



Financing the U.S. Trade Deficit

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Summary

The U.S. merchandise trade deficit is a part of the overall U.S. balance of payments, a summary statement of all economic transactions between the residents of the United States and the rest of the world, during a given period of time. Some Members of Congress and other observers have grown concerned over the magnitude of the U.S. merchandise trade deficit and the associated increase in U.S. dollar-denominated assets owned by foreigners. International trade recovered from the global financial crisis of 2008-2009 and the subsequent slowdown in global economic activity that reduced global trade flows and, consequently, reduced the size of the U.S. trade deficit. Now, however, U.S. exporters face new challenges with economies in Europe and Asia confronting increased risks of a second phase of slow growth. This report provides an overview of the U.S. balance of payments, an explanation of the broader role of capital flows in the U.S. economy, an explanation of how the country finances its trade deficit or a trade surplus, and the implications for Congress and the country of the large inflows of capital from abroad. The major observations indicate that

- Foreign private investors reduced their purchases of U.S. Treasury securities in 2011 after rising sharply in 2010 in response to financial requirements in home markets and continued uncertainty associated with disruptions in global financial markets. During the same period, foreign private investors reduced their purchases of U.S. corporate stocks and bonds in 2011, while foreign official purchases of U.S. Treasury securities continued at a strong pace. The inflow of capital from abroad supplements domestic sources of capital and likely allows the United States to maintain its current level of economic activity at interest rates that are below the level they likely would be without the capital inflows.
- Foreign official and private acquisitions of dollar-denominated assets likely will generate a stream of returns to overseas investors that would have stayed in the U.S. economy and supplemented other domestic sources of capital had the assets not been acquired by foreign investors.

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Background

By standard convention, the balance of payments accounts are based on a double-entry bookkeeping system. As a result, each transaction that is entered into the accounts as a credit must have a corresponding debit and vice versa. This means that a surplus or deficit in one part of the accounts necessarily will be offset by a deficit or surplus, respectively, in another account so that, overall, the accounts are in balance. This convention also means that a deficit in one account, such as the merchandise trade account, is not necessarily the same as a debt.¹ The trade deficit can become a debt equivalent depending on how the deficit is financed and the expectations of those who hold the offsetting dollar-denominated U.S. assets. The balance of payments accounts are divided into three main sections: the current account, which includes the exports and imports of goods and services and personal and government transfer payments; the capital account, which includes such capital transfers as international debt forgiveness; and the financial account, which includes official transactions in financial assets and private transactions in financial assets and direct investment in businesses and real estate.

When the basic structure of the balance of payments was established, merchandise trade transactions dominated the accounts. Financial transactions recorded in the capital accounts generally reflected the payments and receipts of funds that corresponded to the importing and exporting of goods and services. As a result, the capital accounts generally represented “accommodating” transactions, or financial transactions associated directly with the buying and selling of goods and services. During this early period, exchange rates between currencies were fixed, and private capital flows, such as foreign investment, were heavily regulated so that nearly all international flows of funds were associated with merchandise trade transactions and with some limited government transactions.

Since the 1970s, however, private capital flows have grown markedly as countries have liberalized their rules governing overseas investing and as nations have adopted a system of floating exchange rates, where the rates are set by market forces. Floating exchange rates have spurred demand for the dollar. The dollar also is sought for investment purposes as it has become a vehicle itself for investment and speculation and it serves as a major trade invoicing currency. This means that the balance of payments record not only the accommodating flows of capital which correspond to imports and exports of goods and services, but also autonomous flows of capital that are induced by a broad range of economic factors that are unrelated directly to the trading of merchandise goods.

Capital Flows and the Dollar

Liberalized capital flows and floating exchange rates have greatly expanded the amount of autonomous capital flows between countries. These capital transactions are undertaken in response to commercial incentives or political considerations that are independent of the overall balance of payments or of particular accounts. As a result of these transactions, national economies have become more closely linked, the process some refer to as “globalization.” The data in **Table 1** provide selected indicators of the relative sizes of the various capital markets in

¹ For additional information about the causes of the U.S. trade deficit, see CRS Report RL31032, *The U.S. Trade Deficit: Causes, Consequences, and Policy Options*, by Craig K. Elwell.

various countries and regions and the relative importance of international foreign exchange markets. In 2009, these markets amounted to over \$800 trillion, or more than 30 times the size of the U.S. economy. Worldwide, foreign exchange and interest rate derivatives, which are the most widely used hedges against movements in currencies, were valued at \$567 trillion in 2011, more than twice the size of the combined total of all public and private bonds, equities, and bank assets. For the United States, such derivatives total more than three times as much as all U.S. bonds, equities, and bank assets.

Table 1. Selected Indicators of the Size of the Global Capital Markets, 2011

(billions of dollars)

	Gross Domestic Product (GDP)	Total Official Reserves	Bonds, Equities, and Bank Assets				Exchange Market Derivatives		
			Total	Stock Market Capitalization	Debt Securities	Bank Assets	Total	OTC Foreign Exchange Derivatives	OTC Interest Rate Derivatives
World	\$69,899.2	10,650.4	255,855.6	47,089.2	98,388.1	110,378.2	567,447	63,349	504,098
European Union	16,426.5	468.0	82,251.6	8,530.2	31,548.5	42,172.7	NA	NA	NA
Euro Area	13,118.5	316.7	58,874.6	4,586.6	24,976.2	29,311.8	207,937	23,235	184,702
United Kingdom	2,431.3	79.3	19,055.6	3,266.4	4,839.2	10,950.0	50,390	7,023	43,367
United States	15,075.7	136.9	63,976.9	15,640.7	33,700.9	14,635.3	215,925	54,061	161,864
Japan	5,866.5	1,258.2	31,666.1	3,540.7	15,369.3	12,756.1	80,480	13,661	66,819
Emerging markets	25,438.4	6,944.5	44,553.7	9,771.0	9,240.2	25,542.5	NA	NA	NA

Source: *Global Financial Stability Report*, International Monetary Fund, October 2012. Statistical Appendix, Table 1; *Quarterly Review*, Bank for International Settlements, September, 2012, Tables 20b and 21b.

Note: Total derivatives does not include equity and commodity-linked derivatives.

Another aspect of capital mobility and capital inflows is the impact such capital flows have on the international exchange value of the dollar. Demand for U.S. assets, such as financial securities, translates into demand for the dollar, since U.S. securities are denominated in dollars. As demand for the dollar rises or falls according to overall demand for dollar-denominated assets, the value of the dollar changes. These exchange rate changes, in turn, have secondary effects on the prices of U.S. and foreign goods, which tend to alter the U.S. trade balance. At times, foreign governments intervene in international capital markets to acquire the dollar directly or to acquire Treasury securities in order to strengthen the value of the dollar against particular currencies. In addition, various central banks moved aggressively following the Asian financial crisis in the 1990s to bolster their holdings of dollars in order to use the dollars to support their currencies should the need arise.

The dollar is also heavily traded in financial markets around the globe and, at times, plays the role of a global currency. Disruptions in this role have important implications for the United States and for the smooth functioning of the international financial system. During the decade preceding the recent global financial crisis, banks and other financial institutions expanded their global

balance sheets from \$10 trillion in 2000 to \$34 trillion in 2007. These assets were comprised primarily of dollar-denominated claims on non-bank entities, including retail and corporate lending, loans to hedge funds, and holdings of structured finance products based on U.S. mortgages and other underlying assets. As the crisis unfolded, the short-term dollar funding markets served as a major conduit through which financial distress was transmitted across financial markets and national borders, according to analysts with the Bank for International Settlements (BIS).² When these short-term dollar funding markets collapsed in the early stages of the crisis, the U.S. Federal Reserve had to engage in extraordinary measures, including a vast system of currency swap arrangements with central banks around the world, to supply nearly \$300 billion. After initially expanding the then-existing reciprocal currency arrangements (swap lines) with the European Central Bank, the Bank of England, the Swiss National Bank, and the Bank of Japan, the Federal Reserve made an unprecedented announcement in October 2008 that it would provide swap lines to “accommodate whatever quantity of U.S. dollar funding is necessary” to stem the dollar shortage.³ At the same time, the U.S. Treasury announced a money market guarantee program to stop the withdrawal of funds from the money markets and to offset the withdrawals by providing public funds.

The prominent role of the dollar means that the exchange value of the dollar often acts as a mechanism for transmitting economic and political news and events across national borders. While such a role helps facilitate a broad range of international economic and financial activities, it also means that the dollar’s exchange value can vary greatly on a daily or weekly basis as it is buffeted by international events. A triennial survey of the world’s leading central banks conducted by the Bank for International Settlements in April 2010 indicates that the **daily** trading of foreign currencies through traditional foreign exchange markets⁴ totals \$4.0 trillion, up 20% from the \$3.3 trillion reported in the previous survey conducted in 2007. In addition to the traditional foreign exchange market, the over-the-counter (OTC)⁵ foreign exchange derivatives market reported that daily turnover of interest rate and non-traditional foreign exchange derivatives contracts reached \$2.1 trillion in April 2010. The combined amount of \$6.1 trillion for daily foreign exchange trading in the traditional and OTC markets is more than three times the **annual** amount of U.S. exports of goods and services. The data also indicate that 84.9% of the global foreign exchange turnover in April 2010 was in U.S. dollars, slightly lower than the 85.6% share reported in a similar survey conducted in 2007.⁶

² McGuire, Patrick, and Gotz von Peter, “The US Dollar Shortage in Global Banking and the International Policy Response,” BIS Working Paper No. 291, the Bank For International Settlements, October 2009; McGuire, Patrick, and Goetz von Peter, “The U.S. Dollar Shortage in Global Banking,” *BIS Quarterly Review*, March 2009.

³ *Ibid.*, p. 76.

⁴ Traditional foreign exchange markets are organized exchanges which trade primarily in foreign exchange futures and options contracts where the terms and condition of the contracts are standardized.

⁵ The over-the-counter foreign exchange derivatives market is an informal market consisting of dealers who custom-tailor agreements to meet the specific needs regarding maturity, payments intervals or other terms that allow the contracts to meet specific requirements for risk.

⁶ *Triennial Central Bank Survey: Foreign Exchange and Derivatives Market Activity in 2010*. Bank for International Settlement, September 2010. pp. 1-2. A copy of the report is available at <http://www.bis.org/publ/rpfx10.pdf>.

The U.S. Balance of Payments

Table 2 presents a summary of the major accounts in the U.S. balance of payments over the last six quarters. The data indicate that in 2011 and 2012 the U.S. current account, or the balance of exports and imports of goods, services and transfers, was in deficit, or the United States imported more than it exported. On a quarterly basis, the deficit in the current account has varied from quarter to quarter, although remaining negative, reflecting a broad range of economic activities. According to the balance of payments accounts, the United States experienced deficits in the merchandise trade goods accounts through the most recent six quarters from the third quarter of 2011 to the fourth quarter of 2012 in the range of \$174 to \$195 billion and a surplus in the services accounts during the six quarters in the range of about \$46 billion. In the income accounts, which represent inflows of income on U.S. assets abroad relative to outflows of income earned on U.S. assets owned by foreigners, the net balance of the accounts was in surplus throughout the six-quarter period.

Table 2. U.S. International Transactions, Selected Accounts
(billions of dollars)

	2011	2012	2011		2012			
			III	IV	I	II	III	IV
Current account								
Balance on current account	\$-466	\$-475	\$-108	\$-119	\$-134	\$-118	\$-112	\$-110
Balance on goods and services	-560	-540	-135	-146	-149	-138	-125	-128
Balance on goods	-738	-735	-181	-189	-195	-186	-174	-181
Exports	1,497	1,564	382	382	388	394	393	390
Imports	-2,236	-2,299	-563	-571	-583	-580	-567	-570
Balance on services	179	196	46	43	46	48	49	52
Exports	606	630	155	151	156	158	158	160
Imports	-427	-435	-109	-108	-110	-109	-108	-107
Balance on income	227	199	58	60	48	52	47	52
Income Receipts	745	742	187	187	184	184	183	191
Income Payments	-518	-543	-129	-127	-137	-132	-136	-139
Unilateral current transfers	-133	-134	-32	-32	-33	-33	-34	-34
Capital account								
Capital account transactions	-1	6	0	0	0	0	0	7
Financial account								
Balance on financial account	556	400	171	63	166	107	68	58
U.S.-owned assets abroad, net	-484	18	-92	-26	107	249	-217	-120
U.S. official reserve assets, net	-16	-4	-4	-2	-1	-3	-1	1
U.S. Government assets, net	-104	85	-1	-101	51	17	15	2
U.S. private assets, net	-364	-63	-84	76	57	235	-232	-124
Foreign-owned assets in the U.S.	1,001	385	266	57	61	-142	291	176

	2011	2012	2011		2012			
			III	IV	I	II	III	IV
Foreign official assets, net	212	374	20	-3	70	80	131	93
U.S. Treasury Securities	171	355	28	-18	85	85	105	80
Foreign private assets, net	789	11	247	60	-9	-222	159	83
U.S. Treasury Securities	241	124	121	83	44	6	48	26
Financial derivatives	39	-3	-4	33	-1	0	-5	3
Statistical discrepancy	-89	69	-62	55	-32	12	45	45

Source: Scott, Sarah P., U.S. International Transactions: Fourth Quarter and Year 2012, BEA Release, March 14, 2013.

The data also indicate that the U.S. financial accounts were in surplus throughout the period, because they represent the opposite and offsetting transactions to the deficits in the current account. Indeed, the accounting of the balance of payments is such that the surplus in the financial accounts is equivalent to the deficit in the combined balance in the capital account, the statistical discrepancy, and the balance on the current account. The balance in the financial accounts represents the difference between the capital outflows associated with U.S. investments abroad, which are recorded as a negative value, and the capital inflows associated with foreign investment in the United States, which are recorded as a positive value. This investment is a combination of both private and official investments, or investments by private individuals and institutions and investments by governments and governmental institutions, respectively. Data for the past six quarters indicate that foreign official purchases of U.S. Treasury securities peaked in the third quarter of 2012, far different from the net sales of such securities during the fourth quarter of 2011. Private foreign purchases of Treasury securities in 2012 were positive, but low on a quarterly basis compared with those in 2011. On an annual basis, foreign private purchases of U.S. Treasury securities were about half of those in 2011.

The data in **Table 2** also indicate that in 2011 and in 2012, private capital outflows generally were greater than official outflows, while foreign private capital inflows generally were overshadowed by foreign official capital inflows, likely reflecting the slowdown in private economic activity in global markets. Another way of viewing the data is presented in **Table 3** which shows the *net* amount of the flows in the major accounts, or the difference between the inflows and outflows. In 2012 for instance, total net capital inflows representing the net balance on the current account, the capital account, and the statistical discrepancy, were a negative \$400 billion, which was equivalent to the \$400 billion recorded in the financial accounts. The 2012 values represent a decrease in the net amount recorded in 2011 and reflect a higher merchandise trade deficit as a result of the slowdown in economic activity in Europe and elsewhere. These totals, however, are subject to periodic revisions.

Table 3. Summary of the Net Balances by Major Accounts in the U.S. Balance of Payments

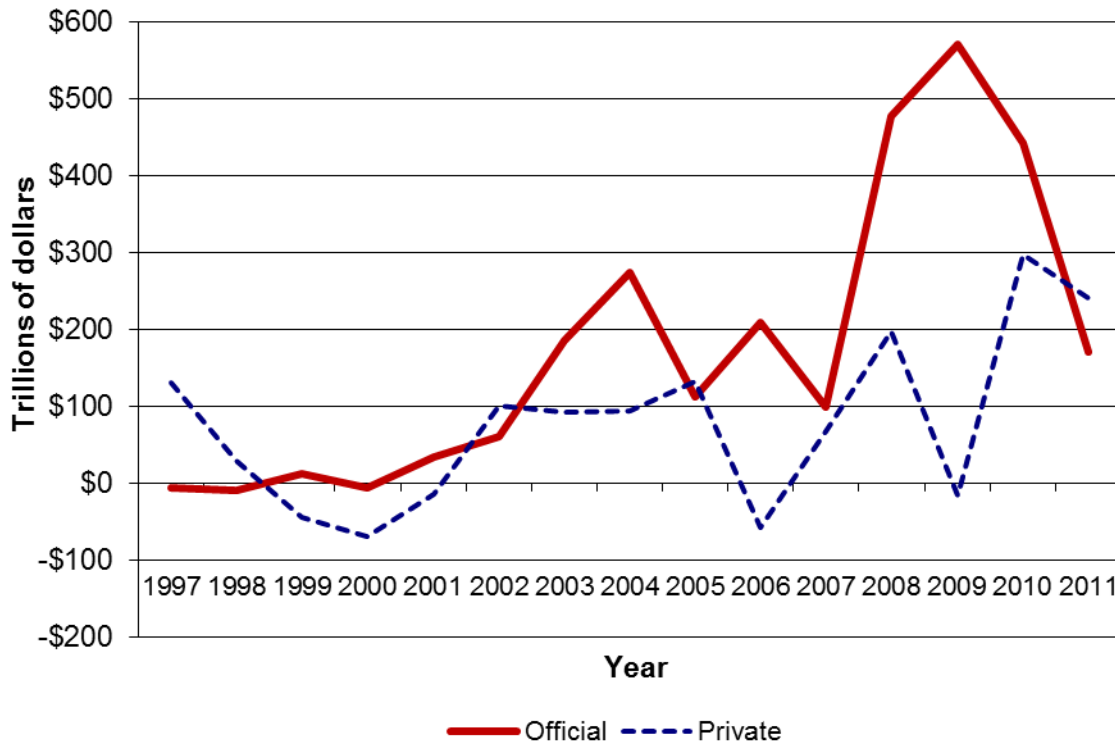
(billions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012
Total Net Capital Inflows	-\$701	-\$809	-\$664	-\$578	-\$240	-\$383	-\$556	-\$400
Total Net Goods	-791	-847	-831	-835	-506	-645	-738	-735
Total Net Services	76	87	130	136	127	150	179	196
Total Net Income	72	48	91	152	120	184	227	199
Total Net Transfers	-106	-91	-116	-122	-122	-131	-133	-134
Total Net Capital Account	11	-4	-2	6	0	0	-1	6
Statistical Discrepancy	37	-2	65	85	142	59	-89	69
Total Net Financial Account	\$701	\$809	\$664	578	240	383	556	400
Total Net Official	279	496	459	16	969	404	92	454
Total Net Private	422	284	199	594	-775	-35	425	-51
Direct Investment	76	-2	-123	-23	-139	-122	-185	-177
Portfolio Investment	331	260	306	193	-241	298	38	148
Other Private (Banks)	14	26	16	424	-395	-211	573	-23
Financial Derivatives	0	30	6	-33	45	14	39	-3

Source: Data developed by CRS from data published by the Department of Commerce.

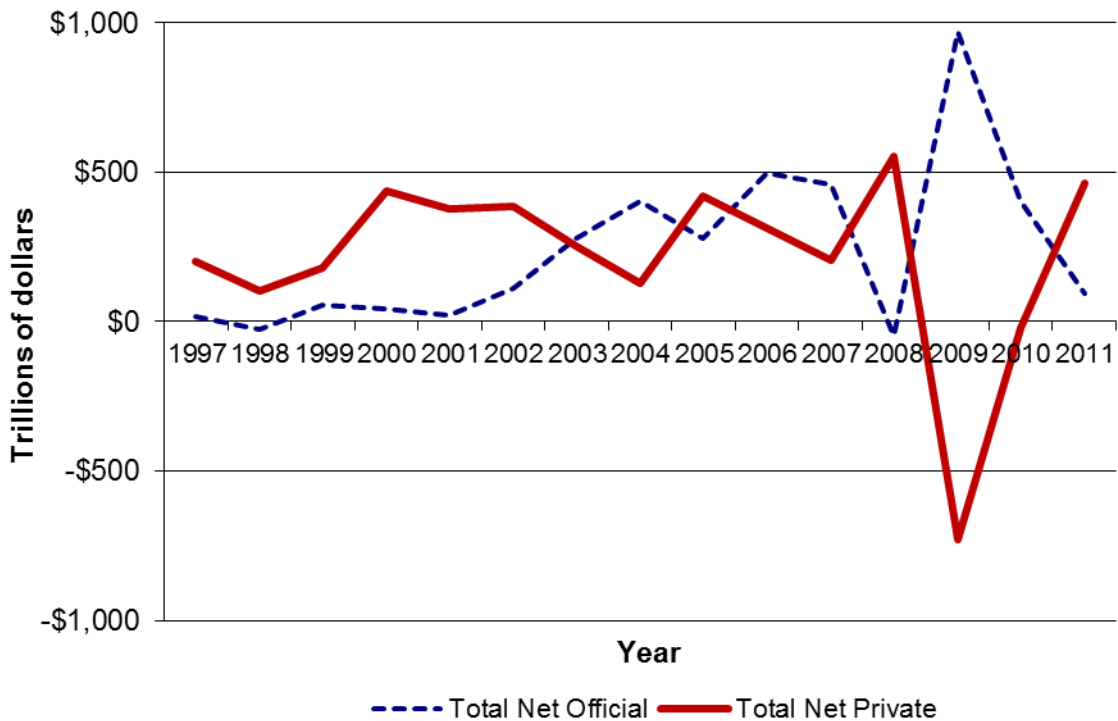
Commerce Department data indicate that foreign private purchases of Treasury securities turned negative between 1999 and 2001, in 2006, and again in 2009 as foreign private investors experienced net sales of Treasury securities, as indicated in **Figure 1**. In 2002, foreign private investors returned to acquiring Treasury securities, but the amount they acquired remained relatively level at \$100 billion per year from 2002 to 2005. In contrast, foreign official net acquisitions of Treasury securities trended slightly upward between 2000 and 2002, but such net acquisitions more than doubled over the 2002 to 2004 period, rising to \$273 billion in 2004. In 2005, though, official purchases of Treasury securities plummeted to \$112 billion and were less than private purchases of \$132 billion. In 2006, private foreign investors again reduced their net holdings of Treasury securities. This action was offset by a large increase in acquisitions of Treasury securities by foreign governments, directed at least in part to slow the decline in the international exchange value of the dollar. In 2009, foreign private investors sold off \$15 billion in Treasury securities, down sharply from the \$197 billion they accumulated in 2008. Foreign governments, however, increased their net purchases of Treasury securities in 2009, which rose from \$478 billion in 2008 to \$570 billion in 2009. In 2010, foreign private investments in treasury securities rose to nearly \$300 billion, while foreign official purchases fell to \$442 billion. In 2011, foreign private purchases of treasury securities rose to \$241 billion, outpacing foreign official purchases of \$171 billion. Over the eleven-year period 2001-2011, net foreign official purchases of treasury securities were more than twice as large as net foreign private purchases.

Figure 1. Foreign Private and Official Purchases of U.S. Treasury Securities, 1997-2011



Source: Department of Commerce.

As the data in **Table 3** indicate, a deficit in the net capital inflow account is financed by an offsetting net inflow in the financial account. One striking feature of the financial flows over the 2004-2011 period is the way the composition of the balances in the net financial account has changed. Net private and net official capital inflows have changed abruptly since the period prior to 2002, when private inflows were greater than official inflows, as indicated in **Figure 2**. In 2004, 2006, 2007, 2009, and 2010, net official inflows exceeded net private inflows. Recently, private capital flows by U.S. citizens shifted from a net outflow of \$1.4 trillion in 2007 to a net inflow of \$866 billion in 2008, reflecting the financial turmoil during that period. Net private outflows by U.S. citizens, however, resumed in the 2009 to 2011 period. During the same period, U.S. official outflows increased from \$22 billion in 2007 to \$530 billion in 2008. In contrast, foreign private inflows of capital dropped from \$1.6 trillion in 2007 to \$47 billion in 2008. During the same period, foreign official inflows increased slightly from \$481 billion in 2007 to \$487 billion in 2008. As a result of these changes, net official flows, or the combination of U.S. and foreign official flows dropped from a net outflow of \$458 billion in 2007 to a net inflow of \$47 billion in 2008. In addition, net private flows increased from a net inflow of \$199 billion in 2007 to a net inflow of \$581 billion in 2008. In 2009, however, net private inflows dropped to a negative \$774 billion, while net official inflows rose to nearly \$1 trillion.

Figure 2. Net Inflows of Private and Official Sources of Capital, 1997-2011

Source: Department of Commerce.

The data in **Table 4** show the total net accumulation of long-term U.S. securities, or the amount of securities purchased less those that were sold, by foreign private and official sources from 2004-2011. The data indicate that in 2008, the net foreign private accumulation of U.S. securities dropped by three-fourths as foreign private investors withdrew funds from the U.S. during the financial crisis. In 2009, however, foreign private purchases of U.S. securities rebounded from a negative \$186.5 in 2008 to a positive \$51 in 2009, reflecting increased net purchases of U.S. corporate stocks and U.S. Treasury securities. Similar purchases increased eight-fold between 2009 and 2010 as foreign private purchases reached over \$400 billion before falling to \$140 billion in 2011. In 2011, private foreign investors operating in Europe reduced their purchases of corporate stocks and bonds and U.S. government agency bonds, but increased their purchases of Treasury securities by \$150 billion. With a few exceptions, foreign private investors from other areas increased their purchases of all asset classes in 2011.

Table 4. Net Foreign Purchases of Long-Term U.S. Securities
(billions of dollars)

	2004	2005	2006	2007	2008	2009	2010	2011
Total private and official net purchases of U.S. securities	\$767.8	\$875.7	\$1,099.1	\$989.6	\$236.3	\$484.8	\$571.0	\$419.1
Total private purchases	455.6	598.3	611.4	644.8	-186.5	51.1	412.3	143.0
Corporate stocks	59.5	88.3	139.7	230.5	57.5	163.4	137.8	12.4
Europe	36.3	44.0	92.6	90.5	-2.1	79.6	80.8	-36.9
United Kingdom	28.9	21.2	73.2	67.9	28.4	33.3	34.9	2.2
Canada	3.9	21.0	12.6	9.8	6.7	9.5	17.5	14.6
Caribbean financial centers	3.1	14.8	34.4	95.4	1.7	34.2	22.6	30.5
Latin America	-0.4	-0.4	1.8	1.1	3.5	5.2	4.8	0.9
Asia	5.5	8.7	-2.2	27.9	50.7	31.4	10.6	2.0
Of which: Japan	4.9	-0.1	-1.2	-5.6	21.8	20.6	11.5	3.1
Africa	-0.1	0.3	0.0	-0.4	-4.7	-0.8	-0.4	0.8
Corporate bonds	254.6	312.3	517.8	383.7	-51.4	-117.3	-24.7	-68.8
Europe	126.3	199.8	332.1	225.9	-80.4	-105.7	-64.6	-98.3
United Kingdom	69.6	144.7	203.6	130.5	-46.3	-56.1	-30.8	-51.0
Canada	6.0	1.9	7.9	12.4	-2.0	-0.1	9.8	-0.8
Caribbean financial centers	47.1	40.2	106.9	61.9	12.1	-7.4	21.3	16.1
Latin America	20.2	7.3	9.3	4.7	-13.7	-4.5	3.4	3.8
Asia	51.9	54.4	53.7	72.8	32.4	1.6	6.8	14.7
Japan	33.5	25.6	12.2	39.5	21.7	-1.6	0.8	9.3
Africa	0.6	0.6	0.2	-0.4	-0.4	0.1	0.1	0.0
Other	2.6	8.1	7.7	6.4	0.7	-1.3	-1.4	-4.3
U.S. Treasury bonds	74.1	147.9	-71.9	39.2	-20.0	49.2	273.0	199.5
Europe	38.2	65.2	-61.9	57.8	-43.5	-38.0	104.7	156.0
Canada	16.3	21.8	14.7	-1.9	-6.2	19.7	35.8	-4.0
Caribbean financial centers	22.1	44.9	-10.9	-6.2	2.6	-13.8	22.1	12.9
Latin America	-3.4	10.4	-2.1	9.8	-5.0	6.1	0.4	-6.7
Asia	1.0	1.3	-10.7	-20.8	29.3	71.9	111.0	39.2
Africa	0.7	1.7	1.1	1.5	7.0	1.1	5.5	1.9
Other	-0.8	2.5	-2.1	-1.1	-4.3	2.3	-6.4	0.3
Federal agency bonds	67.4	49.8	25.8	-8.6	-172.6	-44.3	26.2	0.0

	2004	2005	2006	2007	2008	2009	2010	2011
Europe	13.3	-11.9	-8.1	42.3	-17.4	-46.6	1.1	-16.0
United Kingdom	31.4	-1.3	-8.8	70.9	42.4	-30.4	25.0	0.5
Canada	5.0	12.1	9.7	3.0	5.0	1.8	8.1	3.3
Caribbean financial centers	11.3	3.0	31.3	-21.6	-75.8	7.9	-14.5	5.8
Latin America	1.8	7.1	3.4	2.8	0.8	0.8	5.0	6.6
Asia	36.4	40.2	-10.8	-34.6	-81.4	-3.7	28.7	0.6
Japan	16.5	15.6	2.9	-14.9	-39.0	-1.2	21.7	15.9
Africa	-0.1	-0.3	-0.3	-0.6	-2.9	-2.0	-0.9	-0.2
Other	-0.3	-0.4	0.6	0.1	-1.0	-2.4	-1.2	-0.1
Total official purchases	312.2	277.4	487.7	344.8	422.8	433.7	458.7	276.1
U.S. Treasury bonds	256.8	156.9	233.5	76.6	276.2	512.7	506.8	274.5
Other U.S. Government securities	41.7	100.5	219.8	171.5	42.7	-132.6	-88.7	-12.4
Corporate bonds	11.5	19.1	28.6	51.6	35.0	-2.3	0.8	-0.9
Corporate stocks	2.2	1.0	5.8	45.1	68.9	55.9	39.7	15.0

Source: Scott, Sarah P., "U.S. International Transactions: Second Quarter 2012." *Survey of Current Business*, October, 2012. Table 8a.

The U.S. Net International Investment Position

As indicated above, the data in **Table 2** and **Table 3** show that the trade deficit is accompanied by an equal capital inflow that represents an accumulation of dollar-denominated assets by foreigners. Some observers have equated the trade deficit and the associated accumulation of foreign-owned dollar-denominated assets as a debt that the U.S. economy owes to foreigners that will have to be repaid. This characterization, however, is not entirely appropriate. The debts owned by foreign investors represents claims on assets, rather than loans where payments on the principle and interest are specified according to a fixed schedule and where failure to meet the repayment schedule can result in the loans being called in and made payable in full. While foreign investors have expectations of a positive return on their dollar-denominated assets, returns, except for Treasury securities, are not guaranteed, but are subject to market forces. An important feature of claims by foreign investors on U.S. assets is that some or all of the profits or returns on the assets can be repatriated to the home country of the foreign investor, thereby reducing the returns that otherwise would remain in the U.S. economy.

According to the most commonly accepted approach to the balance of payments, macroeconomic developments in the U.S. economy are the major driving forces behind the magnitudes of capital flows, because the macroeconomic factors determine the overall demand for and supply of capital in the economy. Economists generally conclude that the rise in capital inflows can be attributed to comparatively favorable returns on investments in the United States when adjusted for risk, a surplus of saving in other areas of the world, the well-developed U.S. financial system, the overall stability of the U.S. economy, and the generally held view that U.S. securities, especially Treasury securities, are high quality financial instruments that are low risk. In turn, these net

capital inflows (inflows net of outflows) bridge the gap in the United States between the amount of credit demanded and the domestic supply of funds, likely keeping U.S. interest rates below the level they would have reached without the foreign capital. These capital inflows also allow the United States to spend beyond its means, including financing its trade deficit, because foreigners are willing to lend to the United States in the form of exchanging goods, represented by U.S. imports, for such U.S. assets as stocks, bonds, U.S. Treasury securities, and real estate and U.S. businesses.

While this exchange of assets is implicit in the balance of payments, the Department of Commerce explicitly accounts for this broad flow of dollar-denominated assets through the nation's net international investment position. The U.S. net international investment position represents the accumulated value of U.S.-owned assets abroad and foreign-owned assets in the United States measured on an annual basis at the end of the calendar year. Some observers refer to the net of this investment position (or the difference between the value of U.S.-owned assets abroad and the value of foreign-owned assets in the United States) as a debt, or indicate that the United States is a net debtor nation, because the value of foreign-owned assets in the United States is greater than the value of U.S.-owned assets abroad.

In fact, the nation's net international investment position is not a measure of the nation's indebtedness similar to the debt borrowed by some developing countries, but it is simply an accounting of assets. By year-end 2011, the latest year for which data are available, the overseas assets of U.S. residents totaled \$20.6 trillion, while foreigners had acquired about \$24.8 trillion in assets in the United States, with direct investment measured at historical cost. As a result, the U.S. net international investment position was about a negative \$4.2 trillion, with direct investment measured at historical cost, as indicated in **Table 5**.

Table 5. U.S. Net International Investment Position
(billions of dollars)

Type of Investment	2008	2008	2010	2011
Net international investment position of the United States:				
With direct investment at current cost	\$-3,260.2	\$-2,321.8	\$-2,473.6	\$-4,030.3
With direct investment at market value	-3,995.3	-2,661.3	-2,813.4	-4,812.4
With direct investment at historical cost	-3,425.4	-2,503.8	-2,656.2	-4,195.3
Financial derivatives	159.6	126.3	110.4	126.3
U.S.-owned assets abroad:				
With direct investment at current cost	19,464.7	18,511.7	20,298.4	21,132.4
With direct investment at market value	18,818.6	18,769.4	20,758.3	20,950.8
With direct investment at historical cost	18,948.7	18,000.9	19,782.5	20,606.4
Financial derivatives	6,127.5	3,489.8	3,652.3	4,704.7
U.S. official reserve assets	293.7	403.8	488.7	536.0
U.S. Government assets, other	624.1	82.8	75.2	178.9
U.S. private assets:				
With direct investment at current cost	12,419.4	14,535.3	16,082.2	15,712.8
With direct investment at market value	11,773.3	14,793.1	16,542.1	15,531.2

Type of Investment	2008	2008	2010	2011
With direct investment at historical cost	11,903.4	14,024.5	15,566.3	15,186.7
Direct investment abroad:				
—At current cost	3,748.5	4,029.5	4,306.8	4,681.6
—At market value	3,102.4	4,287.2	4,766.7	4,500.0
—At historical cost	3,232.5	3,518.7	3,790.9	4,155.6
Foreign securities	3,985.7	5,565.6	6,336.4	5,922.0
—Bonds	1,237.3	1,570.3	1,689.5	1,763.8
—Corporate stocks	2,748.4	3,995.3	4,646.9	4,158.2
U.S. claims by US nonbanking concerns	930.9	930.3	874.8	796.8
U.S. claims reported by US banks	3,754.3	4,009.9	4,564.2	4,312.4
Foreign-owned assets in the United States:				
With direct investment at current cost	22,724.9	20,833.5	22,772.0	25,162.6
With direct investment at market value	22,813.9	21,430.7	23,571.7	25,763.2
With direct investment at historical cost	22,374.1	20,504.7	22,438.7	24,801.7
Financial derivatives	5,967.8	3,363.4	3,541.9	4,578.4
Foreign official assets in the United States	3,943.9	4,402.8	4,912.7	5,250.8
Foreign private assets:				
With direct investment at current cost	12,813.2	13,067.2	14,317.4	15,333.4
With direct investment at market value	12,902.2	13,664.5	15,117.1	15,934.0
With direct investment at historical cost	12,462.5	12,738.4	13,984.0	14,972.5
Direct investment in the United States:				
—At current cost	2,397.4	2,398.2	2,597.7	2,908.8
—At market value	2,486.4	2,995.5	3,397.4	3,509.4
—At historical cost	2,046.7	2,069.4	2,264.4	2,547.8
U.S. Treasury securities	852.5	791.0	1,101.8	1,418.1
U.S. other securities	4,620.7	5,319.9	5,934.0	5,968.2
—Corporate and other bonds	2,770.6	2,825.6	2,915.7	2,910.0
—Corporate stocks	1,850.1	2,494.3	3,018.3	3,058.2
U.S. currency	301.1	313.8	342.1	397.1
U.S. liabilities by U.S. nonbanking concerns	740.6	706.4	643.6	629.7
U.S. liabilities reported by U.S. banks	3,901.0	3,537.9	3,698.2	4,011.6

Source: Nguyen, Elena L., "The International Investment Position of the United States at Yearend 2011," *Survey of Current Business*, July 2012. p. 18.

Foreign investors who acquire U.S. assets do so at their own risk and accept the returns accordingly, unlike the debt owed by developing countries where principle and debt service payments are guaranteed in advance. While foreign investors likely expect positive returns from their dollar-denominated assets, the returns on most of the assets in the international investment

position, except for bonds, are not guaranteed and foreign investors stand to gain or lose on them similar to the way U.S. domestic investors gain or lose.

As **Table 5** indicates, the investments in the international investment position include such financial assets as corporate stocks and bonds, government securities, and direct investment⁷ in businesses and real estate. The value of these assets, measured on an annual basis, can change as a result of purchases and sales of new or existing assets; changes in the financial value of the assets that arise through appreciation, depreciation, or inflation; changes in the market values of stocks and bonds; or changes in the value of currencies. For instance, by year-end 2011, U.S. private holdings abroad had fallen in value from \$15.6 trillion to \$15.2 trillion, with direct investment valued at historical cost, due in part to a downward revaluation in the values of foreign corporate stocks, reflecting a decline in stock market values, primarily in Europe, combined with a rise in the exchange value of the euro, which depreciates the value of assets held abroad when translated into dollar equivalents. Similarly, the value of foreign owned corporate stocks in the United States rose in value in 2011, pulling up the overall investment position of foreign investors. The Department of Commerce uses three different methods for valuing direct investments that yield roughly comparable estimates for the net position, although the three methods do provide estimates on U.S. direct investment abroad and foreign direct investment that can be considerably different at times.⁸

The foreign investment position in the United States continues to increase as foreigners acquire additional U.S. assets and as the value of existing assets appreciates. These assets are broadly divided into official and private investments reflecting transactions by governments among themselves and transactions among the public. While the foreign official share of the overall amount of capital inflows has grown sharply as indicated in **Table 3**, the overall foreign official share of foreign-owned assets in the United States has remained relatively modest.

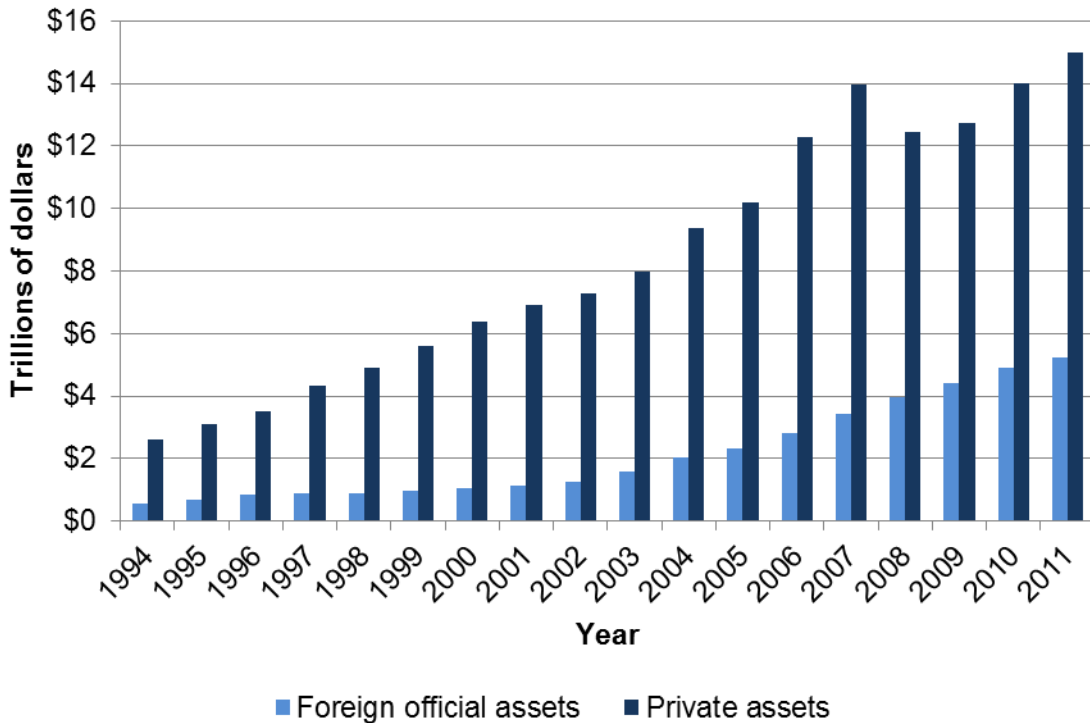
As **Figure 3** indicates, foreign official asset holdings were valued at about \$5.2 trillion in 2011, or about 26% of the total foreign investment position, a share that has rose above 20% in 2008 as foreign official holdings of U.S. Treasury securities rose during the global financial crisis. Official assets include such monetary reserve assets as gold, the reserve position with the International Monetary Fund (IMF), and holdings of foreign currency. An important component of foreign official holdings in the United States is the acquisitions of U.S. Treasury securities by foreign governments. At times, such acquisitions are used by foreign governments, either through coordinated actions or by themselves, to affect the foreign exchange price of the dollar. Foreign currency holdings account for a relatively small share of the total foreign investment position.⁹

⁷ The United States defines foreign direct investment as the ownership or control, directly or indirectly, by one foreign person (individual, branch, partnership, association, government, etc.) of 10% or more of the voting securities of an incorporated U.S. business enterprise or an equivalent interest in an unincorporated U.S. business enterprise. 15 CFR §806.15 (a)(1). Similarly, the United States defines direct investment abroad as the ownership or control, directly or indirectly, by one person (individual, branch, partnership, association, government, etc.) of 10% or more of the voting securities of an incorporated business enterprise or an equivalent interest in an unincorporated business enterprise. 15 CFR §806.15 (a)(1).

⁸ For additional information, see CRS Report RL32964, *The United States as a Net Debtor Nation: Overview of the International Investment Position*, by James K. Jackson.

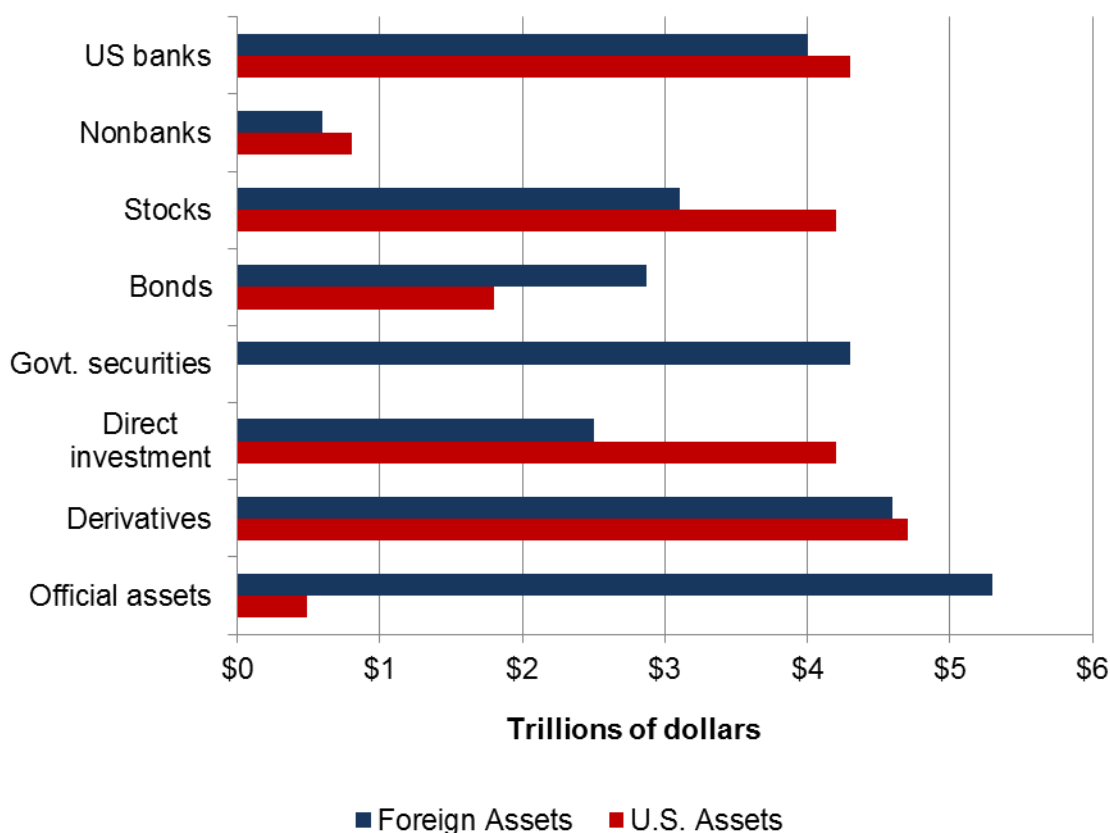
⁹ For additional information, see CRS Report RL32462, *Foreign Investment in U.S. Securities*, by James K. Jackson.

Figure 3. Foreign Official and Private Investment Positions in the United States, 1994-2011



Source: Department of Commerce.

Private asset holdings are comprised primarily of direct investment in businesses and real estate, purchases of publicly traded government securities, and corporate stocks and bonds. As indicated in **Figure 4**, the composition of U.S. assets abroad and foreign-owned assets in the United States differ in a number of ways. The strength and uniqueness of the U.S. Treasury securities markets make these assets sought after by both official and private foreign investors, whereas U.S. investors hold few foreign government securities. As a result, foreign official assets in the United States far outweigh U.S. official assets abroad. Both foreign private and official investors have been drawn at times to U.S. government securities as a safe haven investment during troubled or unsettled economic conditions.

Figure 4. U.S. and Foreign Investment Position, By Major Component, 2011

Source: Department of Commerce.

Implications

The persistent U.S. trade deficit raises concerns in Congress and elsewhere due to the potential risks such deficits may pose for the long term rate of growth for the economy. In particular, some observers are concerned that foreign investors' portfolios will become saturated with dollar-denominated assets and foreign investors will become unwilling to accommodate the trade deficit by holding more dollar-denominated assets. The shift in 2004 in the balance of payments toward a larger share of assets being acquired by official sources generated speculation that foreign private investors had indeed reached the point where they were no longer willing to add more dollar-denominated assets to their portfolios. This shift was reversed in 2005, however, as foreign private investments rebounded.

Another concern is with the outflow of profits that arise from the dollar-denominated assets owned by foreign investors. This outflow stems from the profits or interest generated by the assets and represent a clear outflow of capital from the economy that otherwise would not occur if the assets were owned by U.S. investors. These capital outflows represent the most tangible cost to the economy of the present mix of economic policies in which foreign capital inflows are needed to fill the gap between the demand for capital in the economy and the domestic supply of capital.

Indeed, as the data presented indicate, it is important to consider the underlying cause of the trade deficit. According to the most commonly accepted economic approach, in a world with floating exchange rates and the free flow of large amounts dollars in the world economy and international access to dollar-denominated assets, macroeconomic developments, particularly the demand for and supply of credit in the economy, are the driving forces behind the movements in the dollar's international exchange rate and, therefore, the price of exports and imports in the economy. As a result, according to this approach, the trade deficit is a reflection of macroeconomic conditions within the domestic economy and an attempt to address the issue of the trade deficit without addressing the underlying macroeconomic factors in the economy likely would prove to be of limited effectiveness.

In addition, the nation's net international investment position indicates that the largest share of U.S. assets owned by foreigners is held by private investors who acquired the assets for any number of reasons. As a result, the United States is not in debt to foreign investors or to foreign governments similar to some developing countries that run into balance of payments problems, because the United States has not borrowed to finance its trade deficit. Instead the United States has traded assets with foreign investors who are prepared to gain or lose on their investments in the same way private U.S. investors can gain or lose. It is certainly possible that foreign investors, whether they are private or official, could eventually decide to limit their continued acquisition of dollar-denominated assets or even reduce the size of their holdings, but there is no firm evidence that such presently is the case.

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