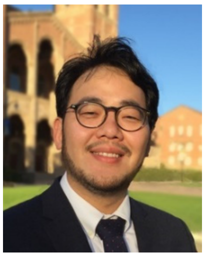
KIEP Opinions

External Adjustment after the Pandemic: Valuation Effects of Net Foreign Asset Positions



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Due to globalization and development in financial integration over the last three decades, gross foreign assets and liabilities have increased dramatically in developed and emerging countries. The foreign assets and liabilities of developed countries were, on average, about 50% of GDP in the early 90s, but now reach nearly 400%. Emerging countries have historically tended to have more foreign liabilities than foreign assets, but both have gradually increased in size since the 90s. Regardless of their foreign asset and liability portfolio positions, countries are exposed to capital gains and losses from external balance caused by fluctuations in exchange rates and asset values, and the impacts become more substantial because of the size effect. For example, the cumulative gain of the United States, a country well known for huge capital gains from the external position, stands at about 30% of its GDP (annually, 1.5% of its GDP) over the last two decades, while the cumulative loss of Korea is about 20% of its GDP (annually, 1.0% of its GDP) for the same periods. Does this mean that the United States is performing well and Korea is doing poorly on foreign investment?

The capital gains and losses are not the ends of the story. These external adjustments also have a role in international risk sharing and consumption smoothing for individual countries. In asset pricing theory, assets that provide higher returns on bad times should be more valuable, and the external portfolios are such assets. As a result, we can observe that the GDP growth and return on net foreign asset positions are negatively correlated in most countries. The reason is simple. Let us consider the case when a country undergoes a crisis, leading to negative GDP growth compared to its norm. On the one hand, the country's foreign assets in domestic currency terms will increase as the domestic currency is likely to depreciate over the crisis period. On the other hand, the foreign liabilities, which are foreign-owned domestic assets, will decrease as the values of domestic assets plummet.

The compositions of external balance would matter for the external adjustments. If we go back to the United States and Korea case, the United States buys risky assets and sells safe assets abroad, while Korea is the opposite. Korea substantially purchases US Treasury bonds as foreign reserves. The proportion of the foreign reserve is about, on average, 37% of Korea's overall foreign asset position for the last decade. This causes low returns on the external balance of Korea, while bringing several benefits. First of all, it helps manage domestic financial stability to prevent potential financial and external crises, even though it may be hard to measure the actual benefit. Moreover, it provides excessive capital gains in bad times as the price of safe-haven assets surges. Korea was a debtor country in 2008, and its net foreign assets were dramatically reduced during the global financial crisis. Thus, Korea has been in a hedger’s position in the international asset markets.

Even though the financial markets suffered a sharp drop-fall in April 2020 due to the outbreak of the Covid-19 pandemic, we are experiencing rapid recovery in the financial markets with worldwide fiscal stimulus and expansionary monetary policy. Consequently, the financial markets have skyrocketed, and experts and policymakers are concerned about the discrepancy between the real economy and financial markets. From the ongoing risks of the pandemic to unprecedented levels in both private and public debt across the world, the global financial markets have the most vulnerable economic backgrounds ever. Under this background, small shocks in the financial markets can trigger an enormous crisis. As in 2008, or even to a larger extent, this is likely to have a global impact rather than an idiosyncratic one. Then, it may be impossible to hedge all potential losses through the international financial markets. Along with the current external position, however, Korea would be seen as a better position. KIEP