

## **Which Marbles?**

Comments on “Losing Our Marbles in the New Century? The Great Rebalancing in Historical Perspective” by C.M. Meissner and A.M. Taylor

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John F. Helliwell

For someone of my age, losing one’s marbles is about things much more important than GDP, so when I first saw the title of the Meissner and Taylor paper I thought they were going to be impolite about the current state of debate and policy relating to the US current account and the exchange rate for the dollar. I was quite mistaken. Instead, this urbane and creative paper treats other authors with respect and care, and adds greatly to the range and quality of comparative data and analysis of current account reversals over the past 120 years.

When they talk of keeping marbles, they are referring (at least in the historical case) to the fine trick of borrowing on one set of expected returns and repaying on another set more favourable to the debtor. The reference to marbles was apparently first made by the French gold-standard enthusiast Jacques Rueff, who was, I gather, worried about both the moral hazard and the excess returns to the core country in the effectively dollar-based Bretton Woods system. The moral hazard worry was that US dollar reserves would be built up by European and other central banks (their winnings in a mercantilist game of marbles), after which the United States would figuratively reclaim a large fraction of the lost marbles through the US dollar inflation and dollar devaluations that would eventually be forced upon dollar-holding countries at the periphery of the Bretton Woods system. And as long as the system remained in place, the United States would benefit from the super-seigniorage available accruing to the core country in a fixed exchange-rate system. In this metaphor, the implied schoolyard bullying was presumably the so-called ‘Nixon

Shock' of August 15, 1971, imposing import surcharges on everyone, to remain in place until exchange rates were realigned to US preferences<sup>1</sup>.

The use of metaphors in international finance has for decades been so rampant as to deserve inspection by the New Yorker's team of metaphor blockers. Before the marbles trope, there was Machlup's wardrobe theory of the demand for foreign exchange reserves, and in the current literature so ably synthesized and extended by Meissner and Taylor, there is even an appeal to 'dark matter', which turns out to refer to cosmology rather than witchcraft, although some commentators (e.g. Buiters 2006) on the 'dark matter' approach would think the witchcraft interpretation to be more appropriate.

Meissner and Taylor wade into this field of metaphors by asking whether in the forthcoming 'great rebalancing' the United States will this time lose its marbles. This involves recasting somewhat the notion of the game being played, including its rules and whatever new extra-legal twists might be thought up to get or keep marbles as the game progresses. This time, compared to the end of the Bretton Woods system, there is little reference to the United States devaluing the value of the foreign-held marbles. Why the change in emphasis? First, because anyone who now holds US dollar assets does so of their own free will, and not because the rules demand that they do so. Second, almost everyone now expects that the US dollar will in fact fall further in the course of the great rebalancing, so there should be no surprises there. Third, and perhaps most important, there is still widespread belief (in contrast to the 1960s and 70s) that the United States will do whatever is required to keep domestic inflation rates modest. Thus current holders of US dollar assets think that they will avoid any serious erosion of their real claims on goods and services, at least on goods and services sold in the United States.

If the Bretton Woods-era metaphor does not apply, then what marbles are at stake, and how can they be won or lost by the United States in the new century? I take the potential US marble losses in the current rebalancing to take one of two forms: either through loss

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<sup>1</sup> Econometric analysis of these measures was the subject of my presentation to the September 1971 conference of the Federal Reserve Bank of Boston on financial relations between the United States and Canada, as described in Helliwell (2005).

of the current capacity to generate much higher earnings on US investments abroad than are paid on US liabilities to foreigners, or through some sort of ‘hard landing’ involving nasty macroeconomic consequences.

Meissner and Taylor consider both of these forms, and so shall I. The first form is more in keeping with the zero-sum nature of a game of marbles. The second form may involve losses for all parties, reminiscent of any schoolyard game gone sour, with bad tempers and a possible punch-up. The two forms are linked, as if the proponents of dark matter are correct, then very large US current account deficits are possibly sustainable for far longer than most analysts forecast. This in turn would lessen the likelihood of large and immediate changes in US domestic demand and output, or in the external value of the dollar. Conversely, if the excess return privilege were to evaporate, then the required adjustment would be that much larger, and correspondingly harder to achieve smoothly.

One of the chief innovations of the paper is to consider both issues in historical context. Their primary reference for the excess rate of return (or ‘privilege’) calculations is the United Kingdom in the late 19<sup>th</sup> and early 20<sup>th</sup> centuries, but they also calculate contemporary privilege estimates for the other countries of the G7. On the basis of their analysis of privilege, they find no grounds for thinking that current account imbalances at today’s levels for the United States are sustainable. There are several key reasons for this. First, they argue that the currently high rate-of-return differential favouring US assets over US liabilities is a blip in a generally downward trend. Second, UK net foreign income from investments a century ago was driven predominantly by positive current accounts and by large and growing net foreign asset positions (reaching 200% of GDP by 1913). By contrast, the comparably measured US net foreign asset is by now well into net liability territory. Third, as long as the US current account remains significantly in deficit the rate of return differential favouring US assets abroad has to be continually increasing, while the trend they find is in the other direction. Meissner and Taylor agree with Gourchinis and Rey (2005) that some part of the recent increase in US privilege is due to an increasingly leveraged US position, effectively a change from banker to merchant banker, or even, some might argue, something even further out on the high-risk end of the

spectrum. Some analysts have noted that there is quite a lot of leverage inherent in much of US direct investment abroad, with acquisitions and even greenfield projects being largely financed by local banks. The possibility of getting good US ideas to produce foreign profits with little required by way of net capital inflow from the United States lies behind the optimism of those like Hausmann and Sturzenegger (2006), who see this sort of leverage as underpinning the continuing US net investment income from abroad. Like all leverage, it can turn vicious if and when the profits are not high enough to service the debt. It has long been thought that much of the measured privilege of the United States relative to Canada- Meissner and Taylor report (in their Table 3) that the United States has a yield differential (assets versus liabilities) of +1.7%, while Canada has one of -1.4% - is due to US investments in Canadian branch plants, since Canada has long had the highest share of its business capital stock controlled from outside the country, with the United States as the predominant investor. This privilege of the core versus the periphery underlay much of the Canadian economic historian Harold Innis' theories of North American economic development<sup>2</sup>.

For their historical analysis of the macroeconomic consequences of current account rebalancing, Meissner and Taylor use a panel data set including 33 current account reversals (exceeding 4% of GDP) from 13 countries over the period between 1890 and 1913. They find that the more developed countries and their offshoots were able to run current account deficits more persistently, and had smaller real exchange rate fluctuations and growth reductions in the aftermath of current-account reversals. They find no evidence, looking across countries in their historical sample, that increased openness to trade altered the severity of output losses. This makes them more sanguine than are some students of recent data (e.g Freund and Warnock 2005) about the possibilities for achieving significant current account reversals without serious macroeconomic consequences.

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<sup>2</sup> He apparently knew how to work to good effect from the periphery better than most, as he was, I gather, the only non-resident foreigner ever to be president of the American Economic Association.

Which of the earlier examples are most relevant today? It is important to distinguish, as do Meissner and Taylor, between the gold-standard and the flexible exchange rate cases. The gold standard cases usually involved fewer financial crises associated with current account recoveries, and had smaller swings in their real exchange rates, when compared in both cases to the flexible exchange rate cases. The smaller real exchange rate movements under the gold standard are to be expected, since both then and now real exchange rate changes are largely driven by changes in nominal exchange rates, which are more volatile than prices of goods and services. Today, flexible exchange rates are the norm, and more real exchange volatility is the order of the day, whether or not current account transitions are taking place.

In their interpretation of the historical experience, Meissner and Taylor emphasize that current account reversals occurred most smoothly in those cases where the original deficits were triggered by direct investment, often in natural resources, in offshoot economies, and where the current account reversals were fuelled by the exports, usually resource-based, whose development had been financed by the original investment. Where matching imports of goods and capital are part of a foreign direct investment boom, and the subsequent net exports are matched with capital service payments, there is little call for real exchange rate changes. In these same resource-based offshoot economies, things are different in response to changes in the relative prices of the primary products. In such 'Dutch disease' cases, terms of trade changes are inevitable; and force real adjustments. It was for good reason that in 1950, when agricultural exports from Australia, primarily wool, were 90% of total exports and 25% of GDP, the Australian dollar moved closely with the price of wool, foreshadowing the petro-currencies of today (Helliwell 1984, 91). I make the parallel between Australia long ago and the United States today because in both cases capital was flowing from rich countries to even richer countries. In 1861, real output per capita in Australia was five times as high as in Canada, twenty times as high as in Japan, and 40% higher than in Great Britain, from which migrants, goods and capital were flowing in search of wool and gold (Helliwell 1984, 85).

Today, there are large movements of migrants, goods and capital to the United States from many other countries. What is the parallel with the long-ago lure of the Australian outback? And is it sustainable? In this part of my discussion, I shall be combining consideration of privilege with that of the adjustment process, since I would agree with Meissner and Taylor that their two issues are inevitably linked. The primary reason for the linkage is not that any fixed rate of privilege could forever offset the requirements of servicing a growing net debt, because it cannot. It is rather because sustainability would require an increasing appetite for investment in the United States, and more importantly because expectations about future international differences in real returns are, in a flexible exchange rate world, what drive the dynamics of the adjustment process, and establish the probabilities of hard and soft landings.

Those who argue for sustainability for the current account deficits of the United States will be heartened by the Meissner and Taylor finding that richer capital importers in the pre-1913 period had a better chance of sustaining current account deficits for longer, and for reversing them without crisis. What is the current lure of the United States as a magnet for investment? A decade ago, the high-tech boom was held thought to provide the underpinnings for larger net foreign investment in the United States, and to some extent this probably remains the case, although productivity levels and rates of growth in these industries are notoriously hard to measure. However, the fact that US investments abroad still earn materially more than foreign investments in the United States must mean that the hopes of foreign investors for super-normal returns from their US investments are on average not being realized, or at least not yet.

Are there other relevant issues that might have deserved a mention in the Meissner and Taylor paper? Given its length and high average value, a general answer must be 'no', but it might be worth flagging some items for future consideration. First, one of the important elements of the contemporary US balance of payments is migrants' remittances. These have grown very rapidly, especially to Mexico, and are now about as large, as a share of GDP, as is net US financial income from abroad. Hausmann and Sturzenegger (2006, 6) use a 5% rate of return to capitalize a \$30 billion net financial

income into a net US external financial capital ('dark matter') of \$600 billion, or 5% of GDP. The 2005 US balance of payments shows net private foreign remittances of \$46 billion (BEA 2006, most of which are workers' remittances, CBO 2005). A similar calculation for human capital 'dark matter', based on remittances would yield a net foreign human capital debt as great as the net foreign financial asset position calculated by Hausmann and Sturzenegger. This human capital is embodied mainly in recent migrants, so the net remittances to foreigners might be expected to stop growing as and when the share of foreign-born workers in the United States should stop its recent growth. The larger the share of US residents who are in effect guest workers, the larger is the fraction of their incomes that is likely to be repatriated.

There is a related issue posed by the growing international trade in services, and especially that described as off-shoring. In a narrow sense, services obtained offshore count directly as components of imports, and hence of the current account deficit. In the larger picture, they may be held to be part of a necessary increase in international supply-chain slicing needed to maintain growth of average incomes in the richest country. As international convergence in per capita incomes has become applicable to an increasing share of the world's population, terms of trade losses for the richest countries are inevitable. This is because the countries converging from below face higher real values for their currencies as inevitable parts of the adjustment process, although this may be forestalled during a period, which may be lengthy in the cases of China and India, in which there are still large reserve armies of the unemployed. But throughout most of this process, factor costs remain higher in the richer countries, and there is continuing pressure to spin off lower value-added parts of the production process to where they can be done more cheaply. If India now represents a cost-effective back office, and by a sufficient margin, then offshoring will be a growing part of the unfolding adjustment process.

If the richest country is to remain a magnet for foreign capital inflows, it must be for one of two reasons: either there are key franchise values that exist or can be more easily created there, or else there is no other credible place to store liquid assets. Both of these

possibilities lie at the core of the debates about privilege so ably summarized by Meissner and Taylor. In the Bretton Woods days, the pivot country had a special position, and this provided some basis for continuing privilege. But the Meissner and Taylor analysis of the pre-1913 returns for Great Britain, which was then at the centre of the gold standard and world financial markets, showed modest and declining estimates of privilege. They thereby invite us to conclude that, in today's world of flexible exchange rates and multiple financial centres, the United States is likely to need some source of franchise values in financial intermediation as well as in the production of goods and other services. Failing these, then growing shares of world portfolios invested in the United States are likely to require higher returns, either currently or in prospect.

Meissner and Taylor are largely sceptical about there being enough new franchise values—the Boeings, Coca-Colas and Microsofts of the 21<sup>st</sup> Century— to rationalize continued global net acquisition of claims on the United States. To evaluate the prospects, it would be useful to further unpack the recent historical returns, including the mysterious ‘other’ components of the capital gains so critical to calculation of ‘dark matter’. The parallel with Australia a century ago shows that prospects of gold are enough to get people and investments to flow, and the US economy has had real productivity levels and growth rates to underpin parallel hopes. But the gold boom ended, like all booms, when there was enough, or more than enough, capital to exploit any high-return investments. And when the lustre disappears, then disappointed investors, especially those following the pack, may flee, just as they did from Asia in 1998.

Meissner and Taylor do a splendid job of making the history of the last great globalization relevant to the current great rebalancing. In their admirably under-stated way, they have argued that there is no credible evidence supporting the status quo, and have shown that the savings and investment patterns that mark today's US current account deficit pose more problems for adjustment than were faced when the offshoot countries reversed their current account deficits so painlessly a century ago. I agree with them on both counts, and have learned much from their evidence and explanations.

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