

# The internationalization of Uncle Sam

*Jack L. Hervey*

For well over two decades after the end of World War II the international trade of the United States was primarily viewed by Americans as a one-way street synonymous with rapidly expanding markets abroad for U.S. goods and services and the rapid acquisition of foreign assets by U.S. investors. Critics called it economic imperialism. By the late 1960s a hint of change was in the wind. Import growth began to exceed export growth. The rate of increase in foreign direct investment in the United States outpaced that of U.S. direct investment abroad. By the late 1970s the growing presence of foreign goods and services and foreign investment on U.S. shores was beginning to force a reassessment of the U.S. place in the international economy.

Over a relatively short span the U.S. economy experienced a transition from a state of high level self-sufficiency to one of considerable international interdependence with respect to the provision of goods, services, and capital. Consumers, from the household to the manufacturer, increasingly looked for the "foreign brand" that signified quality and a competitive price. As a result, businesses and workers (in many cases those same householders and manufacturers) grudgingly have become aware that they are competing in a worldwide market. The competition for sales and jobs no longer comes only from across the street or across state lines but from an apparel shop in Hong Kong, a steel mill in Brazil, a wheat farmer in Australia, or a computer chip manufacturer in Japan.

The new competition is coming from countries where wage standards, capital costs, economic and social structures, and government involvement in the economy may be vastly different from the economic environment of the United States. At the same time U.S. consumers and businesses increasingly are taking for granted, and loath to give up, the benefits of lower price, improved quality, and extended selection derived from the intensified foreign competition. Many U.S. manufacturers now depend on foreign-made components in order to remain competitive—in terms of price and quality.

Some industries, firms, and workers suffer injury in the short-term and possibly long-term by the increasing international involvement of the U.S. economy. But in the aggregate the economic benefit of internationalization outweighs the economic costs.

Various interest groups and economic sectors may quarrel over the associated benefits and costs, the necessary economic adjustments and dislocations, and how the rewards and burdens are to be distributed in response to the transition to greater international interdependence. Such conflicts are inherent in the rapid development of the international sector. As the adjustments become more difficult for larger and more vocal sectors of the economy the conflict becomes more intense. As a consequence, emotional and political content has been loaded onto terminology historically used to define specific international trade relationships. These economically neutral but increasingly value-laden relationships have become the focus of proposed political action manifest in the form of intensified pressures for interventionist trade policies by government that are outside the existing framework of fiscal and monetary policy.

As a result, the economic content of such relationships as the trade deficit (the relationship between aggregate value of exports and imports) or the debtor/creditor position of the United States for the most part has been lost. Indeed, it is of concern to this author that these terms have become widely used by politicians, business and labor leaders, the business press, and others as code words synonymous with an implied need for and, not so coincidentally, providing a justification for direct government intervention. The cry that "this country needs a trade policy" too often may be translated to mean this country needs increased import tariffs, a general import surcharge, export subsidies, adjustment assistance to domestic workers and firms, capital controls, depending upon the persuasion of the speaker.

---

Jack L. Hervey is a senior economist at the Federal Reserve Bank of Chicago.

Such “solutions” to the “trade problem” implicitly assume that existing economic distortions can be corrected by the imposition of additional market distortions, which unwittingly lessen the incentives to adjust to the new environment. Ignored are the consequences of critical economic relationships between the domestic and international sectors that are based on past and present governmental fiscal and monetary policy and business and labor policy. These relationships underlie the recent surge in the U.S. international trade deficit and the fact that the United States recently became a net debtor to the rest of the world (foreign ownership of U.S. assets now exceeds U.S. ownership of foreign assets).

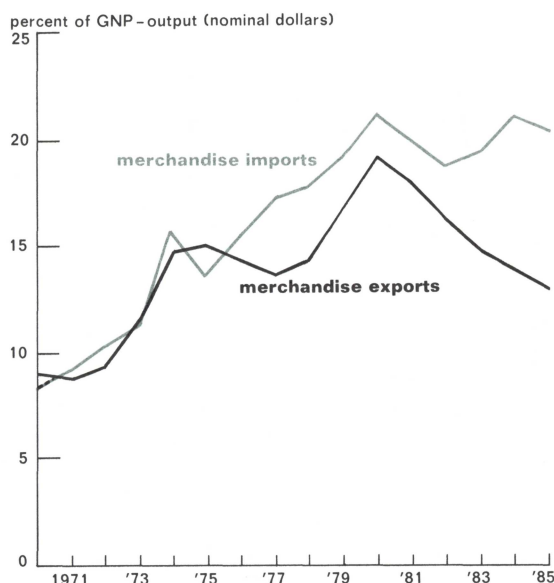
### The internationalization—a background

The combined value of U.S. trade in goods and services, net unilateral transfers abroad by the U.S. government and private individuals (the current account), and net capital transactions abroad by U.S. residents and net capital transactions in the United States by foreigners rose to a record \$1 trillion in 1985.<sup>1</sup> A similar compilation for 1970 totaled \$146 billion. This seven-fold increase in U.S. international activity occurred during a span of only 16 years.<sup>2</sup>

As dramatic as the growth in U.S. international activity has been, it appears even more so when placed in juxtaposition to GNP growth. While such a compilation of international activity does not represent the dependence of the U.S. economy on foreign markets it does provide, nonetheless, an indication of the increasing relative importance of the international sector to the overall economy. During the period 1970-1985 nominal GNP grew, on average, 9.5 percent per year, while at the same time the nominal value of international activity rose, on average, 14 percent per year.

A more conventional measure of the increasing involvement of the international sector in the U.S. economy becomes apparent when we relate the value of the merchandise trade component of the current account to the value of the nation's production of goods. The greater the proportion of exports or imports to the value of GNP goods-output (excluding structures) the more dependent the economy is on foreign markets. Throughout the 1960s U.S. merchandise exports as a percent of

Figure 1  
International trade share of U.S. output  
increases during the 1970s



goods-output (in current dollars) fluctuated in a range of 7 to 8 percent. During the 1970s U.S. export markets grew rapidly and in 1980 exports were equivalent to 19 percent of U.S. output—a peak. Since then sluggishness in world markets and competitive problems for U.S. goods has resulted in a fall-off in the export measure to 13 percent in 1985.

During the same span of time, merchandise imports as a percent of goods-output increased from about 5½ percent in the early 1960s to about 8 percent late in the decade. The percentage continued to increase during the 1970s, rising to a peak of 21 percent of output in 1980 before the slackening in 1981-1982. The surge in imports resumed during the 1983-1984 recovery-expansion and pushed the imports-to-output figure back up to nearly 21 percent in 1985. In sum, U.S. merchandise trade has become substantially more important, relative to the goods-output sector of the economy, during the past two-and-one-half decades.

### The current account

The current account records international transactions involving merchandise and services



and unilateral transfer payments such as government and private gifts and pensions.

**Merchandise trade** is the largest component. In each year from the end of World War II until 1971, the United States exported more goods than it imported. Beginning in 1971, however, merchandise imports exceeded exports in every year but two—1973 and 1975. During the period 1971-1976 imports exceeded exports by an average of \$2.3 billion each year. This was a period during which multiple increases in the value of petroleum imports dominated merchandise trade developments. During 1977-1982 imports exceeded exports by an average of \$30.2 billion each year. By 1981 nonpetroleum imports were more than double their 1976 level, as were exports. But imported oil prices in 1981 were nearly *three times* those of 1976, further increasing the margin of imports over exports.

The continued appreciation in the value of the dollar during the early 1980s (a development that began late in 1980 following a substantial depreciation the previous three years) contributed to a decline in the competitiveness of many U.S. goods. This, in combination with the worldwide recession of 1982, resulted in a decline in U.S. merchandise exports.

Despite the recession, however, U.S. non-petroleum imports remained steady in 1982, and in 1983 through 1985 advanced as U.S. economic growth resumed and the appreciating dollar further enhanced the competitive position of foreign-produced goods. In 1983, imports, excluding petroleum, exceeded exports by 12 billion. In 1984, nonpetroleum imports exceeded exports by \$57 billion and in 1985 the margin expanded to \$74 billion. Exports receded again in 1985 following a 9 percent gain in 1984. They remained 10 percent lower than in 1981. As a result, the total value of merchandise imports exceeded exports by \$124 billion in 1985 (balance of payments basis).

**Trade in services**, the other major component in the current account, is sometimes referred to as trade in "invisibles." It also increased in value by more than six-fold since 1970. Exports have exceeded imports throughout the period. The margin increased steadily from \$3 billion in 1970 to a peak of more than \$41 billion in 1981. Thereafter the

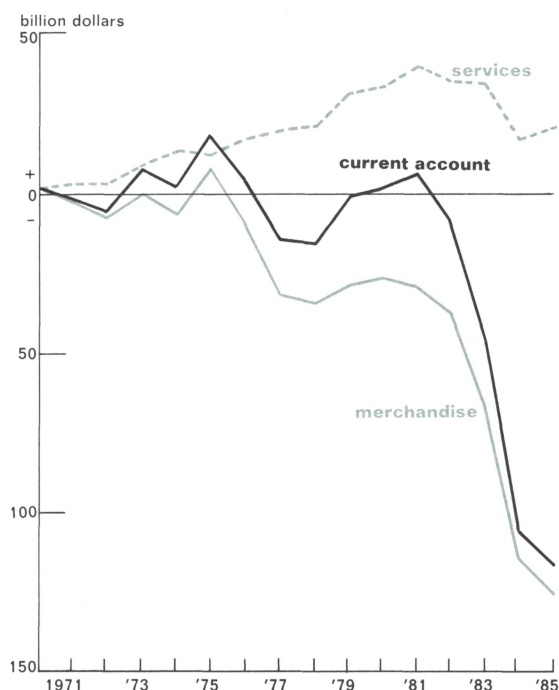
margin dropped yearly, to \$18 billion in 1984 before recovering to \$21 billion in 1985. In 1985 the export and import of services totaled \$146 billion and \$124 billion, respectively.

Throughout the 1970s and early 1980s, increasing positive balances on the services account provided a substantial offset to the negative balances recorded in merchandise trade. As a result, the cumulative current account balance for the period 1970-1981 was a positive \$3.8 billion. But since 1981, progressively smaller positive balances in services provided a diminishing offset to increasingly negative balances in merchandise. Consequently, the current account balance in 1984 dropped \$67 billion to a negative \$107 billion and deteriorated further in 1985 to a negative \$118 billion—by comparison, the current account recorded a \$6 billion positive balance as recently as 1981.

A major factor in the deterioration in the services balance has been the large increase in U.S. payments to foreigners of income derived from their holdings of U.S. assets. Such payments of income are financial services provided to the United States by foreigners and are counted as imports of services in the current account. They are generated by direct investment in U.S. industry, lending to U.S. banks and other firms, portfolio investment in U.S. companies, and lending to government and individuals. Payments to foreigners through this portion of the services account increased 30 percent from the 1983 level to \$68.5 billion in 1984 and declined slightly to \$65.8 billion in 1985 (partially in response to lower interest rates), after holding steady at about \$53 annually during 1981-1983. As recently as 1977, U.S. payments to foreigners derived from their asset holdings in the United States totaled only \$14 billion.

Not only has the absolute value of income paid for financial services rendered by foreigners increased but the category has increased substantially as a proportion of total services imports—from 27 percent in 1970 to 53 percent of the \$124 billion total in 1985. The major portion of that increase is attributable to increased foreign holdings of U.S. financial assets (and increased payments due to higher interest rates). Significantly, much of this development in the services account is rooted in the relationship between merchandise ac-

Figure 2  
U.S. international trade balances



count transactions and capital account transactions—an issue discussed below.

U.S. exports of services have also increased substantially during the past 15 years, as the continued positive balance on the service account implies. However, following a peak in 1981, services exports declined in 1982 and 1983 and the modest increases recorded in 1985 resulted in a services export total only 5 percent higher than in 1981. As a consequence the services balance in 1984 was at its lowest level since 1975 and the \$3 billion increase in 1985 still left the balance lower than that recorded in 1977.

As with imports, considerable restructuring in the composition of services exports has occurred during the past 15 years. Historically, income derived from U.S. holdings of foreign assets has been a larger proportion of total exports of services than was the comparable item on the import side. During 1985 exports attributable to holdings of foreign assets were \$90 billion—about 62 percent of the \$145 billion total. As was the case with service imports, the proportion of services exports attributable to

income on foreign assets has trended upward—from around 50 percent in the early 1970s.

Income derived from U.S. direct investment abroad is also counted as part of services exports in figuring transactions balances. Indeed, this source of income was the dominant factor in the growth of service exports throughout the 1970s. But in more recent years income to U.S. residents on portfolio holdings of foreign financial assets increased sharply in response to a rapid increase in such holdings during the late 1970s and early 1980s. Reflecting that change, U.S. private and government income derived from holdings of foreign financial assets exceeded income derived from direct investment for the first time in 1981. Income from such portfolio (non-direct) investment assets totaled \$55 billion in 1985, down from \$64 billion in 1984, but still well above the \$35 billion in direct investment income.

**Unilateral transfers**, the final category making up the current account, is a relatively small item. Net transfers to foreigners totaled \$14.8 billion in 1985, up from \$11.4 billion in 1984. During the first half of the 1970s such payments averaged \$4.4 billion per year. They increased to \$5 billion per year during the second half of the 1970s and for the period 1980-1985 they averaged \$9.5 billion per year. But they accounted only for about 2 percent of current account transactions in the early 1970s, less than 1 percent in the late 1970s-early 1980s, and about 1.8 percent in 1985.

### The capital account

The capital account is the final major component of the recorded international accounts. Recorded capital account activity (defined as net U.S. acquisitions abroad plus net foreign acquisitions in the United States) plus "statistical discrepancy" totaled \$194 billion in 1985, up from \$142 billion in 1984 but, still below the more than \$210 billion annual average for the period 1980-1982 (see footnote 1).

Of special interest is the recent abrupt change in composition of the capital account transactions. Throughout the 1970s and the early 1980s the recorded net acquisition of foreign assets by U.S. residents accelerated, reaching a peak of \$119 billion in 1982. The recorded net acquisition of U.S. assets by



foreigners also increased rapidly then held in the \$80-\$95 billion range during 1981-1984 before moving sharply upward again in 1985 to \$123 billion. However, U.S. residents' net additions to assets abroad decelerated dramatically from the 1982 peak—to \$20 billion in 1984 before recovering somewhat to \$38 billion in 1985. Recorded capital transactions shifted from a net outflow of funds (net increase in U.S. claims on foreigners) equal to \$24 billion in 1982 to a net inflow of funds (net increase in foreign claims on the U.S.) equal to \$77 billion in 1984 and \$85 billion in 1985.

**Activities of banks.** The largest component of this shift was the change in lending and borrowing activities of U.S. banks. For the second consecutive year, and only the fourth time in the past 26 years, U.S. banks were net borrowers abroad in 1984—by \$36 billion. Substantial change occurred on both sides of the ledger. The increase in foreign lending by U.S. banks was only \$6 billion in 1984, the smallest increase since 1972. It compares with an increase of \$111 billion in 1982.<sup>3</sup> Continued international debt repayment problems of several Latin American countries have contributed to a sharp curtailment in banks' willingness to extend additional credits to these countries—countries that had been large takers of new funds through 1982. In addition, the rapid economic expansion in the United States during 1984 and continued heavy borrowing by the federal government in 1985 resulted in strong domestic demand for funds. This also contributed to a contraction in lending abroad.

On the other side of the ledger, U.S. banks' net additional borrowing from foreigners has slowed in comparison with the early 1980s. Liabilities to foreigners reported for 1984 and 1985 increased \$32 billion and \$41 billion, respectively, but were well below the increases of \$49 billion in 1983 and \$66 billion in 1982 (see footnote 3).

**Investment.** Foreign investment is the second major component of capital transactions and is composed of direct investment transactions and securities investment transactions.

Direct investment transactions (investment in plant, equipment, and land) in recent years have taken a turn contrary to the historical relationship.<sup>4</sup> Throughout the post World War I period, net increases in U.S. direct in-

vestment abroad (funds outflows) exceeded net new foreign direct investment in the United States (funds inflow) by substantial amounts. As recently as 1979 the net capital outflow (U.S. direct investment abroad minus foreign direct investment in the United States) totaled \$13 billion. What historically had been a net capital outflow shifted to a net capital inflow in 1981—by nearly \$14 billion. From 1981 through 1984 foreign direct investment in the U.S. continued to exceed U.S. direct investment abroad. In 1984 net new U.S. direct investment abroad totaled \$4.5 billion as compared with a net addition in foreign direct investment in the United States of \$22.5 billion. During that four-year period net foreign direct investment in the U.S. outstripped U.S. direct investment abroad by a cumulative total of \$58 billion. However, in 1985 the historical pattern reemerged with U.S. direct investment abroad, at \$19 billion, exceeding by a relatively small margin the \$16 billion in foreign direct investment in the United States.

The recent direct investment pattern has occurred during a period of conflicting economic and political pressures. The dollar has appreciated in foreign exchange markets and the cost of capital in the U.S. has been relatively high—both developments that would tend to encourage U.S. investment abroad and discourage foreign investment in the United States.

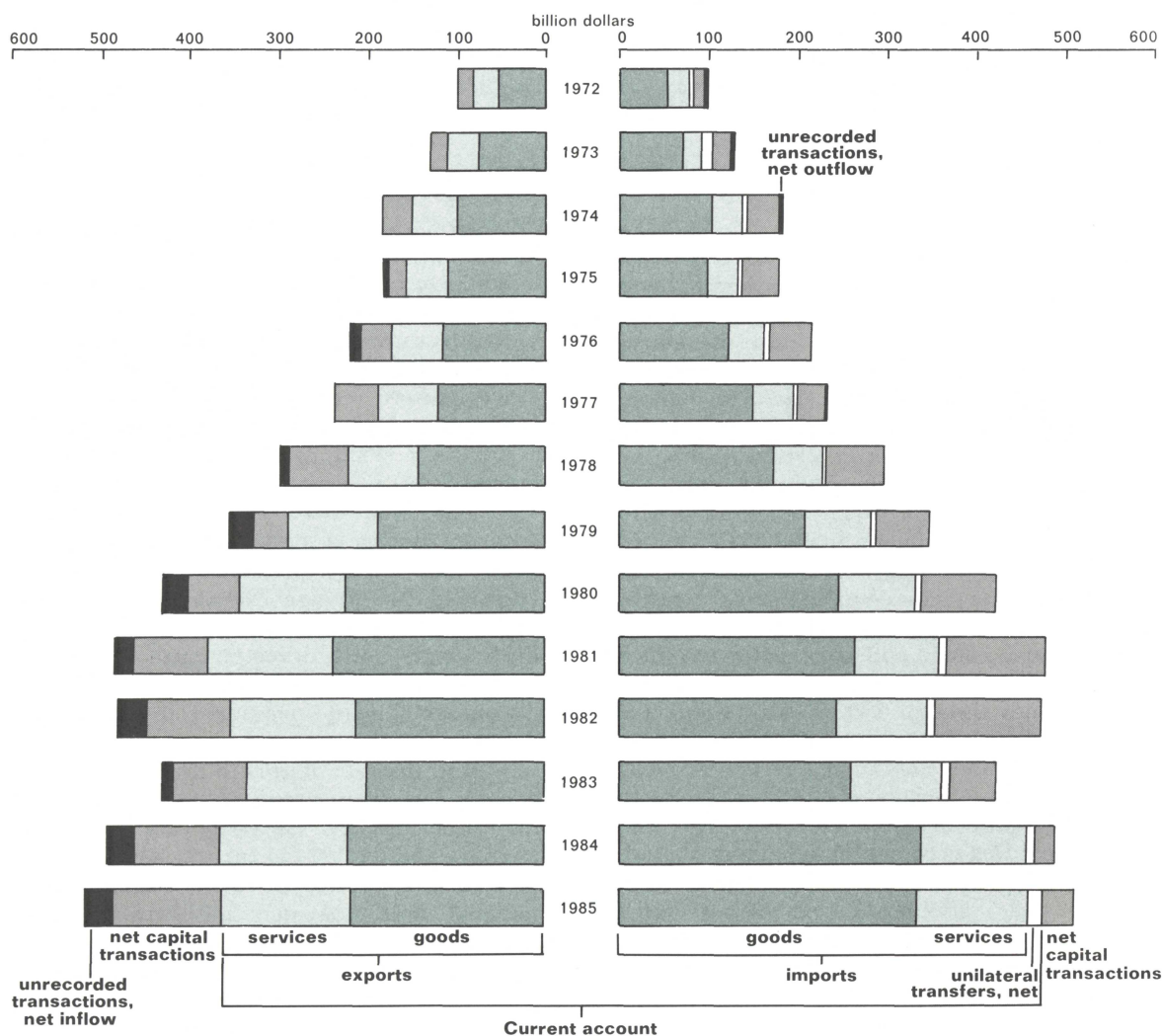
But, the rate of growth in U.S. economic activity has been strong in comparison with most other markets, especially during the 1983 recovery and the 1984 expansion, although that pattern was reversed in 1985. Further, international debt repayment problems have discouraged direct investment in the developing countries. At the same time strong pressures have developed within the U.S. to restrict a wide range of imported products. These developments have favored investment in the U.S. relative to investment abroad, and encouraged foreign investors to develop facilities within the United States to forestall being closed out of a major market. Foreign investment in the automotive, consumer electronics, and metals industries are prime examples of this phenomenon.

Capital flows into the securities markets have also recorded marked change in recent years. As noted earlier, during each of the last five years total foreign acquisition of U.S. assets

Figure 3  
U.S. international transactions\*

Funds inflow resulting from the U.S. sale of goods and services abroad and the foreign net acquisition of U.S. assets.

Funds outflow resulting from the U.S. purchase of foreign goods and services, net unilateral transfers abroad, and the U.S. net acquisition of foreign assets.



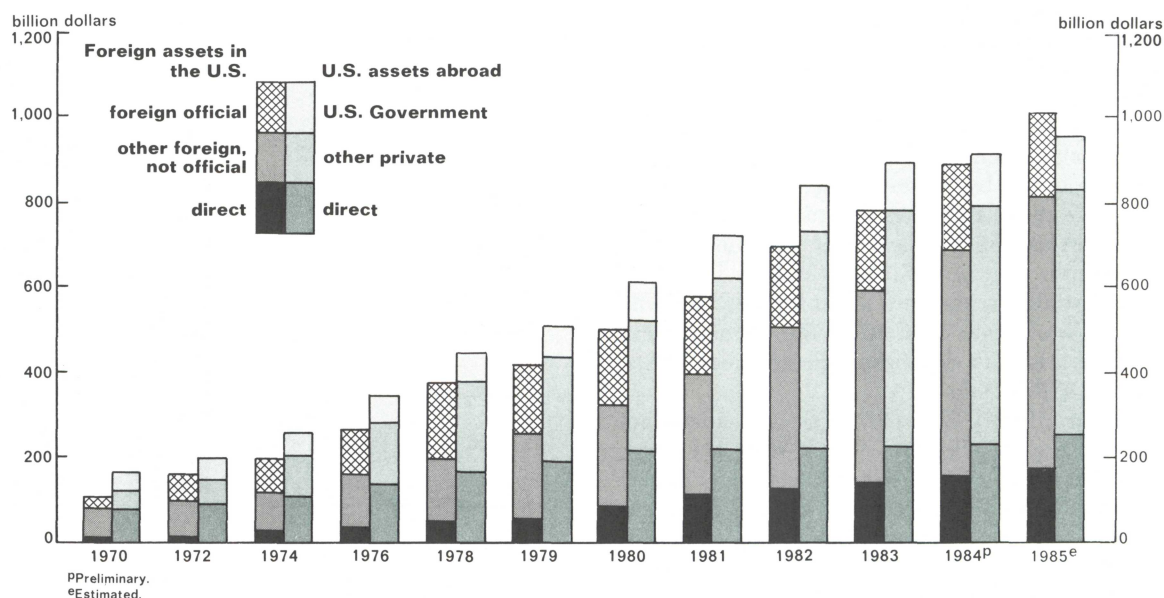
have hovered in the \$80-\$120 billion range and yet since 1982 the rate of increase in new foreign claims on U.S. banks has decelerated appreciably. Part of the resulting "slack" has been picked up by direct investment inflows. More important, however, has been an increase in foreigners' acquisition of U.S. Treasury securities and corporate stocks and bonds. Drawn by high interest rates, changes in the

withholding tax law, and increasing stock prices, net new acquisitions by "non-official" foreigners totaled \$72 billion in 1985 (\$21 billion of which were U.S. Treasury securities), double the \$35 billion (\$22 billion Treasury) in 1984, and seven times the \$10 billion (\$3 billion Treasury) in 1981.

It is apparent that foreign capital is once again playing an important role in the financ-



Figure 4  
International investment position of the United States



ing of U.S. capital markets. The yearly net foreign acquisition of U.S. Treasury securities has increased seven-fold since 1981. Still, the proportion of the gross public debt of the U.S. Treasury held by foreigners has declined relative to the total size of the Treasury's debt, a point sometimes cited to support the contention that foreigners have not contributed significantly to financing the recent dramatic increase in government debt. Indeed, at midyear 1985 the proportion of U.S. Treasury debt held by foreigners stood at 11.3 percent, the lowest since 1971, and down from a peak of 17.5 percent in 1978. Significantly, this recent decline is due primarily to relatively less activity by foreign official institutions. Approximately 66 percent (\$137 billion) of the \$209 billion in foreign holdings of U.S. Treasury debt was held by foreign official institutions at the end of September 1985, down from an 84 percent share as recently as 1981. Conversely, the proportion of total foreign holdings of U.S. Treasury debt held privately increased from 14 percent to 35 percent (\$72 billion) between 1981 and September 1985. As a proportion of total Treasury debt, foreign private holdings increased from less than 1 percent in 1981 to

nearly 4 percent at the end of the third quarter of 1985.

This relative decline in foreign holdings of the federal debt is not what it appears on its face, however. Indeed, "funds are fungible" as the saying goes. Coincident with the surge in aggregate demand for borrowed funds by government (state, local, and federal) was an acceleration in private demand for investment funds. Foreign investors had numerous alternatives for placement of their funds: With a rapidly expanding private economy in 1983 and 1984 and the consequent increase in private credit demand it made little difference whether the influx of foreign capital financed private debt or public debt. What the inflow did do was reduce the incidence of "crowding out" in private markets by government borrowing and facilitated larger private investment at lower interest rates than would otherwise have been the case—assuming the government deficit remained the same.<sup>5</sup>

The importance of foreign capital in financing U.S. private and public demand for investment funds is reflected in the proportion of the total demand for investment funds (private and public) accounted for by net capital inflows. Empirically, this may be derived from

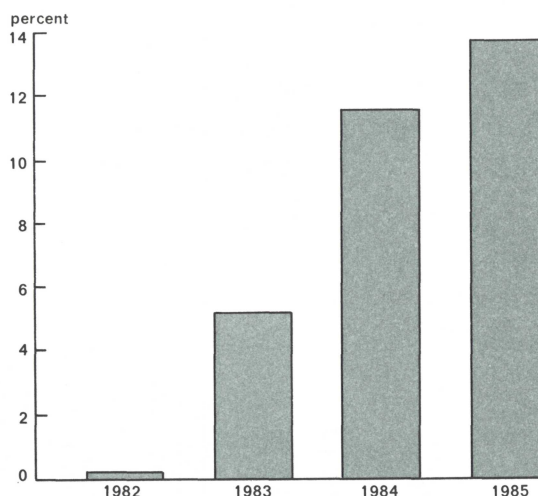
data available in the National Income and Product Accounts. An approximate measure of investment funds is represented by: 1) gross private domestic investment plus 2) the excess of government (federal, state, and local) expenditures over receipts. Net foreign investment equals: 1) net exports minus 2) net transfer payment to foreign recipients minus 3) interest paid by government to foreigners—a negative result indicates a capital inflow to the U.S. From these data we see that net foreign investment in the U.S. has not only increased substantially in absolute terms but also became a source of funds to finance the economic expansion and the expanding government deficit during 1983-1985.

In 1980-1981, the U.S. provided net funds abroad. But in 1982 a shift occurred. In that year net foreign investment in the United States accounted for a scant 0.2 percent of U.S. private and public demand for investment funds. That proportion increased markedly to 5.2 percent in 1983, surged to 11.6 percent in 1984, and stood at 13.7 percent in 1985. This dramatic increase indicates that the large capital inflow was requisite to financing the private investment boom and the large government deficit. On the other side of the coin it follows that for that net capital inflow to occur the large trade and current account deficits during the 1983-1985 period were a necessity.

As noted in the discussion on the services account the recent rapid increase in U.S. income receipts from foreigners and U.S. payments to foreigners is related to developments in the capital account. These income receipts and payments are derived from investment activity, as recorded in the capital account. As foreign direct investment and foreign capital claims on banks, government, and other issuers of securities have increased so have U.S. payments of income to foreigners on holdings of those assets. As net capital inflows increase so will the net funds outflow through payments to foreigners in the services account.

Of course the same relationship holds for U.S. direct and capital investment abroad and its impact on the U.S. export of services. It is significant, however, that the recent shift in capital flows—the U.S. becoming a net importer of capital—has and will further accelerate the relative growth of service imports over

Figure 5  
Foreign capital contribution to U.S. investment increased rapidly during 1982-1985\*



\*The percentages are derived from the National Income and Product Accounts. Investment is defined here to include gross private domestic investment plus the excess of government expenditures over receipts. Foreign capital is net foreign investment in the United States. During the period 1973-1981, the U.S. provided net investment funds abroad, except in 1977 and 1978.

service exports. This will in turn tend to further reduce net exports of services.

**Unrecorded transactions**, or “statistical discrepancy,” is a final component in the makeup of international transactions. This “balancing item” between the current account and the capital account was equivalent to a \$33 billion capital inflow in 1985—an amount equal to 28 percent of the nearly \$118 billion current account outflow. The large magnitude of the unrecorded transactions is not totally new. During the previous six years unrecorded transactions averaged a \$24 billion annual inflow, and at least for the period 1980-1983 the unrecorded inflow was well above the \$9 billion average current account outflow.

The emergence of the large unrecorded transactions category is a bedeviling development to international trade observers. Some have suggested that changing corporate structures and intra-company capital movements within multinational financial and nonfinancial institutions may contribute to part of the increase observed in recent years. In addition,



international debt servicing difficulties of numerous less-developed countries have prompted an increase in barter and counter trade in goods and services. Such transactions may distort trade valuations and consequently understate or overstate the value of exports or imports. To the extent this occurs a portion of these unrecorded transactions should be charged to the current account and consequently the funds outflow implied in the current account deficit might be overstated, or understated.

### **The relationship between the current and capital accounts**

The relationship between current account transactions and capital account transactions is one of the more confusing aspects of international trade. It is instructive, therefore, to examine these relationships before we look again at what appears to be happening in the U.S. international accounts.

Consider a situation in which a U.S. resident exports goods to a foreign buyer. In the process of exchange the foreign buyer pays for the goods; in so doing the foreign buyer has exchanged an asset funds (a general claim against future resources) for a specific asset goods (a current resource). The U.S. exporter has exported goods (real resources) and acquired funds (a claim against the future real resources of the foreign country). In sum, there has been a transfer of real resources from the U.S. to the foreign country in exchange for a U.S. claim on future real resources of the foreign country. A U.S. import from a foreign seller reverses the transaction.

If a country's merchandise trade is in balance during a specified period residents of that country have exchanged (sold and purchased) real resources of equal value. Over any given time period only a highly unusual set of economic circumstances would result in such a balance. Rather, under "normal" circumstances a country's merchandise trade account would be expected to be in "surplus" (sold more abroad than purchased from abroad—acquired net claims on the future production of foreigners) or "deficit" (sold less abroad than purchased from abroad—assumed net liabilities against future domestic production in favor of foreigners). An example similar to that for merchandise could be devel-

oped for trade in services with the result tending either to offset or augment the result of a positive or negative merchandise balance. Again, only rare circumstances would result in a zero balance between services exports and imports.

The trade account examples above essentially assume instantaneous offsetting transactions. However, as noted, a zero balance at any given time is highly unlikely. A positive or negative balance on trade transactions is one of two bases for a capital account transaction to occur. Indeed, implicit in a trade transaction is a capital transaction. They are the two sides of the same coin. It is when export and import trade transactions do not balance (during any given period) that a net capital inflow/outflow takes place. The U.S. import of goods initially results in a foreign-owned U.S. deposit resulting from a U.S. payment to the foreigner for the goods (alternatively, U.S. balances abroad might be reduced by the amount of the transaction). It is in this sense that a negative balance on the trade account must be financed by an infusion of funds through the capital account.

Capital account transactions may take numerous forms, including: acquisition or liquidation of bank deposits, purchase or sale of stocks and other private securities, direct investment purchases or sales of plant and equipment (see footnote 4), and the purchase or sale of government obligations.

Recognizing the various forms of capital transactions helps place in perspective the interrelationship between the trade and capital accounts. It becomes apparent that an individual with funds available is faced with a range of alternatives—the purchase of goods and services domestically or from abroad, investment domestically or abroad, or some combination of those alternatives based on relative cost, expected return, and time preference. Time preference is particularly relevant in understanding capital account transactions that are not initiated in direct association with a trade transaction.

Thus emerges the second basis for capital flows—investment. Consider a capital transaction: The U.S. government or a private resident wishes to borrow funds and thus sells a security. A foreign individual evaluates his situation and decides to acquire the security as the best alternative use of his available funds.

The U.S.-originated security, in effect, is exported. The exported security represents a claim by a foreigner against the future production of the U.S. issuer-exporter. (In the case where U.S. goods or services were exported, the goods represented a claim against an immediate, or past, U.S. output.) Thus, in the capital transaction the foreign buyer-importer has exchanged funds that represent a general claim against future resources for a claim against the future resources of the United States. The foreigner has only changed the form of its claim (assets) against the future. As far as the U.S. is concerned, the sale (export) of the security represents an obligation to transfer real resources from the U.S. to the foreign country at some time in the future. In the meantime, there has been a transfer of funds from abroad to the U.S.—funds which may be used immediately or in the future to purchase goods and services or securities (domestic or foreign).

The key difference that emerges between the trade account and the capital account is the timing in the transfer of real resources. In effect, interaction of the two accounts—trade and capital—facilitates different time preferences between countries with respect to the inter-country transfer of real resources.

### **Determinants of trade balances and capital flows**

During any given period a constellation of economic determinants—relative rates of economic growth, domestic price change, interest rates, exchange rates, productivity, and so forth—interact such that a country may be a net importer of real resources (and an exporter of securities-importer of capital), a net exporter of real resources, or in balance. Residents of the net importing country must understand that, as a result of the net real imports, the foreign exporters of those real resources are acquiring claims against the goods-importer's future output. The goods-importer, thus, is "exporting" claims against its future real production. These claims represent *output which cannot be utilized in the domestic market when the claim falls due*.

Looked at from the other side of the coin the above situation may be viewed as follows: The constellation of economic determinants are such that residents of one country prefer to

forgo current consumption or domestic investment in favor of saving abroad (acquiring future claims on the real resources of a second country). Thus, they "import" securities rather than goods. If the relationships between the economic determinants change (e.g., relative interest rates, or exchange rates, or security holders' views about the economic stability of the country whose securities are being exported), the change will feed into the time preference function of the securities importers and an adjustment between the capital and current accounts will occur. With the appropriate relative mix between countries of domestic real growth, inflation, productivity, interest rates, exchange rates, and so forth residents of the securities-importing country will prefer to convert those future claims on foreign production (represented for example by their holdings of securities issued abroad) to claims on current foreign production. Likewise, the time preferences of those who were formerly net importers of real resources will change as they look forward to an environment of net acquisition of claims on future foreign production and current net exports of real resources.

The critical economic issue from the perspective of the capital-importing country is: How is the imported capital being utilized in the domestic economy? It is the same basic question that faces any borrower of funds. In the simplest terms from a consumer's point of view borrowed funds are used to increase current consumption at the expense of future consumption. If borrowed funds are used to improve productivity and increase output in a business the debt can be serviced and paid back in the future out of the resultant increase in real income, with a balance remaining that contributes to a net real increase in income to the borrower. Thus, current *and* future consumption both may be increased. On the other hand, the borrowed funds may be expended on current consumption or nonproductive endeavor so that when the liability comes due the real income of the borrower has not increased sufficiently to service and pay off the debt. Then the level of living (capital base) of the borrower must be depressed in order to satisfy the payment of interest and the repayment of principal.

A net inflow of capital (imports of goods and services exceed exports of goods and services) is not inherently undesirable. Indeed, it



may result not only in an increase in the current level of living for the importers but also in the future level of living for residents of the capital-importing country.<sup>6</sup> But, the key issue is: To what use is the imported goods-services-capital directed?

### **Where stands the United States?**

In the current economic environment the critical concern relative to the trade and capital accounts of the United States is not so much that imports exceed exports and that capital inflows exceed capital outflows *but* rather whether that net import of capital is being utilized to finance nonproductive consumption and government expenditures rather than to enhance the productive capacity and competitive position of the United States vis-à-vis the rest of the world. In 1983, 1984, and 1985 foreign capital financed an economic expansion in the United States that otherwise would have been less robust. But the recovery/expansion was not uniform across the economy. In fact, export industries and import-competing industries bore the brunt of the surge in the government deficit and the transfer of resources that permitted the increased net capital inflow from abroad.

Other questions that must be addressed, in addition to the burgeoning government deficit, are: Does government policy, legislation, and regulation facilitate increases in productivity and investment or does it contribute to distortions in the economy that discourage productivity and competitiveness? Are management and labor pursuing practices that promote or detract from increased productivity and competitiveness? Is the vision of government, business, and labor capable of looking past the next election, annual report, or wage negotiation to promote a less parochial view of the economic environment in which we now live, or, will the short-term view prevail, to the detriment of living standards in the not-so-distant future? The U.S. propensity for "buying time" (viewed by some as providing more rope for the hangman) does not inspire optimism as to the outcome.

The United States has been a world power for the better part of this century. But it has only recently begun to experience the growing pains of becoming a full-fledged inter-

national economy. That process, having begun, means the United States does not control its economic destiny to the same degree it did 15 or 20 years ago. It means that numerous adjustments must be made to accommodate its new role in the international economy. Reversion to isolationism is not an option. Market forces can effectively facilitate the adjustments necessary to integrate the domestic and international sectors, but only within the constraints set by government fiscal/monetary policy and the distortions introduced through the myriad regulations controlling commerce. Tinkering with trade cannot cure these ills, but it can make them worse. Instead, it is the basic issues associated with the distortions imposed on productivity and competitiveness and the central issue of the influence of the fiscal/monetary policy environment and the impact of regulatory distortions on economic activity that must be addressed. If not soon, then indeed the economy of the United States faces leaner times ahead as additions to future real income are siphoned off to pay for the excesses of today.

---

<sup>1</sup> The summation (using absolute values) of the various individual components of international transactions—exports and imports of goods and services (excluding military grant programs), unilateral transfers (excluding military grants), net acquisition of assets abroad by U.S. residents, net acquisition of U.S. assets by foreigners, the allocation of SDRs (special drawing rights) by the IMF, and unrecorded transactions ("statistical discrepancy")—is used here only as a relative gauge of internationalization of the U.S. economy. From an analytical view such a compilation includes substantial double counting; most obvious, to the extent that either exports or imports exceed the other, the offsetting entry on the capital account is counting the second side of the same coin. On the other hand, capital transactions and unilateral transfers are recorded as net inflows or outflows, thus as a measure of the volume of transactions the reported capital transactions are undercounted.

<sup>2</sup> Looking at only trade in goods and services the increase (in nominal value) from 1970 to 1985 was about 6½-fold. Capital transactions (in nominal value)—net acquisition of assets abroad by U.S. residents plus net acquisition of U.S. assets by foreigners (including various unrecorded transactions)—were 12 times larger in 1985 than in 1970. The increase in unilateral transfers was 5-fold.

<sup>3</sup> Capital flows reported by U.S. banks, in particular for 1982, are inflated due to changes in regulations and tax laws that encourage U.S. parent banks to handle international banking operations through a domestically located International Banking Facility (IBF) instead of through foreign located branches. IBFs were allowed to commence accepting deposits from and making loans to foreign residents on December 3, 1981. As a result U.S. banks transferred substantial assets and liabilities of their foreign branches to their domestic IBFs. Consequently, banks' claims on foreigners (loans to) and liabilities to foreigners (deposits by) increased. For a detailed discussion of early development of IBFs see Sydney J. Key, "Activities of International Banking Facilities: The early experience," *Economic Perspectives*, Federal Reserve Bank of Chicago, Fall, 1982; reprinted in *Readings in International Finance*, second edition, published by the Federal Reserve Bank of Chicago, September 1984.

<sup>4</sup> Direct investment is defined as ownership of 10 percent or more of the voting stock or other means of control over an enterprise by an individual or corporation. Ownership of less than 10 percent of the stock is defined as a portfolio investment.

<sup>5</sup> This is not a limiting assumption for had not the accelerated rate of private investment occurred the government deficit would have been even larger than it actually was because of lower tax receipts stemming from the lower level of economic activity and larger government expenditures—both a response to higher interest rates.

<sup>6</sup> Developing countries have historically been capital importers. High rates of return on investment resulted in an ability of such economies to service rapidly increasing levels of debt. Problems can result, however, if the magnitude of the debt and its servicing costs outrun the country's ability to pay as we have recently observed in numerous Latin American and African countries when the economies are forced to accept reduced current levels of living to pay for past excesses.