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Is the USA Depriving the Rest of the World of Capital?

by Anton Konrad, Munich*

High American interest rates and confident expectations about the future dollar exchange rate have exerted an unprecedented attraction on foreign capital in the past two years. Gross capital inflows into the USA came to as much as \$ 89 billion and \$ 83 billion in 1982 and 1983 respectively. It is widely held that this is depleting the supply of capital to the rest of the world. Is this view justified?

At a number of summit conferences the USA has been accused of starving other economies of capital.¹ Similar views find expression in demands such as "Germany must curb the outflow of capital that is urgently needed for investment in this country".² In the United States itself capital imports are also clearly regarded as an effective way of financing the budget deficit without impeding private investment. The authorities endeavoured to do this mainly by creating a kind of two-tier interest rate structure; nominal interest rates, which are a significant factor in stimulating capital imports, remained relatively high, but interest rates *after* tax, which are more important for the investment decisions of US corporations, were brought down by providing massive tax concessions for investment.

Efforts have recently been made to stimulate capital imports by means of institutional changes in order to dampen the rise in interest rates. This was the aim of the recent decision to abolish withholding tax for foreign holders of US securities. A number of other measures are also under discussion, such as the issue of special loans by the Federal Government and public credit institutions for subscription by foreigners or allowing US firms to issue bearer instruments rather than the registered securities usually issued to foreigners.

Budget Deficit and Foreign Debt

The need for the USA to import capital is usually ascribed to the fact that domestic saving is insufficient to meet the borrowing requirement of both the government and private investors. Table 1 shows the scale of foreign

borrowing that was needed to finance both investment and the budget deficit.

The data on the budget deficit relate to the consolidated public-sector budget. This gives a smaller figure than that for the Federal budget deficit on which attention is currently focused. For example, the 1983 Federal budget deficit of \$182.8 billion was partly offset by a surplus of \$51.1 billion in the budgets of the states and local authorities. The resultant overall deficit of \$131.7 billion represented just under 4 % of gross national product. (The corresponding figure for the Federal Republic of Germany was 3.3 %.) Net foreign debt is calculated by aggregating the balance on capital transactions and net foreign exchange movements; it is therefore the counterpart of the balance on current account. However, the net foreign debt given here is lower than that shown in the balance of payments statistics owing to differences in the methods of calculation.³

It can be seen from Table 1 that in 1982 the emergence of a large budget deficit could still be regarded as a welcome development to offset the

¹ Similar remarks are to be found in documents published by the International Monetary Fund: "Given the magnitude of the U.S. fiscal imbalance in relation to domestic saving, the deficits in this country are contributing to keeping interest rates high worldwide and to absorbing scarce capital from the rest of the world". Cf. IMF Survey, March 26, 1984, p.83.

² "Dollar weiter auf dem Höhenflug", in: General-Anzeiger, Bonn, July 24, 1984.

³ As far as the current account balance is concerned, the most important difference between the balance of payments statistics and the national accounts, from which the data in Table 1 are drawn, is that the latter excludes capital losses or gains from direct investment abroad.

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Table 1
Sources and Uses of Money Capital
(in billions of dollars)

Year	Sources		Uses	
	Private saving	Net foreign indebtedness	Net investment	Budget deficit
1981	159.6	-4.2	128.9	25.7
1982	162.4	8.3	55.3	115.8
1983	193.0	32.3	93.7	131.7

Source: Survey of Current Business, June 1983 and February 1984.

decline in private investment. Moreover, private saving subsequently proved not to be the virtually constant variable that current analyses of the capital market have assumed. Instead, the upturn in 1983 induced, via an increase in national income, an increase in saving; higher investment and the budget deficits themselves therefore to some extent generated the saving required to finance them. The increase in saving was not sufficient, however, to finance both the budget deficit and all of the growth in private investment, so that the gap had to be filled by net capital imports.

Automatic Adjustment

The view that the USA was thus appropriating a disproportionately large share of the saving available in the rest of the world is based on considerations that relate more to fixed exchange rates, however. In the original Bretton Woods System net outflows of private capital in excess of the surplus on current account led to official sales of dollars, so that the money supply of the economy in question was reduced. The European central banks are still making intervention sales of dollars, but these are more a rate smoothing exercise and their impact on the domestic money supply is neutralised. If these neutralising operations take the form of purchases on the open market, adjustment occurs in fact in the capital market itself – the private domestic demand for securities that is lost as a result of capital outflows is replaced by demand from the central bank.

Leaving aside the relatively small volume of central bank intervention, purchasers of American financial assets must obtain the necessary dollars by selling their own currency to US banks either directly or via domestic banks. In this way the US banks cover the demand for foreign exchange arising from the US current account deficit and lending abroad. An inflow of foreign exchange in excess of this requirement is held for investment purposes; by definition, this too constitutes a

capital export. The foreign exchange that the US monetary authorities buy to replenish their own exchange reserves or to regulate the exchange rate also represents a capital export in the broader sense. Hence, any capital inflows into the United States that are not required to offset the current account deficit lead to an automatic re-export of capital.

Utilisation of Imported Capital

In view of the higher interest rates in the USA, only a lower exchange rate offering the prospect of future exchange gains can give American banks or other investors an incentive to hold foreign assets. On the other hand, a decline in exchange rates or an appreciation of the dollar causes a further expansion in the current account deficit. In these circumstances a correspondingly higher net inflow of capital must be absorbed. US Government agencies have occasionally expressed the hope that the budget deficit can be financed entirely through capital imports; this is possible on the condition that the current account deficit becomes as large as the budget deficit, for only in that event would the net inflow of capital also equal the budget deficit.

The US balance of payments summary reproduced in Table 2 can be interpreted as an equation of the utilisation of capital inflows; there are three kinds of utilisation:

- offsetting the current account deficit,
- capital outflows in the narrow sense, in other words the acquisition of foreign assets by private and public-sector bodies with the exception of the monetary authorities,
- the replenishment of America's foreign exchange reserves.

It can be seen that the emergence of a surplus on the US capital account between 1982 and the spring of

Table 2
US Balance of Payments
(in billions of dollars)

	1982	1983	1983 1st quarter	1984 1st quarter
Current account	- 9.199	-41.563	- 2.332	-18.360
Capital exports	-113.933	-48.304	-24.767	- 6.491
Foreign exchange reserves (increase = minus)	- 4.965	- 1.196	- 0.787	- 0.657
Capital imports	+ 95.181	+81.722	+15.888	+11.803
Errors & omissions	+ 32.916	+ 9.331	+11.999	+13.704

Source: Survey of Current Business, June 1984.

1984 was due to a decline in capital outflows rather than an increase in inflows. The decline can be explained by the fact that during the economic upswing strong domestic credit demand competed for funds with foreign lending and that US banks were very reluctant to lend to developing countries after the onset of the Latin American debt crisis. The main factor, however, was that a rising proportion of the capital inflow was needed to offset the current account deficit, so that the amount available for reinvestment in foreign financial assets declined. The dramatic deterioration in the current account is particularly apparent in the increase in the deficit from \$ 2.3 billion in the first quarter of 1983 to \$ 18.3 billion in the first quarter of 1984. A current account deficit of more than \$ 80 billion has been forecast for 1984 as a whole.

No Misappropriation

The following conclusions can now be drawn with regard to the question whether the USA is absorbing an excessive amount of capital:

- If the rest of the world buys American financial assets instead of domestic ones, this does not mean that America is depriving the rest of the world of capital to the extent that the funds flow abroad again via American capital exports or purchases of foreign exchange reserves by the US monetary authorities. At worst, US capital exporters might conceivably prefer shorter-term investments, causing a shortage of long-term capital. However, even detailed balance of payments statistics show no evidence of this, as capital flows in both directions are dominated by bank deposits.
- Most of the portion of American capital imports that serves to offset the current account deficit flows back to the rest of the world in the form of export earnings, so that it no longer constitutes money capital directly available for investment. However, additional export earnings lead to income growth, which in turn generates increased saving. The circular flow leads to a surplus of saving over net investment equal to the current account surplus. Hence, on balance the rest of the world does not suffer a capital loss, because (assuming unchanged net investment) the net capital exports or the corresponding current account surplus generate additional saving of the same amount. To put it another way, net capital exports are fuelled by saving that would not have occurred had there been no net capital exports. For that reason, the fear that capital exports have an adverse effect on real investment is also unfounded. Only in an economy with full employment would a rising export surplus lead to excess demand and cause the

central bank to take restrictive measures that would damp down investment. Most economies are far from that situation at present. Instead, rising export earnings are welcomed unreservedly in order to bolster demand.

High Interest Rates not an Imperative

There is therefore no need for the European countries to prevent capital exports to the USA by pursuing a high interest rate policy or restricting capital flows. At most, a case might be made for such measures on the grounds that the downward floating of the exchange rate caused by capital exports creates the risk of inflation. However, if a sufficiently large bloc of currencies float jointly against the dollar, the proportion of imports that rise in price and, thus, the danger of inflation is kept within limits. Moreover, capital outflows do not depend solely on the rate of return on financial assets at home and abroad but also on the rate of return on real investments; the downward floating of a country's currency has a positive impact on the yield on domestic real investments because of the improved international competitiveness. This in turn places a check on the tendency for capital to flow out of the country. Nevertheless, it cannot be denied that concern about the inflationary pressure generated by currency depreciation has prevented the industrialised European countries from fully exploiting the scope for decoupling their interest rates from those in the USA; admittedly, concern about persisting home-grown inflationary tendencies also played a part in this.

Capital Imports and the Supply of Capital

The capital inflows to the USA no more indicate an expansion in the supply of capital than the outflows from the rest of the world signify that other countries are being deprived of capital. Let us first examine two cases in which the exchange rate remains unaffected by capital imports.

- A relatively small proportion of the dollar demand created by US capital imports is met by exchange market intervention by the central banks of the capital-exporting countries. However, this does not create an additional supply of capital in the USA, for the dollar reserves of these central banks were already deposited in the US money market and simply change hands as a result of the intervention sales. The central banks concerned may regard it as highly undesirable to lose foreign exchange reserves to make possible private capital exports to the USA, but they are losing them to their own banks, not to the United States.
- One of the declared objectives of removing withholding tax was to enable the Treasury to borrow in

the Euro-dollar market. It is a peculiarity of the Euro-dollar market that the Euro-banks hold their liquid reserves in the form of deposits with US banks, either directly or through the intermediary of other Euro-banks. A Euro-dollar credit therefore entails transferring the right to draw on a balance at a US bank. Hence, if the Treasury or another American borrower takes up a loan on the Euro-dollar market it receives the credit in the form of an existing balance with a US bank. No inflow of funds from abroad is involved here. The most that can happen is that balances held in the USA by foreign banks are withdrawn from another use and placed at the Treasury's disposal.

Crowding-out caused by Exchange Rates

Except in these two special cases, additional capital imports by the USA nonetheless tend to cause the dollar to appreciate. If this leads to a fall in exports and the substitution of home-produced goods by imports, the national income of the USA will be lower than if there had been no additional capital inflows. This in turn reduces saving and tax revenues. The attempt to ease the financing of the budget deficit by importing capital therefore causes an increase in the deficit itself; in other words, capital imports serve to finance a deficit that would not have been as high but for the capital imports. Of course, the dampening of demand also checks the rise in interest rates, but if the aim of importing capital was to prevent private investment being crowded out by

the public sector, that objective has not ultimately been achieved; crowding-out on interest-rate terms has simply been replaced by crowding-out on exchange-rate terms.

Conclusions

The encouragement of capital imports into the USA would therefore have to be justified on grounds other than the supposed expansion in the supply of money capital. One rational argument would be the fight against inflationary pressures, which might be triggered by the steep economic upturn in the USA. A stabilising effect on prices may develop partly through the fall in the price of imported goods owing to the appreciation of the dollar and partly through the rising excess of imports over exports. However, the United States is paying a high price for this form of inflation prevention in the shape of the imminent loss of its international net creditor position and the damage being done to those sectors of the economy that are exposed to international competition. The USA will therefore be unable to avoid switching to another policy mix in which the burden of combating inflation will be borne more by fiscal policy rather than by monetary and exchange rate policy as hitherto. In this way, the authorities could aim to achieve a current account balance more appropriate for the leading international investment currency by reducing interest rates and bringing down the dollar exchange rate.

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