

TOPICAL STUDY #10 THE U.S. BECOMES THE WORLD'S LARGEST DEBTOR: SO WHAT?

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Economics

I. Introduction

U.S. assets held abroad exceeded foreign assets in the U.S. from 1920 to 1984. In 1981, the U.S. international investment position peaked at a positive \$140.7 billion (Exhibit 1, column 3). It's been downhill ever since. According to the Commerce Department, the *negative* net international position of the United States increased to \$263.6 billion in 1986 from \$111.9 billion in 1985.

So it seems as though the U.S. has become the world's largest debtor nation. Is that bad? Is it dangerous? Is our economy hostage to the whims of foreigners? Will our standard of living suffer? Should we do something about it? *What sorts of risks does this situation pose for bond and stock investors?*

II. The Old Crowding-Out Scare

Before we tackle these questions ourselves, let's review the opinions of others. Let's start by going back to the February 1983 *Economic Report of the President*, which was written by the Council of Economic Advisers under the chairmanship of Professor Martin Feldstein. The report warned that a "succession of large budget deficits is likely to reduce substantially the rate of capital formation. The government's borrowing to finance such deficits would compete directly with borrowing by private businesses and households. With a limited amount of savings available for borrowing, high budget deficits would cause interest rates to rise until private demand for funds was reduced to the amount that remained after the government's borrowing needs were satisfied." (See page 27 of the report.)

Professor Feldstein believed that the government would crowd out the private sector, so he forecast a sub-par and unbalanced recovery for 1983. Instead, real GNP rose 6.5% during 1983, faster than the 6.0% average increase recorded during the first year of the previous five economic recoveries (excluding the short-lived 1980-1981 recovery and the unusually strong recovery extending into the Korean War).¹ Then, real GNP rose a hefty 4.6% during 1984, well above the 3.6% average for the second year of previous post-war recoveries. Not only was the recovery better than average, it was also very well balanced. For example, capital spending soared 27.1% during 1983 and 1984, the best two-year performance since 1966!

During 1985 and 1986, economic growth did slow down. And interest rates declined sharply despite huge federal deficits.

What happened? The U.S. trade deficit widened dramatically and dampened the growth of real GNP, *which is a measure of production*. Final consumer and business demands remained robust, but rising imports and lackluster exports seemed to put a lid on domestic industrial activity. Interest rates declined because the huge trade deficits brought in equally huge capital inflows. (Remember, "the balance of payments always balances.") In addition, falling oil and other commodity prices pushed inflation close to zero and made bonds very attractive investments.

¹Based on four-quarter percent change.

Exhibit 1: International Investment Position of the United States, 1970-1986*

| | TOTAL | | OFFICIAL | | U.S. BANK | | U.S. NONBANKS | | DIRECT INVESTMENT | | SECURITIES | |
|------|------------|-----------------|------------|-----------------|------------|-----------------|---------------|------------------|-------------------|------------------|-------------|------------------|
| | Assets (1) | Liabilities (2) | Assets (4) | Liabilities (5) | Assets (7) | Liabilities (8) | Assets (10) | Liabilities (11) | Assets (13) | Liabilities (14) | Assets (16) | Liabilities (17) |
| 1986 | 1,067.9 | 1,331.5 | 138.0 | 240.8 | 506.4 | 449.2 | 32.6 | 26.7 | 259.9 | 209.3 | 131.1 | 405.5 |
| 1985 | 949.4 | 1,061.3 | 130.8 | 202.5 | 447.4 | 354.5 | 28.6 | 29.4 | 229.7 | 184.6 | 112.8 | 290.3 |
| 1984 | 898.2 | 893.8 | 119.6 | 199.1 | 445.6 | 312.2 | 30.1 | 31.0 | 211.5 | 164.7 | 89.1 | 185.5 |
| 1983 | 874.1 | 785.6 | 113.0 | 194.6 | 434.5 | 278.3 | 35.1 | 26.9 | 207.2 | 137.1 | 83.8 | 147.5 |
| 1982 | 824.9 | 688.7 | 108.3 | 189.1 | 404.6 | 228.0 | 28.6 | 27.5 | 207.8 | 124.7 | 75.5 | 118.8 |
| 1981 | 719.7 | 579.0 | 98.5 | 180.4 | 393.5 | 165.4 | 35.9 | 30.6 | 228.3 | 108.7 | 63.4 | 93.6 |
| 1980 | 606.9 | 500.8 | 90.3 | 176.1 | 203.9 | 121.1 | 34.7 | 30.4 | 215.4 | 83.0 | 62.8 | 90.2 |
| 1979 | 510.6 | 416.1 | 77.4 | 159.9 | 157.0 | 110.3 | 31.5 | 18.7 | 187.9 | 54.5 | 56.8 | 72.8 |
| 1978 | 447.8 | 371.7 | 72.9 | 173.1 | 130.8 | 77.7 | 28.1 | 16.0 | 162.7 | 42.5 | 53.4 | 62.5 |
| 1977 | 379.1 | 306.4 | 68.9 | 140.9 | 92.6 | 60.2 | 22.3 | 11.9 | 146.0 | 34.6 | 49.4 | 58.8 |
| 1976 | 347.2 | 263.6 | 64.7 | 104.4 | 81.1 | 53.5 | 20.3 | 13.0 | 136.8 | 30.8 | 44.2 | 61.9 |
| 1975 | 295.1 | 220.9 | 58.0 | 86.9 | 59.8 | 42.5 | 18.3 | 13.9 | 124.1 | 27.7 | 34.9 | 49.9 |
| 1974 | 255.7 | 197.0 | 54.2 | 79.9 | 46.2 | 41.8 | 17.0 | 13.6 | 110.1 | 25.1 | 28.2 | 36.5 |
| 1973 | 222.4 | 174.5 | 53.2 | 69.3 | 26.7 | 25.9 | 13.8 | 11.7 | 101.3 | 20.6 | 27.4 | 47.1 |
| 1972 | 198.7 | 161.7 | 49.3 | 63.0 | 20.7 | 21.2 | 11.4 | 10.7 | 89.9 | 14.9 | 27.4 | 51.9 |
| 1971 | 179.0 | 133.5 | 46.3 | 52.5 | 16.9 | 16.5 | 9.6 | 9.2 | 82.8 | 13.9 | 23.4 | 41.4 |
| 1970 | 165.4 | 106.9 | 46.6 | 26.2 | 13.8 | 22.7 | 8.5 | 8.8 | 75.5 | 13.3 | 20.9 | 36.0 |

*All series are billions of dollars.
Source: Survey of Current Business.

Exhibit 2: International Capital Transactions of the United States, 1970-1986*

| | TOTAL | | OFFICIAL | | U.S. BANK | | U.S. NONBANKS | | DIRECT INVESTMENT | | SECURITIES | |
|------|-------------|------------|-------------|------------|-------------|------------|---------------|-------------|-------------------|-------------|--------------|-------------|
| | Outflow (1) | Inflow (2) | Outflow (4) | Inflow (5) | Outflow (7) | Inflow (8) | Outflow (10) | Inflow (11) | Outflow (13) | Inflow (14) | Outflow (16) | Inflow (17) |
| 1986 | 96.0 | 213.4 | 1.6 | 34.7 | 59.0 | 77.4 | 4.0 | -2.8 | 28.0 | 25.1 | 3.3 | 79.1 |
| 1985 | 31.4 | 129.9 | 6.7 | -0.1 | 1.3 | 41.0 | -1.4 | -0.5 | 17.3 | 19.0 | 7.5 | 71.4 |
| 1984 | 22.3 | 102.5 | 8.6 | 3.0 | 11.1 | 33.8 | -5.0 | 4.7 | 2.8 | 25.4 | 4.8 | 35.6 |
| 1983 | 49.8 | 84.9 | 6.2 | 5.8 | 29.9 | 50.3 | 6.5 | -0.1 | 0.4 | 11.9 | 6.8 | 16.9 |
| 1982 | 121.2 | 93.7 | 11.1 | 3.6 | 111.1 | 65.6 | -6.6 | -2.4 | -2.4 | 13.8 | 8.0 | 13.1 |
| 1981 | 111.0 | 83.0 | 10.3 | 5.0 | 84.2 | 42.1 | 1.2 | 0.9 | 9.6 | 25.2 | 5.7 | 9.8 |
| 1980 | 86.1 | 58.1 | 13.3 | 15.5 | 46.8 | 10.7 | 3.2 | 6.9 | 19.2 | 16.9 | 3.6 | 8.1 |
| 1979 | 64.3 | 38.8 | 4.9 | -13.7 | 26.2 | 32.6 | 3.3 | 1.6 | 25.2 | 11.9 | 4.7 | 6.3 |
| 1978 | 61.1 | 64.0 | 3.9 | 33.7 | 33.7 | 16.1 | 3.9 | 1.9 | 16.1 | 7.9 | 3.6 | 4.4 |
| 1977 | 34.8 | 51.3 | 4.1 | 36.8 | 11.4 | 6.7 | 1.9 | 1.1 | 11.9 | 3.7 | 5.5 | 3.0 |
| 1976 | 51.3 | 36.5 | 6.8 | 17.7 | 21.4 | 11.0 | 2.3 | -0.6 | 11.9 | 4.3 | 8.2 | 4.1 |
| 1975 | 39.7 | 15.7 | 4.3 | 7.0 | 13.5 | 0.6 | 1.4 | 0.3 | 14.2 | 2.6 | 6.9 | 5.1 |
| 1974 | 34.7 | 34.2 | 1.1 | 10.5 | 19.5 | 16.0 | 3.2 | 1.8 | 9.1 | 4.8 | 1.9 | 1.1 |
| 1973 | 22.9 | 18.4 | 2.5 | 6.0 | 6.0 | 4.7 | 2.4 | 1.0 | 11.4 | 2.8 | 0.7 | 3.8 |
| 1972 | 14.5 | 21.5 | 1.6 | 10.5 | 3.5 | 4.8 | 1.1 | 0.8 | 7.7 | 1.0 | 0.6 | 4.5 |
| 1971 | 12.5 | 23.0 | -0.5 | 26.9 | 3.0 | -6.9 | 1.2 | 0.4 | 7.6 | 0.4 | 1.1 | 2.3 |
| 1970 | 9.3 | 6.4 | -0.9 | 6.9 | 1.0 | -6.3 | 0.6 | 2.0 | 7.6 | 1.5 | 1.1 | 2.3 |

*All series are billions of dollars.
Source: Survey of Current Business.

III. The New Crowding-Out Disaster Scenario

Of course, back in 1983, many economists shared Professor Feldstein's concerns about crowding out and also predicted troubled times ahead. *The crowding-out crowd now argues that an influx of unpredictable, and therefore undependable, foreign saving, delayed the day of reckoning when huge deficits would push interest rates skyward and cause a recession. Woe onto us once the foreigners decide to take their money elsewhere!*

Fed Chairman Paul Volcker expressed similar views in a speech presented on November 29, 1984, at the New York Arthritis Foundation. Mr. Volcker stated that the crowding-out analysis, which "focused primarily on the U.S. potential to save, failed to take account of the sharp increase in the inflow of capital from abroad." Then Mr. Volcker warned that "borrowing so much abroad, and running so large a trade deficit, is not sustainable indefinitely."

Mr. Volcker saw the following dangers in the situation:

- 1) The "United States is importing capital so fast that the largest and richest country in the world is well on its way to becoming the largest international debtor as well."
- 2) The flip side of large capital inflows is a huge trade deficit that "understandably intensifies, among affected industries, the already strong pressures for protection."
- 3) Our interest rates, our exchange rate, and our inflation rate are "hostage to events beyond our control," as we become more "addicted to foreign borrowings to reconcile our deficit and our investment needs with our limited propensity to save at home."
- 4) The "only result of trying to substitute money creation for real savings would be to restimulate inflation and inflationary expectations, undercutting all that has been achieved, and ultimately driving interest rates higher, not lower. And those risks would only be multiplied should we, in our actions, inadvertently undermine the confidence that attracts capital from abroad at tolerable interest rates."

That's quite a grim assessment. According to this new crowding-out disaster scenario, if we don't cut the federal deficit soon and reduce our reliance on capital inflows, our fate will be determined by fickle foreigners. If they suddenly decide to stop investing in the securities of the world's largest debtor, then the dollar would tumble, inflation would come back, and interest rates would soar. If the Fed tries to hold interest rates down then 1) the money supply would explode; 2) foreigners would run for the exit doors even faster; 3) inflation would come back even sooner; and 4) the dollar would collapse.

A mini-version of this disaster scenario was played out earlier this year. On March 19, the U.S. Senate passed a resolution asking the President to retaliate against the Japanese for failing to abide by a semiconductor trade agreement reached between the two countries and signed on July 31, 1986. *The vote was 93 to 0.* On Friday, March 27, 1987, the administration announced that effective April 17, \$300 million worth of U.S. imports of selected Japanese electronic products would face a tariff of 100%.

The American-initiated trade skirmish unnerved Japanese investors. So they stayed home and stopped sending capital into the U.S. bond market. That explains why U.S. bond prices collapsed, while Japanese bond prices soared during April and May.

By staying home, Japanese investors also helped to drive down the yen value of the dollar. The dollar plunged 12.1% from 158.2 yen per dollar during the first week of the year to a low of 139.0 during the week of May 3. (In contrast, the dollar has been relatively stable against the German mark, hovering between 1.77 and 1.86 marks per dollar since the start of the year.)

Although the dollar has been falling since early 1985, the drop in April seemed to trigger a big jump in commodity prices. This, in turn, started an inflation scare that caused many

American bond investors to sell. Net purchases of bond mutual funds had averaged \$10.2 billion per month from October 1985 to March 1987. During April, net purchases were a meager \$1.6 billion. And in May, there was net liquidation of about \$1 billion.

Many investors are worried that the April and May debacle in the bond market could happen again. They recognize that the trade deficit is narrowing and that U.S. bond yields are now much higher, relative to Japanese bond yields, than at the start of the year. Both factors should help to stabilize the foreign-exchange value of the dollar. "But what if the dollar falls again?" ask the worriers. "The bond crop never fails: The next Treasury refunding will take place in early September. If the dollar weakens, foreign investors will require a higher yield to offset some of the currency risk. Another bond debacle could push government yields over 10%. If a recession results, the U.S. federal deficit will be uncontrollable. Bond investors would suffer. Stock investors would suffer. The economy would be a wreck."

Before we get too hysterical, let's have a cool, close look at the facts and figures.

IV. Lending Less Is One Way To Become A Debtor

The U.S. net investment position equals the difference between U.S. assets held abroad and foreign assets held in the U.S. Changes in this position are attributable to capital outflows, which add to our position, or capital inflows, which subtract from our position.² (Exhibit 1 shows the international investment position of the United States and Exhibit 2 shows the corresponding international capital transactions from 1970 to 1986.)

Capital outflows include U.S. purchases of foreign real assets and financial securities, as well as U.S. bank loans to overseas borrowers. Capital inflows include foreign purchases of U.S. real assets and financial securities, as well as the acquisition of U.S. bank deposits by foreigners.

The U.S. net international investment position has moved into the red recently because: 1) foreign central banks have purchased huge sums of U.S. Treasury securities in an effort to avert the collapse in the foreign-exchange value of the dollar; 2) U.S. banks have reduced their lending to the rest of the world, particularly Latin American debtors; 3) foreign direct investment in the U.S. has outpaced U.S. direct investment overseas; and 4) foreign purchases of U.S. securities have risen sharply in recent years.

1) On An Official Accounts Basis, The U.S. Has Been A Debtor Every Year Since 1971. The U.S. dollar is a key reserve currency. Foreign central banks hold dollars for the purpose of intervening in the foreign-exchange markets and financing any balance of payments deficits generated by their country's nonofficial international transactions.

From 1979 to 1985, the gap between U.S. government claims on foreigners and U.S. government liabilities to official foreigners hovered in negative territory between \$71.7 billion and \$85.8 billion. It widened by \$31.1 billion to \$102.8 billion during 1986 (Exhibit 1, column 6).

During 1986, foreign official accounts purchased \$34.5 billion of U.S. Treasury securities (Exhibit 3, column 4). Weekly data reported by the Federal Reserve Bank of New York show that U.S. Treasury securities held in custody for foreign central banks soared \$36.8 billion from \$125.6 billion at the start of the year to \$162.4 billion at the end of the year (Exhibit 4). By the middle of 1987, their holdings were up another \$18 billion to \$180.4 billion. This sharp increase in foreign central bank purchases of U.S. Treasuries was directly related to massive foreign-exchange market purchases of U.S. dollars aimed at supporting the dollar.

2) U.S. Banks Are Lending Less To The Rest Of The World. One of the main reasons that the U.S. has become an international debtor is that U.S. banks have reduced their net exposure to overseas loans. For example, during 1982, U.S. bank claims on foreigners exceeded U.S.

²Obviously, changes in this position can also be caused by price and exchange rate movements.

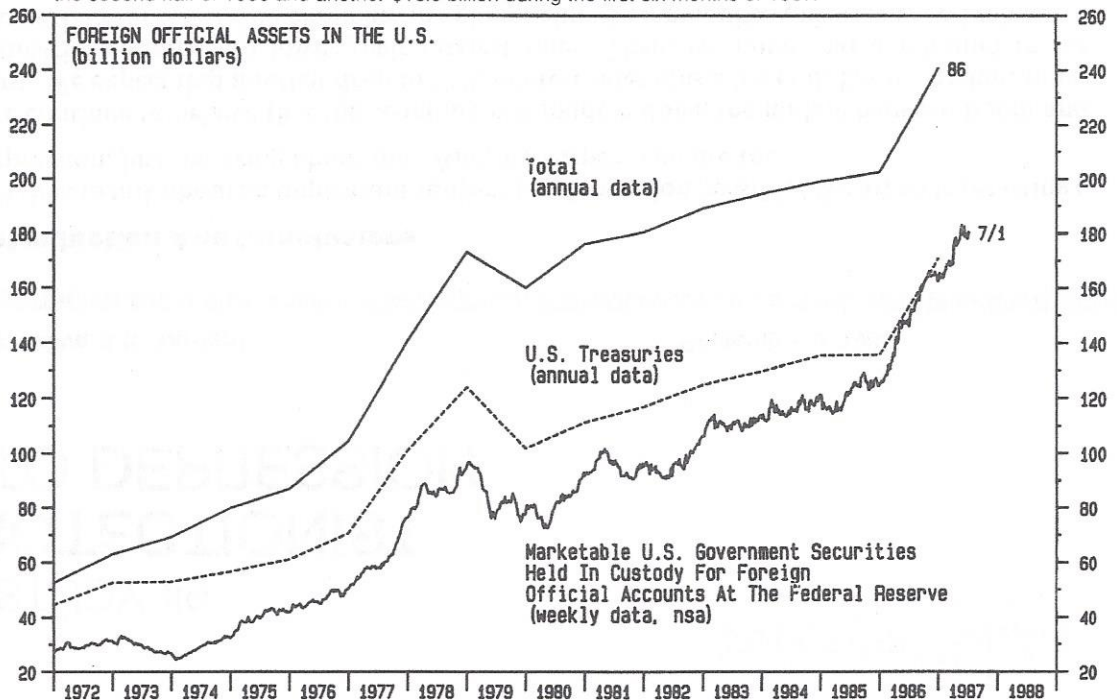
Exhibit 3. Foreign Transactions In U.S. Treasury Securities*

| | HOLDINGS | | | NET PURCHASES | | |
|------|-----------------|----------------|--------------|-----------------|----------------|--------------|
| | Official (1) | Private (2) | Total (3) | Official (4) | Private (5) | Total (6) |
| 1986 | 170.7 | 96.0 | 266.7 | 34.5 | 8.3 | 42.8 |
| 1985 | 135.7 | 83.6 | 219.3 | -0.8 | 20.4 | 19.6 |
| 1984 | 135.5 | 58.2 | 193.7 | 4.7 | 23.0 | 27.7 |
| 1983 | 129.7 | 33.8 | 163.5 | 7.0 | 8.7 | 15.7 |
| 1982 | 124.9 | 25.8 | 150.7 | 5.8 | 7.0 | 12.8 |
| 1981 | 117.0 | 18.5 | 135.5 | 5.0 | 2.9 | 7.9 |
| 1980 | 111.3 | 16.1 | 127.4 | 9.7 | 2.6 | 12.3 |
| 1979 | 101.7 | 14.2 | 115.9 | -22.4 | 5.0 | -17.4 |
| 1978 | 124.0 | 8.9 | 132.9 | 23.6 | 2.2 | 25.8 |
| 1977 | 101.1 | 7.6 | 108.7 | 30.2 | 0.5 | 30.7 |
| 1976 | 70.6 | 7.0 | 77.6 | 9.3 | 2.8 | 12.1 |
| 1975 | 61.1 | 4.2 | 65.3 | 4.7 | 2.6 | 7.3 |
| 1974 | 56.5 | 1.7 | 58.2 | 3.3 | 0.7 | 4.0 |
| 1973 | 52.9 | 1.0 | 53.9 | 0.1 | -0.2 | -0.1 |
| 1972 | 52.6 | 1.2 | 53.8 | n.a. | 0.0 | n.a. |
| 1971 | 44.4 | 1.2 | 45.6 | n.a. | 0.0 | n.a. |
| 1970 | 17.7 | 1.2 | 18.9 | n.a. | 0.1 | n.a. |

*All series are billions of dollars.
Source: Survey of Current Business.

Exhibit 4: Massive Foreign-Exchange Intervention Makes Foreign Central Banks Big Purchasers of U.S. Treasuries.

The dollar started to fall against other major currencies early in 1985. On September 22, 1985, the G-5 finance ministers agreed that it should move still lower. Apparently, the foreign central bankers started to have major second thoughts by early 1986 when they began to intervene in the foreign-exchange markets to support the dollar. U.S. Treasuries held in custody for foreign official accounts rose by a whopping \$20.4 billion during the first half of 1986 and another \$16.4 billion during the second half of 1986 and another \$18.0 billion during the first six months of 1987.



bank liabilities to foreigners by \$176.6 billion. In 1986, U.S. banks were still net international lenders, but their assets exceeded their liabilities by only \$57.2 billion (Exhibit 1, column 9). Clearly, the Third World debt crisis caused U.S. banks to reduce their net international exposure. (Note that loans to foreigners are still rising, but not as fast as deposits owed to foreigners.)

U.S. banks' net capital transactions swung from net capital outflows (i.e., net lending) averaging \$41.2 billion during 1980-1982 to net inflows (i.e., net borrowing) averaging \$25.3 billion during 1983-1986 (Exhibit 2, column 9).

3) Direct Investments: We Still Own More Of Them Than They Own Of Us. But they are gaining on us.

The Commerce Department is careful to note that its data reflect the "international investment position" of the U.S. Yet, most interested observers seem to believe that the data reflect the international *debt* position of the U.S.

In fact, the data include both direct and financial equity investments. The net direct investment position totalled \$50.6 billion in 1986. Back in 1979, this series hit a high of \$133.4 billion (Exhibit 1, column 15).

4) Private Foreign Investors Are Big Purchasers Of U.S. Stocks And Bonds, But Not Treasuries. For many years now, foreign ownership of U.S. financial securities has exceeded U.S. investments in foreign securities markets. Last year, this gap widened by almost \$100 billion (Exhibit 1, column 18). Price and exchange rate changes accounted for \$21.2 billion, or roughly one-fifth of the deterioration in the U.S. international investment position in securities. That leaves \$75.7 billion in capital inflows to account for.

Most of the purchasing activity by private foreigners was in U.S. corporate bonds and stocks, not in Treasuries. Treasury purchases slowed dramatically from \$23.0 billion and \$20.4 billion in 1984 and 1985, respectively, to only \$8.3 billion in 1986 (see Exhibit 3, column 5 and Exhibit 5).

Overseas purchases of U.S. corporate bonds amounted to a whopping \$53.8 billion, most of which represented Eurobonds issued abroad by U.S. corporations, partly for the purpose of financing acquisitions (Exhibit 6). Equity investments accounted for another \$17.0 billion of the 1986 capital inflow (Exhibit 7).

5) Errors And Omissions Could Add Another \$200 Billion To U.S. Debt Position. The balance of payments always balances which means that current account transactions (i.e., exports and imports of goods and services) must be offset, or balanced, by capital account transactions. That's in theory. In practice, the two accounts rarely match because of statistical and reporting errors and omissions. Since trade data are usually more reliable than capital account data, the large positive statistical discrepancy is believed to represent unreported capital inflows. Since 1980, the sum of the annual statistical discrepancies has risen to almost \$200 billion (Exhibit 8). *If we assume that part of the discrepancies was accounted for by unrecorded net capital inflows, then the U.S. is even a bigger debtor than suggested by the reported data.*

On the other hand, understatement of some U.S. assets abroad, e.g., direct investment, which is carried at book value, may work in the opposite direction.

Exhibit 5: Lower Interest Rates And Greater Currency Risk Dampen Private Foreign Demand For Treasuries.

Net foreign purchases of U.S. Treasury securities by private foreigners and international financial institutions were \$8.3 billion in 1986 compared with \$20.4 billion in 1985 and \$23.0 billion in 1984. Japanese net purchases accounted for less than one-fifth of total net purchases in 1986 compared with 85% in 1985. Net foreign purchases of U.S. Treasuries during the first quarter were \$5.4 billion. International financial institutions were the big buyers; net sales by other private foreigners slowed slightly compared to the fourth quarter.

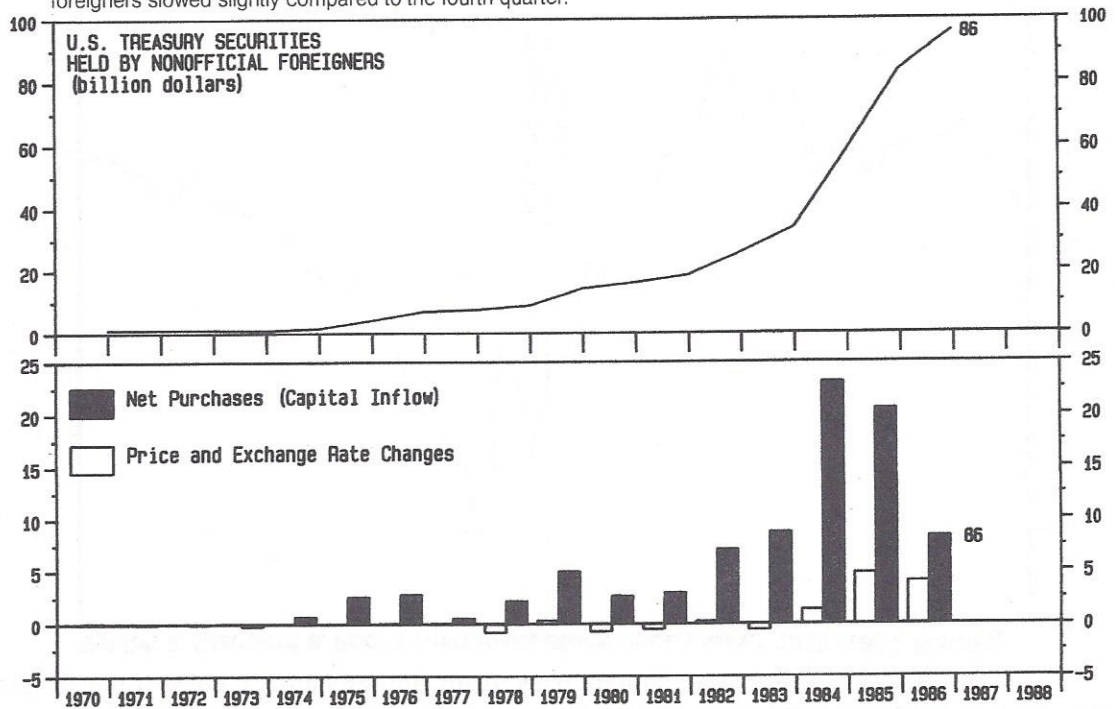


Exhibit 6: U.S. Corporations Found Welcome Mat in Eurobond Market. So they refinanced outstanding domestic debt and raised funds to finance acquisitions. Net foreign purchases of U.S. corporate bonds was a record \$53.8 billion last year. Foreigners purchased \$39.4 billion in Eurobonds issued abroad by U.S. corporations, up slightly from \$37.6 billion during 1985. Net foreign purchases of outstanding U.S. bonds were \$14.0 billion last year versus \$8.4 billion in 1985.

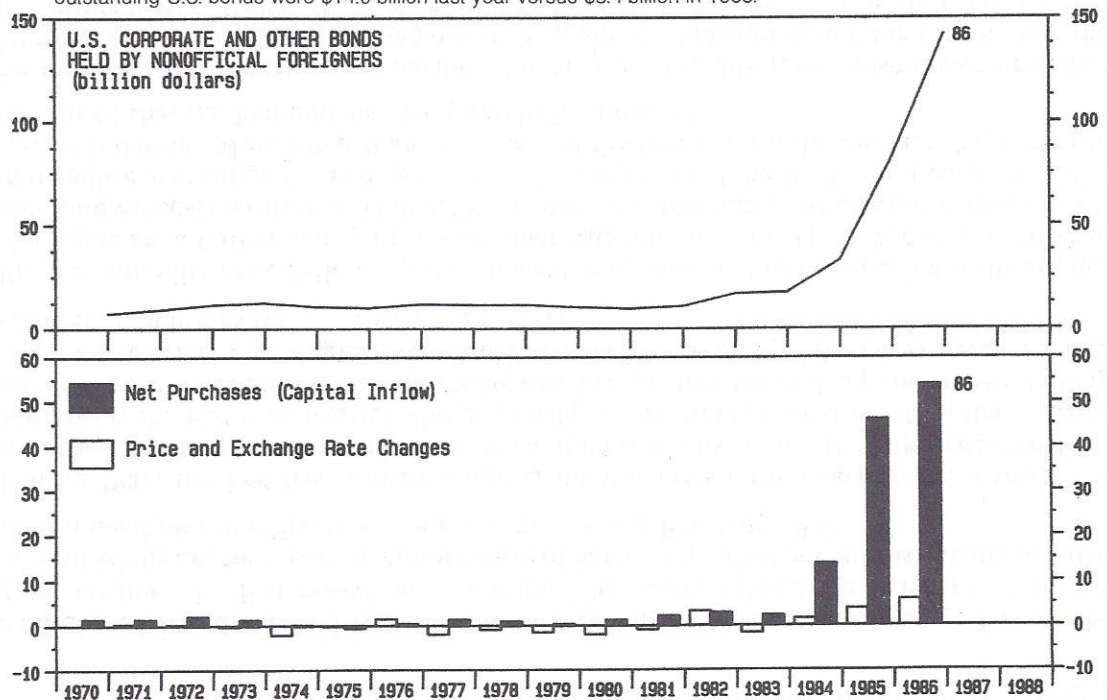


Exhibit 7: Net Foreign Purchases Of U.S. Stocks At A Record. They purchased \$17.0 billion last year, up sharply from \$4.9 billion during 1985. While net purchases remained strong throughout much of 1986, all major European countries shifted to net sales in October, which resulted in net sales for the fourth quarter. By December, nearly all of these same countries had returned as net purchasers. For the year, net purchases by British residents were \$4.6 billion and Japanese purchases totalled \$3.3 billion. During the first quarter, record purchases were fueled by rising prices and the lower foreign currency cost of U.S. stocks due to depreciation of the dollar.

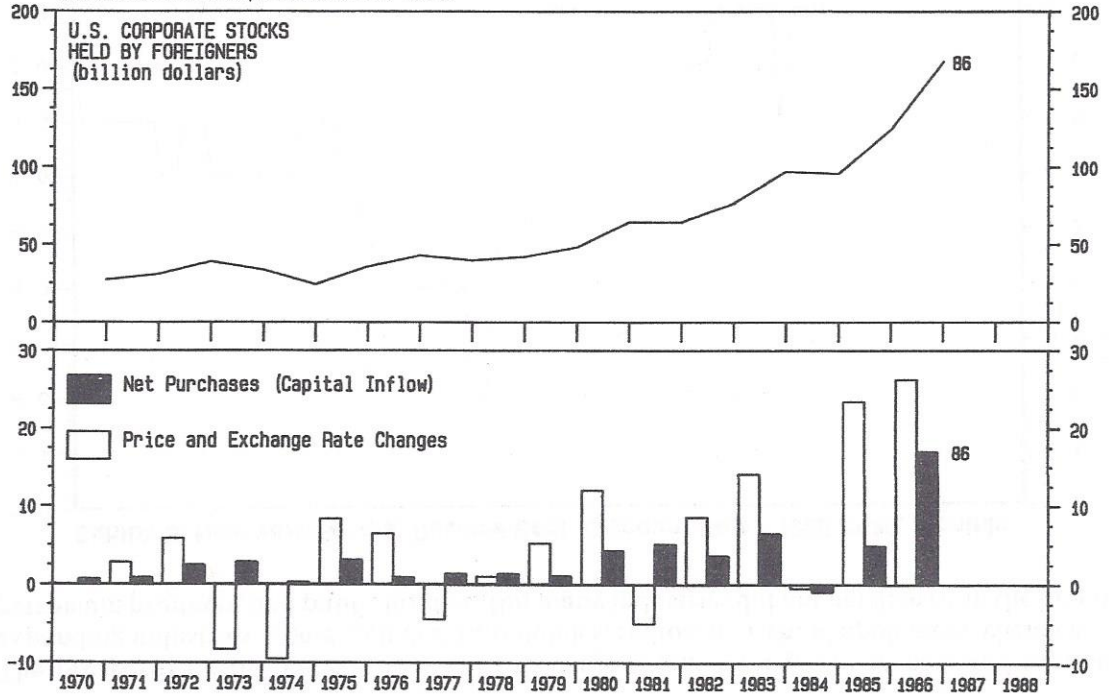
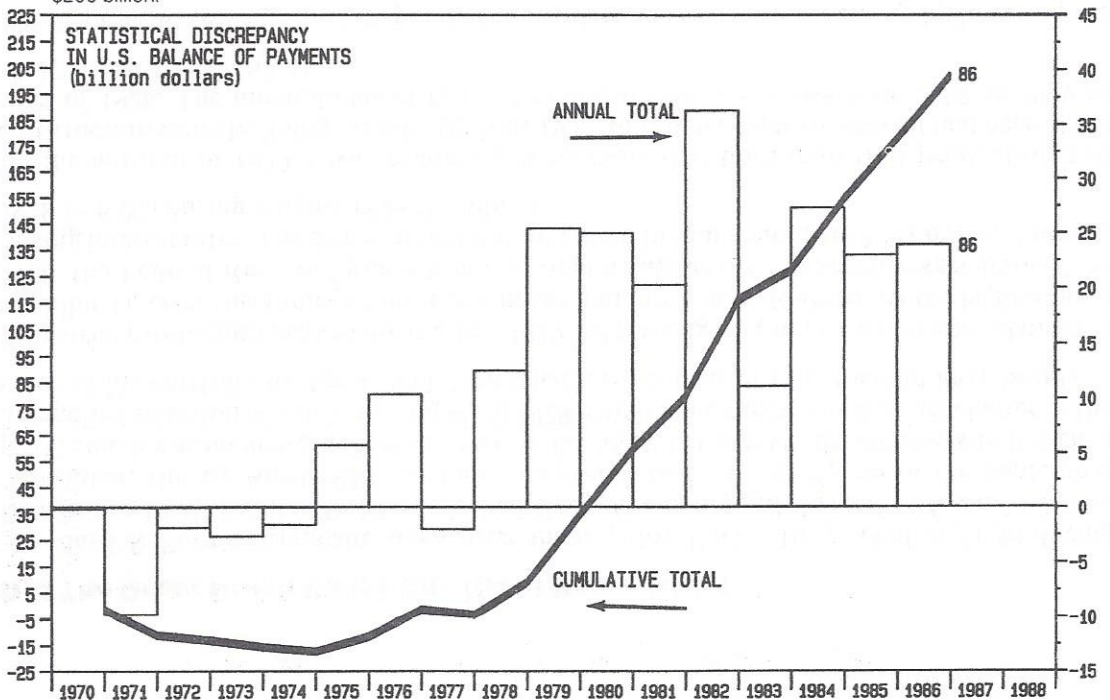


Exhibit 8: Unrecorded Capital Inflows Could Add \$200 Billion To U.S. Debtor

Status. The balance of payments always balances, in theory. But, in practice there has been a large positive statistical discrepancy in the international transactions accounts over the past several years. Because trade data are more reliable than capital account data, these errors and omissions imply large unrecorded capital inflows. Since 1980, the sum of the annual statistical discrepancies has risen to almost \$200 billion.



V. Do Income Figures Belie U.S. Debtor Status?

The current account includes trade in both goods and services. During 1986, the merchandise trade deficit totalled \$144.3 billion. The services trade balance showed a net surplus of \$18.6 billion. The main source of this surplus was net investment income which totalled \$20.8 billion last year.

If the U.S. is a net debtor, why do we receive more investment income from our assets abroad than foreigners receive from their assets in the U.S.? The balance sheet says we're a debtor nation; the income statement says we are still lenders. So who are we?

A closer look at the investment income data clearly reveals trends which corroborate our debtor status (Exhibits 9 and 10). Not surprisingly, the U.S. government's payments to foreigners have exceeded receipts from foreigners since 1970. Last year, such net payments totalled \$16.3 billion. Net income earned by U.S. private investors totalled \$37.1 billion last year, but most of that was attributable to profits from direct investments. Such earnings have been inflated by the sharp appreciation of major currencies against the dollar during 1985 and 1986. Other private payments have plunged from an annual average of \$22.5 billion from 1981 to 1984 down to only \$6.3 billion during 1986.

Exhibit 9: If the U.S. Is A Debtor, Why Do Receipts Of Income On U.S. Assets Abroad Exceed Payments On Foreign Assets In U.S.?

In 1986, the U.S. earned net international investment income of \$20.8 billion, down only slightly from \$25.4 billion in 1985. Net income from direct investments equalled \$30.9 billion while other private investments yielded net income of only \$6.3 billion in 1986. The U.S. government paid \$16.3 billion more than it took in from foreigners last year.

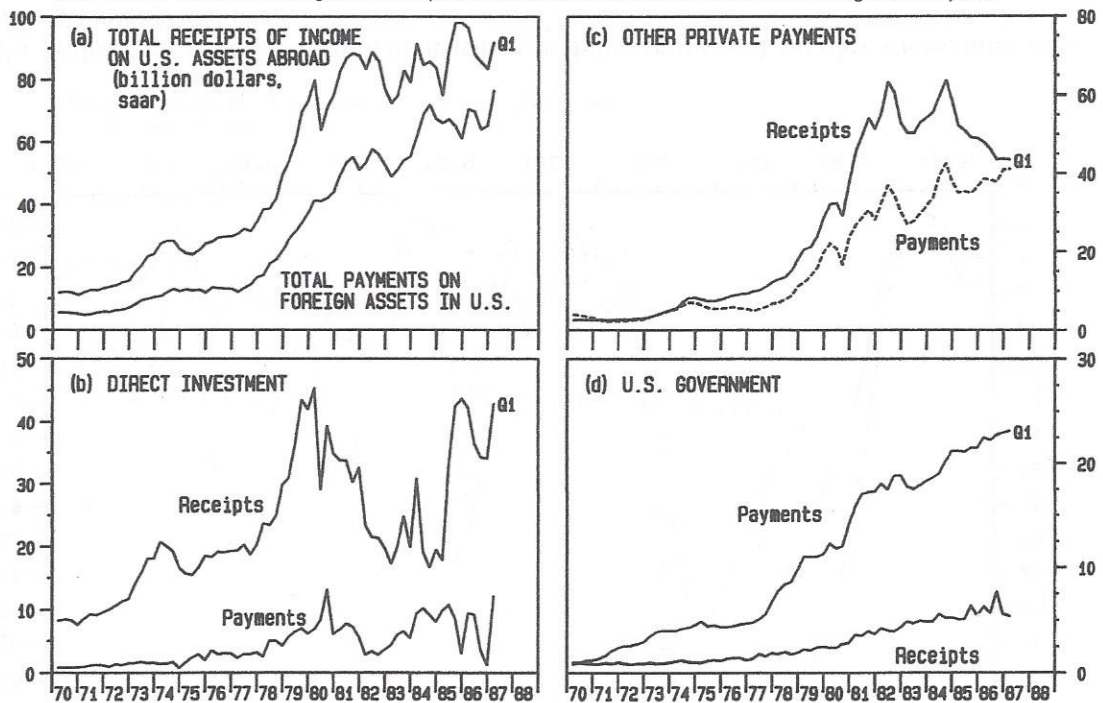
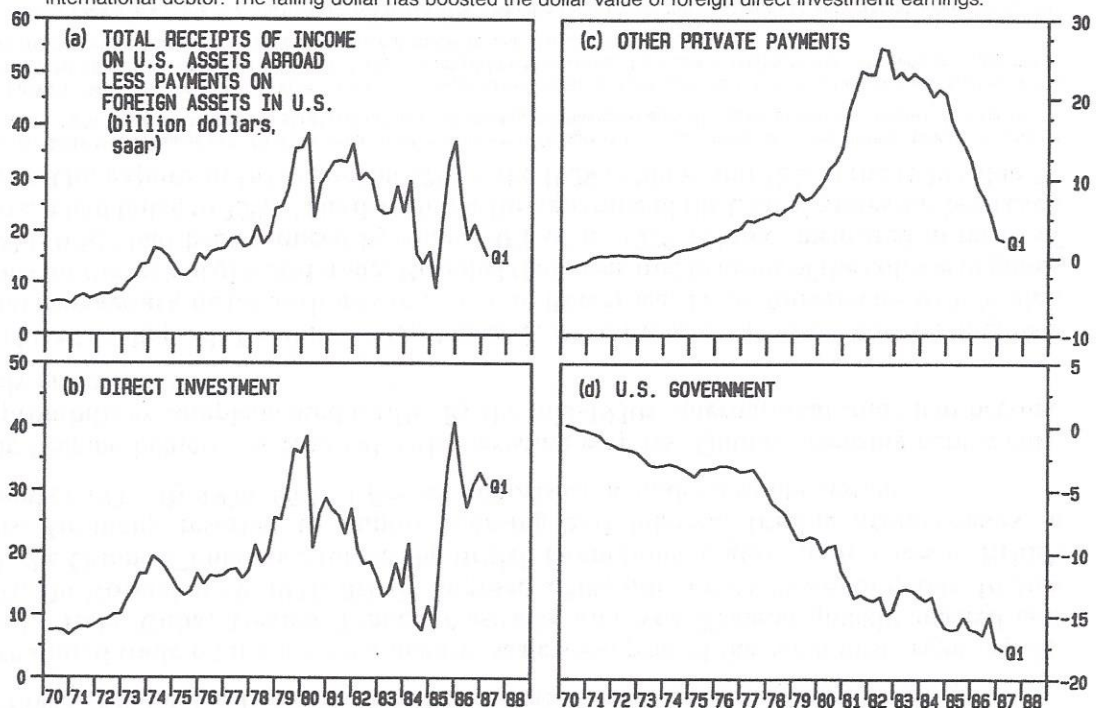


Exhibit 10: Reduced U.S. Bank Lending (Net) And Increased Eurobond Borrowing Depress Foreign Income.

From 1981 to 1984, income from net private international investments, excluding direct investments, averaged \$22.5 billion per year. It fell to \$14.6 billion in 1985 and to \$6.3 billion in 1986. On both a balance sheet and income statement basis, the U.S. government is an international debtor. The falling dollar has boosted the dollar value of foreign direct investment earnings.



VI. Are We Too Dependent On The Kindness Of Strangers?

Yes we are. But what's our choice? The U.S. would be less of a debtor today if U.S. policymakers had moved faster to keep the trade deficit from widening. They should have cut the federal deficit by increasing taxes and decreasing federal spending. Such actions would have dampened U.S. final demand for all goods, including imported products.

Yes, but if the global economy just barely muddled along with \$200 billion U.S. federal deficits, what would have happened if we had cut the federal deficits, say, in half? Chances are the domestic and global economies would have fallen into recession. *In other words, we became a debtor nation because we were the only ones providing enough economic growth to keep the world out of a recession.*

Trade-surplus nations in Europe and the Far East should have done more to help. Instead, they chose to provide some of their savings to fuel the American engine of growth. And they absorbed much of this growth by exporting to the U.S. more than they imported from the U.S. Not that it has been a bad deal for us. After all, we got their cars, and they received our promissory notes.

Last year, private foreign investors lost their interest in some of these promissory notes, particularly U.S. Treasury securities: As mentioned previously, they purchased only \$8.3 billion after buying \$20.4 billion in 1985 and \$23.0 billion in 1984 (Exhibit 3). The sharp drop in interest rates reduced the appeal of U.S. bonds for foreign investors. The reduced appeal of U.S. Treasuries combined with the widening trade deficit put tremendous downward pressure on the dollar. This drop seriously threatened the competitive position of countries like Japan and Germany.

So their central banks intervened. They purchased \$34.5 billion worth of U.S. Treasuries last year (Exhibit 3). They also acquired Eurodollar deposits which, in turn, were deposited in the

U.S. banking system by U.S. overseas bank branches. That helps to explain why U.S. banks experienced a capital inflow of \$77.4 billion last year, up from \$41.0 billion in 1985 (Exhibit 2, column 8).

If central banks hadn't intervened, the dollar would have plunged further and faster. U.S. interest rates would have soared sooner and higher. In this case, too, the U.S. would be less of a debtor today because higher interest rates would have triggered a recession which would have decreased the U.S. trade deficit, along with capital inflows.

So the U.S. trade deficit swelled and the U.S. became an international debtor because domestic economic demand has grown more rapidly in the U.S. than in the rest of the world. More specifically,

1) Huge federal deficits boosted U.S. demand. Americans have been living beyond their means in the sense that U.S. consumption exceeds production: The gap has been filled by net imports.

2) Other countries have been living below their means. Of course, the Third World debtors were forced to cut back as a result of their debt crisis. U.S. banks reduced their lending activities overseas which depressed Third World economic growth and hurt U.S. exports to those marketplaces. Since U.S. growth exceeded overseas growth, bank capital flowed into the U.S. because there were more attractive lending opportunities in the U.S. than abroad.

3) The awesome wave of corporate restructurings also explains how the U.S. became a debtor. Restructuring generated a tremendous demand for financing. A large chunk of the needed funds were raised in the Eurobond market.

4) The pressure to restructure was partly attributable to fierce international competition caused by the falling dollar. The lower dollar, in turn, reduced the foreign-currency cost of acquiring U.S. businesses and real estate. So foreign direct investment in the U.S. swelled, which also increased the international debt position of the U.S.

Our analysis suggests that the U.S. debtor problem, and the underlying trade imbalances, can be fixed with faster domestic demand growth overseas. (Faster production growth overseas worsens the situation if the products are sold in the U.S. rather than in the home market.)

That's the happy solution. The unhappy one is a U.S. recession, which unquestionably would trigger a global recession. A replay of the April and May debacle for the dollar and bonds certainly could set the stage for the unhappy solution.

So what are the odds? Not very high for the happy solution. Japanese officials are moving toward promoting a bit more domestic growth. The Germans aren't. The Third World economies, on balance, are likely to remain depressed.

Does this mean that the unhappy solution is inevitable? Not necessarily. There is a middle, muddling solution—short of a recession. Slower domestic demand growth in the U.S. and the lower dollar cause a narrowing of the U.S. trade deficit. The dollar stabilizes because the trade deficit is improving and because U.S. interest rates have risen to levels that attract foreign capital.

The bond market responds favorably to the better dollar and to weakness in consumer and business spending. Thanks to restructuring, corporate earnings increase sharply even though economic growth is lackluster. The stock market moves higher.

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