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Are Foreign Trade and Investment Unbalanced?

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On May 10, Treasury Secretary Hank Paulson led a small panel discussion about the importance of foreign direct investment in the American economy. Just a few hours earlier, a government report was released showing a trade deficit of $63.9 billion in March, nearly 10 percent higher than in February. The trade deficit is a favorite bogeyman of those who predict a coming economic apocalypse, so the latest figures are certain to be much cited. The coincidence of the trade figures and the Paulson panel just might goad policymakers to focus on the real economic issue in play. Trade "imbalances" in goods and services pose no danger as long as they are counterbalanced by a surplus of investment. Fortunately, the U.S. enjoys exactly such a surplus. The potential danger, then, is radical policy changes that would worsen the investment climate. Investors need certainty, and uncertainty is a growing concern, according to Paulson's panel.

A Trade Surplus with Free Economies. Total March exports were $126.2 billion, or barely two-thirds of the $190.1 billion in total imports, according to the U.S. Bureau of Economic Analysis. The result was a trade deficit $6.0 billion larger than in February.

By country, the U.S. had the largest trade *surpluses* with Hong Kong ($1.3 billion), Australia ($1.3 billion), and Singapore ($0.9 billion). The largest trade deficits in March were with China ($17.2 billion, compared to $18.4 billion in February), Europe ($8.9 billion, compared to $7.2 billion in February), OPEC ($8.9 billion, compared to $7.0 billion in February), Japan ($7.1 billion), and Mexico ($6.7 billion).

Notably, the top three largest U.S. trade surpluses came from the *2007 Index of Economic Freedom*'s three freest countries: Hong Kong, Singapore, and Australia. This indicates that the United States can compete in a more liberalized trading environment. The other implication is that trade restrictions in less free economies are hindering exports from the U.S.

The good news is that exports are still growing, up $1.8 billion for goods in March to $90.2 billion. Services exports grew $0.4 billion to $36.1 billion, primarily in financial, insurance, and technical/professional services.

Imports grew even faster, which may seem counter-intuitive given the weaker exchange rate. However, the combination of long-term contracts and a short-term dollar decline inevitably leads to a short-term widening of the trade gap before it narrows, which is known as the "J-Curve." Imports of goods alone increased $7.8 billion in March. But this should turn around if the dollar stabilizes.

Investment Clouds. Two decades ago, investors from Japan famously snapped up American movie studios, manufacturers, and even famous properties like the Rockefeller Center. Foreign investors were also eager to get in on the ground floor of the Internet revolution and participated heavily in private

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equity deals in U.S. startups during the late 1990s. According to the Council of Economic Advisors, "U.S. affiliates owned $5.5 trillion in assets and had $2.3 trillion in sales." Foreign multinational employment accounts for 4.7 percent of all U.S. jobs, and those jobs pay $15,200 more, on average, than purely domestic jobs.

A useful framework for thinking about economic issues is to identify differences between levels and changes, or "stock" versus "flow." For example, a nation may have no stock of fresh water but receive a regular flow of thousands of gallons from rains. America enjoys a healthy stock of foreign investment from abroad and continues to enjoy a very large flow of new inbound investments. But there is a qualitative difference in the two.

Foreign investors own a total stock of over $9 trillion in U.S. assets, according to 2005 CEA data. The assets are composed of four basic types, and the largest portion is foreign direct investment (FDI, $2.8 trillion). This type of investment goes directly into companies and infrastructure and, so, is considered the best in terms of creating high-value jobs for U.S. workers. Inward FDI is more stable and less liquid than other sorts of capital inflows, demonstrating long-term foreign investor confidence in the U.S. economy. U.S.-based multinational companies, a key source of FDI, also contribute to the U.S. economy by exposing domestic firms to the best business management techniques.

The other three types of foreign investment are corporate stocks, private bonds, and U.S. Treasury bonds and bills.[1] Each of these types comprises about $2 trillion of the total investment stock.

But the stock is only part of the story, because it includes investments that have accumulated over decades, even centuries. What about the flow of investments in recent years? Professor Menzie Chin, an economist at the University of Wisconsin, writes that the U.S. has become overly reliant on bond financing and that FDI has been drying up significantly.[2] In the last five years, only one in 10 dollars invested in the U.S. has been in FDI, while eight have been in bonds. This is a cause of concern.

If investors lose faith in the investment process, including things like cumbersome approval rules and strict travel restrictions, then they will react, often by investing elsewhere. The visa waiver issue in particular has become a point of contention for America's friends. One investor reaction has been a shift toward passive investments in the U.S., which are much more liquid. The danger is that if the demand for passive investments flags, U.S. interest rates will rise.

The policy implication for Congress is to tread very carefully in regulating capital markets and playing politics with the international economy. The Dubai Ports World imbroglio was nothing short of a fiasco in terms of the signal it sent to foreign investors. Ongoing saber rattling about exchange rates and punitive tariffs may seem to be harmless rhetoric, but it has an impact. American legislators who are talking tough do not intend to scare away good jobs, but that appears to be the result.

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1. *Economic Report of the President*, (Washington, D.C.: GPO, 2007), p. 178.
2. Menzie Chinn, "The Coming (?) US Current Account Adjustment: Two Questions Inspired by Two Graphs," Econbrowser, Weblog, April 17, 2007, at *www.econbrowser.com/archives/2007/04/two_questions_i.html*.