

Panel Discussion on Challenges for U.S. Businesses

Growing Global 2004
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I am pleased to be here today to participate in the *Growing Global 2004* program. The World Trade Center Saint Louis serves an important function in promoting the development of international business in our region.

As with most economists, I am a strong advocate of freer international trade. Why does trade matter and why is the World Trade Center St. Louis important? Trade provides the incentives for efficient allocation of resources internationally and is a key feature of an environment that encourages economic growth.

I'll focus my remarks on the aggregate balance of payments position of the United States. In discussing trade, it is useful to consider the broad concept of the current account, which includes current earnings on capital as well as trade in goods and services. A corresponding account on the other side of the ledger, known as the "capital and financial account," measures flows of capital assets internationally. Putting aside errors and omissions in the data, a current account deficit is necessarily equal to a capital account surplus. A country in this position—like the U.S. today—is exporting more capital claims than it is importing. My principal theme is that a capital account surplus is evidence of economic strength.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis, especially Michael R. Pakko, senior economist in the

Research Division, for their assistance, but I retain full responsibility for errors.

TRADE FLOWS AND CAPITAL FLOWS

A country's current and capital accounts are clearly very closely related. The flows of goods, services and income flows on capital that comprise the current account tell only part of the story of a country's international economic relations. I'm going to concentrate on the capital account because that part of the international economic story is commonly neglected.

It is a mistake to treat international capital flows, as many do, as though they are passively responding to what is happening in the current account. The trade deficit, some say, is "financed" by U.S. borrowing abroad. In fact, investors abroad buy U.S. assets not for the purpose of financing the U.S. trade deficit but because they believe these are sound investments promising a good combination of safety and return. Many of these investments have nothing whatsoever to do with borrowing in the conventional meaning of the word, but instead involve purchases of land, businesses, and common stock in the United States. Foreign auto companies, for example, have purchased land and built manufacturing plants in the United States. These simple examples should make clear that a careful analysis of the nature of international capital flows is necessary before offering judgments about the U.S. external imbalance.

As trade and commerce around the world have grown increasingly integrated—the process often referred to as “globalization”—the growth of cross-border financial flows has become particularly prominent. Since 1990, foreign-owned U.S. assets increased from less than \$2.5 trillion to approximately \$10 trillion at the end of 2003—a fourfold increase. Capital flows are not a one-way street, however—over the same period, U.S. ownership of foreign assets has increased from \$2.3 trillion to nearly \$7.9 trillion.¹

These figures document a negative net international investment position for the United States, amounting to about \$2.7 trillion at the end of 2003 when valuing direct investment at market value. This negative net international investment position has been a source of consternation among those who see the globalization of financial markets as a worrisome phenomenon. I am much more sanguine about the U.S. international asset position.

THE INTERNATIONAL FINANCIAL MARKETS VIEW

In today’s world, with electronic funds transfers, financial derivatives, and largely unrestricted capital flows, investors have a global marketplace in which to seek profitable returns and diversify risk. In such an environment, we should consider the possibility that aggregate patterns of international trade flows may simply be the by-product of a process through which financial resources are seeking their most efficient allocations in a worldwide capital market. That is, instead of thinking that capital flows are financing the current account deficit, it may well be that the trade deficit is driven by—is financing, so to speak—capital flows determined by investors seeking the best combination of risk and return in the international capital market.

While such a conclusion is surely an overstatement, because capital and trade flows are

jointly determined, it is worth emphasizing that capital flows are a highly dynamic feature of the world economy. Changes in investor attitudes and expectations can alter capital flows quickly and force changes in the trade account. From this perspective, capital account adjustment can play an important independent role that is determined by the motivations of both foreign and domestic investors. In particular, we can think of capital flows as the equilibrium outcome of investors worldwide seeking to acquire portfolios that balance risk and return through diversification.

The globalization of financial markets—spurred by technological advances and liberalization of capital flow restrictions worldwide—has created entirely new investment opportunities for investors in both the United States and abroad. These new opportunities have undoubtedly given rise to a re-balancing of portfolios, and there are reasons to believe that this process might be associated with a net export of claims on U.S. assets—a capital account surplus.

U.S. financial markets are among the most highly developed in the world, offering efficiency, transparency, and liquidity. Moreover, the U.S. dollar serves as both a medium of exchange and a unit of account in many international transactions. These factors make dollar-denominated claims attractive assets in any international portfolio. No capital market in the world has a combination of strengths superior to that of the United States. Our advantages include the promise of a good return, safety, secure political institutions, liquidity, and an enormous depth of financial expertise.

For some purposes, it is useful to think of U.S. financial markets as serving as a world financial intermediary. Just as a bank, or a mutual fund, channels the savings of many individuals toward productive investments, the U.S. financial markets play a similar role for many investors from around the world. In the process, individuals, companies and governments around the world accumulate dollar-denominated assets to serve

¹ Data are from the Bureau of Economic Analysis, as reported in the U.S. Investment Position tables. Direct investment is measured at market value.

as a vehicle for facilitating transactions and storing liquid wealth safely.

A bank earns a return on its capital by holding assets that have a higher yield than the interest rate it pays to depositors. Similarly, the United States earns a higher return on its investments abroad than foreigners do on their investments in the United States. Despite the fact that the U.S. international investment position has been negative since the late 1980s, U.S. net income on its investments abroad has consistently exceeded income payments on foreign-owned assets in the United States. Examination of the data shows that the average return on U.S. assets abroad consistently exceeds the corresponding average return on foreign holdings of U.S. assets by a full percentage point or more.

How is the United States able to earn a significantly higher return on its assets abroad than foreigners earn on their assets in the United States? Consider currency, which pays a zero return. At the end of 2003, U.S. currency held abroad was estimated to be about \$320 billion, whereas only a trivial amount of foreign currency is held in the United States. Incidentally, it is a remarkable fact that U.S. currency circulating abroad is about half the total U.S. currency outstanding.

More generally, many private and governmental investors abroad rely on the U.S. capital market as the best place to invest in extremely safe and highly liquid securities. Along a spectrum of safety and liquidity, these assets include currency, U.S. government obligations, agency debt, and corporate bonds. U.S. equity markets are also highly liquid. The United States as a whole earns a return from providing these safe

and liquid investments to the world. Indeed, the evident desire of foreigners to hold U.S. Treasury securities is a testament to the confidence that the world has in the safety and soundness of our financial system.

Part of the reason U.S. capital markets have unrivaled strength in the world economy is that U.S. financial institutions provide services of extremely high quality. In the detailed trade accounts, only available through 2002 at this time, we see that the United States has a lopsided trade advantage in financial services. In 2002, U.S. exports of financial services amounted to \$15.9 billion, as against imports of such services of only \$3.7 billion. Another line in the table of trade statistics tells the same story: business, professional, and technical services yielded U.S. export earnings in 2002 of \$28.8 billion as against imports of such services \$10.7 billion. Some of these services, such as legal and accounting services, are closely connected to success in financial services trade.

CONCLUSION

Right here at home, we in the United States benefit tremendously from access to the world's best capital market and financial institutions that provide superb financial services. Others in the world also need access to capital markets and financial services. The United States has created for itself a comparative advantage in these markets, and we should not be surprised that investors all over the world come to buy the product.