

# Is the United States Too Dependent On Foreign Capital?

*By Craig S. Hakkio and Bryon Higgins*

The growing U.S. foreign trade deficit in recent years has been accompanied by an increasing net inflow of foreign capital. As a result of these net capital inflows, the United States has become—or soon will become—a net debtor to the rest of the world. Indeed, unless the trends are reversed, this country will soon become the largest debtor nation in the world.

The growing net capital inflows have caused many to be concerned that the United States is increasingly dependent on foreign capital. They argue that increased borrowing from foreigners is both unsustainable and dangerous.<sup>1</sup> One danger is that at some point foreigners will be reluctant to provide additional capital to the United States, creating the potential for a precipitous decline in the exchange value of the dollar and an attendant rise in interest rates to ration the limited

domestic supply of credit. Another concern is that the large net capital inflows threaten to drain capital from Europe and elsewhere that will be needed to finance real investment abroad. Many of those who consider the net capital inflow dangerous think it results from high federal government budget deficits in the United States. They argue that high budget deficits have forced up U.S. interest rates, thereby attracting foreign capital. Their recommendation, therefore, is to reduce the budget deficit to bring down interest rates, the exchange rate, the trade deficit, and capital inflows.

An alternative point of view is that the net capital inflows are not dangerous because they merely reflect the U.S. economy's vitality,

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<sup>1</sup> See, for example, the statement by Henry Wallich, member, Board of Governors of the Federal Reserve System, before the House Subcommittee on International Economic Policy and Trade, March 22, 1985, or the statement by C. Fred Bergsten, director, Institute for International Economics, before the Senate Subcommittee on International Finance and Monetary Policy, June 6, 1984.

which is attributed to the 1981 tax cuts and the improved inflation outlook in the United States.<sup>2</sup> Those who hold this point of view deny that budget deficits cause high interest rates and conclude that reducing budget deficits would not deter continued net capital inflows. In addition, they do not agree that the United States is increasingly dependent on foreign capital or that the reluctance of foreigners to acquire additional U.S. assets threatens to disrupt exchange or domestic credit markets. Part of this sanguine attitude results from a certain interpretation of the balance of payments statistics. This interpretation holds that the increase in net capital inflows has resulted from a reduction in gross capital outflows rather than from an increase in gross capital inflows. They conclude from this interpretation that the United States has not become increasingly dependent on foreign capital.

This article argues that the United States has become increasingly dependent on foreign capital and that this dependence poses risks for the balance and stability of the domestic and world economies. The first section discusses the causes of the rise in net capital inflows, concluding that the large government budget deficit has been a major factor. The second section discusses the two points of view regarding the consequences of the net capital inflow and argues that continued large net capital inflows are likely to pose problems for both the U.S. economy and the world economy. The conclusion from this analysis is that reducing the budget deficit would help reduce dangerous U.S. dependence on foreign capital.

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<sup>2</sup> This point of view has been expressed by supply-side economists and members of the Reagan administration. See, for example, Paul Craig Roberts, "The Strong Dollar: A Sheep in Wolf's Clothing," *Business Week*, March 11, 1985, and the comments by Treasury Secretary James Baker reported in *Daily Report for Executives*, April 15, 1985.

## **Causes of the net capital inflow**

Several explanations have been offered for the large U.S. net capital inflows. Some of these explanations mistake symptoms for causes, however. The ultimate determinants of capital inflows are domestic spending and saving. To see why this is so, it is useful to see how capital flows fit into the overall balance of payments and to develop a framework for analyzing net capital inflows.

### *Capital flows in the balance of payments*

A country's balance of international payments is a summary statement of all transactions between residents of that country and the rest of the world. The balance of payments has three basic components.

The most familiar component is the merchandise balance of trade. A surplus in the merchandise balance of trade occurs when more goods are exported than are imported, and a deficit occurs when more goods are imported than are exported.

The second component is the service account balance, which includes net interest income and other services. Net interest payments are equal to interest payments to foreign investors minus interest receipts of domestic residents on foreign investments. Interest payments are included in the services account since they are viewed as current payment for capital services. The balance on other services is the net sale of insurance, real estate, shipping, and similar tradeable services to the rest of the world. The sum of the services balance

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<sup>3</sup> There is one additional, but small, component to the current account—"remittances, pensions, and other unilateral transfers."

and the merchandise trade balance is the current account balance.<sup>3</sup>

Capital flows are the final component of the balance of payments. International capital flows pertain to exchanges of assets—mostly financial assets—between countries. There are several categories of international capital flows. One category is official capital flows, which consist of changes in the asset holdings of an official agency in at least one country. This type of capital flow often arises as a result of exchange market intervention or accumulation of reserve assets by central banks. All other capital flows involve the exchange of assets by private citizens or firms. These private capital flows include direct investment, securities purchases, and bank flows.

Since all of a country's international transactions must sum to zero, a net capital inflow must offset a deficit or surplus on the current account. A country with a deficit in its current account must finance that deficit by borrowing

abroad—that is, by a net capital inflow.<sup>4</sup> Similarly, a change in the current account balance must be accompanied by an equal but opposite change in the net capital flow.

Most short-run changes in the current account balance result from changes in the merchandise trade balance. Net interest payments change little over short periods, being determined primarily by the size of past capital flows; and flows of other services are smaller and less volatile than merchandise trade flows. Therefore, a change from net capital outflow to large net capital inflow is almost inevitably associated with a surge in merchandise imports or a sharp cutback in merchandise exports.

The United States has experienced such a turnaround in net capital flows in recent years. As shown in Chart 1, the United States had a net capital outflow most of the time from 1960 through 1982. Since 1982, though, the United States has had a growing net capital inflow, which totaled over \$70 billion in 1984. As the chart also shows, the turnaround in net capital flows has been associated with a deterioration in the merchandise trade balance, which has posted large and growing deficits in recent years.

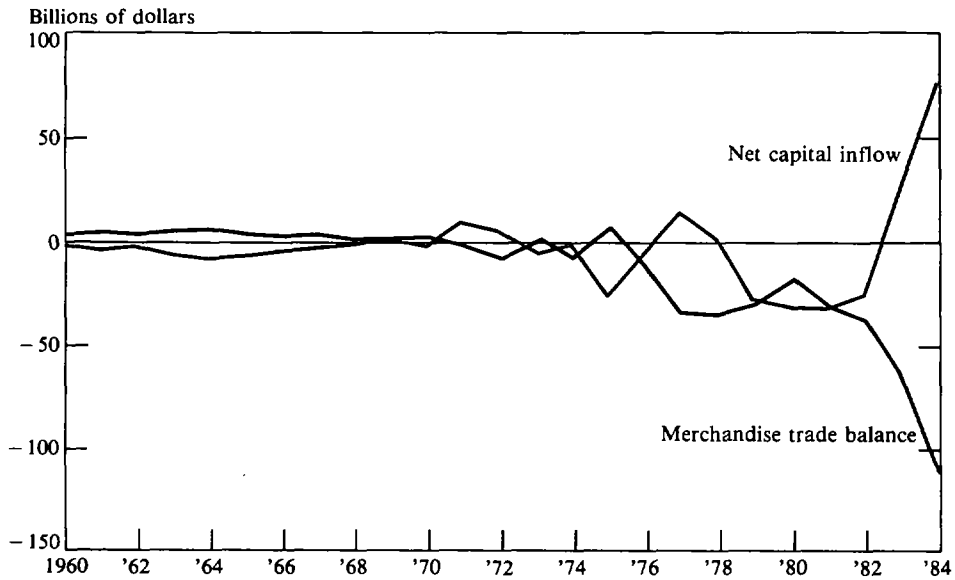
The sources and uses of funds framework shows why the net capital inflow is equal to the difference between domestic uses of funds and domestic sources of funds. Investment spending and the budget deficit are the two domestic uses of funds. Domestic savings and the net capital inflow are the two sources of funds. Therefore, funds to finance investment spending and the budget deficit must come either from domestic savings or from the net capital inflow from abroad. If the domestic uses of funds exceed the domestic sources of funds, the excess must be borrowed from abroad, resulting in a net capital inflow. This relationship can be seen in Equation 1.

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<sup>4</sup> The actual balance of payments accounts are much more complex than suggested by this discussion. However, all of the important conceptual points can be made using the tripartite division of merchandise trade flows, service flows, and capital flows. In the actual balance of payments statistics, measured capital flows need not entirely offset the current account surplus or deficit. Because of measurement problems, there is a large residual category for statistical discrepancy, which amounted to \$24.7 billion in 1984. Although large, the statistical discrepancy does not pose insurmountable problems for analyzing balance of payments changes over time, especially those as large as have occurred in the U.S. balance of payments in recent years. However, all empirical estimates using balance of payments figures are subject to unusually large errors because of the large statistical discrepancy.

The discussion in the text should not be interpreted as implying that current account deficits *cause* net capital inflows. The current account and capital account are jointly determined because both are endogenous variables. According to the portfolio balance approach to international economics, changes in capital flows are if anything causally prior to changes in the current account. Statements in the text that could be interpreted otherwise are used only for expositional ease.

**CHART 1**  
**Net capital inflow and merchandise trade balance**



Source: Board of Governors of the Federal Reserve System

$$(1) \quad NKIN = (G-T) + I-S$$

where NKIN = net capital inflow to the United States,

G = government spending,

T = government tax revenues,

I = domestic private investment spending, and

S = domestic private saving.

The equation shows that a country with a large government budget deficit, good investment prospects, or a low propensity to save will tend to have a net capital inflow. The equation also shows that factors which do not affect

budget deficits, investment, or domestic saving do not affect the capital inflow.

#### *Factors leading to a net capital inflow*

The sources and uses of funds framework can be used to analyze the factors contributing to the increased net capital inflow to the United States. In an integrated world economy, almost everything that happens in the United States and other countries affects U.S. capital flows to some extent. However, three factors have been cited as the principal causes of the increased U.S. net capital inflow. These factors are U.S. government budget deficits, the robust economic expansion of the U.S. economy and associated rapid growth in investment spending by U.S. businesses, and the LDC debt crisis and accompanying desire

of investors for a "safe haven" for their funds.

Many analysts think the large U.S. government budget deficits are the most important cause of the net capital inflow. This view is based in part on the approximate coincidence of increased budget deficits and increased capital inflows. Capital inflows began rising soon after federal government deficits burgeoned.<sup>5</sup> More importantly, though, is the close economic relationship between budget deficits and capital inflows. As shown by Equation 1, if commensurate reductions in investment spending or increases in domestic saving do not accompany higher budget deficits, the deficits will necessarily lead to higher net capital inflow.

The logic behind this relationship is straightforward. Higher budget deficits lead to increased government demand for credit. Unless this increase in borrowing is offset by a reduction in private demand for credit or an increase in private saving, the net capital inflow from abroad must rise. Such a rise in the net capital inflow could be due to increased borrowing from foreigners, reduced foreign lending by domestic investors, or some combination of the two. Regardless of how it is achieved, though, the increased net inflow of capital to the United States in recent years is thought by many to have been due primarily to the unprecedented size of federal budget deficits.

Similarly, these analysts point to budget deficits as the ultimate reason for the sharp deterioration of the U.S. foreign trade balance

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<sup>5</sup> The precise timing of increased capital inflow depends on whether published data or data adjusted for introduction of international banking facilities are used. If official data are used, the net capital inflow did not increase appreciably until 1983. If adjusted data are used, the net capital inflow increased steadily beginning in 1981. A fuller explanation of this point is given below.

in recent years. They argue that increased budget deficits led to increased interest rates to ration the limited credit supply.<sup>6</sup> And higher interest rates in the United States than abroad caused foreign investors to shift funds into U.S. assets, a move that contributed to the sustained rise in the exchange value of the dollar. The strength of the dollar, in turn, was a major factor in the deterioration of the merchandise trade balance. In this way, it is argued, the budget deficit led to massive trade deficits that have accompanied the large net capital inflow.

The robust recovery of the U.S. economy and rapid growth of investment spending in 1983 and 1984 may also have contributed to increased net capital inflows. Economic growth and investment spending in the United States have been very strong, especially when compared with European economies. As a result, private credit demands have increased more in the United States than in most other countries, contributing to higher U.S. interest rates that have encouraged the inflow of foreign capital and discouraged the outflow of domestic capital. Moreover, some argue that the relative strength of the U.S. economic expansion has improved the long-run prospects for a healthy U.S. economy, especially because robust economic growth has been

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<sup>6</sup> This argument assumes that an increase in the budget deficit leads to an increase in the real interest rate. There are some who do not believe that such a link exists. For support, they refer to a study published by the U.S. Treasury Department, "The Effects of Deficits on Prices of Financial Assets," January 1984. The argument is that an increase in the budget deficit implies an increase in future taxes, so that savings rise by an equal amount, with no change in interest rates. However, there are also many economists who believe that an increase in the budget deficit does lead to a higher interest rate. For evidence in support of this proposition, see Michael Hutchison and David Pyle, "The Real Interest Rate/Budget Deficit Link: International Evidence, 1973-82," *Economic Review*, Federal Reserve Bank of San Francisco, Fall 1984, pp. 26-35.

achieved without a reacceleration of inflation. If so, both foreign and domestic investors may have become more inclined to buy U.S. assets, thereby contributing to the increased net capital inflow.

There is no consensus on why the economy and investment spending have grown so rapidly. Supply-side economists and some members of the Reagan administration attribute most of the improved economic performance to the favorable supply-side effects of the 1981 tax cuts. By providing incentives for investment, saving, and work, they argue, the tax cuts led to a boom in investment, productivity, and economic activity. In contrast, other analysts say the primary effects of the 1981 tax cuts were through traditional demand stimulus channels. While admitting that the large business tax cuts increased the profitability of real investment, these analysts attribute most of the rapid economic growth in 1983 and 1984 to the large fiscal stimulus resulting from the reduction in taxes that was not offset by a commensurate reduction in government spending. To the extent that this explanation is correct, part of the contribution of rapid economic and investment growth to the net capital inflow is an indirect effect of increased budget deficits.

Some think the LDC debt crisis contributed to the net capital inflow to the United States. As investors became concerned about the ability of LDC debtors to service their foreign debt, they shifted funds to the United States to guard against capital controls and other financial disruptions. Together with increased political instability in Europe, the financial difficulties of LDC debtors made the United States' reputation as a safe haven for investments more important in investors' portfolio decisions.

Banks in the United States substantially reduced their lending to LDC's after the Mexi-

can debt crisis in 1982. Some analysts claim that the cutback in U.S. bank lending to LDC's has been a major factor in reducing capital outflows from the United States and that the capital flight from Latin America and other areas in search of a safe haven for investments has been a major factor increasing capital inflows to the United States.

The importance of the LDC debt crisis as a cause of the U.S. net capital inflow is questionable, however. Although the financial difficulties of LDC's caused an increase in the net capital inflow to the United States from those countries, the increased flow of funds from LDC's could have been lent to other countries were it not for the deficiency of domestic sources of funds in the United States in the face of rapidly growing credit demands. Since net capital inflows are determined by domestic spending and saving decisions, the LDC debt crisis is a cause of U.S. net capital inflows only to the extent that it lowered U.S. saving or increased U.S. investment and budget deficits. For example, the LDC debt crisis may have stimulated investment or lowered saving in the United States by keeping U.S. interest rates lower than they might otherwise have been. But the size of this effect may well have been small. Therefore, the most significant effect of the LDC debt crisis on U.S. capital inflows has probably been on the channels through which that inflow occurred and the accompanying interest rates rather than on the size of the inflow itself. In short, given the deficiency of domestic saving compared with investment and budget deficits, the United States would have had to attract capital from other countries if not from LDC's. For that reason, neither the LDC debt crisis nor the view of the United States as a safe haven for investment has likely been a major cause of the increase in U.S. net capital inflows.

### *Empirical evidence on causes of net capital inflows*

Several types of empirical evidence can be brought to bear in judging what factors have been most important in causing U.S. net capital inflows. One possible source of evidence is the composition of net capital inflows. Some analysts argue that the causes of the net capital inflow can be inferred from the types of assets foreigners have acquired and the channels through which the funds have flowed. According to this reasoning, for example, the large \$59.3 billion increase between 1980 and 1984 in net flows of funds through banks could be considered evidence that the LDC debt crisis was responsible for much of the increased net capital inflow. Much of the capital transferred from LDC's into U.S. assets may have been deposited in U.S. banks. In addition, U.S. banks reduced their lending to LDC's. Both of these actions contributed to an increase in the net bank flows from LDC's to the United States.

But this kind of evidence is unreliable. Banks, especially those with foreign branches, obtain funds wherever deposits can be found and lend funds wherever creditworthy borrowers can be found. Moreover, banks are financial intermediaries that arbitrage any interest rate differentials. For these reasons, a significant part of any change in capital flows might occur through banks regardless of the ultimate cause of the change. For example, a capital inflow caused by government budget deficits that caused an increase in U.S. interest rates would lead banks to borrow more abroad, where funds are cheaper, and lend more domestically, where loan rates are higher. Therefore, a rise in net capital inflows might be manifested as increased inflows through banks even if the cause of the net capital inflow were higher budget deficits. Similarly,

the relatively small \$20.3 billion increase in direct investment between 1980 and 1984 in the United States is not decisive evidence against the claim that the net capital inflow is due to business tax cuts having improved the profitability of real investment in U.S. businesses. Because credit is fungible, the sources of credit and the channels through which it flows are not reliable evidence regarding the causes of the increased demand for credit.

Another type of evidence is the size of changes in the components of domestic saving and spending. These changes can be analyzed in the framework provided by Equation 1. According to that equation, changes in the net capital inflow from 1980 to 1984 must be equal to the change in government budget deficits and investment spending minus the changes in domestic saving. As shown in Table 1, the U.S. net capital inflow increased \$104.9 billion from 1980 to 1984. Over the same period, the combined budget deficits of all levels of government rose \$92.1 billion, net investment spending rose \$125.8 billion, and net private saving rose \$129.3 billion. The larger rise in investment spending than in budget deficits since 1980 might seem to imply that business tax cuts or the robustness of the U.S. economic expansion have been the most important factors causing the net capital inflow. But this conclusion could be affected by the short-run nature of the comparison. In particular, both investment spending and budget deficits were affected in 1980 by the credit control program and the recession. As a result, comparison of changes in sources and uses of funds from 1980 to 1984 is not a reliable way of evaluating the causes of increased net capital inflows.

A more reliable source of evidence is the deviations of sources and uses of funds from their long-run trends. Comparing the ratios of budget deficits, investment, and saving to

**TABLE 1**  
**Changes in sources and uses of funds, 1980 to 1984**  
 (Billions of dollars)

	<u>Net Capital Inflow</u>	<u>Budget Deficit</u>	<u>Net Investment</u>	<u>Net Private Saving</u>
Change from 1980 to 1984	104.9	92.1	125.8	129.3
Notes: The net capital inflow does not equal the budget deficit plus investment minus savings due to several minor factors. These factors reflect statistical discrepancies and differences between the National Income and Product accounts and the Balance of Payments accounts. The budget deficit is the combined federal, state, and local budget deficits; investment is net private domestic investment; saving is net private domestic saving.				

GNP in recent years with the average ratios in the 1970s sheds light on the factors responsible for the recent scarcity of domestic sources of funds relative to domestic uses of funds. This comparison indicates that the biggest change in recent years has been in the size of budget deficits. Budget deficits averaged only 1.2 percent of GNP in the 1970s. But by 1984, budget deficits had risen to 3.4 percent of GNP. In contrast, the ratios of net investment and net saving to GNP in 1984 were 6.4 percent and 7.4 percent, very close to their average values in the 1970s. Although investment grew rapidly in 1983 and 1984, it started from a very low base. As a result, net investment had only returned to a normal level by 1984. Moreover, the rapid investment growth may have come to an end. Projections based on recent data suggest that business spending on plant and equipment as well as spending on housing will increase only modestly in 1985. This projected dissipation of growth in investment spending conforms with analysis indicating that the effects of the 1981 business tax cuts would have only a temporary stimulative impact on investment spending.<sup>7</sup> Overall,

<sup>7</sup> See, for example, John Makin and Raymond Sauer, "Effects of Debt Accumulation on Capital Formation," American Enterprise Institute, 1984.

then, comparison of sources and uses of funds in recent years with historical values suggests that increased budget deficits have been an important—perhaps even the predominant—cause of net capital inflows in recent years.

The conclusion that budget deficits are an important cause of the net capital inflow is confirmed by evidence from an econometric model. The staff at the Federal Reserve's Board of Governors has developed a model of international economic relationships. The model is called the multicountry model (MCM) because it includes models of both the U.S. economy and other major economies. Simulations of the model have been conducted to determine the effect of U.S. budget deficits on the U.S. current account balance.<sup>8</sup> Since changes in the current account balance must be

<sup>8</sup> Gilles Oudiz and Jeffrey Sachs, "Macroeconomic Policy Coordination Among the Industrial Economies," *Brookings Papers on Economic Activity*, 1984:1, pp. 1-64. Sachs and Oudiz simulate the effect of a fiscal expansion on the current account, using the MCM model. They find, for example, that a \$100 billion fiscal expansion leads to a \$47 billion worsening of the current account. Peter Hooper, "International Repercussions of the U.S. Budget Deficit," Board of Governors International Finance Discussion Paper No. 246, September 1984, estimates the effect of recent fiscal policy actions on the budget deficit and the current account, also using the MCM model. He finds that such actions worsened the budget deficit by \$65 billion and the current account by \$30 billion. These estimates imply that 46



reflected in changes in net capital inflows, these simulations can be used to estimate how much increased budget deficits have contributed to the rise in the net capital inflow in recent years. According to the simulations, the increase in federal budget deficits from \$61.2 billion in 1980 to \$175.8 billion in 1984 would lead to an increase of more than \$50 billion in net capital inflows. Since the actual increase in net capital inflows from 1980 to 1984 was \$104.9 billion, the estimates from the MCM suggest that about half of the total increase in net capital inflows has been due to higher federal budget deficits. According to the MCM, therefore, large and growing budget deficits have been an important cause of the U.S. net capital inflow.

### **Consequences of continued net capital inflows**

Net capital inflows to the United States are widely expected to continue for some time. For example, Data Resources Incorporated predictions through 2010 project a current account deficit and associated capital inflow throughout the period. Some have argued that this net capital inflow does not pose any serious problems since it has been and will continue to be due to a decrease in gross outflows rather than an increase in gross inflows. Others, however, believe that a continued net capital inflow poses serious problems. This section investigates both of these arguments.

#### *Does the composition of the net capital inflow matter?*

According to economic theory, the composition of a net capital inflow is largely unimportant.

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percent of the higher budget deficit is reflected in an increase in current account deficits.

ant. The theory of international portfolio balance holds that interest rates, exchange rates, and other important economic variables depend on net asset demands—that is, on the difference between the demands for assets denominated in a particular currency and liabilities denominated in that currency.<sup>9</sup> Accordingly, an increase in gross capital inflows to the United States, which results in an increase in foreign holdings of dollar assets, has the same aggregate effects as a reduction in gross capital outflows from the United States, which results in a reduction in dollar liabilities by foreigners. Since both increase the net dollar assets of foreigners, it is not necessary to know the composition of an increase in net capital inflows to the United States to predict their overall impact.

Based on this economic theory, the composition of net capital inflows has little if any effect on the price and quantity of credit to foreigners. If the net capital inflow is due to increased lending by foreigners to U.S. residents, the net capital inflow literally drains capital from abroad. If the net capital inflow is due to a reduction in U.S. lending abroad, the supplement to foreign domestic saving available to foreign borrowers is being reduced. Whether this is characterized as a drain on foreign capital or not, the important point is that reduction of U.S. lending abroad reduces the amount of credit available to foreign borrowers

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<sup>9</sup> See, for example, William Branson and Dale Henderson, "The Specification and Influence of Asset Prices," in Ronald Jones and Peter Kenen, editors, *Handbook of International Economics*. Volume 2, North Holland, New York, 1985.

Strictly speaking, the balance of payments accounts record the increase in foreign claims against the United States (the gross inflow) and the increase in U.S. claims against foreigners (the gross outflow), which is not quite the same as an increase in dollar-denominated assets or liabilities. For simplicity, though, this distinction is not made in the remainder of this article.

by the same amount as an increase in U.S. borrowing abroad.<sup>10</sup>

Because increased net capital inflows to the United States imply less capital available for foreign borrowers, regardless of the composition of the increased net capital inflow, foreign interest rates must be higher than otherwise to ration the reduced supply of loanable funds. Therefore, an increase in net capital inflows to the United States inevitably reduces the availability of credit to foreign borrowers and increases the interest rate they pay, regardless of the composition of the net capital inflow.

Nor does the composition of a net capital inflow substantially alter the possibility of portfolio saturation, which might cause a precipitous decline in the value of the dollar. If the net capital inflow is due primarily to an increase in gross inflows, foreign investors could decide at some point to stop acquiring dollar assets or even to liquidate their current holdings. Such a decision would presumably be based on a judgment that their portfolios were becoming too risky because they were too heavily tilted toward dollar assets. Diversifying portfolios by including assets denominated in different currencies reduces risk from exchange rate changes and other economic developments that have differential effects on the value of the

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<sup>10</sup> A physical analogy helps demonstrate this equivalence. Imagine a situation in which the amount of water in a bathtub is in "equilibrium" at 100 gallons, with 2 gallons being added and 2 gallons being drained each hour. The amount of water in the bathtub can be reduced 1 gallon an hour either by increasing the outflow of water by 1 gallon an hour or by reducing the inflow of water by the same rate. If the amount of water in the bathtub is considered to be the funds available to foreign borrowers, an increase in the capital outflow from abroad—that is, increased gross capital inflows to the United States—has the same effect as a reduction in the capital inflow from the United States—that is, lower gross capital outflows from the United States. For the same reason that only the difference between inflows and outflows matters in determining the change in the water level in the tub, only the difference between gross capital inflows and gross capital outflows matters in determining the amount of credit available to foreign borrowers.

assets. If there is diminishing marginal risk reduction from continuing to build up dollar assets in a portfolio, investors would become increasingly reluctant to acquire dollar assets as their percentage of the total portfolio increase. In this situation, relatively small changes in expected yields on dollar assets—brought about, for example, by changes in exchange rate expectations—could lead to very large reductions in desired dollar holdings. The resulting liquidation of dollar assets by foreign investors could cause a sharp decline in the exchange value of the dollar. Therefore, an increase in capital inflows can result in portfolio saturation that could increase the risk of a precipitous decline in the dollar.

Analogous reasoning suggests that a reduction in gross capital outflows may pose similar risks. A reduction in gross outflows increases the proportion of dollar assets in the portfolios of U.S. residents. Like foreigners, domestic residents can reduce risk by holding a diversified portfolio containing both dollar and non-dollar assets. Although U.S. residents may be less sensitive to expected exchange rate movements, if they too become increasingly reluctant to continue acquiring dollar assets, liquidation of those assets could also disrupt foreign exchange markets and domestic credit markets.

The real world is far more complicated than economic theory suggests. Capital markets are not frictionless; some investors are liquidity-constrained; and domestic investors may evaluate risks differently or have different information available than do foreign investors. For these reasons, the composition of a net capital inflow may have some aggregate effects. But these effects are presumably minor, especially if the net capital inflow results from important changes in both gross outflows and gross inflows.

This leads to the second question regarding the sanguine attitude about increased net capi-

tal inflow—the extent to which it has been due to reduced gross outflows rather than increased gross inflows of private capital.

### *Composition of the net capital inflow*

Those who deny the United States has become more dependent on foreign capital have focused primarily on the published balance of payments statistics from 1981 to 1984. According to those statistics, private capital inflows increased only \$18 billion from 1981 to 1984, while private capital outflows declined \$89 billion. It appears from these figures that the increased net capital inflow was due almost entirely to a cutback in foreign lending rather than to an increase in borrowing from abroad.

A very different picture emerges, however, when 1980 is used as the first year in the comparison. Private capital outflows declined \$60 billion from 1980 to 1984, only slightly larger than the increased private inflows of \$51 billion. This comparison suggests that the increased net capital inflow has been due in almost equal measure to reductions in foreign lending and increases in foreign borrowing. A similar conclusion is suggested by other comparisons that do not use 1981 as the base year.<sup>11</sup> Thus, the claim that the growing trade deficit has been financed without significantly greater dependence on foreign capital appears to be very sensitive to the choice of the period used.

Closer examination of the data suggests that capital flows in 1981 and 1982 were aberrations from the underlying trends. Private capital outflows jumped \$28 billion in 1981 and increased another \$7 billion in 1982 before

declining sharply in the last two years. Similarly, private capital inflows jumped \$34 billion in 1981, increased an additional \$16 billion in 1982, and then leveled off on balance in the last two years.

The seemingly incongruous capital flow statistics in 1981 and 1982 may well result from aberrations caused by the introduction of international banking facilities (IBF's) in late 1981. Until then, U.S. banks had conducted much of their international business from offshore branches to avoid the competitive disadvantage of regulations that applied to domestic branches. In response, Congress authorized banks to establish IBF's in the United States to conduct international business on the same basis as U.S. branches of foreign banks. As a consequence, U.S. banks shifted both assets and liabilities from banking offices abroad to domestic offices. This had the effect of raising both reported capital outflows and reported capital inflows substantially in 1981 and 1982. It has been estimated that the introduction of IBF's inflated capital outflows and capital inflows by an average of \$58 billion in 1981 and 1982.<sup>12</sup> Although admittedly imprecise, these estimates suggest that the official statistics on capital flows in 1981 and 1982 are so contaminated that use of either year as the base for evaluating the extent of increased dependence on foreign capital can be very misleading. For this reason, the comparisons that do not use 1981 or 1982 as the base—such as those comparing 1984 with 1980—are much more indicative of the trends regarding dependence on capital flows.<sup>13</sup> These comparisons

<sup>11</sup> For example, comparison of the averages for 1977-80 to the averages for 1981-84 also indicates that the increased net capital inflow in recent years has been about equally divided between a reduction in gross outflows and an increase in gross inflows.

<sup>12</sup> Lois Stekler and Peter Isard, "U.S. International Capital Flows and the Dollar: Recent Developments and Concerns." *Brookings Papers on Economic Activity*, forthcoming.

<sup>13</sup> Moreover, using a 1980 base for computing the growing dependence on foreign capital allows an evaluation of the effects of the 1981 tax cuts, which are commonly thought to have been a major factor contributing to the net capital inflows.

indicate that the United States has indeed become increasingly dependent on foreign capital in recent years.

### *Consequences of continued net capital inflows*

If continued, large net capital inflows could have several adverse consequences. Among the most important are a reduction in future living standards, a drain of capital needed abroad, and the increased likelihood of disruptions to foreign exchange and domestic credit markets.

Large and sustained net capital inflows threaten to lower future living standards in the United States. A large buildup of foreign net dollar claims implies large future net interest payments to foreigners. To meet these interest obligations, the United States will have to export more goods and services than it imports. As a result, less will be available for domestic consumption, and the average living standard of U.S. residents will be lower than it otherwise would be.

This would not be the case, though, if the capital inflows were being used primarily to finance productive investment in the United States, as was true during much of the 19th century, when the United States borrowed from abroad to finance the building of railroads and other productive capacity. In that case, the increased future production would more than offset the higher future interest obligations, allowing increased living standards. As discussed in the preceding section, though, the predominant reason for the large capital inflows in recent years has been the increase in the federal budget deficit.

Because the high budget deficits have not been associated with investment spending that is high by historical standards, the accompanying net capital inflows represent borrowing from future consumption possibilities to

finance current consumption. Except for the possibility that the budget deficit has resulted from increased defense spending essential to the survival of future productive capacity, it seems most likely that recent capital inflows have been due to consumption exceeding current productive capacity. Under these circumstances, the United States cannot continue consuming more than it produces. To offset this current imbalance, U.S. residents will have to produce more in the future than they consume, and "pay" the remainder of the nation's domestic output to foreigners as interest on their holdings of dollar assets. In this sense, large net capital inflows are mortgaging the country's economic future, just as previous capital inflows to LDC's from the United States and elsewhere mortgaged their economic futures by leading eventually to a need to curtail consumption to pay the interest on their foreign debt. Mexico's mortgage has come due; the United States' has not. But the ultimate effect of sustained net capital inflows to finance consumption is unavoidable.

Capital inflows also threaten to drain capital from abroad that is needed for productive investment. As pointed out above, a net capital inflow to the United States reduces the quantity of credit available to foreign borrowers, regardless of the composition of that inflow. Currently, such a drain may be relatively innocuous. Because of the slow recovery of European economies from the worldwide recession of 1981-82 and the LDC debt problems that have effectively precluded their borrowing in the last few years, foreign demand for credit to finance productive investment is comparatively low. But as European economies move toward full employment and LDC debtor countries work their way out of their difficulties, foreign demand for credit could rise substantially. If so, world interest rates would rise, increasingly crowding out domestic

and foreign investment. Whereas it used to be thought that budget deficits crowded out only domestic investment, in the current world economy with flexible exchange rates and integrated world capital markets, the crowding out effect of budget deficits is allocated among domestic investment, tradeable goods sectors, and foreign investment.

Continued large net capital inflows also pose the increasing danger of disruptions to exchange and domestic credit markets. Net capital inflows lead to commensurate increases in the net dollar asset holdings of foreigners. Since portfolio decisions depend on net asset positions, continued large net capital inflows could at some point lead to saturation of foreign portfolios with dollar assets.<sup>14</sup> For the same reason, portfolios of U.S. investors could also become saturated with dollar assets because U.S. investors, like foreign investors, prefer to hold portfolios that are diversified between dollar assets and other assets. The desired ratio of dollar assets to nondollar assets is, of course, higher for U.S. residents than for foreigners, and changes in desired holdings may respond somewhat differently to interest rate or exchange rate expectations. But the growing proportion of net dollar claims in both foreign and domestic portfolios could lead to portfolio saturation that poses risk for the smooth functioning of exchange markets and domestic credit markets. Resistance to acquiring more dollar claims could lead to a sharp fall in the exchange value of the dollar and a sharp rise in U.S. interest rates.

Portfolio saturation is, to be sure, a relative rather than an absolute concept. There is no unique amount of dollar claims beyond which

<sup>14</sup> At the end of 1983, U.S. claims on foreigners were \$887 billion and foreign claims on the United States were \$781 billion, for a net asset position of \$106 billion. The net capital inflow in 1984 was \$77 billion, which reduced the net asset position to \$29 billion at the end of 1984. This means that the United States will almost surely become a net debtor in 1985.

investors refuse to acquire more assets. But, as the relative proportion of dollar assets increases, investors become more reluctant to acquire additional dollar assets. They can be induced to buy more only by increasingly higher expected returns, due either to expected capital gains because of expected exchange rate changes or to higher expected real yields on the assets themselves.

However, portfolio saturation would not necessarily lead to gradual and nondisruptive changes in exchange rates and interest rates. Because asset markets are heavily influenced by expectations, asset prices are highly volatile, even without such extraordinary circumstances as rapid growth in net dollar asset positions resulting from large net capital inflows. With such circumstances, the effects of changes in expectations could be magnified. Moreover, increasing portfolio saturation could itself lead to changes in expectations about exchange rates and interest rates that would, in effect, become a self-fulfilling prophecy. To the extent that either of these developments occur, continued large net capital inflows increase the risk of a precipitous decline in the dollar, accompanied by a sharp increase in U.S. interest rates, that would disrupt both the domestic and world economies.

In contrast, progress in reducing the federal budget deficit could lead to a gradual decline in interest rates and the exchange rate. Reduction in the budget deficit would alleviate the deficiency of domestic credit supplies relative to domestic credit demands. The consequent relief in pressure on interest rates would reduce the attractiveness of U.S. assets to both foreign and domestic investors, thereby reducing the net capital inflow and the exchange value of the dollar. The decline in the exchange value of the dollar to a more sustainable level would improve the competitiveness of U.S. goods in domestic and international markets. And this

improved competitive position would lower the trade deficit. Therefore, cutting the budget deficit could set in motion forces that would reduce dependence on foreign capital and improve the prospects for sustainable and balanced real growth of the U.S. economy.

### **Conclusion**

The increased net capital inflow and associated growing dependence on foreign capital could pose serious risks for the U.S. and world economies. But policy actions to reduce the dependence on foreign capital are not likely to

be successful unless they treat the root causes of the problem. The fundamental problem stems from the United States consuming more than it produces. Attempting to solve the problem through exchange controls, exchange market intervention, expansionary monetary policy, or increased trade barriers would at most only temporarily obscure the fundamental source of the problem. Empirical evidence implies that high government budget deficits have been a major factor contributing to large U.S. net capital inflows. As a consequence, reducing budget deficits would reduce the troublesome U.S. dependence on foreign capital.