September 29, 2020

Economics Group

Special Commentary

Jay H. Bryson, Chief Economist
jay.bryson@wellsfargo.com • (704) 410-3274
Shannon Seery, Economist
shannon.seery@wellsfargo.com • (704) 410-1681

The U.S. Has a Large Negative NIIP. Should We Worry?

Executive Summary

With the United States on its way to running the largest federal budget deficit since the Second World War, there is growing concern about the deteriorating fiscal position of the U.S. government. But there is another measure in which the United States has been running red ink for years. Specifically, the U.S. net international investment position (NIIP), which is essentially the U.S. balance sheet with the rest of the world, deteriorated to -$13.0 trillion in the second quarter. The United States has increasingly become a net borrower from the rest of the world with a growing gap between American holdings of foreign assets and foreign holdings of U.S. assets. Although most observers do not pay much attention to the deteriorating NIIP of the United States, should we be worried about its nosedive in recent years?

Government Debt and the NIIP: Lots of Red Ink

With 11 months of fiscal year (FY) 2020 already in the books, the federal government has racked up a record $3 trillion worth of deficits. Moreover, the Congressional Budget Office (CBO) projects that the federal government will incur annual deficits of $1 trillion or more every year through at least 2030 (Figure 1). This red ink in the government's fiscal accounts will push debt held by the public to more than 100% starting in FY 2022, the highest ratio since the end of the Second World War. The deteriorating fiscal position of the U.S. government has led to significant concern among some observers, which we addressed in a series of reports earlier this year.[1]

Figure 1

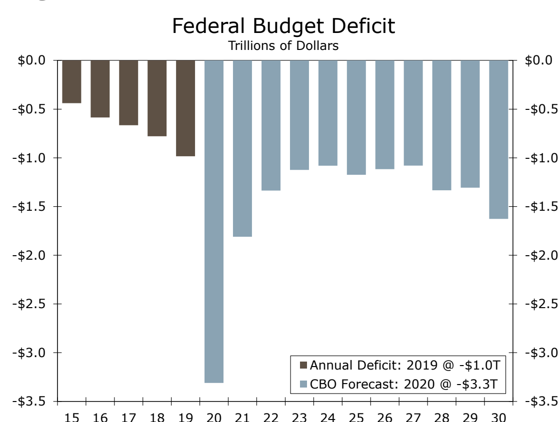
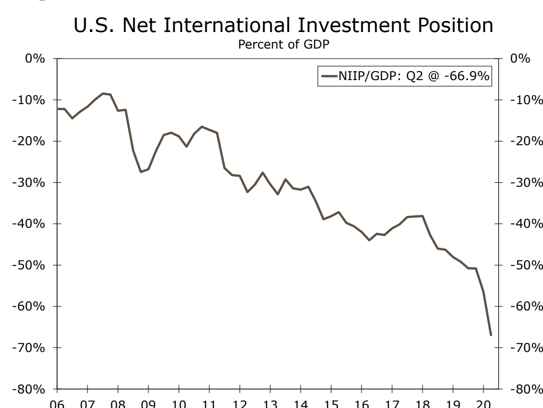


Figure 2



Source: Congressional Budget Office, U.S. Commerce Department and Wells Fargo Securities

As a percent of GDP, the NIIP now stands at a record –67%.

But, there is another measure in which the United States has been running red ink for years. Specifically, data released on September 29 showed that the net international investment position (NIIP) of the United States deteriorated to -$13.0 trillion in Q2-2020. As a percent of nominal GDP, the country's NIIP now stands at –67%, also an all-time record low (Figure 2). What exactly is the NIIP, and does it matter? Although most observers do not pay much attention to the NIIP, should we be worried about its nosedive in recent years?

[1] **See "Fiscal Fallout from the COVID-19 Pandemic: Part I, Part II & Part III" for more detail.**

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

What is the NIIP?

Let's return to the discussion above about the government's fiscal accounts. The government's deficit (or surplus) is a flow concept. That is, it measures the difference between government revenues and outlays over some period of time (*e.g.*, a fiscal year). Government debt, which is a stock concept, essentially measures the aggregation of fiscal deficits and surpluses. It is measured at a point in time (*e.g.*, the end of Q2-2020).

The United States has increasingly become a net borrower from the rest of the world.

Similarly, there is a flow concept that is associated with a country's current account that gives rise to its NIIP, a stock concept. If a country incurs a current account deficit over some period of time, say a quarter, then it has essentially imported more than it has exported during that quarter. At a basic level, a country imports more than it exports when it spends more than it produces. As with the case of an individual who spends more than he or she produces, a country that spends more than it produces must essentially be a net borrower from the rest of the world.

As shown in Figure 3, the United States has been incurring red ink in its current account since the early 1990s. This uninterrupted string of current account deficits over the past thirty years means that the United States has been a net borrower over that period, which has led to the significant slide in the NIIP in recent years (Figure 4). Specifically, foreign holdings of U.S. assets exceeded American holdings of foreign assets by $13.0 trillion at the end of Q2-2020.[2] In short, the United States is in hock to the rest of the world.

Figure 3

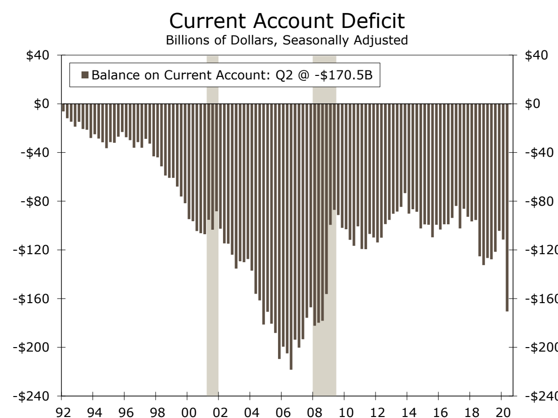
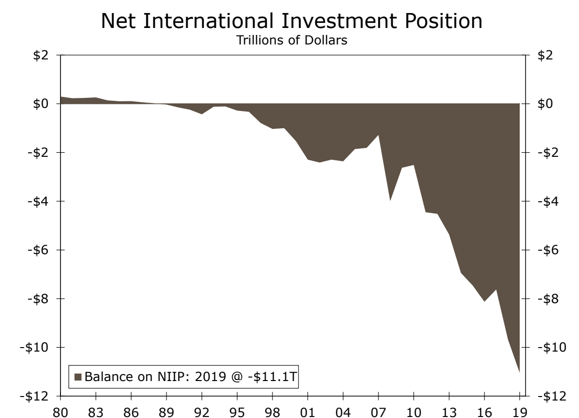


Figure 4



Source: U.S. Commerce Department and Wells Fargo Securities

Is a Negative NIIP a "Problem"?

Let's return again to the government's fiscal accounts. A government's deficit and its outstanding debt can become a problem if lenders start to worry that the government will not be able to honor its financial obligations. When this happens, borrowing costs can shoot significantly higher which then leads to a vicious cycle of higher borrowing costs, widening deficits, etc. Worries of default can become self-fulfilling. Similarly, foreign creditors could become concerned about the ability of debtors in a country to meet their foreign obligations. If foreign creditors start to dump their foreign assets, the country's exchange rate could depreciate significantly, reducing the country's real income.

A sustained deficit in a country's balance on primary income in its current account is a warning sign.

A sustained deficit in a country's balance on primary income in its current account is a warning sign that it could be facing a potential problem. A country incurs a deficit in its primary income balance when the income that it receives from its holdings of foreign assets is less than the income it pays on its assets that foreigners hold. But this warning sign does not apply to the United States at present because the country has been running a surplus in its primary income balance for years

[2] **Foreign holdings of U.S. assets include the obligations of American businesses, households and public sector.**

(Figure 5). Indeed, the United States has racked up an aggregate surplus of $205 billion in its primary income balance over the past four quarters.

Figure 5

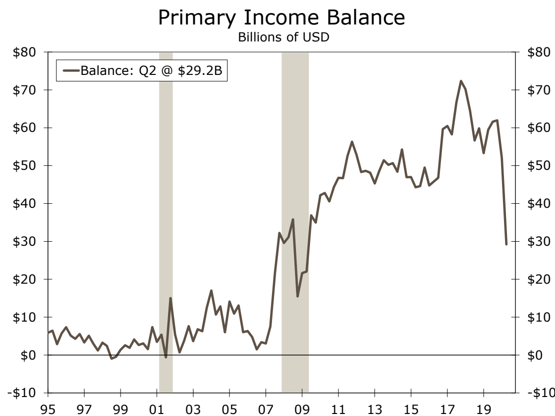
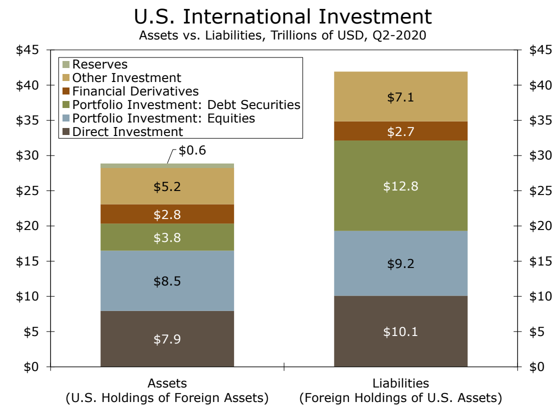


Figure 6



Source: U.S. Commerce Department and Wells Fargo Securities

So why does the United States run large primary income balances? To answer this question, it is first necessary to consider the structure of America's assets and liabilities (Figure 6). A sizeable share of America's foreign assets take the form of portfolio investment, accounting for about 40% of total foreign assets. Diving a bit deeper, equity and investment fund shares accounted for roughly $8.5 trillion of the $12.4 trillion in foreign portfolio assets in Q2-2020, with the remaining $3.8 trillion taking the form of debt instruments. In short, American's foreign portfolio assets are concentrated in equities.

American holdings of foreign assets are concentrated in equity investments.

On the liabilities side, portfolio investment also accounts for the largest share of foreign-owned American assets, comprising roughly one-half of the $41.9 trillion total, but much of the foreign holdings take the form of debt instruments. That is, the $22.0 trillion worth of American portfolio assets in the second quarter can be broken down into $12.8 trillion worth of debt securities, which includes $7.0 trillion in Treasury bills, notes and bonds. Foreign holdings of American portfolio assets are thus concentrated in debt instruments and a large proportion of these holdings take the form of U.S. Treasury securities.

After portfolio investment, direct investment is the next largest share of both assets (28% of total assets) and liabilities (24%), with the U.S. holding about $7.9 trillion of foreign directly-held assets (i.e. foreign direct investment) and foreigners holding about $10.0 trillion of American directly-held assets. Despite the comparable stock of direct investment held on both the asset and liability side, the United States earns a higher return on its foreign assets. Research suggests offshore profit sharing, or when U.S. multinationals establish affiliates in low-tax jurisdictions where they book profits, may result in higher income on U.S. direct investment abroad.[3] Under profit sharing, U.S. foreign affiliates returns are captured in direct investment receipts.

After focusing on the structure of American assets and liabilities it becomes clear how the United States runs a large primary income balance. U.S. international assets are concentrated in equity investments, which generally earn higher rates of return than the debt instruments that comprise a significant share of foreign holdings of American assets. This has been especially true over the past decade as yields on U.S. Treasury securities have remained depressed. Further, profit sharing results in a higher return on direct investment abroad than the United States pays out on its directly-held liabilities.

Although the United States has been incurring black ink in its primary income balance for years, the surplus plummeted to $29.2 billion in Q2-2020, the lowest since the financial crisis in 2008. Is

[3] **Guvenen, F. et al. "Offshore Profit Shifting and Domestic Productivity Measurement." National Bureau of Economic Research Working Paper 23324. October 2019.**

the recent slide cause for concern? Probably not, because it reflects a larger drop in investment income receipts than in investment income payments in the second quarter. Because income received from equity investments tends to be more volatile than income received from debt instruments, the former tends to decline more than the latter when financial markets encounter volatility. With financial markets finding their footing in recent months, the surplus should rebound over the next few quarters.

The risk of large NIIP's being associated with sharp currency depreciation is not a concern at present.

Nevertheless, Figures 2 & 4 make it clear that the NIIP of the United States continues to trend lower, and large NIIP's can often be associated with periods of sharp currency depreciation (*e.g.*, Brazil at the turn of the 21st century and Turkey at that time and again more recently). However, developing economies often borrow predominately in "hard" foreign currencies (*e.g.*, the U.S. dollar or the euro), and foreign investors can quickly become worried about the ability of those economies to generate the foreign currency earnings needed to service the country's financial obligations. Not only does the United States have the deepest, most liquid and most transparent capital markets in the world, but the household, business and public sectors in the United States borrow in U.S. dollars. Furthermore, some other advanced economies, such as Australia, have had a chronic NIIP with few corresponding financial difficulties. In that regard, the trade-weighted value of the Australian dollar is little changed on balance since the early 1990s despite Australia consistently posting a negative NIIP on the order of 50% or so of GDP over that period.

Conclusion: Not Especially Worried about NIIP at Present

Although the United States has increasingly become a net borrower from the rest of the world in recent years, we are not especially worried about the NIIP at this time. Importantly, and due largely to the composition of U.S. international assets and liabilities, the United States continues to bring in more in receipts on its foreign assets held than it pays out on its liabilities resulting in a sizeable surplus in its primary income balance. We expect the primary income surplus to persist. Additionally, the risk of large NIIP's being associated with sharp currency depreciation is not a concern at present, in our view. That said, we will continue to monitor the external accounts of the United States for potential signs of unsustainable imbalances developing.

Wells Fargo Securities Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	International Economist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	International Economist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Shannon Seery	Economist	(704) 410-1681	shannon.seery@wellsfargo.com
Jen Licis	Economic Analyst	(704) 410-1309	jennifer.licis@wellsfargo.com
Hop Mathews	Economic Analyst	(704) 383-5312	hop.mathews@wellsfargo.com
Nicole Cervi	Economic Analyst	(704) 410-3059	nicole.cervi@wellsfargo.com
Sara Cotsakis	Economic Analyst	(704) 410-1437	sara.cotsakis@wellsfargo.com
Coren Burton	Administrative Assistant	(704) 410-6010	coren.burton@wellsfargo.com

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