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CAPITAL FLOWS QUARTERLY, 2010 Q3

Two Myths About the U.S. Dollar

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INTRODUCTION

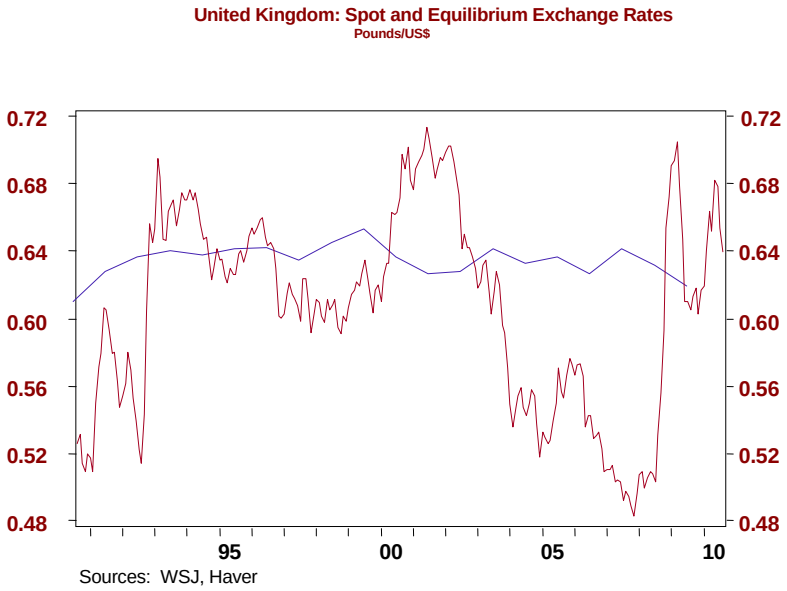
"Who controls the food supply controls the people; who controls the energy can control whole continents; who controls money can control the world." —Henry Kissinger

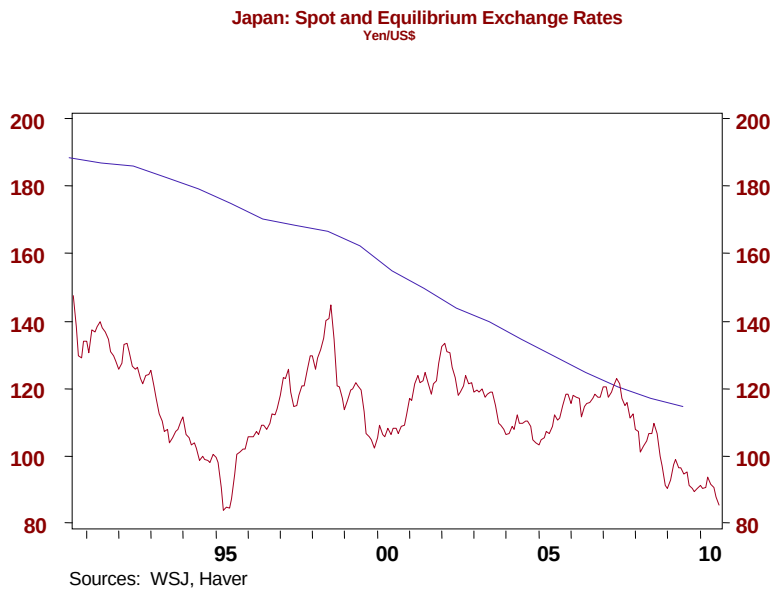
In these times of economic adversity, Henry Kissinger's adage is not much in fashion. Far from aspiring to a strong currency, the great powers of the world appear to wish for a weaker one because they are fixated on one threat above others: a shortage of demand. Demand for a nation's goods can come from households, firms, the government, or foreigners. With over-indebted households forced to save more and consume less, with firms disinclined to spend on capital goods because of the uncertain prospects for growth, and with governments' ability to spend hampered by their own troubling medium-term debt dynamics, an obvious remedy is a cheap currency that will entice foreigners to purchase a nation's wares. Of course, it is impossible for all countries to devalue against each other simultaneously. No matter: The leading economies are strongly tempted to steal a march on their rivals, threatening a repeat of the competitive devaluations that led the world into chaos in the 1930s.

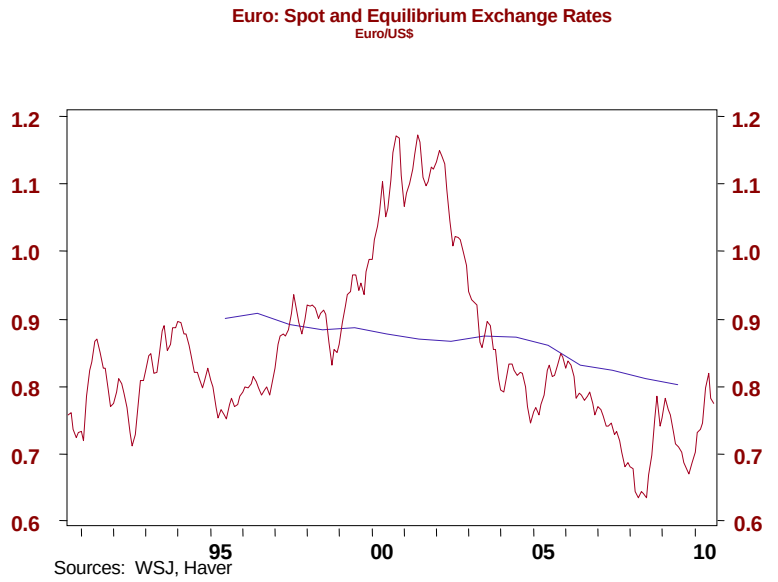
The policy tool of a weak currency appeals most obviously to China. Despite announcing in June a new willingness to allow its currency to rise against the dollar, China continues to hold down the yuan's value in order to boost exports. As part of this strategy, the Chinese have recently stepped up their program of selling yuan for yen, contributing to the appreciation of Japan's currency. The Japanese, for their part, have reacted furiously, denouncing China's policy and then counter-intervening in the markets in an attempt to drive the yen back downward. Japan's reaction to China threatens to trigger a further reaction from Europe—already, European officials have complained that Japan's currency intervention was done in a unilateral fashion, with the result that the fall in the yen came partly at the expense the euro. Of course, the leading economy in Europe, Germany, has itself benefited from a period of exchange-rate weakness: Germany's strong growth performance in the second quarter of 2010 owed something to the fall in the euro caused by the sovereign-debt scare in Greece and other members of the eurozone. Although the U.S. Congress is pressing the administration to manage the value of the dollar by retaliating against foreign currency manipulators, the United States is so far the exception among the four main currency blocks in its lack of active efforts to hold down its exchange rate. The Federal Reserve has not directly intervened in currency markets, unlike its counterparts in Beijing and Tokyo. Nor has the dollar been pulled downward by a sovereign-debt scare analogous to Europe's.

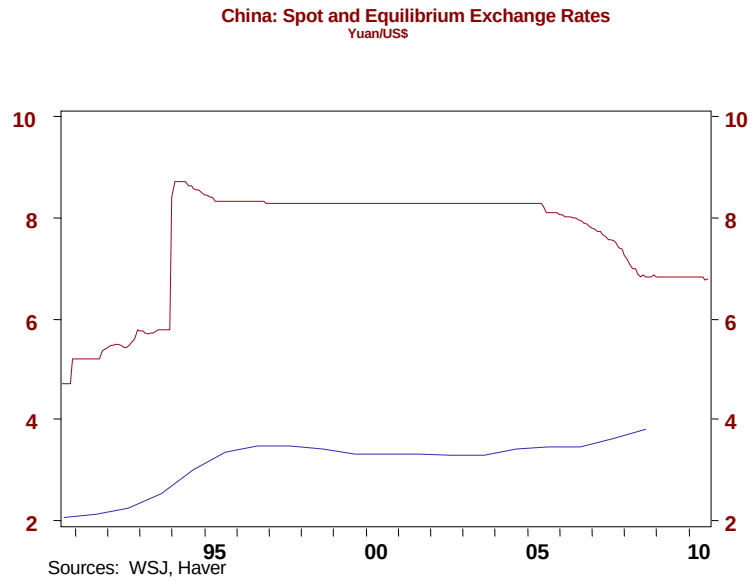
This environment of competitive devaluation is dangerous if countries actively push their currencies away from long-term equilibrium levels, exacerbating deviations from fundamental value. For currencies, long-term equilibrium levels are theoretical constructs, inevitably subject to dispute. In July International Monetary Fund (IMF) staff made a three-pronged argument that the yuan is being held substantially below fundamental levels; Chinese authorities disagreed with each leg of the analysis.[1] Back-of-the-envelope estimates of long-run equilibrium levels suggest that the Japanese are right to be concerned. Vis-à-vis the dollar, the pound and the euro are roughly in line with their long-run equilibrium (Figure 1, smooth lines), whereas the yen is substantially overvalued (i.e., too strong relative to long-run equilibrium) and the yuan is substantially undervalued. But any estimate of a currency's long-run equilibrium level is just that, an estimate, and material disputes about long-term value are both prevalent and likely.[2]

Figure 1


United Kingdom: Spot and Equilibrium Exchange Rates
Pounds/US$
0.72
0.68
0.64
0.60
0.56
0.52
0.48
95
00
05
10
Sources: WSJ, Haver


Japan: Spot and Equilibrium Exchange Rates
Yen/US$
200
180
160
140
120
100
80
95
00
05
10
Sources: WSJ, Haver


Euro: Spot and Equilibrium Exchange Rates
Euro/US$
1.2
1.1
1.0
0.9
0.8
0.7
0.6
95
00
05
10
Sources: WSJ, Haver


China: Spot and Equilibrium Exchange Rates
Yuan/US$
10
8
6
4
2
95
00
05
10
Sources: WSJ, Haver

This edition of the Capital Flows Quarterly (CFQ) focuses on two factors that pertain to the U.S. dollar, investigating not its current deviation from long-run fundamentals, but rather how those fundamentals might evolve going forward, with a particular focus on capital-flows-based drivers of long-term value. This concerns the ability of the dollar to maintain its status as the global reserve currency. The pessimistic case was laid out in 2007 by Jim Rogers, chairman of Beeland Interests and erstwhile colleague of George Soros, as he was shifting his assets out of the dollar and buying Chinese yuan:

> The U.S. dollar is and has been the world's reserve currency, the world's medium of exchange. That's in the process of changing. The pound sterling, which used to be the world's reserve currency, lost 80% of its value, top to bottom, as it went through the whole period of losing its status as the world's reserve currency.[3]

More recently, and as noted in the last quarterly, the European sovereign bond crisis has rekindled investors' appetite for instruments denominated in dollars. But some observers remain worried. In August, a market strategist declared to the *Wall Street Journal* that "Treasury debt purchases by all central banks, not just China, have ground to a complete halt this year."[4] Were the dollar to lose its reserve currency status, its value would decline sharply.

The second concern about the dollar's long-term value hinges on persistent U.S. current-account deficits and the enormous positions foreigners have amassed in the United States. To cover its borrowing needs in the first half of this year, the United States was reliant upon foreigners to lend it around $3.7 billion dollars per day; as White House adviser Lawrence H. Summers observed in 2006, the United States absorbs about 70 percent of the exported savings of the rest of the world. Reliance on foreign lending creates a long-term vulnerability for the dollar. Sooner or later, foreigners may tire of financing the United States. A slowing of capital inflows, let alone a sudden stop or a decision by foreigners to sell some of their U.S. bond stockpiles, could drive the dollar down.

According to one view—the "exorbitant privilege" view—the United States can survive its status as a massive net debtor because its claims on foreigners earn a much higher rate of return than do foreign claims on the United States, making it easier for the United States to finance continued large current account deficits. Borrowing internationally is not problematic if you can, year after year, earn exorbitantly more on your foreign portfolio than you pay foreigners on your liabilities.

This CFQ addresses this question first: Are reserve managers really shunning the dollar, as the quotation in the *Wall Street Journal* suggests? It also addresses a second question: Is the returns differential enjoyed by the United States really so exorbitant, thus relieving the country of potentially problematic dynamics in the current account and international debt? Both questions are investigated by analyzing current and recent trends in international capital flows and international portfolio allocation. As in the first CFQ, published in June 2010, a more detailed perspective on U.S. capital flows is provided in an appendix.

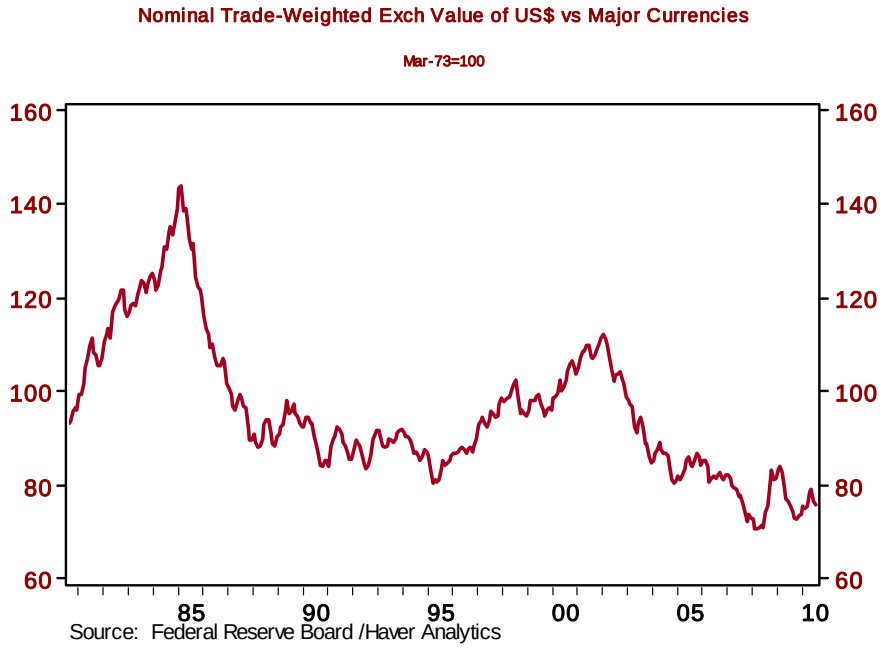
THE DOLLAR'S STATUS AS THE GLOBAL RESERVE CURRENCY

Against major currencies, notwithstanding substantial appreciation from 1995 through 2001, the dollar has trended lower since the mid 1980s (Figure 2). Whenever the dollar suffers a sustained fall, questions about its status as the global reserve currency arise. This quarterly will assess these concerns first by briefly updating last quarter's analysis of cross-border flows into debt instruments, as those are the types of instruments that

most reserve managers operate in, before turning to reserve managers' portfolio allocations across different currencies.

As discussed last quarter, up until recently, the more bonds issued by U.S. firms and the U.S. government, the greater the share that foreigners held. Supply seemingly created proportionally more demand. Of course, there are a host of plausible reasons for this—perhaps foreigners began the decade underweight in U.S. bonds and slowly increased their allocation, or perhaps foreigners experienced an increase in wealth and thus held ever more U.S. bonds without increasing their allocation to them—but from the U.S. perspective greater issuance was repeatedly associated with increased foreign demand. That began to change with the global financial crisis when, with U.S. debt issuance steadily increasing, foreigners began to hold a smaller share of outstanding U.S. bonds, raising the specter that they might have reached their satiation point. As noted in the last quarterly, the European sovereign bond crisis has provided a respite that pushed the satiation point further into the future. But investors remain worried.

Figure 2



Last data point: 2010 August

Myth 1: Treasury debt purchases by central banks have ground to a halt this year.

It is understandable that some think foreign governments' purchases of U.S. Treasury securities have ceased this year. According to the U.S. government's Treasury International Capital (TIC) data, foreign official inflows into Treasury securities totaled only $20 billion in the first seven months of the year, compared with annual amounts of $238 billion last year and $336 billion in 2008 (see Appendix, Table 2). Moreover, Chinese holdings of U.S. Treasury debt fell in May and June by $56.5 billion, according to the TIC Major Foreign Holders table. And if that were not enough, IMF data for the first quarter of 2010 suggests sizeable reserves accumulation in euros and essentially zero reserve flows into dollars.

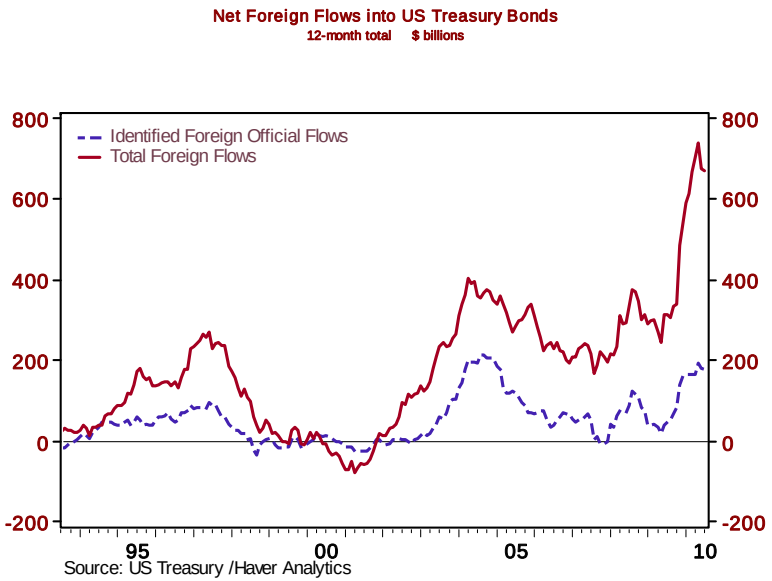
But official flows into Treasury securities have not ground to a halt. While it is true that foreigners now hold a slightly smaller share of all outstanding U.S. bonds—and foreigners' affinity for U.S. agency bonds might have been forever altered by the crisis—flows into the securities that best represent the dollar's reserve currency status remain robust. As noted last quarter, the TIC system's flows data does not properly identify official flows, so it is important to consider both "identified" official and total flows. Total flows into Treasury bonds in the twelve months ending July 2010 are near all-time highs, and even flows identified in the data as coming from foreign official sources are at an elevated level (see Figure 3, upper left panel).[5] To be sure, as discussed in Appendix Table 2, some recent data suggest a modest slowing. But, when the data are all in, this year will probably turn out to have seen robust inflows, albeit with some slowing from past levels.

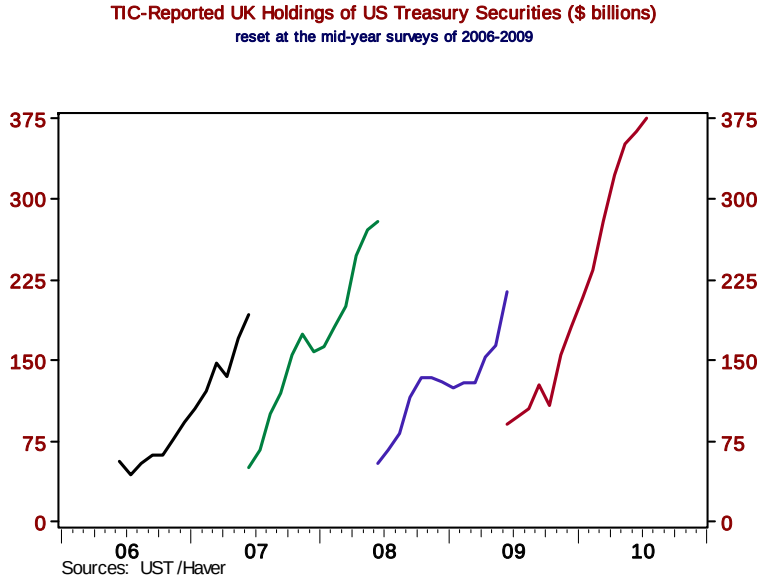
The sharp drop in China's holdings of U.S. treasuries is no cause for alarm, either. One source of confusion related to China's activity in U.S. treasuries is that many observers fail to differentiate between short-term Treasury *bills* (which pay near zero in interest) and medium- to longer-term Treasury *bonds* and notes (which yield about 2.75 percent). During the crisis, China loaded up on the short-term bills, increasing its holdings from $15 billion pre-crisis to a sizeable $210 billion by June 2009 (Figure 3, bottom left, solid line). Since then it has unwound this defensive position, completing the process this June. When China dumps Treasury *bonds*, people should pay attention; the unwinding of its Treasury *bill* position, in contrast, seems quite natural. Moreover, while it is not known what China has done with the funds unlocked by reducing their holdings of Treasury bills, one possibility is that they have been buying Treasury bonds through London intermediaries; there has been a sharp increase in TIC-reported UK holdings of U.S. Treasury bonds (Figure 3, bottom left, dashed line). While the data indicate "UK," that increase almost surely did not originate in the United Kingdom. Year after year, when data from the comprehensive, high quality TIC benchmark surveys become available, Treasury bond holdings are shifted away from the United Kingdom (Figure 3, upper right) and toward other countries. This year, it is eminently plausible that the bulk of the reported increase in (presumably private) UK holdings of U.S. Treasury bonds is neither from the United Kingdom nor from private investors, but rather from the Chinese state.

TIC data include only transactions that involve U.S. entities. IMF reserves data are broader. Do the reserves data indicate global reserve managers are diversifying out of the dollar? Unfortunately, not all central banks report the currency composition of their reserves to the IMF. All told, 140 choose to report, but these account for only 56 percent of global reserves, down from 77 percent in 2001. One must therefore choose between estimating the currency allocation of nontransparent reserves (for some good estimates, see the Center for Geoeconomic Studies Chartbook on BRIC reserves, available at www.cfr.org/cgs) or relying on the transparent portion in the hope that the nontransparent part follows a similar pattern. A Chinese report suggests that the nontransparent and transparent parts (called "unallocated" and "allocated" by the IMF) might currently have a somewhat similar composition, so this paper will follow the second option.[6]

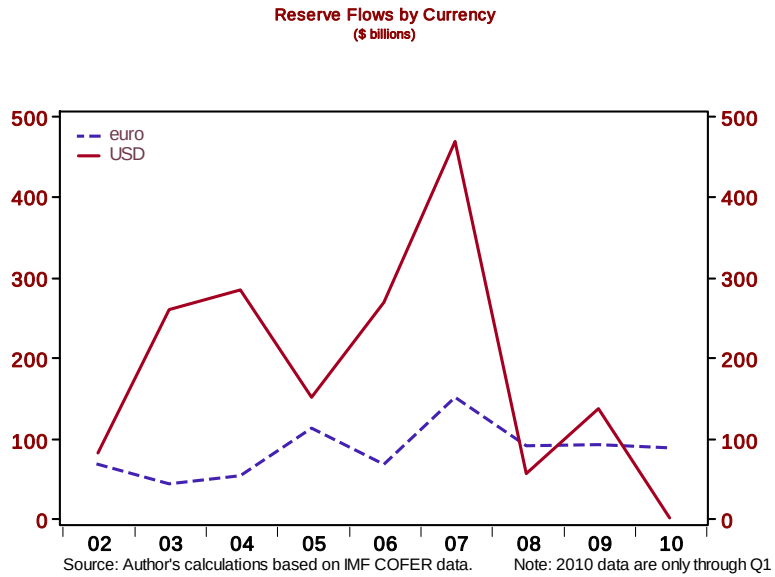
So what are the transparent reserve managers up to? Over the past decade the dollar's share of "allocated" reserves has fallen from 72 percent to 62 percent, with the euro picking up most of that gain as its share increased to 27 percent. By itself that would suggest reserve managers have been actively allocating out of dollars. But changes in portfolio shares result from some combination of two factors: active reallocation and passive changes due to valuation changes. To focus on the policy-driven portion of changes in reserve allocation across currencies, we will attempt to isolate the flows (active changes) from the valuation effects. To do so, we make the simplifying assumptions that there are only two reserve currencies in the world (dollar and euro) and that the only valuation gains on reserves are those due to exchange rate movements.

Figure 3


Net Foreign Flows into US Treasury Bonds
12-month total $ billions
Identified Foreign Official Flows
Total Foreign Flows
800
600
400
200
0
-200
95
00
05
10
Source: US Treasury /Haver Analytics


TIC-Reported UK Holdings of US Treasury Securities ($ billions)
reset at the mid-year surveys of 2006-2009
375
300
225
150
75
0
06
07
08
09
10
Sources: UST /Haver


China's Holdings of US Treasury Bills
$ billions
UK Holdings of US Treasury Bonds
$ billions, current vintage
UKTBOND
CNTBILL
375
300
225
150
75
0
06
07
08
09
10
Sources: US Treasury Dept /Bertaut and Tryon (2007) /Haver Analytics


Reserve Flows by Currency
($ billions)
euro
USD
500
400
300
200
100
0
02
03
04
05
06
07
08
09
10
Source: Author's calculations based on IMF COFER data.
Note: 2010 data are only through Q1

The results (Figure 3, bottom right) suggest that 2008 marked a turning point. Through 2007, the flow estimates do not indicate active reallocations toward euros and away from dollars. The size of the overall reserve portfolio increased, but those increases were allocated across currencies roughly in line with existing allocations; while volatile, over the 2002–2007 period the ratio of dollar to euro reserve flows was 3:1. Then, in 2008, this began to change. For the first time, the euro took the majority of new reserve flows. Prominent economists opined that the euro could overtake the dollar as the world's reserve currency by 2015. Implicit in much of this talk was the idea, since refuted rather forcefully by Barry Eichengreen of the University of California at Berkeley, that the world could only have one dominant reserve currency at a time.[7]

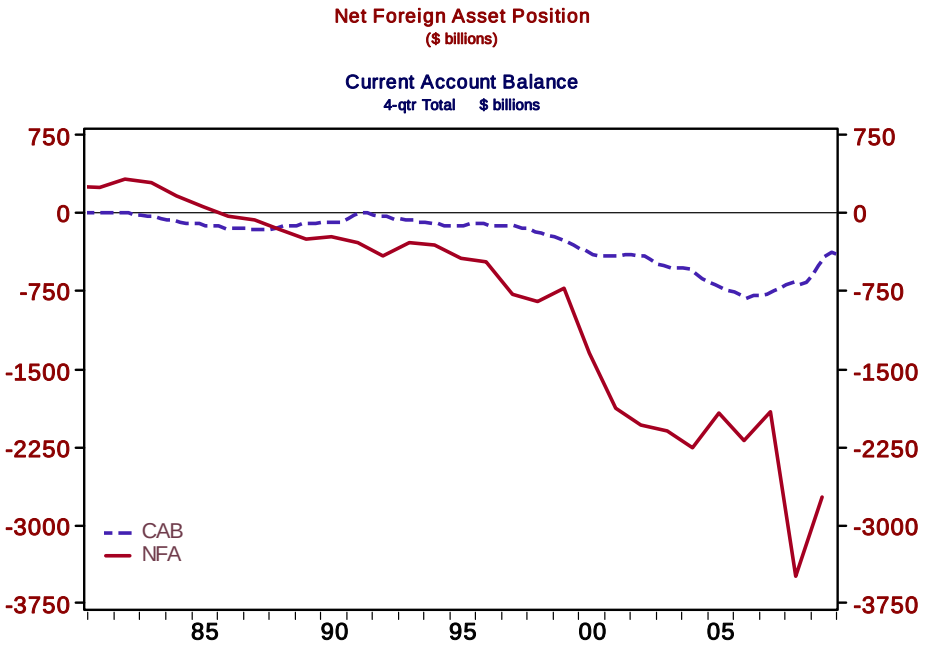
Since the apparent turning point of 2008, the dollar has struggled to retain its footing. In 2009, dollar reserve flows exceeded euro flows, but only slightly. In partial data for 2010 (only through the first quarter) dollar flows were near zero and euro flows were substantial as the Swiss, in particular, acquired a large amount of euro reserves (to lean against the record level of the franc versus the euro). Overall, from 2008 through the first quarter of 2010, euro flows exceeded dollar flows, in sharp contrast to the 3:1 advantage the dollar enjoyed over the previous six years. In sum, while data from the TIC flows discussed earlier in this section do not suggest a sharp movement away from U.S. treasuries, IMF-reported reserves data suggest that the euro is more of a rival than it used to be, the sovereign-debt scare notwithstanding. Going forward, it will be interesting to see which tendency wins out. It is possible that the euro's strong showing in 2010 will prove to be an anomaly created by the one-off Swiss adjustment.

Reserve managers appear to be in a tough spot. On the one hand they are clearly uncomfortable about the weight of dollar assets in their portfolios, but on the other hand no equal to the dollar has emerged. Since the start of the eurozone stage of the crisis, no one still suggests that the euro will soon unseat the dollar. Rather, the speculation has turned to when the Chinese yuan might be ready to do so. Needless to say, the prospect that a currency that is not yet widely available for trading outside its borders will become a world reserve currency is both distant and uncertain. Moreover, as Eichengreen points out, it's not a winner-takes-all game. With a policy mix that defends the dollar's important characteristic as a global store of value, and institutions that protect the interests of outside investors, the dollar will be a major reserve currency for years to come, even if it ceases to be the only one.

THE SUSTAINABILITY OF U.S. NET INTERNATIONAL DEBT

While reserve managers' views toward the dollar have grown more equivocal, another question hangs like a cloud over long-term prospects for the dollar: Are the large and persistent U.S. current account deficits and the associated net international debt position, both depicted in Figure 4, sustainable?[8] A rising debt burden implies rising costs of servicing the deb. At a certain point, the debt may be so large that the only way to service it is to borrow yet more money, setting off a spiral toward default. The recent eurozone debt crisis has shown how quickly sentiment can turn from a benign view of a country's sovereign borrowing to an acutely malign view. Once investors decide that a country cannot afford to service its debt, they anticipate the negative spiral and drive up the country's borrowing costs, hastening the collapse.

Figure 4



Myth 2: The United States enjoys an exorbitant privilege that helps render its massive international debt benign.

This section investigates one view that would, if true, suggest that the U.S. debt burden is less problematic than it might appear. Some economists have argued that the United States has parlayed its "exorbitant privilege" as the issuer of the world's reserve currency into a form of subsidy that renders U.S. borrowing sustainable.[9] According to this "exorbitant privilege" view, the United States can survive its status as a massive net debtor because its claims on foreigners earn a much higher rate of return than do foreign claims on the United States. A number of top economists have computed a differential of as much as three hundred basis points a year.[10] This positive return differential makes it easier for the United States to finance continued large current account deficits. Borrowing internationally isn't problematic if you can, year after year, earn 3 percentage points more on your foreign portfolio than you pay foreigners on your liabilities.

But is the returns differential enjoyed by the United States really so exorbitant, thus relieving the country of potentially problematic dynamics in the current account and international debt? Sadly, no. Early calculations of the U.S. returns differential paid too little attention to the nature of international capital flows data and hence arrived at the wrong view.

To see why this is so, think of the U.S. international accounts data as you would think of a retirement account. There are data on financial flows (similar to your contributions to your retirement account) and financial positions (similar to the balances in your retirement account). If you know the end-2008 and end-2009 positions (analogous to retirement account balances) and you also know the flows during the year 2009 (analogous to the contributions to the retirement account), you can compute a reasonable estimate of the rate of return on your investments.

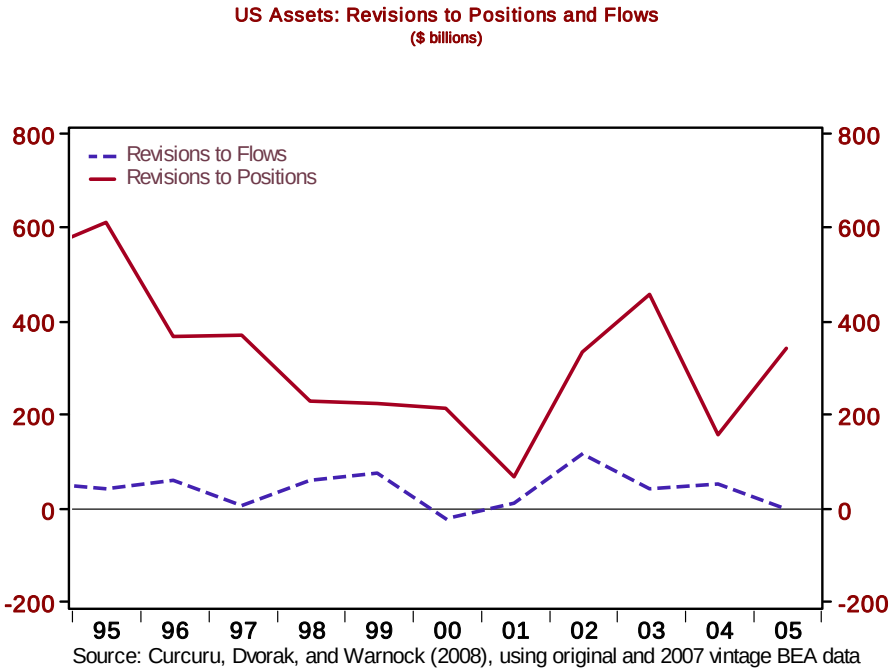
This logic does hold for retirement accounts. But the U.S. system of international accounts is built up from a number of imperfect data collection systems. This is why, within the balance of payments flows data, there is a "statistical discrepancy" and, within the International Investment Position (IIP) data, there is a category

called "other changes." Even within the flows and positions data there are slippages; combining the two, as was done in early calculations of the returns differential, piles slippages upon slippages.

Research originated at the Federal Reserve has shown exactly how these slippages created the appearance of an exorbitant privilege.[11] International capital flows data are rarely if ever revised, while international positions data are regularly and substantially revised, with revised estimates of positions being among the most accurate data in the entire U.S. system of international accounts. Capital flows data are rarely revised because there is no system to go back and collect better estimates. In a few extreme cases, when egregious data errors are discovered, a team will descend upon a data reporter to attempt to recreate the past. But this is both onerous and unlikely to produce entirely satisfactory results, so in practice flows data are little revised even though they can be seriously biased (for an explanation of these biases, see Box 1 in last quarter's CFQ).

These data issues do not much affect estimates of foreign ownership of U.S. assets. Most countries, the United States included, can quite accurately count the amount of foreign investment in their country. In contrast, initial estimates of the size of U.S. residents' overseas investment positions are notoriously inaccurate because they depend on biased flows data. Statisticians later correct these estimates of U.S. portfolios abroad as directly measured, better-quality data on positions become available. But direct measures of flows never become available, so flows—even if it becomes obvious that the initial estimates were incorrect—are usually little revised. Figure 5 depicts one aspect of this story: U.S. outflows have been little revised, while U.S. positions abroad have been repeatedly revised upward.

Figure 5



Source: Curcuru, Dvorak, and Warnock (2008), using original and 2007 vintage BEA data

Think back to your retirement account. If your contributions are low but your year-end balance gets revised upward, you would naturally think that your returns were high, perhaps even exorbitantly high. So it is with the United States: the contributions look low and international positions keep being revised up, so some

have come to believe that Americans have superior skills when it comes to generating returns on their investments.[12] But the truth is likely more mundane. The reason for upward revisions in positions is not high investment returns but more likely unmeasured contributions. The United States is not privileged in an exorbitant way. It does not have otherworldly investment skills that would allow it to ignore budget constraints that might worry lesser investors.

The bottom line is that the United States earns a bit more on its foreign investments than foreigners earn in the United States. Rather than resulting from the superior skill of U.S. investors, this earnings gap reflects the fact that U.S. assets abroad are tilted toward equity-like investments whereas U.S. liabilities to foreigners are weighted toward bonds, and over many (but not all) periods equities have outperformed bonds. But the overall differential is small enough that one cannot count on outsized gains in international investments to loosen the U.S. international budget constraint and ease concerns about the sustainability of the U.S. current account.

POLICY IMPLICATIONS

This CFQ has investigated two factors—the dollar's reserve status and the sustainability of U.S. international debt—that could substantially alter the long-run value of the U.S. dollar. On the dollar's reserve status, the weight of evidence from U.S. data indicates that foreign governments' purchases of U.S. Treasury bonds remain robust, quotes to the contrary notwithstanding. To be sure, IMF data suggest that reserve managers' views toward the dollar appear to have changed in the past few years. Until 2007, while valuation effects decreased the share of dollar assets in reserve managers' portfolios, new reserves were overwhelmingly placed in dollar assets. Since then, the euro has become an equal, if not greater, recipient of new reserve flows. How managers will react to the eurozone debt crisis is not clear. What is clear is that even after a decade of declining value and increasing talk of the need for alternatives, Jim Rogers and other investors who acted in the expectation of a near-term tipping point have so far lost money on their call. One reason is the powerful advantage U.S. capital markets have over foreign rivals. U.S. treasuries—for which the market is large, homogenous, and liquid—are still the world's risk-free asset.[13] But in the future there will be rivals in terms of market depth and liquidity. To remain the world's reserve currency, with all the associated perks and duties, the United States must provide the world with both a stable currency not eroded by inflation and conditions, including deep and transparent markets, in which outsider investors (be they domestic or foreign) are comfortable committing funds. If the United States does this, the longer-term prospects for the U.S. dollar, while uncertain, should be promising.

On the other hand, analysis of the sustainability of the U.S. current account and net international debt position indicates that there is no silver bullet. U.S. investors do not have some exorbitant skill that would make our international budget constraint any less binding. When the United States does run a current account deficit and hence (on net) borrows from abroad, it must expect to have to service that debt—and it cannot meet those payments by generating outsized returns on its foreign portfolio. In consequence, to the extent that the United States continues to borrow, it must consider how it uses those funds. Borrowing to finance consumption (whether public or private) is not sustainable. Borrowing to finance the expansion of the capital stock—improving the economy's productive capacity—is more benign. This isn't a statement about the way foreign capital enters the U.S. financial system. Foreigners may choose to buy mortgage bonds or they may choose to buy equities; given the right policy framework, the financial system should be able to move the money such that the extra expenditure financed by foreign capital goes on investment. But it is up to the government to get the policy right. For too long, tax and other incentives have favored too much spending, too little saving,

and too little investment. To prevent the U.S. dependence on foreign finance from ending painfully, this imbalance must be corrected. Otherwise investors may lose confidence in the dollar, triggering an unwelcome American version of competitive devaluation.

Appendix Table 1. Annotated U.S. BOP Presentation ($billions unless otherwise noted)

		2004-2007	2008	2009	2010H1	
1	**Current Account Balance (% of GDP)**	**-5.6**	**-4.7**	**-2.7**	**-3.2**	**Crisis-related improvement in the CAD now reversing.**
2	Current Account Balance	-725	-669	-378	-465	
3	Trade Balance	-696	-699	-375	-492	…as imports are now growing faster than exports.
4	Income Balance	72	152	121	163	Income balance, which measures income streams (dividends, coupon payments), remains positive, even though U.S. is a net debtor.
5	Current Transfers	-100	-122	-125	-135	
6	Capital Account Balance	4	6	0	0	
7	**Financial Account Balance**	**661**	**611**	**165**	**111**	**Sharp decrease in net financial inflows continues.**
8	**US Outbound Flows**	**-1077**	**156**	**-140**	**-881**	**US flows abroad plummeted in 2008 and 2009, but now have resumed previous pace.**
9	US DI Abroad	-253	-351	-269	-369	US direct investment abroad has maintained a reasonably high level.
10	US Flows into Foreign Securities	-288	198	-208	-134	US investors sold foreign securities in 2008, resumed net purchases in 2009, but some slowing in 2010H1.
11	Foreign Equities	-139	39	-63	-66	
12	Foreign Bonds	-149	159	-145	-68	
13	US Flows into Foreign Banks	-538	844	-153	-391	Net flows into the US banking system (line 13 + line 31) very positive in 2008, very negative in 2009, modestly negative in 2010H1.
14	US Government Assets	2	-534	489	12	US govt assets abroad unprecendently large during crisis, but across time summed to zero, and are near zero in 2010H1.
15	**US Inbound Flows**	**1738**	**455**	**306**	**992**	**Flows into the US fell sharply in 08, remained low in 2009, resumed in 2010H1.**
16	**Foreign Official Flows into the US**	**407**	**551**	**450**	**244**	**Foreign official inflows held up during the crisis, have eased in 2010H1.**
17	Treasury Securities	173	549	561	228	Official flows into Treasuries surged during crisis, slowed from those elevated levels in 2010H1.
18	Treasury Bonds and Notes	181	276	498	375	
19	Treasury Bills	-7	272	63	-147	The large TBill positions put on during the crisis were largely unwound in 2010H1.
20	Agency Bonds	133	43	-120	-25	Official purchases of Agency bonds plummetted during the crisis and have not recovered.
21	Corporate Securities	21	104	22	1	Official flows into corporate bonds and equities near zero in 2009 and 2010H1.
22	Other FOI Inflows	79	-145	-13	40	
23	**Private Flows into the US**	**1332**	**-96**	**-144**	**747**	**Private flows into the US plummetted to roughly zero in 2008 and 2009, resumed somewhat in 2010H1.**
24	FDI in the US	193	328	135	157	Foreign direct investment in the US slowed somewhat.
25	US Equities	130	58	136	80	Private foreign purchases of US equities reasonably large in 2009, slowed somewhat in 2010H1.
26	Treasury Securities	62	191	35	413	Surge in private flows into Treasuries in 2010H1…
27	Treasury Bonds and Notes	47	-20	86	308	…both into Tbonds…
28	Treasury Bills	15	211	-51	105	…and into TBills.
29	Agency Bonds	34	-173	-6	13	But private foreigners have not returned to US agency bonds…
30	US Corportate Bonds	367	-51	-131	-92	…and continue to sell US corporate bonds.
31	Private Flows into US Banks	547	-448	-314	176	
32	Financial Derivatives	.	-33	51	.	
33	Statistical Discrepancy	51	85	163	322	The discrepancy is quite large, suggesting that reported data understate net capital inflows and/or overstate the current-account deficit.

Source: BEA and author's calculations. Note: all data are in BOP accounting terms (that is, outflows [-], inflows [+]). 2010H1 data are annualized.

Summary: Both U.S. flows abroad (line 8) and foreign flows into the United States (line 15) increased sharply in 2010H1, although the net inflow (net financial flows into the United States, line 7) remains subdued. U.S. flows abroad were buoyed by strong U.S. direct investment abroad (line 9) and continued purchases of foreign equities and bonds (line 10). While foreign official flows into the United States continue (line 16), the surge in foreign flows into the United States owes primarily to the actions of private foreigners (line 23), with private foreign purchases of U.S. Treasury securities (line 26) being particularly strong in 2010H1. In contrast to the strong private demand for Treasury securities, demand for agency and corporate bonds (lines 29 and 30) remained virtually non-existent.

Appendix Table 2. Foreign Official Flows ($billions, annual averages)

		2004–2007	2008	2009	2010
BEA's Quarterly Balance of Payment (BOP) Data					H1
1	**Foreign official flows into the United States**	**407**	**551**	**450**	**122**
2	U.S. Treasury securities	173	549	561	114
3	**Short-term bills and certificates**	**-7**	**272**	**63**	**-73**
4	**Medium-to-long-term bonds and notes**	**181**	**276**	**498**	**188**
5	U.S. agency securities	133	43	-120	13
6	Other foreign official inflows	100	-41	9	-5
Treasury's Monthly TIC Data					through July
7	**Foreign official flows into the United States**	**213**	**161**	**32**	**-56**
8	U.S. Treasury securities	82	336	238	20
9	**Short-term bills and certificates**	**-3**	**259**	**76**	**-52**
10	**Medium-to-long-term bonds and notes**	**86**	**76**	**161**	**73**
11	U.S. agency securities	66	-31	-43	3
12	Other foreign official inflows	64	-143	-162	-79
	memo items: Selected Federal Reserve adjustments				
13	**Treasury bonds, foreign official flows**	**113**	**198**	**261**	
14	**Treasury bonds, private flows**	**-75**	**-104**	**-27**	
New York Fed's Weekly H.4.1 Custodial Data					through August
15	**Foreign official flows into the United States**	**247**	**460**	**437**	**237**
16	Change in holdings of Treasury securities	92	477	482	191
17	Change in holdings of agency securities	155	-17	-45	47

Annual averages, except for the partial 2010 data. Fed adjustments for 2009, only available through mid-year, are 2009H1 annualized.

Summary: As noted last quarter, there is no quick, easy, and failsafe method to get a read on foreign official flows into the United States. Appendix Table 2 presents an updated version of the table from Box 1 in the previous CFQ, showing information from three sometimes conflicting data sources. For this year (to date), the three sources are pointing to some slowdown in foreign official inflows. BEA's BOP data suggest a slowdown from $450 billion in official inflows last year to (annualized) $244 billion this year (line 1). Topline TIC data show net official outflows (line 7), although if the Fed "shuffle" factor (lines 13 and 14, described in last quarter's box) is similar to past years the picture shows net official outflows but rather a slowdown in inflows. Finally, FRBNY data (line 15) do not show a slowdown at all. Considering the three sources, as well as the elevated amount of overall flows into long-term Treasury securities (shown in text Figure 3), the detailed data suggest that this year has seen robust inflows but with some slowing from past levels.

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Endnotes

1. "People's Republic of China: 2010 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion," IMF Country Report No. 10/238 (July 2010).
2. Long-run value (the smoother lines) in Figure 1 is based on purchasing power parity (PPP) rates obtained from OECD and World Bank. PPP, while simplistic, is a core component of most models of long-term equilibria. For a discussion of a number of methods to compute equilibrium exchange rate values, with a particular emphasis on the yuan, see Yin-Wong Cheung, Menzie Chinn, and Eiji Fujii, "Measuring Misalignment: Latest Estimates for the Chinese Yuan," in *The US-Sino Currency Dispute: New Insights from Economics, Politics and Law*, edited by Simon Evenett (VoxEU/CEPR, 2010). For an application of long-run levels to the carry trade, see Oscar Jorda and Alan Taylor, "The Carry Trade and Fundamentals: Nothing to Fear but FEER Itself" (NBER Working Paper 15518, November 2009).
3. Marcel van de Hoef and Danielle Rossingh, "Jim Rogers Shifts Assets out of Dollar to Buy Yuan," October 24, 2007, Bloomberg.com, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aqNT0qlW_zQE. Rogers is referring to sterling's fall against the U.S. dollar from its top ($4.86/£) in the early twentieth century to its bottom ($1.09/£ in early 1985). Seen from this perspective, sterling's fall from grace cost investors about 1 percent annually—a significant but not crippling loss.
4. As attributed to Jens Nordvig, currency strategist at Nomura Securities, in "China Sold More Treasurys, but Market Rallies On," *Wall Street Journal*, August 17, 2010.
5. For a detailed explanation of the difference between total and identified foreign official flows, see the previous Capital Flows Quarterly, Box 1.
6. See "Heavy in Dollars, China Warns of Depreciation," *New York Times*, September 3, 2010, which references an article (subsequently pulled from the Web) from *China Securities Journal* that stated that China's reserves are 65 percent in dollars, 26 percent in euros, 5 percent in pounds and 3 percent in yen. Of the central banks that do not report currency allocations, China is by far the most important, accounting for about two-thirds of the nontransparent 44 percent of global reserve assets.
7. See Barry Eichengreen and Marc Flandreau (2008), "The Rise and Fall of the Dollar, or When Did the Dollar Replace Sterling as the Leading International Currency?" NBER Working Paper 14154 and Barry Eichengreen (2011), *Exorbitant Privilege: The Decline of the Dollar and the Future of the International Monetary System*.
8. As the figure depicts, in 2009 the net foreign asset position improved to -$2.7 trillion. This improvement owed to dollar depreciation (which added to returns on foreign-currency-denominated assets) and the strong performance of equities (which are heavily weighted in U.S. foreign portfolios).
9. See, in particular, Pierre-Olivier Gourinchas and Helene Rey, "From world banker to world venture capitalist: The U.S. external adjustment and the exorbitant privilege," in Richard Clarida (ed.), *G7 Current Account Imbalances: Sustainability and Adjustment* (Chicago: University of Chicago Press, 2007), pp. 11–55.
10. When putting forward the exorbitant privilege view, some point to the following papers written very early in this literature: Philip R. Lane and Gian Maria Milesi-Ferretti, "Financial Globalization and Exchange Rates," IMF Working Paper WP/05/3 (2005); Maurice Obstfeld and Kenneth S. Rogoff, "Global Current Account Imbalances and Exchange Rate Adjustments," Brookings Papers on Economic Activity No. 1, pp. 67–123 (2005); and Christopher M. Meissner and Alan M. Taylor, "Losing Our Marbles in the New Century? The Great Rebalancing in Historical Perspective," NBER Working Paper 12580 (2006).
11. See Stephanie E. Curcuru, Tomas Dvorak, and Francis E. Warnock, "Cross-Border Returns Differentials," *Quarterly Journal of Economics*, vol. 123(4), 2008, pp. 1495–1530, and Stephanie E. Curcuru, Charles Thomas, and Francis E. Warnock, "Current Account Sustainability and Relative Reliability," in J. Frankel and C. Pissarides (ed.), *NBER International Seminar on Macroeconomics 2008* (Chicago: University of Chicago Press, 2009), pp. 67–109. See also the contemporaneous contribution by Philip Lane and Gian Maria Milesi-Ferretti, "Where Did All the Borrowing Go? A Forensic Analysis of the U.S. External Position," IMF Working Paper WP/08/28.
12. In the 1990s, flows into one type of U.S. security—asset-backed securities—were continuously over-reported and, hence, initial flows-based positions estimates were too high. The positions were subsequently revised downward, while the flows were little revised, giving the impression that foreigners had exceedingly low returns on U.S. bonds and further propagating the exorbitant privilege view.
13. For a discussion of salient features of the U.S. Treasury market, see Brian Sack, "Dollar Asset Markets: Prospects after the Crisis," remarks at the ACI 2010 World Congress, Sydney, Australia, March 26, 2010.