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International investment positions: a cross-sectional analysis

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Abstract

We explore some empirical properties of the level and composition of gross international investment positions. In a cross-section of countries, we find that more open countries with larger domestic financial markets tend to hold greater quantities of foreign assets and liabilities. There is some evidence that cross-holdings are positively correlated with inflation volatility but negatively correlated with terms of trade volatility. © 2000 Elsevier Science Ltd. All rights reserved.

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1. Introduction

This paper empirically studies gross international investment positions. Although much research has focused on the determinants of net capital flows and external debt, gross holdings of foreign assets and liabilities are arguably a better indicator of the extent of international capital market activity. An interesting aspect of gross international investment positions is that, as is shown in Section 3 below, there is considerable cross-country heterogeneity in the level of cross-holdings of foreign assets and liabilities.[1] Our objective in this paper is to identify factors that explain this cross-sectional variation.

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[1] See also Golub (1990). Golub studied gross capital flows but, unlike this paper, he did not seek to explain the variation in foreign assets and liabilities across countries.

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Understanding the sources of cross-country heterogeneity in ownership levels of foreign assets and liabilities is important for a number of reasons. First, the level and composition of gross international investment positions matters for macroeconomic adjustment to shocks. By generating investment income streams that are imperfectly correlated with domestic output fluctuations, the cross-holding of an appropriate bundle of foreign assets and liabilities can potentially reduce the volatility of national income. On the other side, the international "balance sheet" may propagate some shocks: for instance, an exchange rate devaluation can have a negative effect on the domestic banking system if a country has substantial foreign currency liabilities. The importance of these mechanisms will be different across countries to the extent that stocks of foreign assets and liabilities display cross-section variation.

Second, the size of gross international investment positions can be interpreted as a volume-based measure of financial openness or the level of integration into international capital markets, just as export/gross domestic product (GDP) and import/GDP ratios play this role with respect to openness to trade in goods and services. For this purpose, it is useful to identify the systemic component to financial openness, just as researchers adjust volume-based measures of trade openness for factors such as population, land area and proximity to major markets (Lee, 1993; Frankel and Romer, 1999). By analogy to Grossman and Helpman (1991), the level of financial openness may be important in the diffusion of new financial technologies and in determining the level of productivity in the domestic financial sector.

Heterogeneity may also be helpful in explaining policy differences across countries. At a technical level, a high volume of international asset trade may constrain a country's ability to tax mobile capital and the financial sector. In terms of political economy analysis, the importance of "globalization" forces in shaping domestic politics may vary across countries in line with variation in the level of exposure to international capital markets (Rodrik, 1997).

In selecting factors that may explain the cross-sectional variation in gross international investment positions, we rely on some basic theoretical considerations. For instance, an important potential benefit from ownership of foreign assets and liabilities is the smoothing of national income, by delinking gross national product (GNP) and GDP.[2] In this regard, we would expect that countries that have a greater need for income-smoothing to hold greater quantities of foreign assets and liabilities. For instance, is it the case that those countries that face a more volatile macroeconomic environment tend to have larger gross international investment positions? Second, the costs of engaging in international asset trade also obviously affect the propensity to hold positive gross international investment positions. These costs may vary with the level of output per capita and country size, in addition to legal barriers such as capital controls.

The rest of the paper is organized as follows. Section 2 discusses the factors that may help to explain cross-country variation in gross international investment positions. The empirical analysis is in Section 3, which considers the determinants of

[2] See Svensson (1988), Obstfeld (1995), Obstfeld and Rogoff (1996) and Lane (1999).

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