

# Comments

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**B**enjamin Friedman's preceding chapter investigates recent U.S. international capital transactions along three dimensions. In the section **Capital Inflows, Investment, and Government Deficits** it characterizes the current situation, using national income identities to describe how increased U.S. net capital inflows have been balanced by changes in net private savings, government budget deficits, and net private domestic investment. Its next section addresses the question, what important consequences are likely to occur if the current level and direction of capital flows continue? The following section asks, if certain policy actions are implemented to eliminate existing capital flows, how will these policies affect net private savings, net private domestic investment, and the government budget deficit? In what follows I summarize what I think the chapter's major conclusions are, explain where I disagree with the chapter, and also raise some issues that I feel are relevant but are not discussed in it. Before turning to specifics, however, let me say that the chapter is informative and easy to read, while providing interesting food for thought.

According to the data presented under **Capital Inflows, Investment, and Government Deficits**, the dramatic increase in U.S. current account deficits, and therefore the associated increase in capital inflows, began in 1983 and has continued through 1985. During the period 1983–85, net private savings averaged 6.6 percent of gross national product, dropping somewhat from the average of 7.3 percent over the period 1950–82. Net private domestic investment was also low by historical standards, averaging 4.3 percent of gross national product from 1983–85 compared to 5.7 percent from 1950–82. In contrast, government budget deficits as a fraction of gross national product rose more than five-fold, increasing from an average of .7 percent over the period 1950–82 to an average of 3.7 percent from 1983–85.

This characterization of recent U.S. net capital inflows, private savings, private domestic investment, and government deficits appears to accurately reflect the facts of interest. Admittedly, the contention that private domestic investment actually has fallen recently could be challenged on a variety of

grounds. It may be unwise to compare investment over a relatively short horizon (such as 1983–85) with investment over a relatively long horizon (such as 1950–82 or even decades such as 1961–70) given that investment is so cyclically sensitive. The fact that the United States has been moving from long-lived to short-lived capital and the fact that there have been changes in the price of consumption goods relative to investment goods can also make it difficult to compare investment to gross national product ratios from different points in time. However, these considerations are unlikely to be so important that they could overturn what should be the main message from the analysis of capital inflow, investments, and deficits. Large capital inflows into the United States are not merely replacing diminished private savings in order to maintain the existing level of private domestic investment and government deficits. Nor are they supplementing an unchanging amount of private savings in order to allow increased private domestic investment. Rather, large capital inflows are occurring at a time when the United States has chosen to run historically large government budget deficits.

What important consequences are likely to occur if the current level and direction of capital flows continue? The chapter outlines three. First, these flows could have worrisome implications for the ability of the United States to achieve a rising standard of living. This point is best understood when it is kept in mind that continual capital inflows will eventually turn any nation into a net debtor. As a net debtor, the profile of future consumption and investment must be reduced for a given profile of future production in order to service the debt. Viewed in this way, it is easy to see why it is important to characterize what has been happening with U.S. private domestic investment. If investment has been rising, increased future U.S. production could be available to finance increased debt service obligations and there might not be any reduction of future consumption.

Should changes in the future standard of living be of major concern to the United States today? Obviously it depends on how long the capital flows continue and on their magnitude. According to the figures in table 4–5, the United States has gone from a net creditor of \$147 billion dollars in 1982 to a net creditor of \$28 billion in 1984. Has this made a noticeable change in the U.S. standard of living? Probably not. Despite the large change in the stock of assets, data in the 1984 *Economic Report of the President* indicate that U.S. net investment income has gone from about \$28 billion in 1982 to \$20 billion in 1984, representing a change from 1.0 percent of net national product to 0.6 percent. I think this type of comparison, between the flow variables net investment income and net national product, is more relevant for analyzing welfare than the comparison between the flow variable total exports (or gross national product) and the stock variable net U.S. asset position, which is the one highlighted in the preceding chapter. Thus, I agree wholeheartedly with the proposition that continued capital inflows into the United States will,

given the lack of a noticeable increase in net private domestic investment, diminish the future standard of living, but I disagree with the idea that this reduction will be of major importance in the near future. The remarkably large capital flows experienced recently have had a fairly small impact on resources at the nation's disposal.

The second implication of continued capital inflows that Friedman discusses is their impact on U.S. economic policy. The issue of primary concern here is whether, when the United States becomes a net debtor, it will need to carry out policies that will instill confidence in foreign lenders, presumably to ensure that the real return the nation must pay on its net debt is not too high.

The chapter points out several factors that play a role in determining the importance of this concern. For instance, there has been an increasing trend of foreign private citizens replacing foreign governments as the source of financing for U.S. trade imbalances. This trend presumably raises the probability of an increase in returns being necessary to induce the rest of the world to maintain their net creditor position, *if* assets in the United States become less attractive, because private investors' portfolio decisions are probably less dependent on political factors and more dependent on economic factors than the portfolio decisions of foreign official investors. However, the interaction between U.S. economic policy and the future attractiveness of U.S. assets is not investigated in much detail here so that it is unclear exactly which policies the United States might want to but cannot implement due to concerns over how the policies would alter the attractiveness of U.S. assets to foreign investors.

I think two aspects of the recent capital flows deserve more attention than is given in the chapter. The first is that the increased capital inflow has in large part gone through the private banking sector. Over 40 percent of the net capital inflow during 1983 and 1984 was bank reported, according to figures in the May 1985 *Federal Reserve Bulletin*. Most of this was net own claims as opposed to net custody claims (that is, it was reported by the banks as being for their own accounts as opposed to their custody accounts). In contrast, capital inflows associated with foreign net purchases of U.S. treasury obligations, the second largest category, comprised less than 30 percent of the capital inflow during this period. Thus, although the results presented in table 4-7 indicate that foreign lending to the United States through purchases of U.S. government securities has historically been the most important, this trend is changing. To the extent that U.S. policy is guided by an attempt to instill foreign investors' confidence, it is confidence in the U.S. banking system that appears to be of increasing concern.

The second aspect of recent capital inflows that I think deserves more attention is the interaction between the maturity structure of the debt being incurred and the incentives to return to a higher level of inflation. As noted in this Comment and in the preceding chapter, most U.S. liabilities are nominal

(as opposed to real) and, in addition, are U.S.-dollar-denominated. This raises the possibility that one interaction between the capital flows and U.S. economic policy is to provide an incentive to create unexpected inflation and thereby diminish the real value of U.S. indebtedness. The extent to which this incentive exists depends in large part on the maturity structure of the national debt, with a relatively short maturity debt creating less of an incentive to unexpectedly raise the inflation rate. Based on the data provided in table 4-7, the ratio of short-term debt to long-term debt is 5-to-6, creating the impression that the United States could benefit from its relatively unique position of being able to borrow in a currency whose value it directly controls. The figures of table 4-7 probably overstate the incentive to create unexpected inflation since, according to note 11, they omit \$1.7 trillion of small time and savings deposits and a large fraction of this total is presumably short-term time deposits whose market rates of interest quickly react to changes in inflation. Nonetheless, the incentive to inflate away foreign debt might well be one of the more important consequences of continued capital inflows for U.S. economic policy.

The final implication of continued capital flows to be considered in the chapter is also related to the maturity structure of U.S. liabilities. It is claimed that foreign investors have a preference for short-term assets over long-term assets, relative to domestic investors, and that this may necessitate a premium being paid on long-term assets in order to maintain capital market equilibrium. I do not think that historical evidence would support much concern over this possibility. The most relevant evidence in this regard probably comes from Operation Twist in the late 1960s, when a change in excess demand for longer-maturity assets was presumably brought about by the Fed conducting open market purchases of longer-term government securities instead of treasury bills. The policy had little if any effect on the term structure of interest rates or on the premium associated with long- versus short-maturity assets.

The final section of the chapter addresses the question, if capital inflows do not continue, how will net private savings, net private domestic investment, and the government budget deficit be affected? The important point is made that since there are a variety of changes that could lead to the elimination of the capital inflows, the question cannot be answered without first specifying what causes the capital flows to cease. Three possibilities are considered: changes in full-employment government expenditure, changes in full-employment tax receipts, and changes in monetary growth relative to trend. The empirical results presented are based on reduced-form regressions using quarterly data, estimated over the period 1970-84.

It is estimated that capital inflows can be curtailed by increased money growth, decreased government expenditures, or increased tax collections. Increased money growth impacts on the other accounts in a way consistent

with the predictions of textbook macro models: lowering government deficits (presumably through increased output and endogenous tax collections), raising private savings (again, presumably through increased output), and raising domestic investment (presumably through either increased output or lower interest rates). The estimated impacts and the predictions of textbook macro models also are in agreement for decreased government expenditures: lower government deficits, higher domestic investment, and lower private savings. Only increased tax collections are estimated to have effects qualitatively different from those predicted by a textbook macro model: lower government deficits but, in contrast to predictions, lower domestic investment and higher savings. Quantitatively, the most surprising results are the lack of any noticeable effects of government expenditure and tax receipts on private savings.

When describing these results, the chapter acknowledges that the endogeneity of the policy variables may limit one's ability to interpret the regressions as telling about the outcomes of exogenous policy changes. I share this concern, and would add another. Even if the policies considered here could be treated as exogenous, can one really think of the reduced forms estimated here as being stable over time? I would expect that the reduced-form equations could show a fair amount of instability given that the time period of 1970–84 saw the end of the Bretton Woods era of fixed exchange rates, the dramatic changes of monetary operating procedure in 1979 and 1982, and the oil embargo of 1973–74. Furthermore, even if the reduced-form equations have been stable up until now, do people have any reason to expect that they will continue to be unchanged? The well-known Lucas critique warns that predictions based on a reduced-form equation estimated while one policy regime is in place can be very misleading about how the economy will operate when another policy regime becomes operative. If the policies used to stop the capital inflows are inherently different from the ones observed to date, predicting how savings, investment, and government deficits will be affected is not possible based solely on reduced-form estimates.