FRBSF Weekly Letter

October 30, 1987

Foreign Capital Inflows

The financial flows accompanying the large United States current account deficits of recent years have transformed the U.S. from a net international creditor of $141 billion in 1981, the historic peak, to a net debtor of $264 billion in 1986. Correspondingly, gross U.S. liabilities to foreigners have risen from $689 to $1,331 billion. Since sizable deficits in the U.S. current account are expected to persist, further capital flows into the United States should continue.

Continuing capital inflows have raised several concerns about their effects on U.S. financial markets. One major concern is that foreign portfolios will soon be saturated with holdings of U.S. assets, leading to higher U.S. interest rate levels and a lower value for the dollar. In fact, some contend that private foreign investors have shifted away from holding U.S. liabilities, and that only foreign central bank intervention in support of the dollar has sustained the aggregate level of capital inflows in recent quarters without significant increases in U.S. interest rates.

A secondary concern centers around the rise of foreign holdings of U.S. assets in relation to the overall size of U.S. financial markets and the resulting implications for the term structure of interest rates. In particular, if foreign investors prefer holding proportionately less long-term debt and more short-term debt than domestic U.S. residents, then long-term rates may rise relative to short-term rates. Consequently, economic activity most influenced by long-term rates, such as fixed-capital investment, may be dampened.

This *Letter* examines these concerns about U.S. capital inflows by looking at recent developments and evaluating the potential for future financing of U.S. deficits through continued purchases of U.S. liabilities by foreign investors.

Recent capital inflows

U.S. liabilities to foreign residents include the liabilities of the United States to both foreign governments and foreign private investors. U.S. liabilities to foreign governments, also referred to as foreign official assets, consist largely of U.S. Treasury securities purchased by foreign central banks. U.S. liabilities to private foreign investors consist of direct investment assets, corporate securities, and bank liabilities, as well as Treasury securities. These stocks change from year to year as the result of international capital flows and valuation adjustments, except in the case of direct investment assets, which are carried at book value.

Chart 1 reports the evolution from 1982 through the first half of 1987 of the stock of foreign-held U.S. liabilities, broken down between official and private capital. The figures for 1987 are obtained by adding the annualized flows for the first two quarters of 1987 to the year-end stocks for 1986, as valuation changes are not yet available for any part of 1987.

Over the period from 1982 to 1986, the accumulation of U.S. liabilities to foreign residents was primarily due to foreign *private* investment in the United States. U.S. liabilities to foreign governments remained relatively constant, although they rose somewhat in 1986. In the first half of 1987, however, the growth of privately held liabilities slowed down, while the stock of officially held liabilities increased. The latter development is attributable to foreign central banks' intervention efforts to support the dollar.

To provide further insight into recent trends, Chart 2 separates U.S. liabilities to foreign private residents by type of asset. It shows that foreign-held private holdings of U.S. Treasury securities did slow down between 1985 and 1986, and declined in the first half of 1987. Bank-related capital inflows slowed significantly in 1987, following a marked increase in the fourth quarter of 1986. However, foreign private purchases of corporate securities increased sharply in 1986 and 1987. Direct investment assets also continued to grow, although somewhat more slowly this year.

Thus, it may be premature to conclude that private foreign investors have become more reluctant to add U.S. dollar assets to their portfolios without sharply higher yields. Private investors appear to be acquiring more non-government

assets, particularly corporate stocks and bonds, perhaps to diversify their portfolios.

Future accumulation

While there is as yet no clear indication of a dampening in foreign private demand for U.S. assets at existing interest rate and exchange rate levels, concern still exists that the willingness of foreign investors to continue to accumulate U.S. assets will decline in the near future. In particular, it is felt that, as the share of U.S. assets in foreign portfolios increases, the willingness of foreign investors to acquire more U.S. assets will diminish without significantly higher U.S. interest rates and/or a decline in the value of the dollar.

To address this concern it is necessary to understand the motivation for foreign financial investment in the United States. Much of the increase in U.S. asset holdings by foreigners in recent years can be attributed to a desire to increase the relative share of such assets in their portfolios because of attractive relative U.S. interest yields. Over the period 1982 to 1986, U.S. real short-term rates were roughly two percent above comparable yields in Japan. In addition, foreign investors favor U.S. financial markets for their efficiency, relative stability, and above all, liquidity.

The ongoing liberalization of international capital flows, combined with the widespread deregulation of financial markets all over the world, and particularly in Japan, have been other factors behind U.S. capital inflows. Thus, for example, the proportion of foreign securities in the portfolios of financial institutions in Japan has risen from 6 percent in 1983 to around 15 percent in 1986.

While there obviously are limits to the extent to which foreigners will increase the share of U.S. assets in their overall portfolios, sizable amounts of capital inflows are still likely to be forthcoming as a result of foreign saving and growing foreign wealth. In fact, the acquisition of U.S. assets has not been all that large in relation to world savings. It is estimated that in recent years the United States has absorbed only about 9 percent of estimated gross savings abroad.

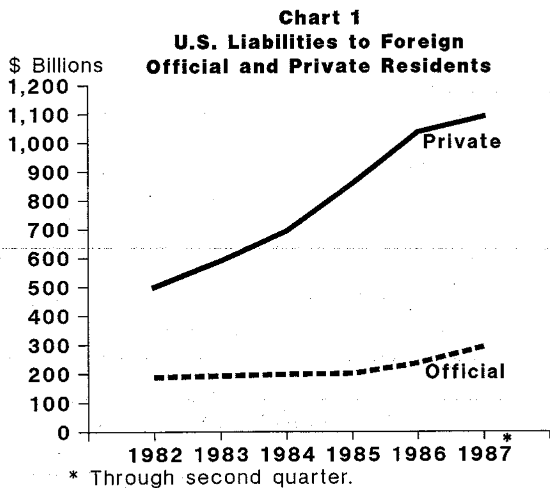
Moreover, despite sizable additions to foreign holdings of U.S. assets during recent years, estimates by Morgan Guaranty indicate that these holdings remain very small in relation to foreigner's total assets. For example, gross foreign liabilities of the United States to western Europe at the end of 1982, amounting to $321 billion, represented just above 1 percent of western Europe's estimated total financial and nonfinancial assets, and less than 3 percent of financial assets alone. By the end of 1985, the total amounted to $518 billion, but the ratios had reached only an estimated 1½ percent for total assets and less than 4 percent for financial assets. The ratios for Japan are even smaller. At the end of 1982, gross liabilities of the United States to Japan, $103 billion in total, represented less than half a percent of Japan's total assets and less than 1 percent of its financial assets. At the end of 1985, with total liabilities rising to $156 billion, these ratios had risen to just above half a percent and above 1 percent, respectively.

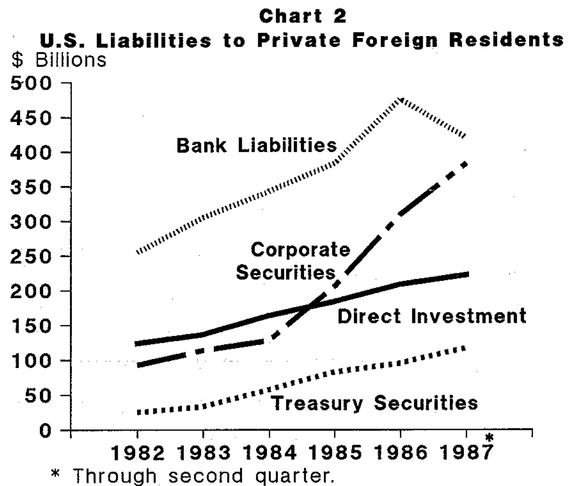
Thus, the data suggest that often-cited concerns about the saturation of foreign portfolios and resulting pressures on the level of U.S. interest rates also are premature. The potential for further large-scale capital inflows into the United States is far from exhausted.

Asset preferences

Even if the magnitude of total foreign capital inflows continues at recent levels, it has been argued that the increasing accumulation of foreign asset holdings in the United States might significantly affect the term structure of interest rates. According to finance theory, equilibrium asset returns should depend on a weighted average of the risk preferences and risk assessments of different groups of investors in financial markets, with the weights depending on the relative market investments of each group. Thus, if U.S. domestic and foreign investors' risk preferences were to differ, or, in the parlance of finance theory, domestic and foreign investors have different "preferred habitats," then asset returns in the United States would change as foreigners increase their presence in U.S. financial markets. In particular, the returns on those assets preferred by foreign investors in comparison to resident U.S. investors will be less than otherwise.

Foreign investors in U.S. asset markets may exhibit portfolio preferences different from those of U.S. investors for a variety of reasons. First, differences in available assets across countries imply that individual assets provide different risk diversification benefits to domestic and foreign





investors. Second, because investors in different countries are likely to have different income streams, the use of individual assets as hedging instruments will vary for domestic and foreign investors. Last, underlying aspects of asset preferences such as the degree of risk aversion may vary across countries because of cultural and societal differences. For any or all of these reasons, foreign investors in U.S. financial markets may prefer to hold either more or less long-term assets overall, or more bonds or more equity securities, etc., than resident U.S. investors.

To explore the significance of possible differences in preferences, it is useful to compare the composition of foreign private and official holdings of U.S. financial assets to the corresponding composition of financial asset holdings by resident U.S. investors. Flow of funds figures for year-end 1986 indicate that foreigners hold 44 percent of their U.S. assets in the form of U.S. federal, state, and local government securities — well above the 29 percent held by U.S. domestic residents. In contrast, foreigners hold only 17 percent of their U.S. portfolios in U.S. corporate equities — below the 22 percent share of domestic residents. Foreign and U.S. investors also differ somewhat with respect to the maturity composition of their debt holdings. The former hold roughly 40 percent of their debt holdings in short-term form, the latter, 30 percent.

If these portfolio preferences remain unchanged over time, then, according to the argument discussed above, as foreigners increase their presence in U.S. financial markets, the required return on long-term debt may rise above recent average levels. However, since the portfolio shares of foreigners do not differ all that substantially from those of domestic investors, this effect may not be of much empirical significance.

Conclusions

The trend toward more foreign official holding of U.S. government securities should not be a source of concern since overall foreign private demand for U.S. assets, particularly for corporate securities, appears strong. The normal growth of foreign wealth should generate enough demand for U.S. assets without significantly higher interest rates, although the composition of this demand may change. Changes in the composition of capital inflows may influence the relative returns for different types of U.S. assets, but they would do so without necessarily affecting the general level of interest rates.

Reuven Glick

Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/7/87	Change from 9/30/87	Change from 10/8/86 Dollar	Change from 10/8/86 Percent[7]
Loans, Leases and Investments[1 2]	208,389	1,723	4,708	2.3
Loans and Leases[1 6]	184,454	1,796	1,702	0.9
Commercial and Industrial	51,205	– 376	763	1.5
Real estate	71,508	1,336	4,909	7.3
Loans to Individuals	36,974	– 92	– 4,373	– 10.5
Leases	5,412	4	– 210	– 3.7
U.S. Treasury and Agency Securities[2]	16,907	– 64	4,077	31.7
Other Securities[2]	7,028	– 9	– 1,073	– 13.2
Total Deposits	206,833	– 1,753	– 395	– 0.1
Demand Deposits	52,158	– 2,900	– 621	– 1.1
Demand Deposits Adjusted[3]	36,368	– 13,419	– 276	– 0.7
Other Transaction Balances[4]	20,240	662	2,269	12.6
Total Non-Transaction Balances[6]	134,436	485	– 2,042	– 1.4
Money Market Deposit Accounts—Total	43,933	– 268	– 2,458	– 5.2
Time Deposits in Amounts of $100,000 or more	31,291	285	– 3,004	– 8.7
Other Liabilities for Borrowed Money[5]	24,938	367	– 4,081	– 14.0

Two Week Averages of Daily Figures	Period ended 10/5/87	Period ended 9/21/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	0	27
Borrowings	158	91
Net free reserves (+)/Net borrowed(–)	– 157	– 63

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change