International Capital Flows, Net Foreign Assets and Real Exchange Rates

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Scope

One of the most important benefits of international capital mobility is to allow the aggregate citizens of a country to smooth macroeconomic consumption across time. Intertemporal variation in macroeconomic savings patterns potentially allows smooth consumption patterns and intergenerational risk sharing. Countries with aging populations can save for some period through investment in other countries and subsequently start to dissave when large fractions of the population retire. Of course, a necessary condition for the success of the strategy is a less than perfect correlation of population demographics across countries.

The Netherlands has been seen as a prime example of the above principle. For over two decades, the Netherlands has been a net-saver in a macroeconomic sense. Annually, the country has continuously realized a substantial trade and current account surplus as a percentage of GDP. These structural surpluses imply a rising cumulative current account position and steadily increasing Dutch net foreign assets. On the surface, it suggests that at some point the Dutch economy will start showing trade deficits financed by the built-up stock of net foreign assets. However, recent research raises questions on the feasibility and optimality of intertemporal consumption smoothing through international (financial) markets.

The Dutch Net Foreign Asset position has deteriorated since 1993 and has turned into a net liability position around 1997. Returns on foreign assets (held by Dutch) typically is below the returns foreigners earn on their Dutch assets. Countries with persistent current account deficits tend to earn more on foreign assets than they pay on their foreign liabilities, while the opposite is true for net savers.

Research Goals

The project will investigate the issue by / through:

- the incorporation of valuation changes into the standard model linking foreign assets and liabilities to the trade balance and the equilibrium real exchange rate;
- including risk into the standard model. A high return on foreign liabilities, compared to the low return on foreign assets, could be the price for risk reduction through diversification;
- analyzing macro risks and the potential use of financial instruments developed especially for such risks;
- study of the demographics of different countries as well as their pension systems (funded versus non-funded, public versus private);
- explanation of cross-country differences in the development of gross foreign assets and liabilities, trade balance positions and real exchange rate changes;
- investigation of the geographic pattern of foreign assets and liabilities in order to analyze whether diversifying within EMU or outside of EMU have different effects in the longer run on the values of the stocks of assets and liabilities respective.