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Testimony by

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I am pleased to appear before this committee today to discuss foreign investment in the United States. Over the past decade, foreign investment in the United States has increased dramatically, reflecting both the increased integration of world financial markets and the financial flows that are the necessary counterpart to large U.S. current account deficits. In my testimony today, I would like to put these developments in perspective and analyze their longer-run implications.

Both direct and portfolio investment by foreigners in the United States have soared in the past decade. Since 1980 the position of foreign direct investors in the United States has increased by 300 percent. Private foreign holdings of U.S. Treasury securities have increased 500 percent and holdings of equities have increased 200 percent. Holdings of corporate and U.S. government agency bonds also have grown rapidly, as have liabilities of banks in the United States to foreigners; growth of the latter was spurred by regulatory changes in late 1981 that permitted the creation of International Banking Facilities.

These statistics on foreign investments in the United States tell only part of the story of increased foreign participation in U.S. financial markets. Foreign-based financial intermediaries play an increasingly prominent role in U.S. banking and securities markets. The volume of transactions by foreigners in U.S. securities markets has increased even more dramatically than foreign holdings. For example, foreign purchases and sales of U.S. Treasury securities surpassed \$3 trillion on a gross basis in 1988, up from \$100 billion to \$200

billion earlier in the decade. Similarly, foreign purchases and sales of U.S. corporate stocks and bonds also have been running dramatically above levels earlier in the decade, although they are off from their peak levels of a couple of years ago.

U.S. investment abroad also has grown in the 1980s, but not as rapidly as foreign investment in the United States. Although the position of U.S. direct investors abroad as measured by book value increased by about 50 percent between the end of 1980 and the end of 1988, the book value of foreign direct investment in the United States rose from much lower levels to about the same total -- \$325 billion as of the end of 1988. However, the market value of U.S. direct investments abroad, which have accumulated over many years, undoubtedly still exceeds the market value of foreign direct investments in the United States by a substantial margin. U.S. holdings of foreign stocks and bonds also have grown in the 1980s, as have the activities abroad of U.S. financial intermediaries.

This surge in cross-border financial transactions has paralleled a large advance in the magnitude of cross-border trade of goods and services. A key factor behind these trends in international trade and securities transactions is a process that I have described elsewhere as the "downsizing of economic output." The creation of economic value has shifted increasingly toward conceptual values with decidedly less reliance on physical volumes. Today, for example, major new insights have led to thin fiber optics replacing vast tonnages of copper in communications. Financial transactions historically buttressed with reams of

paper are being progressively reduced to electronic charges. Such advances not only reduce the amount of human physical effort required in making and completing financial transactions across national borders but facilitate more accuracy, speed and ease in execution.

Underlying this process has been quantum advances in technology, spurred by economic forces. In recent years, the explosive growth in information-gathering and processing techniques has greatly extended our analytic capabilities of substituting ideas for physical volume. The purpose of production of economic value will not change. It will continue to serve human needs and values. But the form of output increasingly will be less tangible and hence more easily traded across international borders. It should not come as a surprise therefore that in recent decades the growth in world trade has far outstripped the growth in domestic demand. As a necessary consequence, imports as a share of output on average have risen significantly. Since irreversible conceptual gains are propelling the downsizing process, these trends almost surely will continue into the twenty-first century and beyond.

New technology -- especially computer and telecommunications technology -- is boosting gross financial transactions across national borders at an even faster pace than the net transactions supporting the increase in trade in goods and services. Rapidly expanding data processing capabilities and virtually instantaneous information transmission are facilitating the development of a broad spectrum of complex financial

instruments that can be tailored to the hedging, funding, and investment needs of a growing array of market participants. These types of instruments were simply not feasible a decade or two ago. Some of this activity has involved an unbundling of financial risk to meet the increasingly specialized risk management requirements of market participants. Exchange rate and interest rate swaps, together with financial futures and options, have become important means by which currency and interest rate risks are shifted to those more willing to take them on. The proliferation of financial instruments, in turn, implies an increasing number of arbitrage opportunities, which tend to boost further the volume of gross financial transactions in relation to output. Moreover, these technological advances and innovations have reduced the costs of managing operations around the globe, and have facilitated direct, as well as portfolio, investment.

Portfolio considerations also are playing an important role in the globalization of securities markets. As the welfare of people in the United States and abroad becomes increasingly dependent on the performance of foreign economies, it is natural for both individual investors and institutions to raise the share of foreign securities in investment portfolios. Such diversification provides investors a means of protecting against both the depreciation of the local currency on foreign exchange markets and the domestic economic disturbances affecting asset values on local markets. As international trade continues to expand more rapidly than global output, and domestic economies

become even more closely linked to those abroad, the objective of diversifying portfolios of international securities will become increasingly important. Moreover, since the U.S. dollar is still the key international currency, such diversification has been, and may continue to be, disproportionately into assets denominated in the dollar.

Another factor facilitating the globalization of capital markets and the growth of foreign investments in the United States has been deregulation. Technological change and innovations that have tied international economies more closely together have increased opportunities for arbitrage around domestic regulations, controls, and taxes, undermining the effectiveness of these policies. Many governments have responded by dismantling domestic regulations designed to allocate credit and by removing controls on international capital flows, relying more heavily instead on market forces to allocate capital. An additional factor contributing to an increase in Japanese gross investments abroad may have been the rise in stock and land prices in Japan that has been leveraged to finance these increased investments.

The 1980s were marked not just by the expansion of gross capital flows in and out of the United States but also by very large net capital inflows. As I noted earlier, foreign investment in the United States has grown faster than U.S. investment abroad. During the decade of the 1980s, the U.S. net international investment position, as published by the Department of Commerce, fell sharply from a positive \$141 billion at the end

of 1981 to a negative \$533 billion by the end of 1988. However, these numbers should not be viewed as precise measures of U.S. net international indebtedness. Because of valuation problems in the U.S. international transactions accounts, the measurement of U.S. indebtedness could be overstated by several hundred billion dollars. Much of this overstatement is the result of the inclusion of direct investment assets in the data at book rather than market value. Nonetheless, while the precise level of our net investment position is uncertain, the direction and magnitude of recent changes are clear. They are the consequence of our large current account deficits.

The growing U.S. net international indebtedness and our large current account deficits are two sides of the same coin. Over the past decade the United States bought more goods and services from the rest of the world than it sold and has paid for the difference, in essence, by borrowing from, and selling assets to, foreigners. The U.S. current account moved from approximate balance in the early 1980s to a deficit of more than \$140 billion in 1987. More recently, the deficit has declined, but it remains substantial.

The most important underlying cause of the surge in our net borrowing from foreigners and the deterioration in our external balance has been the substantial decline in our national savings rate against the background of a relatively stable domestic investment rate. As you are well aware, the decline in our savings rate reflected both the expansion of the fiscal deficit, and some downtrend in the U.S. private savings rate.

The fundamental accounting identity between savings and investment, of course, requires that any shortfall of domestic savings below domestic investment be made up in the form of a net inflow of savings from abroad.

It is important to understand just how this link between lower domestic savings and increased inflows from abroad worked in practice. The increased demand for funds to finance both the gaping budget deficit and growing private investment in the face of a declining private savings rate put substantial upward pressure on U.S. interest rates. Higher interest rates made investment in the United States more attractive to foreigners, increased demand for dollars to implement such investments, and, thereby, pushed up the foreign exchange value of the dollar. The higher dollar in turn reduced U.S. international price competitiveness and contributed to the widening of the external deficit. The fiscal stimulus and downtrend in private savings also led to strong growth in U.S. domestic demand, which raised demand for imports and contributed further to the external deficit.

The behavior of U.S. national savings rate during most of the 1980s contrasted with events abroad. Over much of the past decade, other major industrial countries generally were moving fiscal policies toward restraint. In Germany and Japan, especially, government deficits were being reduced, which contributed to their external surpluses and the outflow of financial resources from those countries.

The widening of the U.S. external deficit also was facilitated by the enhanced mobility of capital; the tremendous growth in gross capital flows undoubtedly permitted the emergence of very large net flows. On balance though, the global integration of financial markets was probably only a facilitating factor, not a motivating force, behind the growth and persistence of U.S. net capital inflows.

The progress that has been made in reducing the budget deficit from its earlier peak levels, along with declines in U.S. interest rates and the dollar since the mid 1980s can explain much of the more recent improvement in the external deficit. Nonetheless, we still have a long way to go to establish equilibrium in our international accounts.

The persistence of inadequate domestic savings, large current account deficits, and continued deterioration of the U.S. net international investment position remain matters of serious concern. Current U.S. savings levels are inadequate to finance the domestic investment necessary to provide rising living standards for future generations on the scale enjoyed by previous generations.

The most important contribution Congress can make to remedying this problem is to continue the progress made in recent years in reducing the federal budget deficit. As I have stated here before, the ultimate target should be a budget surplus.

Efforts to limit directly or to discourage the inflow of capital from abroad would aggravate the problem by raising real interest rates in the United States and lowering domestic

investment towards levels consistent with already low domestic savings. Even limited measures affecting only certain capital flows such as direct investment would necessitate larger inflows through other channels which could only be attracted at higher rates of return or with a weaker dollar.

Measures to restrict or discourage foreign investment in the United States would be undesirable for other reasons as well. The United States has benefitted and will continue to benefit from the inevitably closer integration of world markets for goods, services, and capital. As unfolding events in Eastern Europe indicate, countries that attempt to isolate their economies from the rest of the world and do not heed market signals in allocating scarce resources pay a high price in terms of low levels of economic welfare.

The globalization of capital markets offers many benefits in terms of increased competition, reduced costs of financial intermediation benefiting both savers and borrowers, more efficient allocation of capital, and more rapid spread of innovations. However, this internationalization does pose certain risks as well: the United States has become more vulnerable to disturbances originating outside its borders. The Federal Reserve has been actively interested in efforts to limit risks in international payments and settlement systems. In cooperation with authorities in other countries, the Federal Reserve has pressed for improved capital adequacy for banks and other financial intermediaries.

These measures to protect the soundness and integrity of our financial system are necessary regardless of whether the United States is a net debtor or creditor. It should be noted that in the 1970s, when the United States was still a substantial net creditor, unfavorable developments led to repeated episodes of downward pressure on the foreign exchange value of the dollar. Given the vast array of financial products currently available, and the wealth of U.S. residents themselves, the size of net holdings by foreigners of U.S. assets bears little relationship to the magnitude of pressures that can arise in foreign exchange markets.

Concern about foreign investment in the United States tends to focus on direct investment; highly visible purchases, such as Rockefeller Center, Columbia Pictures, and Bloomingdales, have given rise to fears about the selling of America at bargain basement prices. However, little attention is paid to the benefits of direct investment. The operations of multinational companies play an important role in facilitating the growth of world trade in goods, services, and information. Trade and direct investment are intimately related; transactions between direct investment affiliates and their U.S. or foreign parents accounted for 35 percent of U.S. merchandise exports and 40 percent of U.S. imports in 1987 -- the latest year for which data are available. It is essentially impossible to separate trade from investment and vice versa. Foreign investment in the United States spurs competition, provides infusions of new capital and

technology into industries like steel, and speeds the spread of technological advances.

Concerns about direct investment in the United States are understandable because these investments sometimes disrupt established patterns of doing business. But on the whole such concerns are overblown. It is ironic that if a Japanese real estate company buys a building in the United States, we record it as a direct investment and a possible source of concern. If, however, the real estate company dismantles the building brick by brick and ships it to Japan, it is recorded as a U.S. export, a positive event.

Acquisitions of U.S. companies by foreigners present somewhat different issues. The analysis of mergers and acquisitions in general is controversial, but one conclusion with which nearly all investigators would concur is that the American stockholders of takeover targets are big gainers. The former owners of acquired U.S. companies can reinvest these funds in other enterprises that they judge to have the highest returns. As for foreigners who outbid U.S. competitors for U.S. companies, recent news indicates that overly optimistic estimates of future earnings may have been an important factor in several important cases.

Although foreign direct investment in the United States has grown very rapidly, it is still relatively small. For manufacturing as a whole, direct investment affiliates accounted for 13 percent of assets and 11 percent of sales in 1987, the latest data available. Comparison of the role of direct

investment affiliates in U.S. sales, manufacturing employment, and assets with ratios for other countries indicates that direct investment plays a much smaller role in the U.S. economy than in Canada, the United Kingdom, Germany, or France.

Most direct investment in the United States originates from the United Kingdom, Japan, Canada, the Netherlands, and Germany, countries with which the United States has close economic and political ties. Direct investment in the United States gives these countries an even larger interest in ensuring continued U.S. prosperity. Moreover, the U.S. government has ample authority to block direct investments that have a negative impact on national security or that involve undesirable concentrations of market power.

Comparison of the operations of affiliates of foreign companies with U.S. firms in the same industry indicates that R-and-D expenditures, wage rates, and value added do not differ systematically. Only a tendency to import more clearly distinguishes affiliates from U.S.-owned companies; however, since some foreign companies have built plants in the United States to replace imports, the net effect of direct investment on the U.S. trade balance is probably small.

One area of foreign direct investment of particular interest to the Federal Reserve Board is the banking industry. Foreign banks account for about one-fifth of all banking assets in the United States. However, in many cases foreign banks conduct largely international transactions at their U.S. offices. Foreign-chartered banks typically have not been very successful

at competing for retail U.S. business, but they have been more successful in the area of commercial and industrial lending to large companies. Foreign bank participation in that market has increased competitive pressures to price loans off money market rates. U.S. consumers of banking services have benefitted from a more competitive banking environment. Departure from a policy of national treatment in the banking industry could produce retaliation and could seriously complicate negotiations to ensure access of U.S. banks to markets abroad, particularly to Europe after 1992.

In conclusion, the globalization of markets for goods, services, and finance benefits both the United States and the rest of the world. Efforts to insulate the United States from the inexorable forces of increasing globalization could be very costly to our standard of living. However, continued efforts should be made to limit risks in international payments and securities settlements systems, and to protect investors by increasing international cooperation and coordination of supervision and regulation.

The United States could help to ensure the orderly progress of global integration by reducing its current account imbalance. The necessary policies are not those that attack the symptoms--large accumulations of foreign assets in the United States -- but rather policies that address the underlying cause, which is our inadequate national savings, particularly our large federal budget deficit.