



## Foreign Investment in the US (I): Disappearing in a black hole?

**Daniel Gros**

### Abstract

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'. Between 1982 and 2004, the US has accumulated a grand total of around \$4.5 trillion (thousand billion). (The sum of current account deficits has been about \$1 trillion smaller than the amount of net sales of US assets to the rest of the world because of the anomaly in reinvested earning.) Despite this accumulation of deficits the US net international debtor position (IIP) has deteriorated 'only' by \$2.7 billion (and is now estimated – at the end of 2004, end 2005 figures are not yet available for the US IIP – at 'only' around \$2.5 trillion). This implies a total of 'unearned' gains to the US of around \$1.8 trillion during 22 years. The quite detailed data available for a somewhat shorter period (1989-2004) show that only a very small part of this sum, around 10-20%, can be explained by exchange rate and stock market changes.

One must thus conclude that the US has acted like a black hole for capital from the rest of the world: one can observe a large amount of investment flowing into the US, but after some time it disappears from the statistics (and foreign investment in the US that takes the form of FDI earns almost no return). The discrepancy arises for a simple reason: the flow data are based on actual flows of payments recorded in the balance of payments. By contrast, the stock data (on the US international investment position) are based on US surveys, which tend to miss out on US assets held by foreigners. This implies that it is likely that the true US net debtor position is significantly larger than officially reported.

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# Summary

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The global financial system seems to have a black hole at its heart, i.e. in the US. Over the last two decades, US residents have sold a total of around \$5.5 trillion (thousand billion) worth net of IOUs to foreigners. Yet, the officially recorded net investment position of the US has deteriorated only by a little over one-half of this amount (\$2.8 trillion) over the same period. The US capital market seems to have worked like a black hole for investors from the rest of world in which \$2.7 trillion have 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 in foreign currency and its liabilities denominated in USD. However, the available data indicate that over the last two decades this factor can have netted the US at most \$300-400 billion. This leaves a loss of over \$2 trillion to be explained. The ‘explanation’ comes in two tranches of about \$1 trillion each:

- i. An anomaly in the accounting item ‘reinvested earnings’ in the balance of payments, which improves the US current account by about \$50-100 billion per annum because foreign firms report systematically very low profits for their US-owned operations.
- ii. Very large residual, ‘other’, or rather unexplained, changes recorded by the Bureau of Economic Analysis in its statistics on the net US international investment position, which have averaged a similar order of magnitude.

This note deals with the second element (the first is analysed in a companion paper – see Gros, 2006).

Could the puzzle be due to inaccurate balance of payment statistics? This is unlikely because the financial flows are just the mirror image of the current account which has been closely scrutinised over the last years given the large reported global current account discrepancy that arose over the late 1990s. The global current account balance discrepancy has now almost totally disappeared and even taking it into account for the 1990s would make little difference given the size of the US current account deficits over the last years. It is more likely that the statistics on the net US IIP are collected in a manner that tends to miss foreign-owned assets. It is thus likely that the true US net external debtor position is closer to 35-40% of GDP than the 22% reported officially.

# FOREIGN INVESTMENT IN THE US (I): DISAPPEARING IN A BLACK HOLE?

DANIEL GROS

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## 1. Introduction

The object of study of this note is a gaping stock flow inconsistency in the US international accounts. The US net international investment position (IIP) should in principle be equal to the sum of past current account balances (mostly deficits). However, this is by far not the case. Since 1982, the US has accumulated a grand total of around \$4.5 trillion (\$4.5 thousand billion) of current account deficits. But its net international debtor position has deteriorated during the period 'only' by \$2.7 billion (and is now estimated at 'only' around \$2.5 trillion). This implies a total of 'unearned' gains to the US of around \$1.8 trillion during 22 years. Taking into account the balancing item 'errors and omissions' does not significantly affect this conclusion since over this period this item has summed to less than \$250 billion, thus leaving a hole of close to \$1.6 trillion.

What can explain the approximately \$1.6 trillion in vanishing deficits? The short answer is that this difference cannot be explained. It is as if the US capital market was a black hole: inflows disappear without leaving a trace. For a more detailed description of how this happens, it is necessary to restrict attention to a somewhat shorter period, for which more detailed data are available, namely 1989-2004. Over this 15-year period, the US accumulated current account deficits totalling \$3.7 trillion, but its net IIP deteriorated only by about \$2.5 billion. The lost capital amounts thus 'only' to about \$1.2 trillion since 1989. Given the last of detailed data for the period between 1982 and 1989, all one can say is that the US accumulated current account deficits of around \$700 billion, but its net IIP (according to today's data) deteriorated only by \$100 billion, leaving around \$600 billion of unexplained gains.

These discrepancies are much larger than what one can observe for other countries. For example, Japan has accumulated current account surpluses worth around \$2 trillion and its official net international investment position is very close to this amount. Table A1 in the annex provides more details and the data from Germany where the stock flow discrepancy is even smaller.

## 2. Potential explanations: US capital gains?

Given the better data availability for 1989-2004, the remainder of this note concentrates on this shorter period and the \$1.2 trillion of missing deficits. An excellent starting point is a recent tabulation by the Bureau of Economic Analysis (BEA) of the US Department of Commerce, which shows the main sources of changes in the net US IIP which is reproduced in Table 1. The second column of this table shows for each year the financial flows that 'balance' the current account (minus errors and omissions, whose sum over this period was negligible). The last entry in this column shows the cumulated financial flows, or the cumulated current account deficits, whose sum amounts to \$3.744 trillion over these 15 years. The last column in this table shows the net US IIP position at the end of each year. Comparing the beginning 1989 to the end 2004 value shows that the deterioration has been \$2,542 billion, approximately \$1.2 trillion less than the sum of the current accounts. The explanation (or rather the lack thereof) lies in the columns (b)-(d).

Table 1. Components of changes in the net international investment position with direct investment at market value, 1989-2004 (\$ billions)

Year	Position Beginning	Changes in position					Total (a+b+c+d)	Position Ending
		Attributable to			Total			
		Financial flows	Valuation adjustments					
			Price changes	Exchange rate changes <sup>1</sup>		Other changes <sup>2</sup>		
(a)	(b)	(c)	(d)	(a+b+c+d)				
1989	10	-50	7	-15	0	-57	-47	
1990	-47	-60	-149	57	34	-118	-164	
1991	-164	-46	-96	5	41	-96	-261	
1992	-261	-96	-76	-75	55	-191	-452	
1993	-452	-81	293	-22	119	308	-144	
1994	-144	-127	23	73	40	9	-135	
1995	-135	-86	-152	39	29	-171	-306	
1996	-306	-138	84	-66	65	-54	-360	
1997	-360	-221	-92	-208	58	-463	-823	
1998	-823	-70	-288	68	41	-248	-1,071	
1999	-1,071	-236	330	-126	66	33	-1,037	
2000	-1,037	-486	134	-271	80	-544	-1,581	
2001	-1,581	-400	-224	-152	18	-758	-2,339	
2002	-2,339	-500	-60	231	213	-116	-2,455	
2003	-2,455	-561	-2	416	230	83	-2,372	
2004	-2,372	-585	147	272	-4	-170	-2,542	
	<b>Sum total</b>	<b>-3,744</b>	<b>-121</b>	<b>227</b>	<b>1,086</b>	<b>-2,553</b>		

<sup>1</sup> Represents gains or losses on foreign-currency-denominated assets and liabilities due to their revaluation at current exchange rates.

<sup>2</sup> Includes changes in coverage, capital gains and losses of direct investment affiliates, and other adjustments to the value of assets and value of assets and liabilities

Source: [www.bea.gov](http://www.bea.gov). Data are consistent with those published in "The International Investment Position of the United States at year end 2004", in the July 2005 issue of the *Survey of Current Business*.

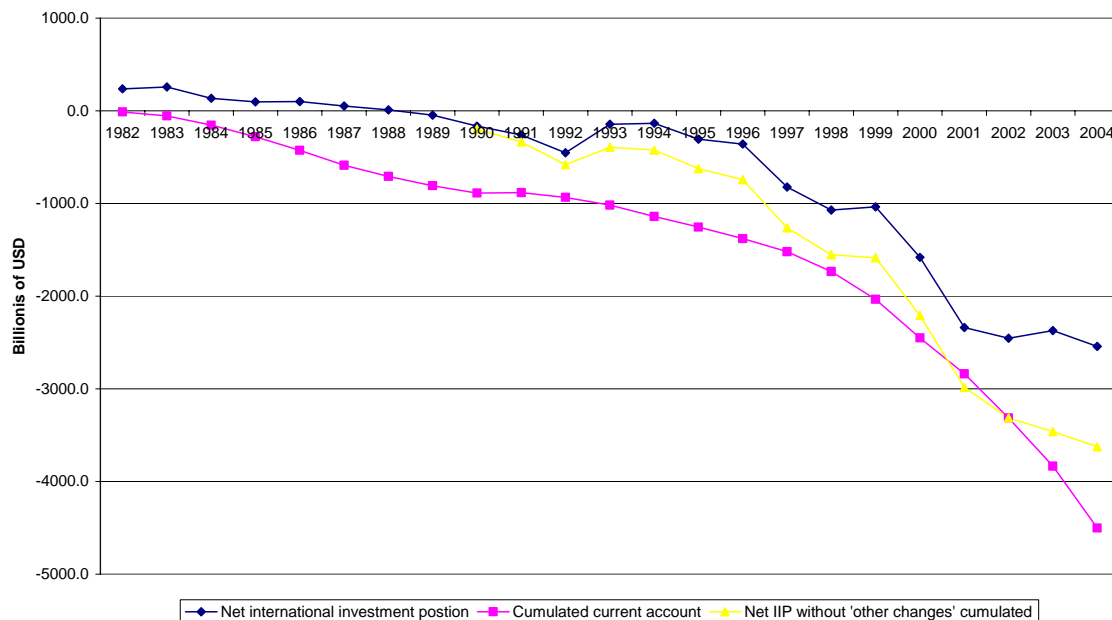
A number of recent analyses of the US external position have emphasised that the US could gain from exchange rate movements because most of its assets are in USD, but a large part of its liabilities are in foreign currency. However, this can only be a partial explanation because by end 2004, the US dollar was not far from the value it had already attained during the early 1990s. The last entry in column (c) in Table 1 shows indeed that since 1989, the net gain from exchange rate changes for the US IIP has been only a bit over \$220 billion.

Could the US have benefited from differential movements in stock markets? This is also unlikely a priori as the US stock market has not performed worse than its foreign counterparts. The last entry in column (b) in Table 1 confirms that this is indeed not the case as the effect of the sum of the capital gains and losses over this time period has been to reduce the US net IIP by around \$0.12 trillion.

This implies that, even taking into account gains from capital revaluation, one cannot explain why the discrepancy between the cumulated current account deficit and the present net IIP of the US is that large. The last entry in column (d) in Table 1 shows that over this period the sum of those changes in the US IIP that cannot be explained either by stock markets or by exchange rate changes, is equal to close to \$1.1 trillion.

The continuously growing importance of the entry ‘other changes’ is illustrated in Figure 1, which shows the cumulated US current account deficits and the net IIP over time. Two series for the IIP are shown. The first one, labelled, net IIP shows the official figures. The second one, labelled ‘net IIP without ‘other changes’ cumulated’, is calculated as the net official net IIP but without the item ‘other changes from the BEA statistics, i.e. without the changes that can be explained by exchange rate movements and stock market price adjustments. The item ‘other changes’ is available from the BEA only since 1989. The second series starts thus only in that year. It is apparent that the difference between these two estimates of the US net IIP grows continuously over time. The difference between these two measures of the IIP increases particularly since 2001, with the official net IIP barely deteriorating since that year, despite cumulated current account deficits of around \$1.6 trillion over only 3 years. Part of this discrepancy can be explained by the large exchange rate gain the US made when the dollar started to depreciate rapidly. However, other changes were also an important factor, improving the US net position by about \$400 billion over this period.

Figure 1. Cumulated US current account deficits and net international investment position



Source: IFS database.

### 3. A case study: Revisions for data for the year 2000

The key to understanding the size of the item ‘other changes’ lies in the fact that the data on financial flows come from a completely different source than that on the net international investment position (IIP). The latter is essentially based on surveys organised by the New York Federal Reserve. The size of foreign portfolio investment in the US is thus estimated on the basis of reports from US-based custodians, who are asked to detail the securities they hold on behalf of foreign owners. By contrast, the data on financial flows is based on the reports of brokers when they sell securities to foreigners. A share of a US company held by a European would thus not appear in the US IIP if the share is not held with a US-based custodian. But the purchase of the share would have been recorded in the balance of payments as a flow in the year the purchase took place.

Measuring the value of foreign ownership of US real estate is even more difficult (unless it is held for business purposes). The balance of payments would record the acquisition, but the surveys used for the IIP would have no way of accounting for it. It is thus apparent that the surveys will tend over time to miss part of foreign-owned assets in the US. However, as the BEA takes the surveys as the best source, it is forced to introduce the item ‘other adjustments’ in order to reconcile the data on the IIP with those from the balance of payments.

BEA comments annually in detail on the sources of changes in the net IIP. However, this is done usually only for the last year and in most cases the (perhaps preliminary) data almost always indicate that ‘other changes’ are not that important. It is therefore not possible to follow the changes over time. However, a comparison of the data for a specific year (in this case 2000) as reported by the BEA at two different points in time is instructive. This is done in Table 2.

*Table 2. Detail of the revisions concerning the US IIP for the year 2000 between 2005 and 2001 (\$ billions)*

	<b>Jul-01</b>	<b>Jul-05</b>	<b>Difference</b>
<b>Net position*</b>	-2,187.4	-1,581.0	606.4
<b>Total US assets abroad*</b>	7,189.8	7,401.2	211.4
of which:			
<b>1. US private assets</b>	6,976.2	7,187.6	211.4
<i>US FDI abroad</i>	2,467.8	2,694.0	226.2
<i>Foreign securities</i>	2,406.5	2,425.5	19.0
<b>Total US liabilities*</b>			
of which:			
<b>1. Foreign official assets</b>	922.4	1,030.7	108.3
<i>US gov. securities</i>	676.9	756.2	79.3
<b>2. Other (non official-private) foreign US liabilities</b>	8,454.8	7,951.5	-503.3
of which;			
<i>FDI at market value</i>	2,736.9	2,783.2	46.3
<i>US Treasury securities</i>	639.7	381.6	-258.1
<i>US non-Treasury securities</i>	2,964.0	2,623.0	-341.0
Corporate and other bonds	1,374.3	1,068.6	-305.7
Corporate stocks	1,589.7	1,554.4	-35.3

(\*) with FDI at market value.

Source: Own calculations on BEA data.

The July 2001 issue of the *Survey of Current Business* contained a first release, which estimated the net US debtor position for end 2000 at roughly \$2.2 trillion (with FDI evaluated at market prices, the preferred measure of FDI by the BEA and most observers). However, the July 2005 issue of the *Survey of Current Business* reports that at the end of 2000, the net debtor position of the US was only around \$1.6 trillion, \$600 billion less than previously reported. What was the main source of this massive improvement in the US IIP? The detail reported in Table 2 shows that this was due mainly to two items: The estimate of the value of US FDI abroad in the year 2000 increased by around \$200 billion between July 2001 and 2005. More astonishing is another change: the reported value US liabilities (always at end 2000) fell by around \$400 billion. Most of this was due to a fall in the value of foreign portfolio investment in the US (mostly bonds, but also some stocks). The most likely reason for the fall in reported holdings of corporate bonds (over a quarter of the total) is probably simply that these bonds were not held by US custodians (to avoid tax on the interest income?).

#### 4. Stock flow discrepancies by major investment category

The cumulative financial flows should add up to the end of period stock provided the returns are properly accounted for each period. These returns should appear in the income part of the current account and the data so far have shown a declining, but persistent surplus despite the large and increasing (even if under-reported) official net debtor position. The absence of a deficit on the income is largely due to an anomaly in the item ‘reinvested earnings’ of which foreign firms tend to report, on average, close to zero, whereas US firms report large reinvested earnings from their operations. In the following it will be assumed that this is not just due to massaging of accounts for tax purposes, but corresponds to reality.

A companion note (see Gros, 2006) argues that this is actually highly unlikely to be the case as it would imply that foreigners instantly start losing when they invest more than 10% into a US company. This conclusion seems unavoidable given that the rate of return on US portfolio assets has been the same as the rate on US portfolio liabilities. Direct investment is any transaction under which a foreigner acquires more than 10% of the capital of an enterprise. It seems that foreign investors in the US get a market rate of return (which can be objectively measured) when they acquire less than 10% of a corporation. But the official statistics (based on accounting data) imply that their returns are much lower once the investment qualifies as direct, i.e. once it goes above the 10% threshold.

However, accounting for FDI does not seem to be the main source for the missing trillion dollars (the difference between financial flows and the change in the net asset position). Table 3 below goes as far back as possible for the financial flows (namely 1975) and shows that the official data on the US net investment position in FDI are rather close to what one obtains by summing past flows (and if one follows the procedure used by the BEA to revalue investment using stock market indices and account for reinvested earnings). The unexplained part that remains is actually rather close to the official data for the US net investment position in FDI in 1975. Yet, it is surprising that in all the other categories, the net US position is much better than one would expect by summing the flows (and adjusting them for stock market movements in the case of portfolio equity). The total sum of the unexplained parts (over \$1.4 trillion) is actually somewhat larger than the figure mentioned above because the phenomenon of disappearing foreign investment in the US seems to have taken place even before 1982 (earliest year with data for FDI at market value) and 1989 (earliest year with detailed data on capital gains due to exchange rates and stock markets). Table A2 in the annex provides further detail separating out assets and liabilities and accounting for stock market movements. Since stock market movements are based on other stock markets translated into USD, this implies that the data used here implicitly also account for exchange rate changes, which as already shown above, have not been as important as often thought.

*Table 3. Cumulative financial flows 1975-2004 and the net international investment position (\$ billions): Detail by financial instrument*

	Cumulative flows (1975-2004)	Revalued cumulative flows (at market value)	Revalued with discounting for dividends	IIP (at end 2004)	Unexplained part
FDI ( including reinvested earnings)	196	428	727	888	161
<i>Portfolio flows: of which</i>					
Equity	271	24		449	425
Portfolio debt	-3,571			-3,334	237
Other investment	-1,039			-448	591
Grand total	-4,143			-2,445	1,414

Source: Own calculations based on IMF BoP data.

At first sight, the large discrepancy in the category ‘Other investment’ is particularly surprising since about two-thirds of the flows under this category consist of bank transactions, which should be very well documented. But a significant part of ‘other investment’ in the BoP consists of real estate, which, as argued above, is particularly likely to be missed by the surveys used to establish the IIP. But it is impossible to establish this in more detail since, unfortunately, the IIP data for this category is incomplete. (What appears to be the biggest item on the asset side of the IIP does not exist on the liability side, and, the biggest item in the IIP other assets is loans to banks, but this is missing under the liabilities side.)

All in all, this more detailed examination of potential reasons why foreign investment in the US tends to disappear from the official IIP statistics only confirms the conclusion reached from the BEA data above: more than \$1 trillion of investment that has flown over the last decades into the US has disappeared (at least from the statistics).

## **5. What does it mean?**

Since stock flows discrepancies arise quite often in economic statistics, one might be tempted to just dismiss the data inconsistency reported here as just another instance. However, the evolution of the US net debtor position has assumed a particular relevance given the large US current account deficits. Any analysis of the sustainability of the US situation must start from data on its current net debtor position. This has been done in a number of recent studies, which have generally concluded that the US net debtor position, expressed as a share of GDP, is deteriorating drastically. In this context it matters whether the US starts with a net IIP of ‘only’ \$2.5 trillion, 22% of GDP, or whether it is \$3.5 trillion or about 30% of GDP (without the unexplained gains).

Another potential reading of the data reported here is that the future will be like the past: the officially reported net US IIP will always deteriorate much less than one would expect from the combined effect of current account deficits and identifiable capital gains from exchange rates and stock markets. If this were the case, one would really have to consider the US capital market like a black hole that devours the savings gravitating around it. In astrophysics, it is generally not possible to measure the mass of a black hole since matter disappears in it. The only way to measure its mass would be to observe it from the beginning, measuring at each instant all the matter it attracts. Transposed to the case at hand, this would imply that cumulating financial flows into the US should give a more accurate picture of its net debtor position (its weight) than trying to measure its weight via the surveys used to establish the official statistics on the net US international investment position.



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## Annex

*Table A1. An international comparison of the stock flow discrepancy*

	2004	Δ (CUM CU and Net IIP)	ratio
<b>Germany</b>			
CUM Current Account	180.9	44.7	6.2
Δ Net IIP	136.2		
CUM Current Acc.( Absolute)	722.7		
<b>Japan</b>			
CUM Current Account	2,061.1	289.2	13.8
Δ Net IIP	1,772.0		
CUM ABS Current Acc	2,100.1		
<b>UK</b>			
CUM Current Account	-402.6	-87.0	-17.9
Δ Net IIP	-315.7		
CUM ABS Current Acc	486.1		
<b>US</b>			
CUM Current Account	-4,504.7	-1,596.9	-35.0
Δ Net IIP	-2,907.8		
CUM ABS Current Acc	4,567.8		

Table A2 below shows separately for assets and liabilities the stock flow differences for major investment categories. It seems that, if one accepts the official BEA methodology to revalue FDI including the anomaly in reinvested earnings, one can account for the reported value of FDI rather well. However, there seem to be more problems in the other categories, which in principle are easier to measure. Portfolio equity positions seem to be much larger than one would expect given the reported flows (even if adjusted for stock market gains). This table also shows that there is very little difference in the average age of US assets and liabilities. For FDI, the average is exactly the same (1997) and it is only in portfolio equity that one can detect a difference of one year between the average age of inflows (1999) and outflows (1998). But any losses foreigners might have made on the US stock market by investing close to the height of the boom should be accounted for by the stock market adjustment in the second column. Hence, this (minute) age difference cannot account for the large discrepancy in the stock data.

Table A2. Stock flow discrepancy by major category of capital flow (\$ billion)

	<b>Cumulative flows (1975-2004)</b>	<b>Equity revalued cumulative flows (at mark. value)</b>	<b>FDI revalued with discounting for dividends</b>	<b>IIP (at end 2004)</b>	<b>Unexplained (IIP 2004 minus cumulated flows)</b>	<b>Average age (average year of investment)</b>
<b>FDI US</b>						
<i><b>FDI flows in US: of which</b></i>						
<i>Equity+reinvested earnings</i>	1,675	3,208	2,260	2,182	-78	1,997
<i><b>US portfolio inflows: of which</b></i>						
<i>Equity</i>	794	1,141		2,071	930	1,999
<i>Portfolio debt: (of which bonds and notes)</i>	4,111			4,250	139	
<i>Other investment</i>	3,641			3,507	-133	
<b>US DIA</b>						
<i><b>US FDI outflows: of which</b></i>						
<i>Equity+reinvested earnings</i>	1,871	3,636	2,986	3,070	84	1,997
<i><b>US portfolio outflows: of which</b></i>						
<i>equity</i>	1,064	1,165		2,520	1,355	1,998
<i>Portfolio debt: (of which bonds and notes)</i>	540			917	377	
<i>Other investment</i>	2,602			3,059	457	

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