

Yesin, Pinar

Article

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Aussenwirtschaft

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Suggested Citation: Yesin, Pinar (2018) : Comment on "Do Swiss foreign assets hedge the business cycle?" by Nicolas Stoffels and Cédric Tille, Aussenwirtschaft, ISSN 0004-8216, Universität St.Gallen, Schweizerisches Institut für Aussenwirtschaft und Angewandte Wirtschaftsforschung (SIAW-HSG), St.Gallen, Vol. 69, Iss. 1, pp. 41-44

This Version is available at:

<https://hdl.handle.net/10419/231254>

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Comment on “Do Swiss foreign assets hedge the business cycle?” by Nicolas Stoffels and Cédric Tille

Pınar Yeşin¹
Swiss National Bank

The paper by NICOLAS STOFFELS and CÉDRIC TILLE in this issue of *Aussenwirtschaft* addresses an important question regarding the cross-border financial integration of Switzerland. In particular, it examines the hedging properties of the Swiss net international investment position (NIIP) against the fluctuations in the Swiss GDP growth during 2000-2017.

The analysis requires a meticulous estimation procedure in three steps. STOFFELS and TILLE first estimate the quarterly valuation changes in the Swiss international investment position (IIP)² and its components. In a second step, the authors calculate the quarterly returns on the IIP and its components, taking into account investment income and the valuation changes due to exchange rate and asset price movements. In the third and last step of the paper, the authors empirically test whether the returns on the NIIP and its components are negatively correlated with the output growth differential between Switzerland and abroad.

This paper provides a timely and relevant contribution to the literature in two ways. First, it documents the fact that valuation changes in the IIP can be volatile and substantial even during tranquil times; second, it reveals that a positive NIIP with a negative return can still be beneficial to an advanced economy from a consumption smoothing view. These findings indicate the need in international finance research to develop a better understanding of the risks and benefits of cross-border investment in future, irrespective of the current account balance.

The paper also contributes to the current policy debate on global imbalances. Developments in current account balances have until now dominated the policy debate with the underlying assumption that a current account surplus (deficit) leads to a one-to-one increase (decrease) in the NIIP of a country. In other words, valuation changes stemming from movements in asset prices and exchange rates have mostly been disregarded in the policy debate. Yet balance-of-payments statistics, and in particular the integrated IIP statement, have repeatedly demonstrated that valuation changes are not negligible. Figure 1 illustrates this point for a large sample of countries over a long horizon. The

1 pınar.yesin@snb.ch. I thank Simon Bösenberg and Jeremias Kläui for their helpful comments and discussions. The views expressed in this article are those of the author and do not represent those of the Swiss National Bank.

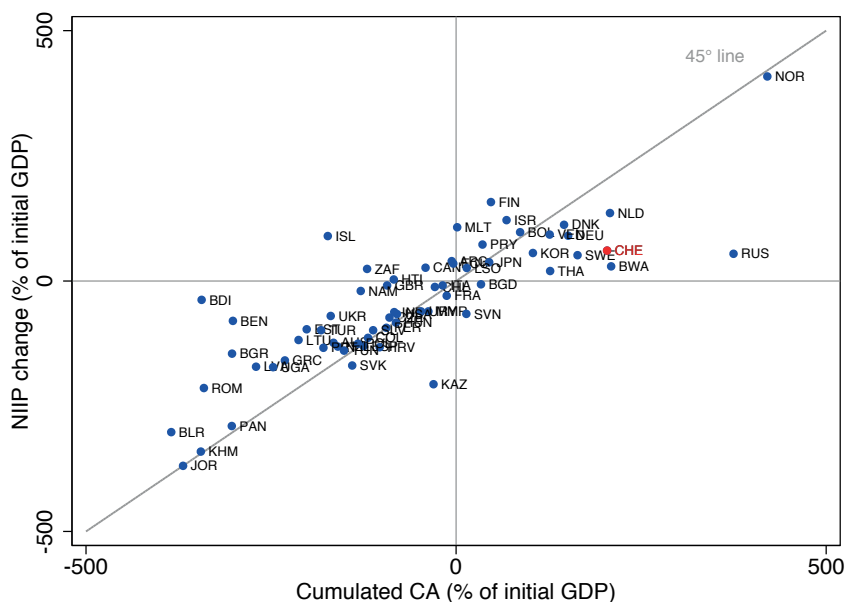
2 The Swiss IIP comprises the stocks of external assets and liabilities between residents in Switzerland vis-à-vis residents of other countries. The difference between Swiss external assets and liabilities is the Swiss NIIP.

significant divergence of observations from the 45-degree line indicates that valuation changes play a critical role in determining the evolution of the NIIP, along with cumulated current account balances. Considering the scale of the axes, covering between -500% of GDP to 500% of GDP, any small divergence from the 45-degree line appearing in this figure is economically substantial. STOFFELS and TILLE carefully study the case of Switzerland, indicated with a red point in Figure 1. In a nutshell, they calculate the breakdown of the vertical distance of the red point to the 45-degree line in terms of *asset price changes*, *exchange rate changes*, and *other changes*. Together, these items constitute the change in the NIIP that cannot be explained by transactions. *Asset price changes* and *exchange rate changes* are categorized as valuation changes, whereas *other changes* are mostly due to adjustments in survey populations and asset reclassifications. The authors conduct this meticulous estimation for both assets and liabilities and in various components and subcomponents of the IIP, and reveal that valuation changes have been volatile and substantial for Switzerland. Future research should therefore encourage a holistic approach in the policy debate on global imbalances, by estimating valuation changes for a larger group of countries. Because policy discussions nowadays presume that a current account surplus (deficit) is an indication of an undervalued (overvalued) currency and draw conclusions regarding the adequacy of monetary policy, valuation losses – in particular exchange rate losses – should be included in the policy debate, as Figure 1 suggests.

Another important contribution by the current paper relates to external adjustment mechanisms. A few papers in the academic literature, such as GOURINCHAS and REY (2007), document the “exorbitant privilege” of the US before the global financial crisis. The United States persistently enjoyed positive valuation changes that compensated its current account deficit such that the NIIP remained stable. Furthermore, despite the negative NIIP, the US investment income balance remained positive. Consequently, the United States exhibited a positive return on its NIIP before the global financial crisis. In a parallel manner, STOFFELS and TILLE document the Swiss “exorbitant burden” between 2000 and 2017 by considering the impact of both the valuation changes and investment income on the IIP. The authors show that returns on Swiss foreign liabilities were indeed higher than on foreign assets.³ This finding is remarkable with potential economic repercussions, also considering the fact that Switzerland has sizeable cross-border linkages to the rest of the world. Indeed, Swiss foreign assets amounted to more than seven times GDP and Swiss foreign liabilities were about six times GDP as of 2017.

3 The return estimates in STOFFELS and TILLE are in line with ADLER and GARCIA-MACIA (2018), who describe the stabilizing role of NIIP for a large group of countries including Switzerland. However, ADLER and GARCIA-MACIA (2018) can only provide a rough estimate of NIIP returns because they implicitly include other changes into valuation changes.

Figure 1: Cumulated current account balances versus change in the NIIP



Source:

IMF BOPS, World Bank WDI

Note:

Cumulated current account balances and the change in the NIIP from 2000 to 2016 are shown for 64 countries. In addition to these 64 countries illustrated in this figure, five countries lie outside of the scale. These five countries are Armenia (-536%; -369%), Georgia (-660%; -589%), Hong Kong (146%; 543%), Kyrgyzstan (-559%; 370%), and Moldova (-524%; -123%).

An important challenge in assessing hedging properties of the NIIP concerns the accuracy of return estimates, which in turn depend on the accuracy of valuation changes estimates. STOFFELS and TILLE meet this challenge by using aggregate data on both stocks and transactions as well as indices of exchange rates and asset prices to estimate valuation changes. The authors’ methodology is inspired by IMF (2009). However, the IMF’s *External Debt Statistics: Guide for Compilers and Users* (IMF, 2014) emphasizes the gain in accuracy when detailed information on individual assets and liabilities are used to estimate valuation changes, for example, in the form of a security-by-security dataset. But disaggregated data on individual assets and liabilities are not available for Switzerland; therefore, the authors use aggregate data and indices to calculate estimates of valuation changes. Hence, their methodology is loosely in line with IMF (2009). Consequently, the findings in the third step depend on the accuracy of their valuation change

estimates. This feature of the estimation method should therefore be emphasized in the paper before interpreting the empirical results.

To sum up, STOFFELS and TILLE contribute to both the academic literature and the policy debate with their paper. Yet their numerical results should be used with caution. As central banks have slowly started publishing integrated IIP statements – and therefore providing the missing link between stocks and transactions in the form of valuation changes and other changes – the return calculations shown by STOFFELS and TILLE may change in the future. In other words, the authors should ideally repeat the second and third steps of their paper after the Swiss National Bank starts publishing official valuation change estimates in the near future.

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