country's net foreign asset position can vary substantially. With the spectacular increase in the holdings of foreign assets and foreign liabilities, these valuation effects can swamp current account imbalances.[20] It is possible that the valuation channel is systemically stabilizing for some countries and shocks but destabilizing for others. This matters at the macroeconomic level; it is also important for financial stability, due to valuation effects on bank balance sheets, but also in relation to the balance sheets of the banks' stakeholders (households, firms, and the government).

Differences in Foreign Currency Exposures

For example, differences in foreign-currency exposures between emerging Asia and Latin America (on the one side) and emerging Europe (on the other) have had important implications for the stability of their financial sectors. Since the first group is long in foreign-currency assets in net terms, currency depreciation generates a valuation gain. Financial and macroeconomic stability is thus enhanced if currency depreciation typically occurs during downturns. In contrast, emerging Europe has net foreign-currency liabilities, so currency depreciation has an adverse impact on balance sheets.[21]

Risk-Sharing Channel

A second dimension relates to the risk sharing properties of net international equity positions and net FDI positions transmitted through valuation effects. When the world is hit by global shocks, countries with net equity and FDI assets absorb losses from countries with net equity and FDI liabilities.

Large foreign equity liabilities can insulate a country from domestic shocks, since domestic losses are shared with foreign investors. For example, the losses from domestic banking crises have been partially absorbed by foreign equity investors, both through portfolio equity stakes and the value of FDI equity positions in foreign-owned banks.

This risk-sharing channel is heavily shaped by the different external balance sheet structures of countries and their heterogeneous weighting of risky versus safe assets on both sides of the balance sheet. It is particularly important in times of high global volatility. In such an environment, valuation effects are particularly large and may lead to substantial wealth transfers across countries.

The United States, as the country at the center of the international monetary and financial system and the issuer of the reserve currency, can be seen as an insurance provider in crisis periods.[22] Unlike that of other countries, its external balance sheet is short on "safe" or liquid securities and long on "risky" or illiquid ones. For instance, the share of bank loans and debt instruments in U.S. external liabilities was sixty-three percent on the eve of the crisis in 2007, while the share of direct investment and equity claims in gross external claims was sixty percent.

The value of U.S. government bonds, which constitute a large part of the country's external debt liabilities, remained stable or actually increased at the height of the crisis. Meanwhile the value of its external assets (dominated by riskier equity and FDI) plummeted. Thus the net foreign asset position of the U.S. declined dramatically. Between 2007Q4 and 2009Q1, the U.S. net foreign asset position deteriorated by twenty-one percent of GDP.[23] In this way, the United States provided insurance to the countries holding U.S. government bonds and shared in the losses of collapsing equity prices around the world.

[20] Lane and Milesi-Ferretti (2007) and Gourinchas and Rey (2007).
[21] Interestingly, Asian economies had net dollar liabilities during the Asian crisis of 1997-1998, and that exposure proved especially destructive.
[22] See Gourinchas et al. (2012) for elaboration of this argument.
[23] For further details, see Gourinchas, Rey and Truempler (2012) and Milesi-Ferretti (2009).