Order Code RL33274

CRS Report for Congress

Received through the CRS Web

Financing the U.S. Trade Deficit

February 14, 2006

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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 growing U.S. merchandise trade deficit and the associated increase in U.S. dollar-denominated assets owned by foreigners. 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:

- Concerns that foreign private investors were turning away from acquiring additional dollar-denominated assets that were prevalent in 2004 as a result of the sharp growth in the shares of foreign capital inflows from official sources, appear to have ameliorated in 2005 with a strong resurgence of capital inflows from private sources.

- 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.

This report will be updated as events warrant.

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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. 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.

[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 Cures,* by Craig Elwell.

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."

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 have intervened 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.

Furthermore, the dollar is 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. This prominent role 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 recent survey by the world's leading central banks indicate that the **daily** trading of foreign currencies totals more than $1.9 trillion, or more than the **annual** amount of U.S. exports of goods and services. The data also indicate that 90% of the global foreign exchange turnover is in U.S. dollars, substantially the same as the share reported in a similar survey conducted in 2001.[2]

The U.S. Balance of Payments

Table 1 presents a summary of the major accounts in the U.S. balance of payments over the last seven quarters. The data indicate that for each quarter 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.

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[2] *Triennial Central Bank Survey: Foreign Exchange and Derivatives Market Activity in 2004*. Bank for International Settlement, March 2005. pp. 1-2. A copy of the report is available at [http://www.bis.org/publ/rpfx05t.pdf]. The 2001 survey is: *Central Bank Survey of Foreign Exchange and Derivatives Market Activity in April 2001: Preliminary Global Data*. Bank for International Settlement, October 2001.

According to the accounts, the United States experienced a deficit in the merchandise trade goods accounts for all seven quarters, and a surplus in the services accounts. 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 accounts were in surplus except for the second quarter of 2005.

Table 1. U.S. International Transactions, Selected Accounts
(in billions of U.S. dollars)

		2004				2005		
	2004	**I**	**II**	**III**	**IV**	**I**	**II**	**III**
Current account								
Balance on current account	-668	-146	-167	-167	-188	-199	-198	-196
Balance on goods and services	-618	-139	-152	-157	-169	-173	-174	-183
Balance on goods	-665	-151	-164	-168	-182	-186	-187	-198
Exports	808	194	200	205	209	214	224	225
Imports	-1,473	-345	-364	-373	-391	-400	-410	-423
Balance on services	48	13	12	10	13	13	13	15
Exports	344	83	85	86	90	93	94	96
Imports	-296	-71	-73	-75	-77	-79	-80	-80
Balance on income	30	15	6	6	3	1	-2	1
Income Receipts	380	86	91	96	106	107	111	119
Income Payments	-349	-71	-86	-89	-103	-106	-113	-118
Unilateral current transfers, net	-81	-22	-21	-16	-22	-26	-23	-14
Capital account								
Capital account transactions, net	-2	-0	-0	-0	-0	-4	-0	-0
Financial account								
Balance on financial account	585	128	171	117	169	162	151	273
U.S.-owned assets abroad, net	-856	-295	-134	-138	-289	-82	-225	-124
U.S. official reserve assets, net	3	1	1	0	1	5	-1	5
U.S. Government assets, net	1	1	-0	-0	1	4	1	1
U.S. private assets, net	-860	-296	-135	-138	-290	-91	-225	-129
Foreign-owned assets in the U.S., net	1,440	423	305	254	458	243	376	397
Foreign official assets, net	395	147	77	76	94	25	83	38
Foreign private assets, net	1,045	276	228	178	363	218	293	359
Statistical discrepancy	85	19	-4	51	20	41	47	-77

Source: Hoang, Mai-Chi, and Matthew J. Argersinger, U.S. International Transactions, Third Quarter of 2005. *Survey of Current Business*, January 2006. p. 20.

The data also indicate that the U.S. financial accounts were in substantial surplus, because they represent the opposite and offsetting transactions to deficits in the current account. Indeed, 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.

The data in **Table 1** also indicate that private capital flows account for the largest share of both U.S. capital inflows and outflows. Perhaps of more importance, however, is the data in **Table 2** which show the *net* amount of the flows in the major accounts, or the difference between the inflows and outflows. In 2004, for instance, total net capital inflows representing the net balance on the current account, the capital account, and the statistical discrepancy, were a negative $585 billion. This deficit was financed by an offsetting net inflow in the financial account. One striking feature of the flows is the recent change in the composition of the balances in the net financial account. Prior to 2004, total net private inflows were greater than total net official inflows, but that trend was reversed in 2004, when net official inflows were nearly double that of the net private inflows, as indicated in **Figure 1**. Through the first three quarters of 2005, official inflows continued to outpace private inflows, but the difference between them had diminished sharply. At current rates, official inflows could amount to about $260 billion in 2005 and private inflows could amount to about $200 billion, a difference of about $60 billion, far below the difference of over $200 billion recorded in 2004.

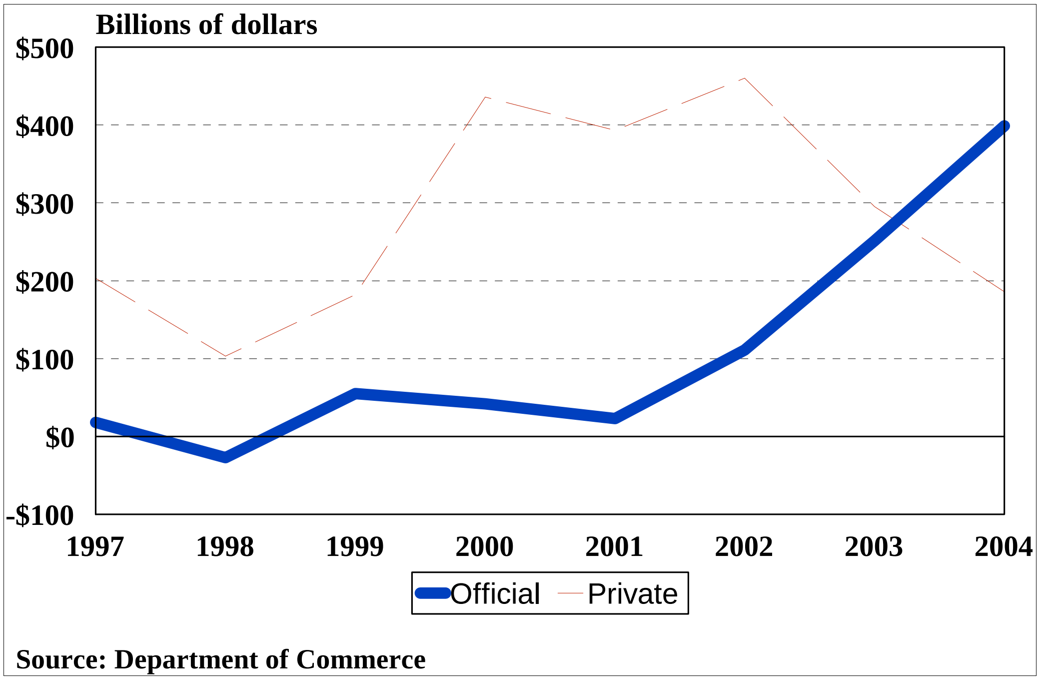
Table 2. Summary of the Net Balances by Major Accounts in the U.S. Balance of Payments

(in billions of U.S. dollars)

	1997	1998	1999	2000	2001	2002	2003	2004
Total Net Capital Inflows	$-221	$-76	$-237	$-477	$-416	$-570	$-546	$-585
Total Net Goods	-198	-247	-346	-452	-427	-483	-548	-665
Total Net Services	90	82	83	74	64	61	51	48
Total Net Income	13	4	13	21	24	7	33	30
Total Net Transfers	-40	-48	-47	-56	-47	-59	-67	-81
Total Net Capital Account	-1	-1	-5	-1	-1	-1	-3	-2
Statistical Discrepancy	-84	135	65	-63	-29	-95	-12	85
Total Net Financial Account	221	76	237	477	416	570	546	585
Total Net Official	18	-27	55	42	23	111	251	399
Total Net Private	203	103	182	436	393	460	295	186
Direct Investment	1	36	65	162	25	-62	-134	-145
Portfolio Investment	175	61	138	268	295	402	292	374
Other Private (Banks)	27	6	-21	6	74	120	137	-43

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

Figure 1. Foreign Private and Official Inflows of Capital



The U.S. Net International Investment Position

As indicated above, the data in **Tables 1 and 2** 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 would otherwise 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, and the overall stability of the U.S. economy. 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 2004, the latest year for which data are available, the overseas assets of U.S. residents totaled approximately $8.7 trillion, while foreigners had acquired about $11.3 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 $2.6 trillion, as indicated in **Table 3**.

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 3** indicates, the investments in the international investment position include such financial assets as corporate stocks and bonds, government securities, and direct investment[3] in businesses and real estate. The value of these assets,

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[3] 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

(continued...)

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. The Department of Commerce also 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.[4]

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 2**, the overall foreign official share of foreign-owned assets in the United States has remained relatively modest.

As **Figure 2** indicates, official asset holdings were valued at nearly $2 trillion in 2004, or about 16% of the total foreign investment position, a share that has remained relatively stable over the 12-year period of 1993 to 2004. 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.[5]

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[3] (...continued)
CFR § 806.15 (a)(1).

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

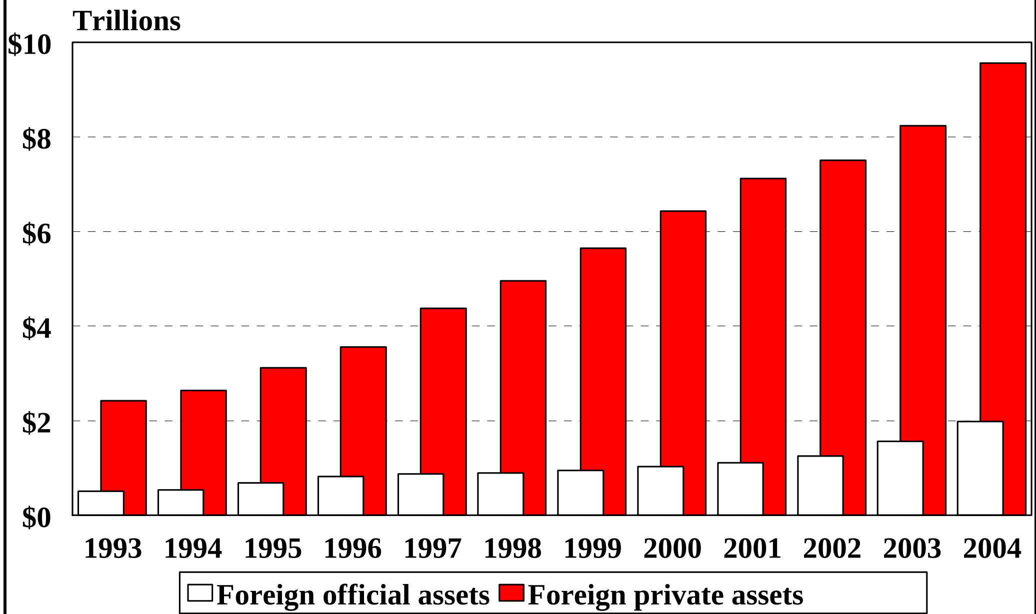
[5] For additional information, see CRS Report RL32462, *Foreign Investment in U.S. Securities*, by James K. Jackson.

Table 3. U.S. International Investment Position
(in millions of dollars)

Type of investment	2001	2002	2003	2004
Net international investment position of the United States:				
With direct investment at current cost	-1,919,430	-2,107,267	-2,156,703	-2,484,219
With direct investment at market value	-2,339,448	-2,455,114	-2,372,370	-2,542,245
With direct investment at historical cost	-1,977,688	-2,178,482	-2,252,156	-2,605,028
U.S.-owned assets abroad:				
With direct investment at current cost	6,308,681	6,645,679	7,640,986	9,052,796
With direct investment at market value	6,930,484	6,807,849	8,296,638	9,972,783
With direct investment at historical cost	6,075,950	6,401,761	7,370,335	8,749,410
U.S. official reserve assets	129,961	158,602	183,577	189,591
U.S. Government assets, other	85,654	85,309	84,772	83,556
U.S. private assets:				
With direct investment at current cost	6,093,066	6,401,768	7,372,637	8,779,649
With direct investment at market value	6,714,869	6,563,938	8,028,289	9,699,636
With direct investment at historical cost	5,860,335	6,157,850	7,101,986	8,476,263
Direct investment abroad:				
At current cost	1,693,131	1,860,418	2,062,551	2,367,386
At market value	2,314,934	2,022,588	2,718,203	3,287,373
At historical cost	1,460,400	1,616,500	1,791,900	2,064,000
Foreign securities	2,169,735	2,079,891	2,953,778	3,436,718
Bonds	557,062	705,226	874,356	916,655
Corporate stocks	1,612,673	1,374,665	2,079,422	2,520,063
U.S. claims by US nonbanking concerns	839,303	902,002	596,961	801,536
U.S. claims reported by U.S. banks	1,390,897	1,559,457	1,759,347	2,174,009
Foreign-owned assets in the United States:				
With direct investment at current cost	8,228,111	8,752,946	9,797,689	11,537,015
With direct investment at market value	9,269,932	9,262,963	10,669,008	12,515,028
With direct investment at historical cost	8,053,638	8,580,243	9,622,491	11,354,438
Foreign official assets in the United States	1,109,072	1,250,977	1,567,124	1,981,992
Foreign private assets:				
With direct investment at current cost	7,119,039	7,501,969	8,230,565	9,555,023
With direct investment at market value	8,160,860	8,011,986	9,101,884	10,533,036
With direct investment at historical cost	6,944,566	7,329,266	8,055,367	9,372,446
Direct investment in the United States:				
At current cost	1,518,473	1,517,403	1,585,898	1,708,877
At market value	2,560,294	2,027,420	2,457,217	2,686,890
At historical cost	1,344,000	1,344,700	1,410,700	1,526,300
U.S. Treasury securities	375,059	473,503	543,209	639,716
U.S. other securities	2,821,372	2,779,067	3,408,113	3,987,797
Corporate and other bonds	1,343,071	1,530,982	1,707,206	2,059,250
Corporate stocks	1,478,301	1,248,085	1,700,907	1,928,547
U.S. currency	279,755	301,268	317,908	332,735
U.S. liabilities by U.S. nonbanking concerns	798,314	892,574	454,317	581,258
U.S. liabilities reported by U.S. banks	1,326,066	1,538,154	1,921,120	2,304,640

Source: Nguyen, Elena L., The International Investment Position of the United States at Yearend 2004, *Survey of Current Business*, July 2005. p. 37.

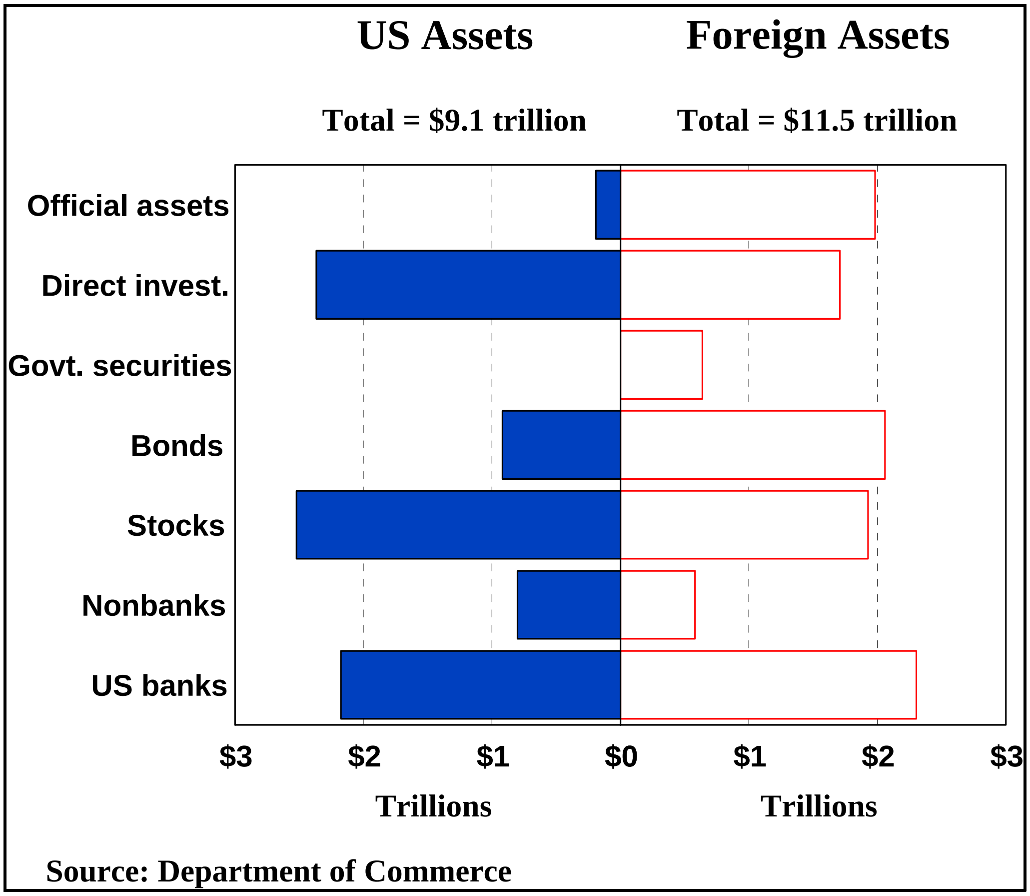
Figure 2. Foreign Official and Private Investment Positions in the United States, 1983-2004



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 3**, 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 3. U.S. and Foreign Investment Position, By Major Component, 2004



Implications

The persistent U.S. trade deficit raises concerns in Congress and elsewhere because of the potential risks such deficits may pose for the long term rate of growth for the economy. In particular, some observers are concerned that foreigners will become saturated with dollar-denominated assets and 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 trend may be nearly reversed in 2005, however, as foreign private investments had rebounded through the first three quarters.

Another concern is with the outflow of profits that arise from the dollar-denominated assets owned by foreign investors. This outflow arises from the profits or interest generated by the assets and represent a clear outflow of capital from the economy that otherwise would not arise 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