# The End of Privilege

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# Introduction

**Summary:**

- Large rise in US net foreign assets despite current account deficits from 2002-2007.
  - "Privilege" — Gourinchas and Rey (2007).
- This paper: rise more than completely reversed due to large US equity appreciation.
- Cost to US households = 2.7% of lifetime consumption.
- International flows favor rise in markups over investment in unmeasured capital.

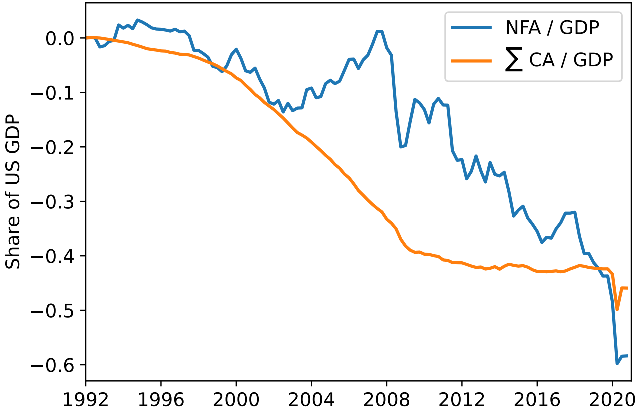
# Introduction

**My Evaluation:**

- Great paper combining empirics and theory to tackle important questions.
  - Clear and compelling data work.
  - Very helpful model able to tractably capture financial and international margins.
- Interpretation: this may be the “start” rather than the “end” of privilege.
  - Trends in gross foreign equity positions may cause bigger deviations going forward.
- Welfare costs may be overstated.
  - My estimates: rise in markups (profits) at least 7x smaller.
  - Ex-post measures ignore ex-ante gains.
- Nice contribution toward disentangling mechanisms, promising area for future work.

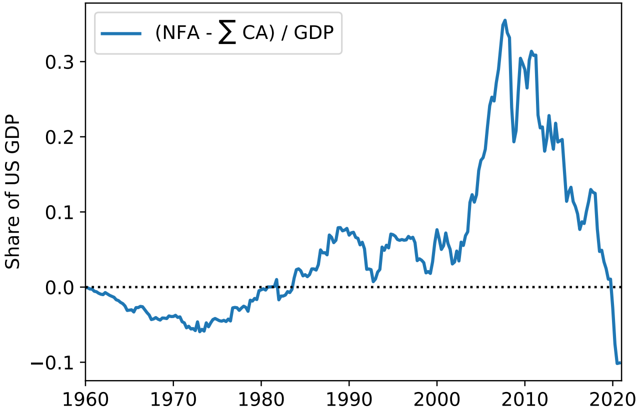
# NFA vs. Current Account

- Below: NFA and cumulated current account (scaled by GDP, normalized to 0 in 1992:Q1)



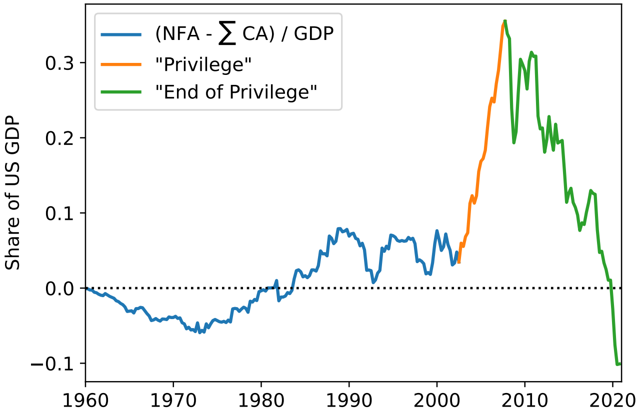
# NFA vs. Current Account

- Display as gap between NFA and cumulated current account, extend to 1960.



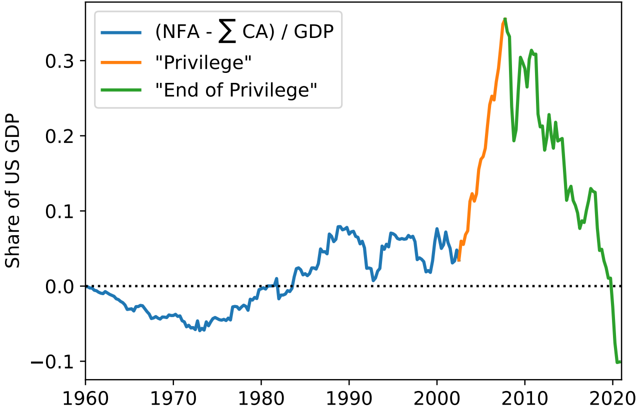
# NFA vs. Current Account

- "Privilege": large discrepancy between current account and NFA from 2002:Q2 to 2007:Q4.
- Helps to close negative NFA created by current account deficits (Gourinchas and Rey, 2007).



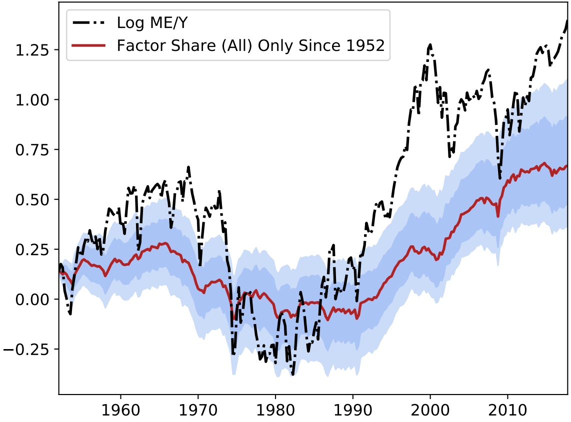
# NFA vs. Current Account

- “End of Privilege” (this paper): large rise in value of US equity causes NFA to fall.
- Unprecedented decline in NFA more than undoes rise. Why is this episode unique?



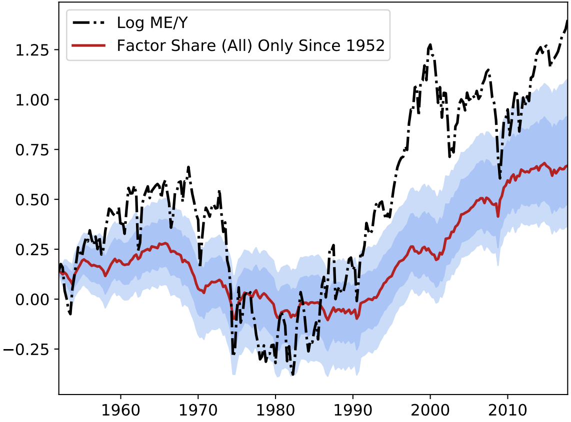
# What Caused this Unprecedented Decline in NFA?

- Plot from Greenwald, Lettau, Ludvigson (2021). Rise in equity values not unique post-2009.
- Black line (data): value of US equity undergoes enormous, steady rise since 1980s.



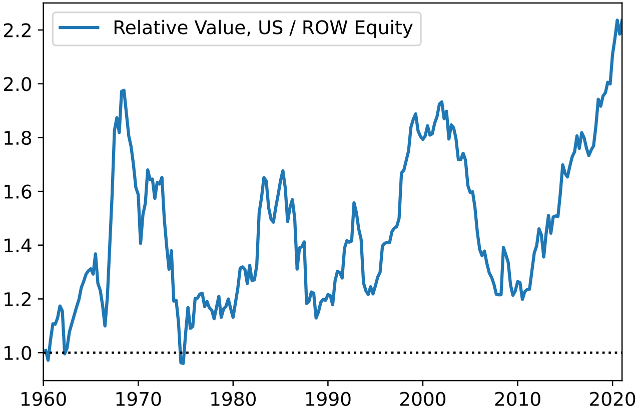
# What Caused this Unprecedented Decline in NFA?

- Is the cause (rising profits) unique? No.
- Red line: contribution of factor shares (profits) also large and steady since 1980s.



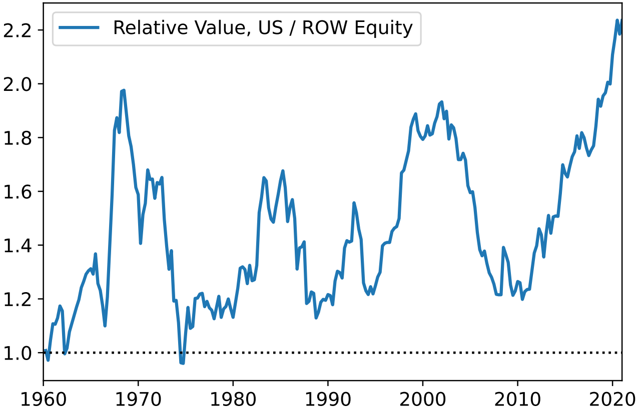
# What Caused this Unprecedented Decline in NFA?

- For NFA to be affected by rising US equity values, must be *relative* to ROW.
- Below: relative values of implied US, ROW equity index (=1 in 1960:Q1).



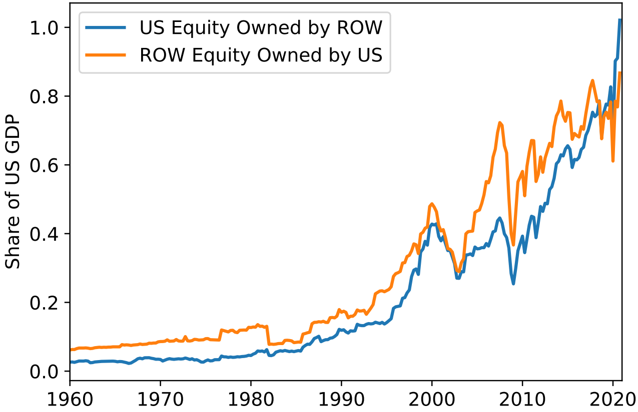
# What Caused this Unprecedented Decline in NFA?

- Swing since 2009 large, but movements of comparable size throughout sample.
- Why haven't these led to large gaps between NFA and current account?



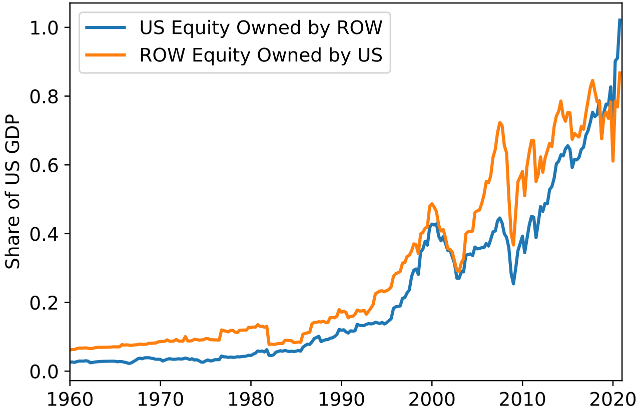
# What Caused this Unprecedented Decline in NFA?

- My take: trends in gross positions in equity across borders.
- ROW owns 39x more US equity relative to US GDP in 2020:Q4 than in 1960:Q1.



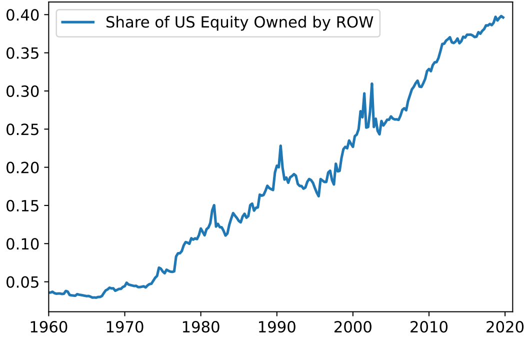
# What Caused this Unprecedented Decline in NFA?

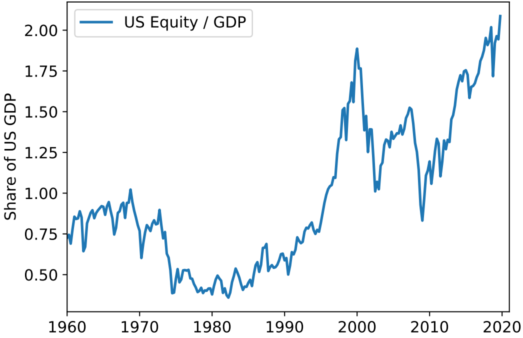
- $\uparrow$ 1% US equity value $\implies$ -0.03% change in NFA in 1960, -1.02% change in 2020.
- $\uparrow$ 1% ROW equity value $\implies$ +0.06% change in NFA in 1960, +0.87% change in 2020.



# What Caused this Unprecedented Decline in NFA?

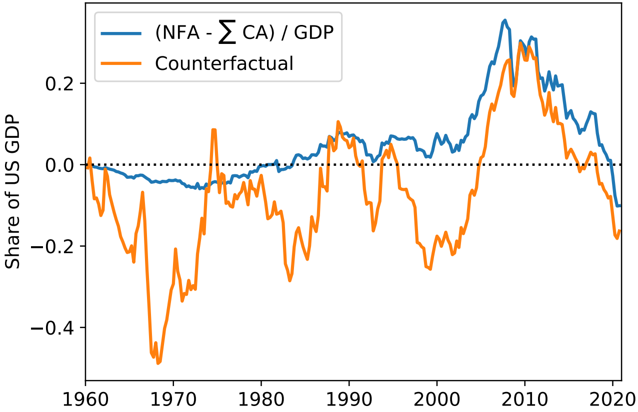
- Larger gross positions composition of two forces:
    1. Larger share of equity owned by foreigners.
    2. Larger value of equity relative to GDP.



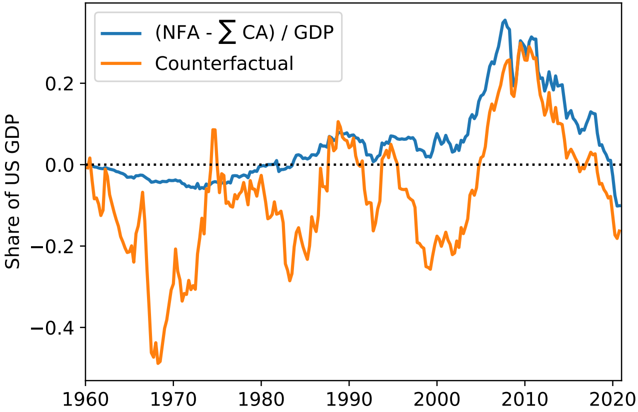
# What Caused this Unprecedented Decline in NFA?

- Sum up: NFA - CA gap since 2002 not due to unprecedented changes in equity value.
- Instead, larger positions mean that the **same** movements have larger impact on NFA.



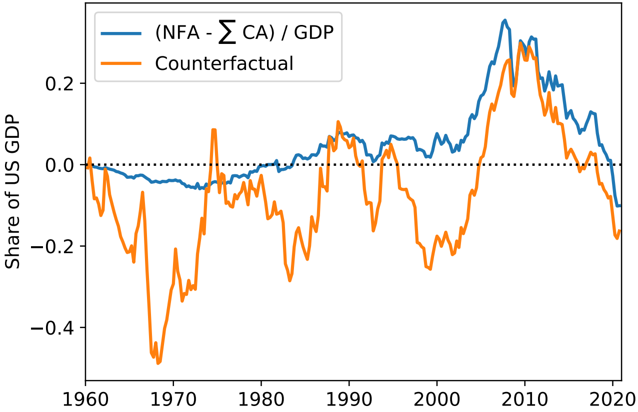
# What Caused this Unprecedented Decline in NFA?

- Below: counterfactual NFA series applying **same equity revaluations** in a world where US and ROW both have positions in other's equity **equal to 75% of US GDP**.
- Many large deviations from $\sum CA$, recent period not abnormal in counterfactual world.



# What Caused this Unprecedented Decline in NFA?

- Conjecture: larger gross positions $\Longrightarrow$ **start** of **era of privilege**.
- Just not clear whose privilege it will be. Expect large deviations in both directions.

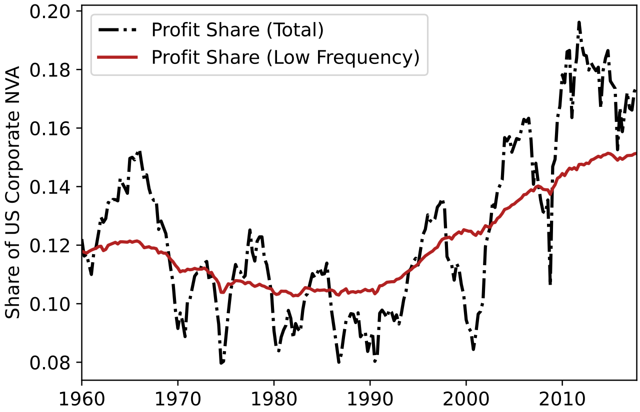


# Welfare Implications

- Normative question: what are the welfare implications for US households?
- Authors: 30% ROW ownership of US equity leads to welfare loss for US equal to 2.7% of permanent consumption.
- Back of the envelope math:
  - Moment matching $\implies$ permanent 8.7pp increase in markups (1.55% $\to$ 10.2%).
  - ROW gets 30% of profits $\implies 0.3 \times 0.087 = 2.6\%$.
- Internally consistent, but 8.7pp rise in markups seems too big to me.
  - May overstate welfare consequences.

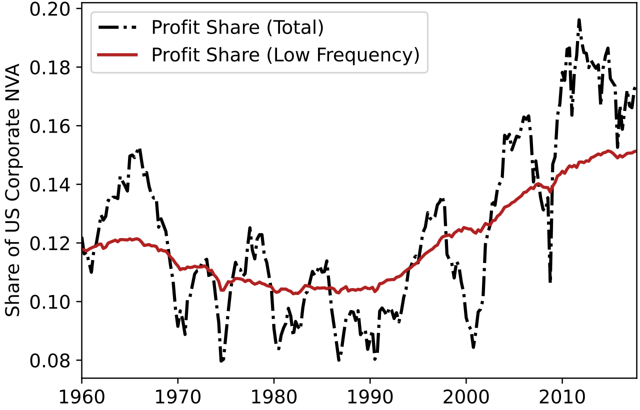
# Rise in Profits

- Black line: corporate profit share (after-tax profits / NVA).
- Red line: estimated low frequency component from Greenwald, Lettau, Ludvigson (2021).



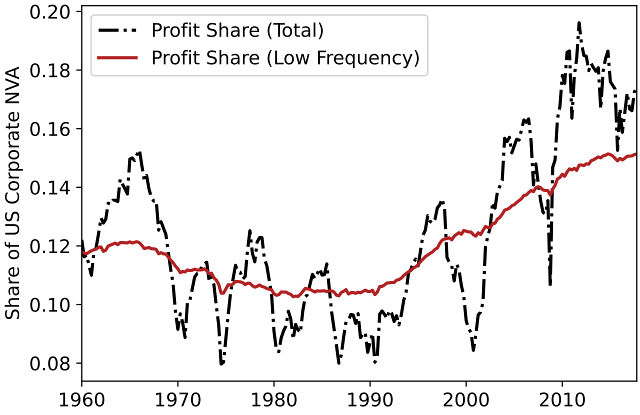
# Rise in Profits

- Total profit share increases 3.9pp from NFA peak (2007:Q4), 6.8pp from 2008:Q4.
- But this is largely due to transitory plunge around the financial crisis.



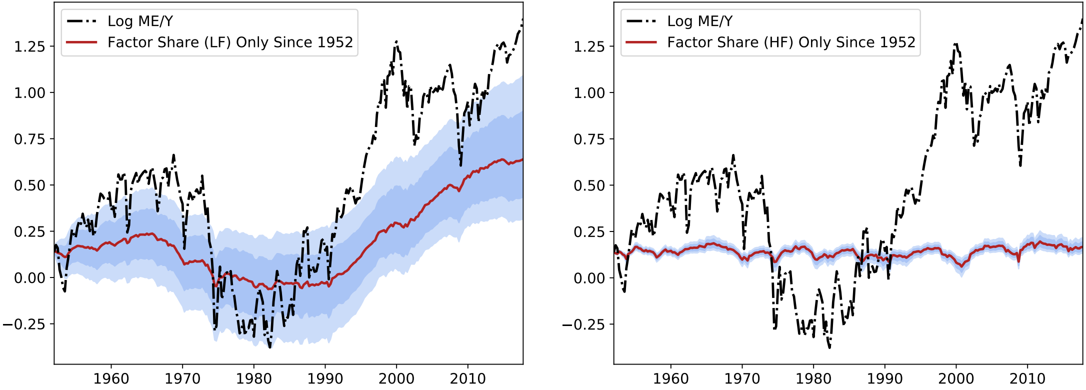
# Rise in Profits

- Low-frequency component increases only 1.2pp since 2007:Q4, 1.4pp from 2008:Q4.



# Rise in Profits

- GLL: high-frequency component too transitory to have strong influence on equity values.
- From welfare perspective, would also expect LF component to dominate, change is 7x smaller than this paper's implied permanent change in markups.



# Rise in Profits

- Both models exactly target rise in equity values, how does our model accomplish this with smaller rise in profits?

1. GLL: rise in valuations since 2007:Q4 caused by rising profits (+60%), falling interest rates (+52%), offset by increase in effective risk aversion (-11%).
   - Measured from 2009:Q1, shares are rising profits (+47%), rising interest rates (-6%), decrease in effective risk aversion (+59%).
   - AHP: $\sim$100% of rise due to rising profits.
2. GLL: profits = NVA - labor compensation - **(taxes + interest)** = 14% in 2007:Q4.
   - AHP: profits = NVA - labor compensation $\simeq$ 35% before shock.
3. GLL: rising profit shares endogenously reduce risk premia.
   - AHP: certainty-equivalent world.

# Welfare Interpretations

- If GLL profit estimates correct, back of envelope welfare impact is 0.37% instead of 2.7%.
  - If ROW do not hold claims on non-corporate sector, impact is 0.21%.
- Bigger picture point for interpretation: this is **one ex-post realization**.
  - Typical share of equity held by concentrated holder, not typical household.
  - US and ROW equity holders effectively insuring each other through diversification.
  - Reduces variance, likely providing **ex-ante welfare gains**.
- Back of the envelope calculation based on sample covariance of equity ex-dividend returns
  - US holding 40% ROW equity **reduces variance of equity appreciation by 15%**.
  - Covariance of US and ROW profit shares would be very interesting moment to measure.

# Distinguishing Mechanisms

- Bringing new data to distinguish observationally equivalent outcomes is fantastic.
- AHP: increase in markups fits the data very well, but investment in unmeasured capital requires current account deficit that is much too large (-107% vs. -8% in data).
- Taken literally, this is a bit of a straw man.
  - Model has no investment frictions so all adjustment takes place in one period.
  - With frictions, could easily slow down current account deficit.
- But deeper point seems correct to me.
  - Increase in equity value through high realized return fits the data.
  - Mechanism where equity value grows through investment under flat equity returns does not.
- Very promising area for future research.

# Conclusion

- Great paper, a few differences on interpretation.
- Swings in NFA due to equity revaluation likely increasing going forward.
  - Unusual rise and fall since 2002 due to large gross positions/exposures, not unusually large changes in equity valuations.
- Welfare implications may be overstated.
  - More direct evidence for 8.7pp permanent increase in markups would be helpful.
  - Interpretation varies ex ante vs. ex post.
- Important agenda to distinguish mechanisms with new moments.
  - Hope to see more of this going forward.