For release on delivery
June 6, 1989
9:00 a.m. E.D.T.

# Foreign Investment and the Economy

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before

Conference Sponsored by
Citizens for a Sound Economy Foundation

Washington, D.C.
June 6, 1989

# Foreign Investment and the Economy

It is a pleasure to be the Keynote speaker at this conference addressing the issue of foreign investment and American competitiveness. This topic has generated much discussion of late, and because international capital flows play such an important role in an increasingly integrated world economy, the subject merits careful examination.

## Concerns about Foreign Investment in the U.S.

Recent years have witnessed an increased presence of foreign investors in transactions involving various forms of U.S. assets. This trend has sparked a number of concerns which undoubtedly will be discussed at today's conference. For example, some fear has developed over the increased debtor status of the U.S. economy and the implications of growing foreign ownership of domestic companies and real estate.

Certain analysts argue that such increased foreign investment and ownership will mortgage our future since the obligation of interest payments abroad will generate an impossible burden. Also, there seems to be a growing fear that increased indebtedness to foreigners will cause Americans to lose control of their own destiny.

Finally, the argument has been made that recent capital inflows are the result of budget-deficit-induced interest rate increases. Because such capital inflows bring about dollar appreciation, they "crowd out" exports and encourage imports, thereby increasing existing trade deficits. And since they help finance wasteful government spending that yields little or no return on investment, they pose future debt service problems.

Some Evidence

Before addressing these concerns, however, a brief review of some statistical facts is in order. These data suggest that while foreign investment has increased

in recent years, and is sizable particularly in nominal terms, it is still not large compared to the scale of the U.S. economy. Moreover, foreign presence in the U.S. economy remains well below that in most other western industrial economies.

For example, total foreign holdings of U.S. assets amounted to about $1.7 trillion or 12 percent of all U.S. net wealth at the end of 1988, up from 5 percent in 1980. This increase reflects the continuing internationalization of world financial markets; U.S. claims on foreigners have also increased significantly during the same period. It is noteworthy that approximately one-third of these foreign-owned assets in the U.S. are the liabilities of banks which are approximately matched by bank claims on foreigners and reflect the role of banks located in the U.S. in international financial intermediation.

As part of these overall figures, foreign direct investment, defined as 10 percent or more ownership of business enterprise or real estate property, has also increased. However, the ratio of the foreign direct investment stock to fixed capital in the U.S. is only about 3 percent. Similarly, the share of foreign affiliates in assets of U.S. manufacturing corporations is about 9 1/2 percent and the share of foreign affiliates in total U.S. employment is less than 3 percent. Also, the relative proportion of direct foreign investment in the U.S. is currently only about half that in the typical large European country. Similarly, foreigners own only a negligible amount of U.S. farmland: recent estimates put foreign ownership at less than 1 percent of all agricultural land.

Foreign portfolio holdings of corporate stocks (excluding direct investment) and bonds as well as government securities are also relatively modest. In fact, the percentage of foreign ownership of outstanding U.S. public debt is actually lower today than in the late 1970s.

In summary, the statistical facts suggest that the relative overall portion of foreign investment in various investment categories remains at low levels. Interestingly, while foreign direct investment in the U.S. has increased, the U.S. remains the largest single direct foreign investor on a worldwide basis. Accordingly, the U.S. still receives more payments from foreigners abroad than it pays to foreign investors.

## Goals of Macropolicy

Before considering the economic implications and policy responses to foreign investment, it is important to first establish the principal goals of macropolicy.

In my view, the facilitation of noninflationary economic growth should be the preeminent goal of U.S. macroeconomic policy. The achievement of this goal fosters higher living standards for all of our citizens and ultimately provides resources with which to address most other problems we face.

In formulating specific policies that allow for noninflationary growth, one economic principle cannot be ignored: economic growth and development depends on the growth of both productive capital and productive labor. Thus, policies that foster economic growth necessarily foster capital investment. Additional capital induces higher productivity, which not only results in faster economic growth but provides for noninflationary wage increases and thereby higher living standards for workers.

The generation of capital, of course, depends on sound economic policies. Such policies should nurture an environment which spawns productive investment; this

requires attractive returns to private capital. To the extent that these policies produce relatively higher returns to capital in the U.S., they should stimulate the growth of internal savings and investment, and should also attract foreign savings and investment.

Macroeconomic policies designed to improve capital productivity include fiscal (tax and spending) policies to raise after-tax rates of return. Minimizing taxation on productive investment including capital gains, personal savings and corporate dividends is particularly pertinent in this regard. Reducing government borrowing by cutting unproductive government spending would also work to increase returns to private capital by channeling savings to the private sector. Credible monetary policies designed to produce both stable prices and expectations of stable prices help minimize risk and uncertainty and encourage long-lived investment. Similarly, policies that remove or reduce unnecessary regulatory burdens can also yield higher returns

to capital. Finally, policies maintaining or promoting open markets for goods, services, capital, and labor also work to make the overall economy more productive and efficient.

Given well-integrated world capital markets, a country that pursues sound economic policies relative to the rest of the world and maintains a stable political environment normally experiences capital inflows. Capital will generally flee restrictive, high tax, unsafe economies and migrate to soundly managed economies. Foreign investors, just like domestic investors, will invest where growth prospects are good. In this sense, foreign investment is consistent with relatively sound economic policy and hence is often a sign of a safe and productive economic environment.

Economic Effects of Foreign Investment

As just suggested, foreign investment can play a role in achieving the overall goals of macroeconomic policy if it contributes to improving economic growth. But let me be more specific about how this occurs. First, all economists agree that if a capital inflow is voluntary, the result of unfettered private exchange where foreigners are seeking the best place to invest and U.S. borrowers are seeking the best source of funds, higher living standards will accrue to both borrower and lender and increased macroeconomic efficiency will result. Foreign investment, after all, is in effect a form of economic integration which yields gains in efficiency.

Second, and more obviously, foreign investment increases the amount of available productive capital in the U.S. economy. As a result of the capital inflow over the

past eight years or so the stock of productive capital in the U.S. is significantly larger than it would have otherwise been.

This increased capital stock produces a number of macroeconomic benefits. Interest rates, for example, are lower than they otherwise would be. Consequently, more productive private domestic investment takes place, or from another perspective, less crowding out occurs than might otherwise be the case with a given federal budget deficit. Such enhanced private investment is often associated with more innovation and new technological advancement. This additional capital stock normally produces higher labor productivity which works to directly benefit American citizens. Higher productivity usually leads not only to additional jobs, but also to greater noninflationary wages and thereby better living standards for most U.S. workers. Increased productivity can also contribute to lower prices and hence higher living standards for U.S. consumers.

The overall benefits from foreign investment outlined here will come as no surprise to any well-read student of American economic history. The U.S. and its predecessor thirteen colonies, after all, offered almost unlimited investment opportunities and a capital inflow for most of the 300 years from Jamestown to World War I. Foreign investors provided substantial portions of the capital necessary for the growth of the U.S. economy during that period. And so it is no exaggeration to say that economic growth in America has been bolstered for hundreds of years by foreign capital investment.

Finally, while foreign investment does work to facilitate trade in goods and services, thereby helping to maintain an open economy, it can nonetheless bring about exchange rate appreciation that restrains exports and alters the composition of output. Also, if foreign capital is borrowed to finance wasteful government consumption, future problems related to servicing such debt could develop.

An Appropriate Policy Posture

In light of this discussion, what should be the policy stance of the U.S. with regard to foreign investment? Foreign investment clearly plays an important role in an overall macroeconomic policy oriented toward promoting economic growth. And the desirable process of economic integration necessarily entails openness and more exchange of goods, services, and securities with foreigners. Economic integration, after all, is the process of becoming a single, unified market. Accordingly, the location or residence of particular participants becomes less and less relevant. Also, we should remember that U.S. residents have the largest single direct investment position overseas.

Appropriate U.S. policies should foster the productive environment that generates domestic investment as well as sometimes attracts investment from foreign sources. Such policies ensure healthy returns to capital by keeping tax rates and regulatory burdens low, by promoting

stable prices, and by resisting those types of government spending that tend to crowd out private economic activity. Also reductions in budget deficits by constraining government spending will help to ensure that capital inflows do finance productive investment.

In circumstances where U.S. policies are relatively more attractive than those abroad, foreign investment often represents a vote of confidence in the health, safety, and productivity of the economy.

Approaches that encourage all countries of the world to pursue equally sound policies would work not only to benefit every country but also to minimize potentially disruptive exchange rate movements. Accordingly, coordinated action to encourage investment while promoting price and exchange rate stability appears desirable for all participants.

Inappropriate Policy

Policies that deliberately prohibit or restrict foreign investment are potentially very dangerous. Attempts to curtail foreign investment could cause the exchange rate to decline sharply and interest rates to increase, thereby crowding out private investment. The capital stock would be lower than otherwise. Productivity would be adversely affected and economic growth and all of its associated benefits would be reduced.

Such action would also encourage retaliation abroad. Because the U.S. has substantial foreign investments overseas, American businesses could be adversely affected. And if carried far enough, these policies could threaten world trading arrangements by promoting an environment fostering protectionism.

Conclusion

In conclusion, we should remember that our country was founded on the free enterprise system premised on competition and open markets. And historically, foreign investment has played a major role in fostering American economic development.

This economic system, which welcomes foreign investment, has created more opportunity and substantially higher living standards for more people than any economic system in human history.

And as you look around the world today, the notion of more open markets has become an integral part of the ideas sweeping the globe today. As a principal proponent of these ideas, the U.S. has played an important role in this process. If we are to maintain this leading role, restrictions or prohibitions on foreign investment should play no part in U.S. economic policy.