Exorbitant Privilege: Does the U.S. still enjoy it?

Samet Efe Keskin
University of Mannheim and Bilkent University, Economics Department

Arda Kırayoğlu
University of Mannheim and Bilkent University, Economics Department

Kaan Hepdurak
University of Mannheim and Koc University, Department of Mathematics and Economics

This research analysis has been prepared for the International Finance course at Mannheim University, and it investigates the concept of exorbitant privilege—the ability of the United States to sustain persistent current account deficits while earning higher returns on foreign assets than it pays on liabilities- and it's ongoing case.

I. Introduction

This research review examines the evolution of the United States' exorbitant privilege—its ability to sustain persistent current account deficits while earning higher returns on foreign assets than it pays on liabilities—through an empirical analysis of post-2020 financial trends. While historical literature (Gourinchas & Rey, 2007; Habib, 2010) suggests that the U.S. has consistently earned excess returns due to valuation effects, recent studies (Atkeson et al., 2022; Chen et al., 2022) highlight an increased erosion of this privilege.

This study evaluates whether the U.S. maintains its financial advantage by analyzing post-2020 trends in net foreign asset positions, valuation effects, and global capital flows.

Using data from the Bureau of Economic Analysis and Federal Reserve, the research investigates whether structural shifts—such as rising U.S. Treasury yields, increasing foreign capital gains on U.S. equities, and global reserves—erode the U.S.'s ability to finance deficits without economic repercussions. If valuation dynamics continue to deteriorate, the U.S. may face a turning point as the global financial hegemon, with significant implications for international economic stability.

II. Variables and Definitions

The analysis of exorbitant privilege requires defining key financial variables related to the U.S. Net Foreign Assets (NFA), asset and liability structures, and Federal Reserve monetary policy. Below are the key equations used in this study:

The Net Foreign Asset (NFA) position is defined as:

$$NFA = US_{assets} - US_{liabilities} \tag{1}$$

To assess the relative magnitude of NFA, we compute the NFA-to-GDP ratio:

$$NFA/GDP_r Ratio = \frac{NFA}{GDP} \times 100 \tag{2}$$

The excess return on U.S. foreign assets is given by:

$$return_o n_a ssets = \left(\frac{Netinternationalinvestment}{US_{assets}} \right) \times 100 \tag{3}$$

The return on U.S. liabilities is similarly calculated as:

$$return_o n_l iabilities = \left(\frac{Financialderivativesother}{US_{liabilities}} \right) \times 100 \tag{4}$$

To examine the role of Federal Reserve interest rate hikes in impacting the exorbitant privilege, we define:

$$FedHike = \begin{cases} 1, & \text{if } D.FEDFUNDS > 0 \text{ 0,} \\ \text{otherwise} & \end{cases} \tag{5}$$

Similarly, a Fed rate cut is defined as:

$$Fed_C ut = \begin{cases} 1, & \text{if } D.FEDFUNDS < 0 \text{ 0,} \\ \text{otherwise} & \end{cases} \tag{6}$$

To quantify the relationship between interest rate hikes and the exorbitant privilege variables, we conduct regression analysis:

$$NFAGDP_r Ratio = \beta_0 + \beta_1 Fed_H ike + \epsilon \tag{7}$$

$$returnOnAssets = \beta_0 + \beta_1 Fed_H ike + \epsilon \tag{8}$$

$$returnOnLiabilities = \beta_0 + \beta_1 Fed_H ike + \epsilon \tag{9}$$

where measures the impact of Federal Reserve rate hikes on each variable.

III. Related Literature

Gourinchas and Rey (2007) first formalized the notion that the United States benefits from excess returns on its net foreign assets due to asymmetric capital flows, mainly through a combination of low-yield safe liabilities (e.g., U.S. Treasuries) and high-yield foreign assets (e.g., equities and direct investments). They found that the U.S. could sustain external deficits without experiencing proportional declines in its net foreign asset (NFA) position due to valuation effects, mainly through dollar depreciation and capital gains on foreign assets. This idea was further supported by Habib (2010), who demonstrated that valuation effects, rather than differences in investment income, accounted for much of the excess returns the U.S. earned on its foreign portfolio. However, more recent research challenges the persistence of exorbitant privilege. Atkeson, Heathcote, and Perri (2022) argue that the privilege has significantly weakened since the 2008 Global Financial Crisis. Their findings indicate that foreign investors have increasingly benefitted from rising U.S. equity prices, reversing historical trends in valuation effects. Over the past decade, the NFA position has deteriorated not due to new borrowing but because U.S. liabilities have appreciated faster than U.S. assets abroad. This suggests a fundamental shift in wealth transfers, whereby foreign investors have gained disproportionately from capital gains in U.S. markets, reducing the traditional U.S. advantage in global financial intermediation. Chen et al. (2022) take a historical approach, comparing the contemporary U.S. situation to the decline of the United Kingdom's financial hegemony after World War II. They argue that safe asset providers experience a temporary ability to borrow beyond their fundamental fiscal capacity, but once investor confidence shifts, their privilege can rapidly erode. Their analysis finds that, in the U.S. case, only *"one-third"* of Treasury debt is backed by future surpluses, highlighting the fragile nature of its financial dominance. Unlike the pre-World War I U.K., which lost its financial hegemony after overspending on military conflicts, the U.S. is experiencing a loss of privilege due to structural changes in global capital flows and the rise of alternative financial centres.

The traditional mechanism of earning excess returns through valuation effects has weakened, and continued fiscal and monetary policy decisions will play a crucial role in determining whether the U.S. can maintain its unique financial position.

IV. Methodology: Observations and Results

We've used the BEA financial reliability data set and the Federal Reserve Interest Rate, GDP, and CPI Index data sets. By analyzing a time series of data from 1976 to 2023, we've investigated whether the NFA to GDP changed over time. A declining NFA/GDP ratio may indicate that the U.S. has been accumulating more foreign liabilities relative to assets, making it a larger net debtor. (Figure 1)

Using the same dataset, we've also observed that the Foreign Income in terms of U.S GDP has declined over the years. One of the other widely used parameters to assess U.S. privilege on foreign asset returns is the difference in the returns on foreign assets and liabilities. As it can be seen in Fig.2, the return on assets is still above the return on

liabilities. But return on assets has tendency to decrease since 2023 whereas return on liabilities stays the same since 2023. This shows that even if it still enjoys the exorbitant privilege, it is likely that this might lose its persistence and the U.S. might lose this advantage of financial flexibility that it gets due to the difference in return on foreign liabilities and assets.

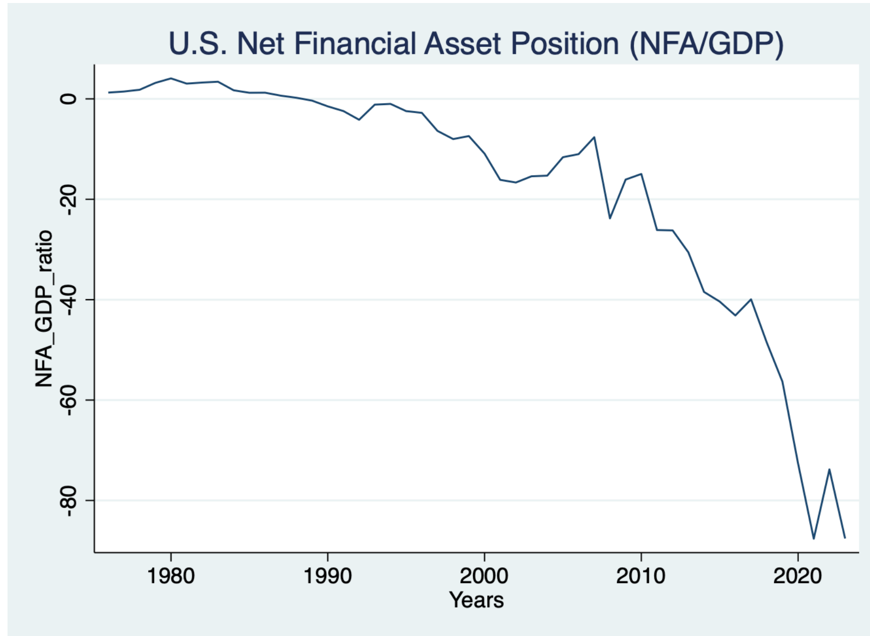

Fig. 1 Graph output of the time series.

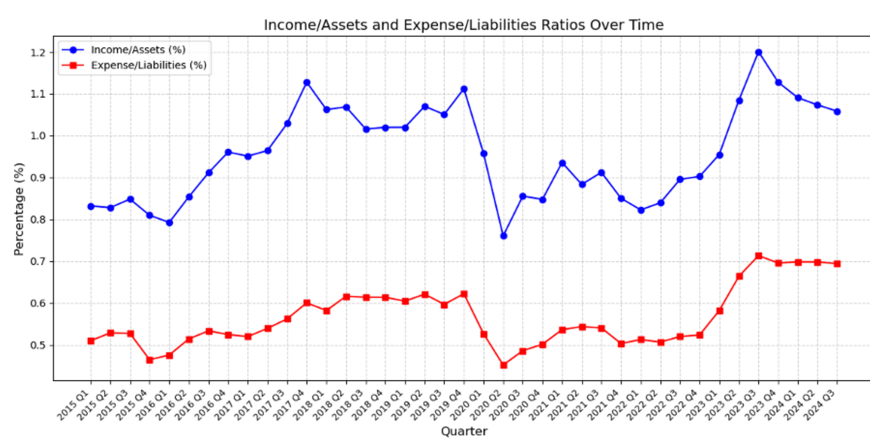

Fig. 2 Graph Output of the time series

It is observable that both U.S. liabilities and assets have increased over time, but liabilities have grown at a much faster rate, particularly post-2000. This state may be indicating that the U.S. has borrowed more from the rest of the world than it has invested abroad. The increasing gap between U.S. assets and liabilities suggests that valuation effects, historically a key component of the U.S. privilege, may be deteriorating. Habib (2010) and Gourinchas, Rey (2007)

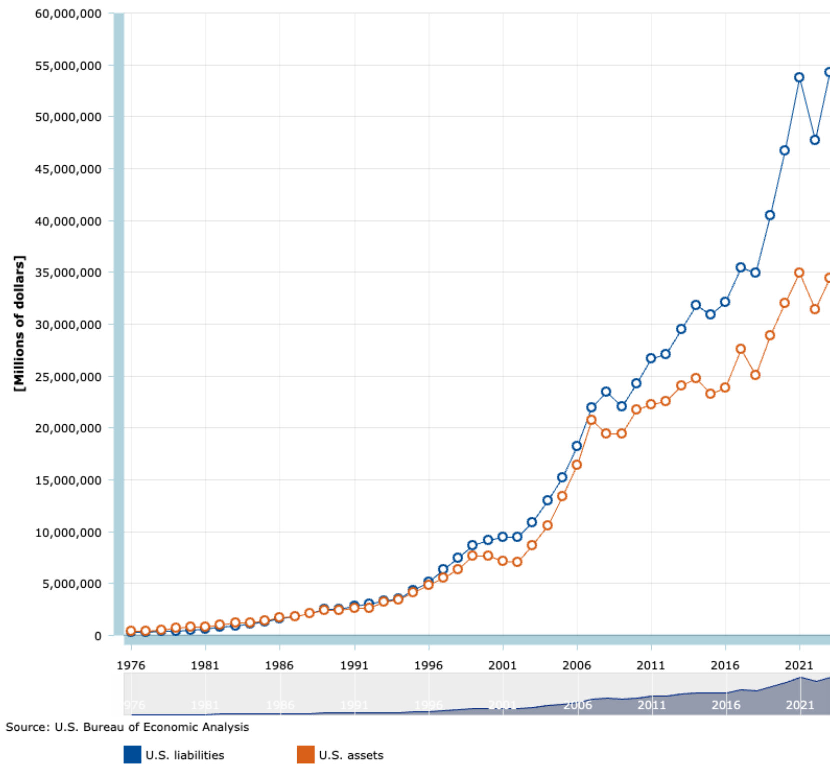

Fig. 3 Source: U.S. Bureau of Economic Analysis (BEA)

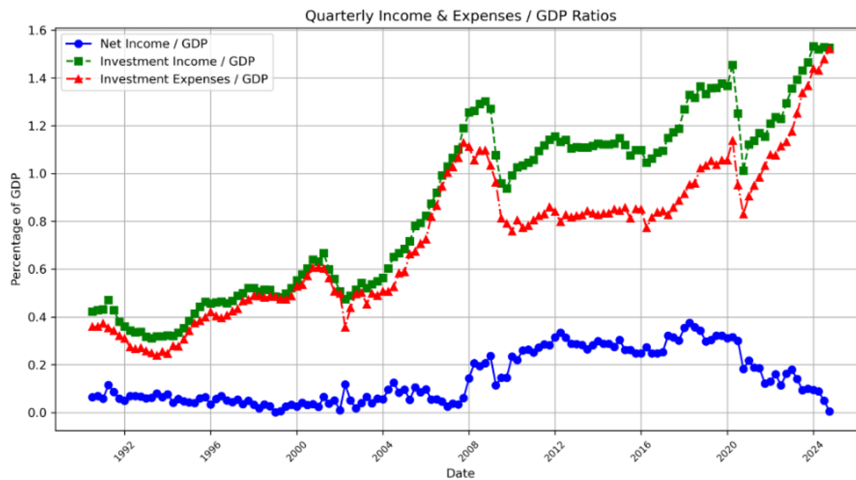

Fig. 4 Graph Output of the time series

emphasized that much of the U.S.'s financial advantage stemmed from capital gains on foreign assets exceeding those on U.S. liabilities. However, if foreign investors earn greater returns on their U.S. holdings, this would erode the traditional privilege. Our emphasis points out that the persistence of demand for U.S. Treasuries may prevent an immediate crisis, but if global investors reduce their U.S. exposure (as seen with rising alternative reserves like the Euro and Yuan),

privilege erosion could accelerate.

We can also take a look at these investment income and expenses as a share of GDP, as it is seen in Fig.4, we see that the net foreign income has declined after 2020, and it seems to keep this decreasing trend until 2024 and is very close to zero. So if it keeps this trend, it is likely that the U.S. will make losses from their foreign assets and liabilities. Considering the U.S. has larger liabilities than their assets, as seen in Fig. 3, the financial instability might be expected and the U.S. might lose its trust causing the U.S. to lose its global dominance.

A. U.S Liabilities vs Fed Hikes

The other part of our analysis relies on the relationship analysis between Fed Rate hikes and U.S. liabilities. The regression equations 7, 8, and 9 (defined in the second part of the paper) and their respective outputs show a weak correlation between liabilities and Fed Hikes. The correlation increases even when we look at the Covid Era. Although the regression performed had only 12 observations of quarterly data, the projected data, when it is scaled more, shows promising results.

```
. reg return_on_liabilities Fed_Hike

      Source |       SS           df       MS      Number of obs   =        12
-------------+----------------------------------   F(1, 10)        =      3.91
       Model |  .012542853         1  .012542853   Prob > F        =    0.0762
    Residual |  .032070652        10  .003207065   R-squared       =    0.2811
-------------+----------------------------------   Adj R-squared   =    0.2093
       Total |  .044613505        11  .004055773   Root MSE        =    .05663

------------------------------------------------------------------------------
return_on~es | Coefficient  Std. err.      t    P>|t|     [95% conf. interval]
-------------+----------------------------------------------------------------
    Fed_Hike |   .0655775   .0331597     1.98   0.076    -.0083069    .1394619
       _cons |    .066109   .0214045     3.09   0.011     .0184168    .1138012
```

Fig. 5 Regression output from Stata.

```
. corr FEDFUNDS NFA_GDP_ratio return_on_assets return_on_liabilities
(obs=12)

             | FEDFUNDS NFA_GD~o retur~ts retur~es
-------------+------------------------------------
    FEDFUNDS |   1.0000
NFA_GDP_ra~o |   0.6418   1.0000
return_on~ts |   0.6260   0.9969   1.0000
return_on~es |   0.4322   0.7277   0.7442   1.0000
```

Fig. 6 Regression output from Stata.

B. Post Covid Era

The Federal Reserve's response to COVID period economic struggles led to a historic tightening cycle, with aggressive rate hikes implemented from 2022 onward. Higher interest rates may have increased the cost of servicing U.S. liabilities, particularly Treasury securities and other dollar-denominated debt held by foreign investors. The rapid

```
. reg NFA_GDP_ratio Fed_Hike

      Source |       SS           df       MS      Number of obs   =        12
-------------+----------------------------------   F(1, 10)        =      0.53
       Model |  30.8982736         1  30.8982736   Prob > F        =    0.4845
    Residual |   586.21949        10   58.621949   R-squared       =    0.0501
-------------+----------------------------------   Adj R-squared   =   -0.0449
       Total |  617.117763        11  56.1016148   Root MSE        =    7.6565

------------------------------------------------------------------------------
NFA_GDP_ra~o | Coefficient  Std. err.      t    P>|t|     [95% conf. interval]
-------------+----------------------------------------------------------------
    Fed_Hike |   3.254796   4.483186     0.73   0.484    -6.734365    13.24396
       _cons |  -45.14105   2.893884   -15.60   0.000    -51.58903   -38.69308
------------------------------------------------------------------------------
```

Fig. 7 Regression output between NFA/GDP ratio and Fed Hikes.

rise in Treasury yields made U.S. liabilities more expensive relative to historical norms, leading to a shift in global capital flows.

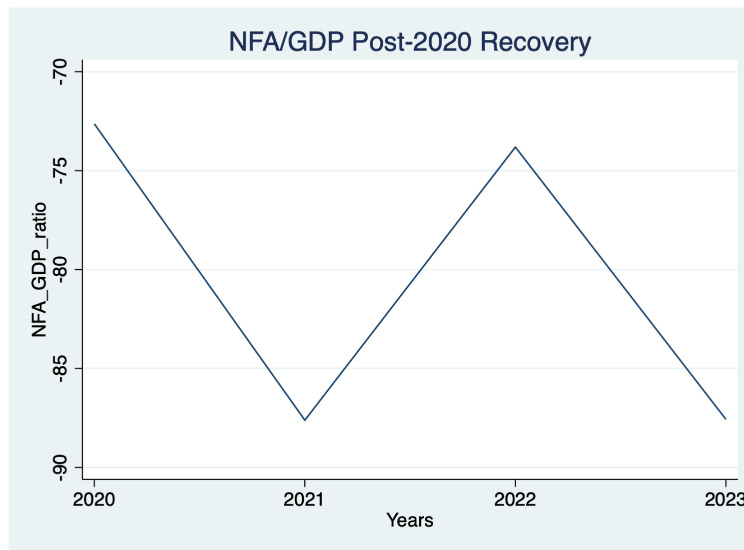

Fig. 8 Regression output from Stata.

V. Geopolitical Projections for Future

Some economies, particularly China, Russia, and BRICS nations, are actively seeking alternatives to the U.S. dollar. Central banks worldwide have reduced their dollar reserves and increased holdings in gold and alternative currencies and financial assets. China's increasing influence in emerging markets with foreign direct investments and financial presence forces countries to shift to the Yuan, which could weaken the dollar's dominance in the long term. Also, the deteriorating relationship between China and the US caused a reduction in China's holdings of U.S Treasury bonds as the world's biggest foreign holder. This trend may cause declining confidence and demand for USD in the long term.

VI. Conclusion

The privilege has shown signs of erosion due to several structural shifts in the global economy. The U.S. net foreign asset position has worsened, foreign investors have gained higher capital returns on U.S. equities, and increased Treasury issuance has raised concerns about fiscal sustainability. Unlike the United Kingdom, which lost its financial dominance entirely, the U.S. retains some privilege in bond markets, where global demand for U.S. Treasuries remains strong. However, its dominance in equity markets has diminished significantly. If the global economy continues to diversify away from U.S. financial assets and alternative reserve assets gain prominence, the United States may face the complete erosion of its exorbitant privilege, with profound implications for its ability to finance deficits and maintain economic stability.

Appendix

The data sets and Stata codes are embedded within the uploaded file.

References

Atkeson, Andrew, Jonathan Heathcote, and Fabrizio Perri. "The End of Privilege." *Federal Reserve Bank of Minneapolis Staff Report*, no. 636, 2022.

Chen, Jiakai, et al. "Exorbitant Privilege Gained and Lost: Fiscal Implications." *National Bureau of Economic Research Working Paper*, no. 30160, 2022.

Gourinchas, Pierre-Olivier, and Hélène Rey. "*International Financial Adjustment." Journal of Political Economy*, vol. 115, no. 4, 2007, pp. 665–703.

Gourinchas, Pierre-Olivier, and Hélène Rey. "From World Banker to World Venture Capitalist: The U.S. External Adjustment and the Exorbitant Privilege." *NBER Working Paper,* no. 11563, 2005.

Habib, Maurizio Michael. "Excess Returns on Net Foreign Assets: The Exorbitant Privilege from a Global Perspective." *European Central Bank Working Paper,* no. 1158, 2010.

U.S. Bureau of Economic Analysis. "International Investment Position of the United States." BEA Data Set, 2023. https://www.bea.gov.