Finance at the Federal Reserve Board of Governors.