Foreign Investment in the US: Disappearing in a black hole?

By Daniel Gros

The global financial system seems to have a black hole at its centre. Over the last two decades, US residents have sold a total of around $5.5 trillion (thousand billion) worth of IOUs to foreigners, yet the officially recorded net investment position of the US has deteriorated only by a little over half of this amount ($2.8 trillion). The US capital market seems to have acted like a black hole for investors from the rest of world in which $2.7 trillion vanished from sight – or at least from the official statistics.

How can $2.7 trillion disappear?

It is often argued that the US simply can make large capital gains on its gross positions, because its assets are denominated in foreign currency and its liabilities in USD. However, the available data indicate that over the last two decades this factor has netted the US at most $300-400 billion. This still leaves a loss of well over $2 trillion to be explained. The 'explanation' comes in two tranches of about $1 trillion each.

One source of 'accounting' revenues for the US derives from an anomaly in the item 'reinvested earnings' on FDI in the US balance of payments. This item improves the US current account by about $100 billon per annum because foreign firms report systematically abnormally low profits for their US operations to avoid US corporate income taxes. If one assumes that foreign firms earn the same rate of return on their direct investment in the US as on their portfolio investment in equity, the US current account would deteriorate by around $100 billion. Properly measured, the current account deficit of the US would thus be about 1% of GDP larger than officially reported.

The underreporting of the current account deficit implies that over US indebtedness is also underestimated. Over the last two decades the cumulated correction for the anomaly in 'reinvested earnings' would lead to a higher US net debtor position of around $1 trillion.

A second source of gains for the US net international investment position comes from very large residuals, labelled 'other changes' by the US Bureau of Economic Analysis, in its statistics on the evolution of the net US international investment position, whose total also reaches about $1 trillion over the last two decades.

The US international investment position today should in principle be equal to the sum of past current account balances (mostly deficits). However, this is by far not the case even taking into account the balancing item 'errors and omissions'. The quite detailed data available for the period 1989-2004 show that the exchange rate and valuation adjustments mentioned above have netted the US $300-400 million, still leaving a discrepancy of around $1 trillion.

The discrepancy arises for a simple reason: the current account data are based on actual flows of payments recorded in the balance of payments. By contrast, the data on the US international investment position are based on surveys of depository institutions, which year after year tend to lose sight of US assets held by foreigners, especially portfolio investment and real estate.

Could the discrepancy be due to inaccurate statistics on the balance of payments? This is unlikely because the financial flows are just the mirror image of the current account which can be accurately measured given that it consists mostly of 'business to business' transactions. With the improvement in current account statistics, the global current account balance discrepancy has now almost totally disappeared. If the current account figures constitute a more reliable source (except for 'reinvested earnings'), it is likely that the true US net external debtor position is around $4 trillion (about 40% of GDP) rather than the $2.5 trillion reported officially for end 2004. Taking into account the current account deficit of around $800 billion for 2005 would bring the net current US debtor position to over $4.5 trillion. (The official US net international investment position as of end 2005 to be published soon is likely to include again a significant 'write down' of foreign assets in the US, so that the official data are likely to show a net indebtedness below $3 trillion.)

A closer look at the data thus suggests that both the current account deficit and the net debtor position of the US are even worse than officially reported. This can only mean that the need for a substantial depreciation of the dollar and/or a period of sub-par growth is even larger than generally accepted.

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