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External Balances, Trade and Financial Conditions

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Abstract

I present a new model for the U.S. external position that accounts for the accumulation of international debt over the past 60 years. The model is based on the present value restriction that links a country's external position to future trade flows and financial conditions in the absence of arbitrage opportunities and Ponzi schemes. It features the role played by the stochastic discount factor, the trade and valuation adjustment channels and provides a decomposition of the U.S. external position into secular and cyclical components. The model shows that shocks operating via the valuation channel are the dominant drivers of cyclical dynamics, accounting for approximately 80 percent of the variance over the 60-year sample. This channel works primarily via capital gains and losses on U.S. foreign assets and is closely tied to the international value of the U.S. dollar. In contrast, there is no evidence that valuation channel adjustments contribute to the secular dynamics, but differences between the average returns on foreign assets and liabilities raise the steady-state debt-to-GDP ratio from approximately 12 to 15 percent. The long-term deterioration in the U.S. position represents a move towards the steady-state before the early 1990's and a move away from the steady-state thereafter. I quantify the expected improvement in future U.S. trade balances needed to justify this as a sustainable path and show that they are very different from its actual behavior during the last 60 years. I also study the behavior of the U.S. position during the 2007-8 financial crisis.

Keywords: Global Imbalances, External Positions, Current Accounts, Trade Flows, Valuation Effects, Stochastic Discount Factors, International Asset Pricing

JEL Codes: F31, F32, F34

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