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Foreign Investment in U.S. Securities

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Foreign Investment in U.S. Securities

Summary

Foreign capital inflows are playing an important role in the U.S. economy by bridging the gap between domestic supplies of and demand for capital. Foreign investors now hold more than 55% of the publicly-held and -traded U.S. Treasury securities. The large foreign accumulation of U.S. securities has spurred some observers to argue that this large foreign presence in U.S. financial markets increases the risk of a financial crisis, whether as a result of the uncoordinated actions of market participants or by a coordinated withdrawal from U.S. financial markets by foreign investors for economic or political reasons.

Congress likely would find itself embroiled in any such financial crisis through its direct role in conducting fiscal policy and in its indirect role in the conduct of monetary policy through its supervisory responsibility over the Federal Reserve. Such a coordinated withdrawal seems highly unlikely, particularly since the vast majority of the investors are private entities that presumably would find it difficult to coordinate a withdrawal. It is uncertain, though, what types of events could provoke a coordinated withdrawal from U.S. securities markets. Short of a financial crisis, events that cause foreign investors to curtail or limit their purchases of U.S. securities likely would complicate efforts to finance budget deficits in the current environment without such foreign actions having an impact on U.S. interest rates, domestic investment, and the long-term rate of growth. This report analyzes the extent of foreign portfolio investment in the U.S. economy and assesses the economic conditions that are attracting such investment and the impact such investments are having on the economy.

Economists generally attribute this rise in foreign investment to comparatively favorable returns on investments, a surplus of saving in other areas of the world, the well-developed U.S. financial system, and the overall stability and rate of growth of the U.S. economy. Capital inflows also allow the United States to finance its trade deficit because foreigners are willing to lend to the United States in the form of exchanging the sale of goods, represented by U.S. imports, for such U.S. assets as U.S. businesses and real estate, stocks, bonds, and U.S. Treasury securities. Despite improvements in capital mobility, foreign capital inflows do not fully replace or compensate for a lack of domestic sources of capital. Economic analysis shows that a nation's rate of capital formation, or domestic investment, seems to have been linked primarily to its domestic rate of saving.

To date, the world economy has benefitted from the stimulus provided by the nation's combination of fiscal and monetary policies and trade deficit. Over the long run, however, concerns are growing that U.S. economic policies and the accompanying large deficit in its international trade accounts could have a negative impact on global economic developments, especially for developing countries.

This report relies on a comprehensive set of data on capital flows, represented by purchases and sales of U.S. government securities and U.S. and foreign corporate stocks, bonds, into and out of the United States, that is reported by the Treasury Department on a monthly basis. This report will be updated as events warrant.

Contents

List of Figures

List of Tables

Foreign Investment in U.S. Securities

Foreign capital inflows are playing an important role in the U.S. economy by bridging the gap between domestic supplies of and demand for capital. International capital flows and international capital markets also give the owners of capital the ability to reduce their risk by diversifying their investments. Foreign investors are now major investors in U.S. corporate stocks and bonds and hold some 55% of the publicly-held and -traded U.S. Treasury securities. These capital inflows help keep U.S. interest rates below the level they would reach without them and allow the Nation to spend beyond its current output, including financing its trade deficit. Some observers, however, are concerned about the extent of these foreign holdings, because they argue that this exposure increases the overall risks to the economy should foreign investors decide to withdraw from the U.S. financial markets for political or economic reasons.

Inflows of capital into the U.S. economy are not new. Such inflows, however, grew sporadically over the last decade, as indicated in **Table 1**. In 1995, total foreign capital inflows to the United States reached over $400 billion. As **Figure 1** shows, these capital inflows are comprised of official inflows, primarily foreign governments' purchases of U.S. Treasury securities, and private inflows comprised of portfolio investment, which includes foreigners' purchases of U.S. Treasury and corporate securities, and financial liabilities, and direct investment in U.S. businesses and real estate. By 2000, total foreign capital inflows totaled more than $1 trillion. Such inflows were reduced in 2001 and 2002 as the growth rate of the U.S. economy slowed, but surged to nearly $1.5 trillion in 2005 as the rate of economic growth improved. Private capital inflows comprise the largest share of the total capital inflows, with foreign purchases of corporate securities, stocks and bonds being the main components of these inflows.

Capital flows are highly liquid, can respond abruptly to changes in economic and financial conditions, and exercise a primary influence on exchange rates and through those on global flows of goods and services. Economists generally attribute this rise in foreign investment to comparatively favorable returns on investments, 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. 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, and U.S. Treasury securities.

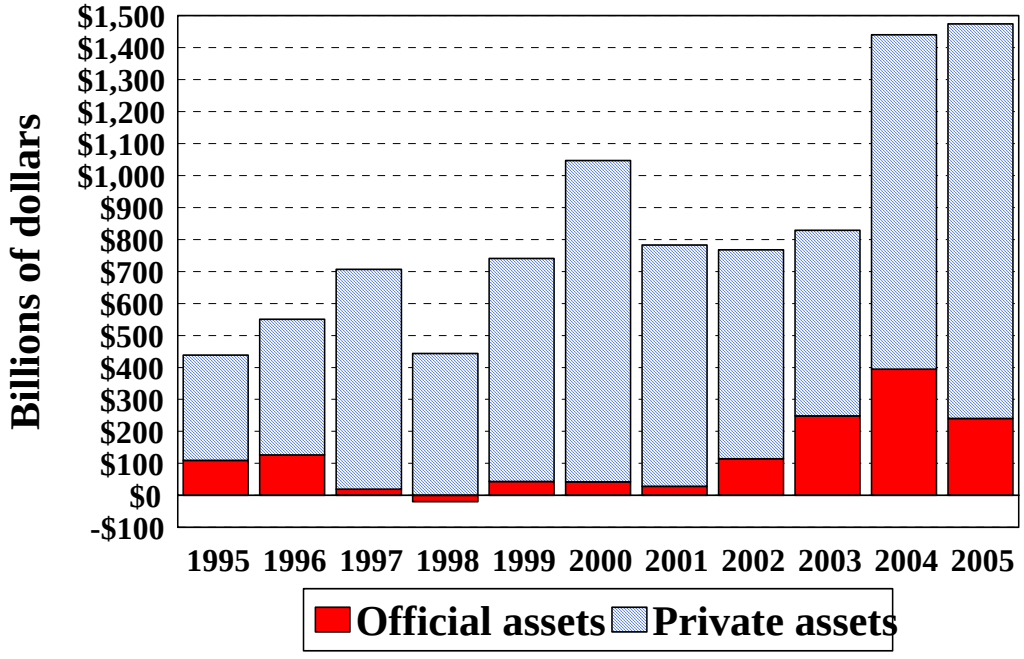
Table 1. Capital Inflows to the United States, 1995-2005

(in billions of dollars)

	Total	Official assets	Private assets					
			Total	Direct investment	Treasury securities	Corporate securities	U.S. currency	Other
1995	$438.6	$109.9	$328.7	$57.8	$91.5	$77.2	$12.3	$89.8
1996	551.1	126.7	424.4	86.5	147.0	103.3	17.4	70.2
1997	706.8	19.0	687.8	105.6	130.4	161.4	24.8	265.5
1998	423.6	-19.9	443.5	179.0	28.6	156.3	16.6	62.9
1999	740.2	43.5	696.7	289.4	-44.5	298.8	22.4	130.5
2000	1,046.9	42.8	1,004.1	321.3	-70.0	459.9	5.3	287.6
2001	782.9	28.1	754.8	167.0	-14.4	393.9	23.8	184.5
2002	768.2	114.0	654.3	72.4	100.4	285.5	21.5	174.4
2003	829.2	248.6	580.6	39.9	113.4	251.0	16.6	159.7
2004	1,440.1	394.7	1,045.4	106.8	107.0	369.8	14.8	477.0
2005	1,474.1	240.8	1,233.7	119.9	142.4	512.9	15.6	442.5

Source: Department of Commerce, *Survey of Current Business*, March, 2006. Data for 2005 are estimates based on third quarter data.

Figure 1. Foreign Official and Private Capital Inflows to the United States, 1995-2005



Source: Department of Commerce

Capital Flows in the Economy

Table 2 shows the flow of funds in the U.S. economy, or the sources and uses of the net amount of funds in the economy by major sectors. Since the demand for funds in the economy as a whole must equal the supply of funds, a deficit in one sector must be offset by a surplus in another sector. Generally, the household sector, or individuals, provides funds to the economy, because individuals save part of their income, while the business sector uses those funds to invest in plant and equipment that, in turn, serve as the building blocks for the production of additional goods and services. The government sector (the combination of federal, state, and local governments) can be either a supplier of funds or a user depending on whether the sector is running a surplus or a deficit, respectively. The interplay within the economy between saving and investment, or the supply and uses of funds, tends to affect domestic interest rates, which move to equate the demand and supply of funds. Shifts in the interest rate also tend to attract capital from abroad, denoted by the rest of the world (ROW) in **Table 2**.

Table 2. Flow of Funds of the U.S. Economy, 1995-2005

(in billions of dollars)

	Households	Business	Government			ROW
			Total	State and Local	Federal	
1995	$133.6	$18.9	$-180.4	$0.0	$-180.4	$86.6
1996	175.2	19.8	-196.8	-1.2	-195.6	137.9
1997	47.4	-18.3	-116.6	-47.5	-69.1	219.6
1998	128.0	-45.7	64.8	48.8	16.0	75.0
1999	-132.7	-62.6	115.3	9.9	105.4	231.7
2000	-494.4	-82.9	233.4	35.4	198.0	485.4
2001	-117.8	33.3	-33.2	-33.7	0.5	399.0
2002	-217.1	8.5	-375.1	-95.6	-279.5	499.0
2003	-65.9	27.9	-557.5	-79.4	-478.1	557.4
2004	-287.6	-61.5	-520.6	-59.8	-460.8	582.9
2005	-609.1	-24.2	-447.6	-69.9	-377.7	795.3

Source: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States, Flows and Outstandings First Quarter 2006*, June 8, 2006.

As **Table 2** indicates, from 1995 through 1998, the household sector ran a net surplus, or provided net savings to the economy. The business sector also provided net surplus funds through 1996, or businesses earned more in profits than they invested. The government sector, primarily the federal government, experienced net deficits, which decreased until 1998, when the federal government and state and local governments experienced financial surpluses. Capital inflows from the rest of the world rose and fell during this period, depending on the combination of household saving, business sector saving and investment, and the extent of the deficit or surplus in the government sector.

Starting in 1999, the household sector began dissaving, as individuals spent more than they earned. Part of this dissaving was offset by the government sector, which experienced a surplus from 1998 to 2001. As a result of the large household dissaving, however, the economy as a whole experienced a gap between domestic saving and investment that was filled with large capital inflows. Those inflows were particularly large in nominal terms from 2000 to 2005 and estimated to increase again in 2006 as household dissaving continued and government sector surpluses turned to historically large deficits in nominal terms. Such inflows have kept interest rates below the level they would have reached without the inflows, but have put added pressure on the international value of the dollar.

Foreign capital inflows augment domestic U.S. sources of capital, which, in turn, keep U.S. interest rates lower than they would be without the foreign capital. Indeed economists generally argue that it is this interplay between the demand for and the supply of credit in the economy that drives the broad inflows and outflows of capital. As U.S. demands for capital outstrip domestic sources of funds, domestic interest rates rise relative to those abroad, which tends to draw capital away from other countries to the United States.

The United States has also benefitted from a surplus of saving over investment in many areas of the world that has provided a supply of funds and accommodated the overall shortfall of saving in the country. This surplus of saving has been available to the United States, because foreigners have remained willing to loan that saving to the United States in the form of acquiring U.S. assets, which have accommodated the growing current account deficits. Over the past decade, the United States experienced a decline in its rate of saving and an increase in the rate of domestic investment, as indicated in **Table 3**. The large increase in the Nation's current account deficit would not have been possible without the accommodating inflows of foreign capital.

As **Table 3** indicates, compared with the 1990-1996 period, U.S. saving in 2004 declined by 2% of gross domestic product (GDP), while investment increased by 1.5% of GDP. This shift toward greater investment relative to saving was accommodated by an increase worldwide in saving relative to investment. Among other advanced economies and the newly industrialized economies in Asia, both saving and investment declined in 2004 relative to the 1990-1996 period, but investment declined more as a share of GDP than did saving, so in relative terms saving increased as a share of GDP. In the emerging developing economies and in the developing economies of Asia, saving as a share of GDP increased faster than did investment, which also increased in these areas.

Capital inflows also allow the United States to finance its trade deficit, because foreigners are willing to lend to the United States in the form of exchanging the sale of goods, represented by U.S. imports, for such U.S. assets as businesses and real estate (referred to as direct investment), and stocks, bonds, and U.S. Treasury securities. Such inflows, however, put upward pressure on the dollar, which tends to push up the price of U.S. exports relative to its imports and to reduce the overall level of exports. Furthermore, foreign investment in the U.S. economy drains off some of the income earned on the foreign-owned assets that otherwise would accrue to the U.S. economy as foreign investors repatriate their earnings back home.

Table 3. Saving and Investment in Selected Countries and Areas; 1990-1996 and 2004

(Percentage of Gross Domestic Product)

Area/Country	Average, 1990-1996	2004	Change
World			
Saving	22.9	24.9	2.0
Investment	24.0	24.6	0.6
United States			
Saving	15.6	13.6	-2.0
Investment	18.1	19.6	1.5
Other Advanced Economies			
Saving	23.7	22.7	-1.0
Investment	23.6	21.3	-2.3
Eurozone			
Saving	21.4	20.9	-0.5
Investment	21.3	20.2	-1.1
Japan			
Saving	32.4	27.6	-4.8
Investment	30.2	23.9	-6.3
Newly Industrialized Asian Economies			
Saving	34.1	30.3	-2.8
Investment	32.6	24.9	-7.7
Emerging Developing Economies			
Saving	25.2	31.5	6.3
Investment	27.5	29.2	1.7
Developing Asia			
Saving	30.7	38.2	7.3
Investment	32.8	35.5	2.7
China			
Saving	40.6	46.4	5.8
Investment	38.8	43.9	5.1

Source: *The Budget and Economic Outlook*, the Congressional Budget Office, August 2005. p. 39.

Some observers are particularly concerned about the long-term impact of the U.S. position as a net international investment debtor on the pattern of U.S. international income receipts and payments. In 2005, the United States received an estimated $443 billion in income receipts on its investments abroad and paid out $440 billion in income payments on foreign-owned assets in the United States for a net surplus of $3 billion in income receipts, about one-tenth of that received in 2004. Considering the overall negative balance of the U.S. net investment position, it is not surprising that the net surplus of income receipts is falling. As the annual amount of foreign investment in the U.S. economy continues to exceed the amount of U.S. investment abroad, however, it seems inevitable that U.S. payments on foreign-owned assets will rise to the point where they exceed U.S. receipts, possibly in 2006.

A net outflow of income payments eventually will act as a drag on the national economy as U.S. national income is reduced by the net amount of funds that are channeled abroad to foreign investors.

Foreign capital inflows, while important, do not fully replace or compensate for a lack of domestic sources of capital. Capital mobility has increased sharply over the last twenty years, but economic analysis shows that a nation's rate of capital formation, or domestic investment, seems to be linked primarily to its domestic rate of saving. This phenomenon was first presented in a paper published in1980 by Martin Feldstein and Charles Horioka.[1] The Feldstein-Horioka paper maintained that despite the dramatic growth in capital flows between nations, international capital mobility remains somewhat limited so that a nation's rate of domestic investment is linked to its domestic rate of saving.[2]

Capital Flows and the Dollar

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 moved aggressively 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.

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

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[1] Feldstein, Martin, and Charles Horioka, Domestic Saving and International Capital Flows, *The Economic Journal*, June, 1980, p. 314-329; Feldstein, Martin, *Aspects of Global Economic Integration: Outlook for the Future*. NBER Working Paper 7899, September 2000, p. 9-12.

[2] Developments in capital markets have improved capital mobility since the Feldstein-Horioka paper was published and have led some economists to question Feldstein and Horioka's conclusion concerning the lack of perfect capital mobility. (Ghosh, Atish R., International Capital Mobility Amongst the Major Industrialized Countries: Too Little or Too Much?, *The Economic Journal*, January 1995, p. 107-128.) Indeed, some authors argue that short-term capital flows among the major developed economies are highly liquid, perhaps too liquid, and seem to be driven as much by short-term economic events and speculation as they are by longer term economic trends.

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.[3]

In the U.S. foreign exchange market, the value of the dollar is followed closely by multinational firms, international banks, and investors who are attempting to offset some of the inherent risks involved with foreign exchange trading. On a daily basis, turnover in the U.S. foreign exchange market[4] averages $461 billion; similar transactions in the U.S. foreign exchange derivative markets[5] averages $355 billion, nearly double the amount reported in a similar survey conducted in 2001.[6] Foreigners also buy and sell U.S. corporate bonds and stocks and U.S. Treasury securities. Foreigners now own 55% of the total amount of outstanding U.S. Treasury securities that are publicly held and traded, as indicated in **Figure 2** (above).[7]

Purchases and Sales of U.S. Securities

A comprehensive set of data on capital flows, represented by purchases and sales of U.S. government securities and U.S. and foreign corporate stocks, bonds, into and out of the United States is published by the Treasury Department on a monthly basis.[8] As these data show in **Table 4**, foreign investors buy and sell large amounts of U.S. financial assets, although the annual accumulation, though large in dollar amounts, is relatively small compared with the large amounts of assets that are traded annually. For instance, in 2005, foreigners purchased $20.7 trillion dollars in U.S. financial assets and sold $19.9 trillion dollars in assets, for a net accumulation of $868 billion in financial assets, or about 4% of the amount of assets that were traded.

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[3] *Triennial Central Bank Survey: Foreign Exchange and Derivatives Market Activity in 2004*. Bank for International Settlement, March 2005. p. 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 Dat*a. Bank for International Settlement, October 2001.

[4] Defined as foreign exchange transactions in the spot and forward exchange markets and foreign exchange swaps.

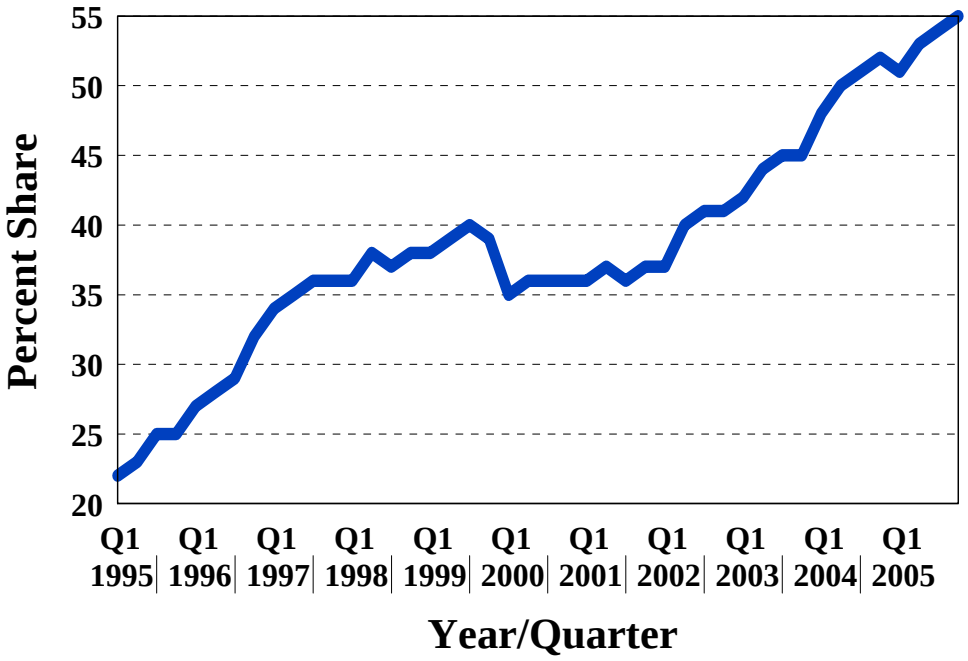
[5] Defined as transactions in foreign reserve accounts, interest rate swaps, cross currency interest rate swaps, and foreign exchange and interest rate options.

[6] *The Foreign Exchange and Interest Rate Derivatives Markets Survey: Turnover in the United States*. The Federal Reserve Bank of New York, April, 2004. p. 1-2. A copy of the report is available at [http://www.newyorkfed.org/pihome/triennial/fx_survey.pdf]

[7] *Treasury Bulletin*, March 2006. Table OFS-2. p. 50.

[8] These data are available through the World Wide Web at Treasury Department's Treasury International Capital (TIC) reporting site: [http://www.treas.gov/tic/]

Figure 2. Foreign Ownership Share of U.S. Publicly-Held Treasury Securities, 1995-2005



Source: Federal Reserve

Table 4. Transactions in U.S. Securities, 2005

(in billions of dollars)

Total	Marketable Treasury Securities	U.S. Govt. Bonds	Corporate Bonds	Corporate Stocks	Foreign Bonds	Foreign Stocks
Gross Purchases by Foreigners						
$20,745.3	$10,181.9	$1,126.0	$1,272.0	$4,463.3	$1,515.1	$2,187.0
Gross Sales by Foreigners						
19,877.4	9,833.9	899.5	901.3	4,383.4	1,545.4	2,313.9
Net Purchases by Foreigners						
867.9	348.0	226.4	370.8	79.9	-30.3	-126.9

Source: Treasury Department International Capital data system.

Marketable U.S. Treasury securities account for one of the largest shares of U.S. securities that are traded by foreign investors, whether this is measured in terms of the total amount of securities that are bought and sold, or in terms of the net annual accumulation of financial assets. The low risk associated with these securities makes them highly desired, especially during periods of market uncertainty. In 2005, foreign trading in Treasury securities accounted for nearly half of all the U.S. securities traded by foreign investors during that year, although the net amount of Treasury securities that were accumulated were only slightly higher than the net amount of corporate bonds accumulated during the year. Demand for Treasury

securities remained strong even after the terrorist attacks of September 11, 2001, when important elements of the U.S. financial system were temporarily shut down.[9]

Table 5 shows gross purchases, gross sales, and net sales of publicly traded U.S. Treasury securities, corporate stocks, and corporate bonds over the seven-year period 1999 to 2005. At about $10 trillion, Treasury securities were the most heavily traded of the three kinds of securities in 2005. From 1997 to 2001, foreign official and private net acquisitions of Treasury securities plummeted as the federal government used its budget surpluses to retire large amounts of securities, as indicated in **Figure 3**. The federal government's budget deficits from 2002 through 2005, however, provided new opportunities for foreign investors to build up their holdings of Treasury securities.

Table 5. Foreign Transactions in U.S. Securities, 1999-2005

(in billions of dollars)

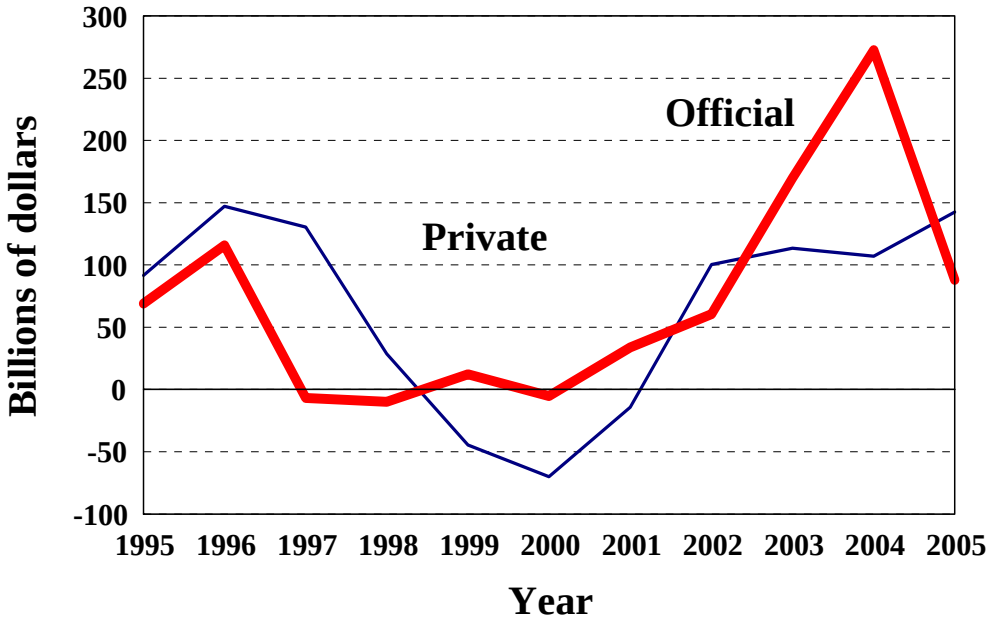
	1999	2000	2001	2001	2003	2004	2005
U.S. Treasury Securities							
Purchases	$4,288.1	$3,870.5	$5,267.7	$7,264.5	$8,001.5	$8,936.0	$10,181.9
Sales	4,298.1	3,924.5	5,249.2	7,144.5	7,737.9	8,584.0	9,833.9
Net	-10.0	-54.0	18.5	119.9	263.6	352.0	348.0
U.S. Corporate Stocks							
Purchases	2,340.7	3,605.2	3,051.3	3,209.8	3,104.2	3,862.0	4,463.3
Sales	2,233.1	3,430.3	2,934.9	3,159.6	3,069.5	3,833.6	4,383.4
Net	107.5	174.9	116.4	50.2	34.7	28.5	79.9
U.S. Corporate Bonds							
Purchases	368.7	479.5	741.0	820.7	979.9	1,171.4	1,272.0
Sales	208.3	295.3	519.1	638.4	714.2	861.9	901.3
Net	160.4	184.1	222.0	182.3	265.7	309.5	370.8

Source: Developed by CRS from the Treasury Department's International Capital data system.

As **Figure 3** indicates, foreign private purchases of Treasury securities turned negative between 1998 and 2001 as such investors experienced net sales of Treasury securities. By 2002, foreign private investors had returned to acquiring Treasury securities, but the amount has remained relatively level at $100 billion per year from 2002 to 2005. In contrast, foreign official net acquisitions of Treasury securities trended slightly upward between 1997 and 2002, but such net acquisitions more than doubled over the 2002 to 2004 period, rising to $261 billion in 2004. In 2005, though, official purchases of Treasury securities plummeted to about $100 billion and were less than private purchases.

[9] For additional information, see CRS Report RS21102, *International Capital Flows Following the September 11 Attacks*, by James K. Jackson.

Figure 3. Foreign Official and Private Purchases of U.S. Treasury Securities, 1995-2005



Source: Department of Commerce

While the nominal amount of total purchases and sales of corporate bonds is much lower than that for Treasury securities, the strong net accumulation of corporate bonds rivals that of Treasury securities and likely reflects the attractiveness of bonds as an alternative to Treasury securities and falling interest rates that marked the period from 2000 through 2003. At times corporate bonds have served foreign investors as an attractive alternative to Treasury securities. The price of a bond is inversely related to the interest rate, so lowering interest rates raises the price, making the bond more valuable. Net accumulations of corporate stocks has been the most volatile of the three groups of securities over the decade. Low levels of stock accumulation at the beginning and end of the period may well reflect economic uncertainties and lower rates of national economic growth that characterized those years. Higher levels of accumulation from 1999 to 2002 likely reflect the low levels of accumulation of Treasury securities and the fast run-up in stocks prices that marked that period. Foreign investors apparently had not regained their enthusiasm for U.S. corporate stocks by year-end 2004, relative to their accumulation of Treasury securities.

Purchases and Sales of U.S. Securities by Foreign Investors

Some foreign investors are more active in U.S. securities markets — U.S. Treasury securities, U.S. corporate stocks and bonds — than are others. Over the period from 1999 to 2005, foreign investors accumulated an estimated $4.1 trillion in U.S. securities. As **Table 6** indicates, the United Kingdom accumulated $1.1 trillion U.S. securities over the 1999-2005 period and could accumulate as much as $178 billion in 2005, based on half-year data.

Large accumulations by British investors is not surprising given the long historical involvement of British investors in the U.S. economy. Other foreign

investors have started acquiring U.S. securities more recently. Some, such as Chinese investors, have moved rapidly to become major investors in some U.S. securities markets. British investors are followed by Japanese investors as the second largest foreign investors with $594 billion in U.S. securities during the 1999-2005 period, or about one-half the amount owned by British investors. During the seven year period, Chinese investors were the third most active investors in U.S. securities, with $363 billion in securities holdings. Following China, Canada ($155 billion), Germany ($135 billion), Hong Kong ($127 billion), Mexico ($99 billion), South Korea ($70 billion), and Singapore ($69 billion) are estimated to have accumulated the largest amounts of U.S. securities over the 1999-2005 period.

Table 6. Net Foreign Purchases of U.S. Securities by Foreigners

(in billions of dollars)

	1999	2000	2001	2002	2003	2004	2005	Total
Total	$360.1	$440.7	$501.2	$574.6	$652.4	$804.1	$770.6	$4,103.7
Total Europe	259.8	269.5	250.8	258.3	268.5	250.6	340.4	1,897.9
-France	3.4	3.8	8.5	2.4	0.4	-9.1	22.5	31.9
-Germany	21.2	29.2	21.1	0.0	10.0	16.8	36.9	135.3
-Italy	17.3	17.7	-2.8	2.3	-2.4	-2.2	-1.1	28.8
-Netherlands	14.8	2.7	9.3	-8.6	3.6	1.0	-5.7	17.0
-Sweden	3.0	7.4	3.1	4.9	2.9	-2.5	2.1	20.9
-Switzerland	12.6	-1.5	13.3	8.6	13.0	13.8	-8.9	50.8
-United Kingdom	168.8	136.1	155.4	191.9	150.4	149.5	178.5	1,130.6
Canada	12.1	14.8	16.9	6.8	32.4	28.2	44.1	155.3
Latin America	51.7	21.0	NA	NA	NA	NA	NA	72.8
-Mexico	1.6	9.3	8.3	10.2	10.8	29.8	28.9	98.9
Asia	34.6	128.6	155.7	203.4	236.6	369.9	201.5	1,330.3
-China	17.4	17.1	55.9	62.9	68.9	50.1	90.9	363.1
-Hong Kong	10.9	8.1	28.4	14.6	16.4	22.2	26.5	127.1
-Indonesia	2.1	0.7	-6.6	1.4	1.6	2.8	2.0	4.0
-Japan	-0.3	73.0	36.5	81.4	139.3	226.5	37.2	593.5
-Korea	9.9	5.0	0.3	13.0	12.2	18.2	11.1	69.8
-Malaysia	-0.8	0.1	2.5	0.9	-1.4	0.7	1.5	3.7
-Philippines	-1.3	1.3	1.1	-1.0	0.3	-0.6	0.5	0.3
-Singapore	-7.8	10.1	16.2	12.0	8.7	17.0	12.5	68.8
-Taiwan	-0.0	-3.4	11.0	17.4	-1.9	10.7	9.2	43.1
-Thailand	2.0	1.3	0.9	-1.4	-5.6	-0.2	10.3	7.1
-Australia	2.0	5.8	-1.7	10.2	4.3	-4.5	-12.0	4.0

Source: Developed by CRS from the Treasury Department's International Capital data system.

Treasury Securities. As previously indicated, foreign investors are most active in participating in the U.S. Treasury securities market. Over the seven-year period, foreign investors acquired on net (purchases less sales) over one trillion dollars in Treasury securities, as indicated in **Table 7**. Japan holds about $377 billion in U.S. publicly held and traded Treasury securities, more than the amount held by all of the European countries. With $274 billion in Treasury securities, Great Britain is the second largest holder. China, a recent participant in the U.S. Treasury securities market has accumulated the third largest amount of these securities with $131 billion in holdings. Nearly half of China's holdings were acquired during 2002 and 2003. Canada ($50 billion) accumulated the next largest amount of Treasury securities, followed by Korea ($40 billion).

Table 7. Net Foreign Purchases of Publicly-Traded U.S. Treasury Securities

(in billions of dollars)

	1999	2000	2001	2002	2003	2004	2005	Total
Total	$360.1	$440.7	$501.2	$574.6	$663.3	$763.6	$867.9	$4,171.4
Total Europe	259.8	269.5	250.8	258.3	281.6	239.4	451.6	2,010.9
-France	3.4	3.8	8.5	2.4	0.9	-9.1	26.3	36.3
-Germany	21.2	29.2	21.1	0.0	12.5	16.8	23.0	123.8
-Italy	17.3	17.7	-2.8	2.3	-2.4	-2.1	1.2	31.1
-Netherlands	14.8	2.7	9.3	-8.6	3.6	0.5	-7.0	15.2
-Sweden	3.0	7.4	3.1	4.9	2.9	-3.5	-7.9	9.9
-Switzerland	12.6	-1.5	13.3	8.6	13.0	13.7	-1.9	57.8
-United Kingdom	168.8	136.1	155.4	191.9	159.8	142.6	321.8	1,276.4
Canada	12.1	14.8	16.9	6.8	32.4	24.0	49.3	156.3
Latin America	51.7	21.0	25.8	21.3	26.0	38.4	20.0	204.3
-Mexico	1.6	9.3	8.3	10.2	10.8	28.2	18.4	86.7
Asia	34.6	128.6	155.7	203.4	234.4	364.7	221.5	1,343.0
-China	17.4	17.1	55.9	62.9	68.9	49.4	92.1	363.6
-Hong Kong	10.9	8.1	28.4	14.6	16.4	22.2	34.3	134.9
-Indonesia	2.1	0.7	-6.6	1.4	1.6	2.8	-1.4	0.6
-Japan	-0.3	73.0	36.5	81.4	137.1	226.5	46.5	600.5
-Korea	9.9	5.0	0.3	13.0	12.2	15.7	6.1	62.3
-Malaysia	-0.8	0.1	2.5	0.9	-1.4	-0.7	4.3	5.0
-Philippines	-1.3	1.3	1.1	-1.0	0.3	-0.6	1.3	1.1
-Singapore	-7.8	10.1	16.2	12.0	8.7	17.0	11.9	68.1
-Taiwan	-0.0	-3.4	11.0	17.4	-1.9	10.7	10.4	44.3
-Thailand	2.0	1.3	0.9	-1.4	-5.6	-0.2	7.6	4.5
-Australia	2.0	5.8	-1.7	10.2	4.3	-8.5	-8.6	3.4

Source: Developed by CRS from the Treasury Department's International Capital data system.

Corporate Stocks. Foreign acquisitions of U.S. corporate stocks peaked in 2000, when foreign investors acquired $175 billion in corporate stocks, as indicated in **Table 8**. By contrast, in 2005, foreign investors acquired $80 billion in such stocks, up sharply from the $28.5 billion they acquired in 2004. In total, foreign investors are estimated to have accumulated $592 billion in U.S. corporate stocks in the 1999-2005 period, more than half of which were acquired during the frenetic

stock market boom of 1999 to 2001. British investors are by far the largest investors in U.S. corporate stocks, with holdings acquired over the 1999-2005 period totaling about $192 billion. Over the 1999-2005 period, Germany and Singapore were the next two largest foreign investors in U.S. corporate stocks with such investments estimated to total $43 billion and $40 billion, respectively. France ($30 billion), the Netherlands ($28 billion), Japan ($28 billion), Italy ($20 billion), and Switzerland ($22 billion), are the next largest foreign investors in U.S. corporate stocks.

Table 8. Net Foreign Purchases of U.S. Corporate Stocks

(in billions of dollars)

	1999	2000	2001	2002	2003	2004	2005	Total
Total	107.5	174.9	116.4	50.2	34.7	28.5	79.9	592.1
Total Europe	98.1	164.7	88.1	32.9	21.4	19.6	39.3	464.0
-France	3.8	5.7	5.9	2.1	6.2	-0.9	7.3	30.2
-Germany	13.4	31.8	8.4	-0.1	-3.8	-2.4	-3.8	43.5
-Italy	8.0	12.2	2.2	1.5	0.4	-1.7	-2.5	20.2
-Netherlands	8.1	4.9	10.9	4.3	0.0	1.7	-2.2	27.8
-Sweden	1.0	2.5	3.6	0.8	3.4	0.8	-0.4	11.7
-Switzerland	5.7	12.0	3.5	2.8	-2.1	-1.2	1.2	21.7
-United Kingdom	42.9	58.7	38.5	15.2	0.7	15.2	20.3	191.5
Canada	-0.3	6.0	11.0	8.2	11.7	1.3	16.4	54.2
Latin America	5.2	-17.8	0.3	1.0	0.7	-0.1	-0.0	-10.7
-Mexico	0.1	0.4	-0.7	0.5	-0.3	-0.2	-0.3	-0.5
Asia	3.4	21.7	22.5	21.4	2.8	6.2	9.6	87.6
-China	0.2	-0.1	0.0	0.2	-0.1	-0.3	-0.5	-0.6
-Hong Kong	-0.2	0.2	0.7	1.8	0.8	-0.8	0.9	3.4
-Indonesia	0.1	0.2	0.1	-0.0	0.1	0.0	-0.1	0.4
-Japan	5.7	2.1	6.8	12.3	-2.2	2.8	0.2	27.7
-Korea	-0.1	-0.2	-0.1	0.1	-0.0	-0.0	-0.1	-0.3
-Malaysia	-0.0	0.0	-0.1	-0.0	-0.0	-0.1	-0.2	-0.4
-Philippines	0.0	0.0	-0.0	-0.0	-0.0	0.0	0.1	0.1
-Singapore	-0.9	10.8	13.1	8.2	3.5	-1.7	7.1	40.2
-Taiwan	0.0	-0.1	0.3	0.3	0.3	-0.3	-0.4	0.0
-Thailand	0.0	-0.1	-0.0	0.0	-0.0	0.0	-0.0	-0.1
-Australia	0.9	1.4	0.1	3.0	-0.6	0.3	0.2	5.3

Source: Developed by CRS from the Treasury Department's International Capital data system.

Corporate Bonds. As **Table 9** indicates, foreign investors have shown particular interest in U.S. corporate bonds since 1999 and accumulated about $1.7 trillion in such securities during the 1999-2005 period. A large share of these accumulations is concentrated among a few large holders. For instance, British investors hold nearly half of the foreign-owned U.S. corporate bonds, with an estimated accumulation of $771 billion over the 1999-2005 period. Japanese investors trail far behind their British counterparts, but acquired an estimated $108 billion in corporate bonds in the 1999-2005 period. China ($57 billion), Germany ($37 billion), France ($35 billion), Hong Kong ($32 billion), and Switzerland ($28 billion) are estimated to be the next largest foreign investors in U.S. corporate bonds during the 1999-2005 period.

Table 9. Net Foreign Purchases of U.S. Corporate Bonds
(in billions of dollars)

	1999	2000	2001	2002	2003	2004	2005	Total
Total	$160.4	$184.1	$222.0	$182.3	$265.7	$309.5	$370.8	$1,694.8
Total Europe	111.9	128.2	134.9	110.7	169.2	172.0	240.7	1,067.7
-France	1.6	2.2	3.0	2.6	4.0	7.6	14.4	35.4
-Germany	4.8	1.6	5.9	2.0	3.5	12.2	6.6	36.5
-Italy	0.5	0.3	0.2	0.2	2.0	0.7	-0.2	3.8
-Netherlands	0.1	-0.2	2.5	1.5	2.3	2.1	2.7	10.9
-Sweden	0.3	1.3	0.2	0.2	0.2	1.1	-0.4	2.9
-Switzerland	3.9	2.4	2.7	4.9	5.7	4.0	4.2	27.8
-United Kingdom	92.3	111.0	108.8	76.8	107.7	107.1	167.4	771.1
Canada	3.6	3.2	3.3	0.4	5.3	6.1	2.5	24.4
Latin America	31.2	29.7	4.8	5.0	6.6	19.9	8.3	105.4
-Mexico	1.6	1.1	1.3	2.2	3.0	15.1	1.5	25.8
Asia	11.2	22.2	27.6	26.4	27.8	60.1	71.5	246.8
-China	0.5	0.8	6.7	6.0	4.8	12.3	26.1	57.2
-Hong Kong	0.6	1.9	4.2	3.7	4.5	5.7	11.1	31.7
-Indonesia	-0.0	0.0	0.1	0.1	0.0	-0.1	0.0	0.2
-Japan	5.9	15.6	6.1	10.9	10.6	33.5	26.0	108.5
-Korea	0.1	-0.8	0.8	1.5	0.5	1.6	0.8	4.5
-Malaysia	0.0	0.1	0.1	0.1	0.0	0.1	1.3	1.7
-Philippines	0.0	0.2	0.2	0.1	0.1	0.2	0.1	1.0
-Singapore	3.6	1.3	5.4	1.3	3.0	4.2	1.0	19.8
-Taiwan	0.3	1.0	2.2	1.4	1.5	1.6	3.2	11.1
-Thailand	0.0	0.1	0.0	0.2	0.4	0.1	-0.0	0.8
-Australia	1.3	0.2	-0.1	3.0	0.4	1.4	5.5	11.7

Source: Developed by CRS from the Treasury Department's International Capital data system.

Economic Implications

The large foreign accumulation of U.S. securities, particularly of U.S. Treasury securities, has spurred some observers to consider the potential for a financial crisis. Such a crisis could result from a coordinated withdrawal from U.S. financial markets staged by foreign investors for economic or political reasons or a sharp drop in U.S. equity prices as a result of an uncoordinated correction in markets prices. Congress would likely find itself embroiled in any such crisis through its direct role in conducting fiscal policy and in its indirect role in the conduct of monetary policy through its supervisory responsibility over the Federal Reserve. A coordinated withdrawal from U.S. securities markets by foreign investors seems highly unlikely, particularly since the vast majority of the investors are private entities that presumably would find it difficult to coordinate a withdrawal.

It is uncertain what events could provoke a coordinated withdrawal from U.S. securities markets. Some surmise that international concern over the ability of the economy to service its large foreign debt could spur foreign investors to rein in their purchases of U.S. financial assets, or that a loss of confidence in the ability of national U.S. policymakers to conduct economic policies that are perceived abroad as prudent and stabilizing could cause foreign investors to reassess their estimates of

the risks involved in holding dollar-denominated assets. In other cases, the international linkages that connect national capital markets could be the conduit through which events in one market are quickly spread to other markets and ignite an abrupt, seemingly uncoordinated decline in equity prices. Such a market correction, or a market panic, is expected to be short-lived, however, as investors would likely move to take advantage of a drop in equity prices to acquire equities that would be deemed to be temporarily undervalued. For instance, concerns in U.S. capital markets in early June 2006 over prospects that a rise in consumer prices and in the core inflation rate would push the Federal Reserve to raise key U.S. interest rates sparked a drop in prices in U.S. capital and equity markets where inflation concerns quickly spread to markets in Europe and Asia, where equity prices fell as well.[10]

Short of a financial crisis, foreign capital inflows are playing an important role in the economy. Such inflows bridge the gap between U.S. supplies and demands for credit, thereby allowing the consumers and businesses to finance purchases at interest rates that are lower than they would be without the capital inflows. Similarly, capital inflows allow federal, state, and local governments to finance their budget deficits at rates that are lower then they would be otherwise.

Capital inflows, however, are not without some cost to the economy. Foreign ownership of U.S. securities means that foreigners receive any dividend or interest payments that arise from those securities and that the economy experiences a transfer of wealth associated with flows of goods and capital across borders. To the extent that foreign investors repatriate their earnings, financial resources within the economy are reduced. Increased foreign ownership of corporate stocks and bonds also blurs the distinction between domestic and foreign-owned firms and may well influence the way firms view trade, economic, and other types of public policies, thereby affecting their relationships with Congress. In addition, as long as credit demands in the economy outstrip domestic supplies of credit, foreign sources of capital will be necessary to reduce pressure on U.S. interest rates. To the extent that foreign investors become reluctant for any reason to continue to supply the economy with capital, Congress could find it more difficult to finance a budget deficit by drawing on domestic capital markets without the economy feeling the impact of such borrowing.

The prospect of continued high levels of U.S. borrowing from the rest of the world concerns various international organizations, such as the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD). In its April 2006 edition of *World Economic Outlook*,[11] the IMF highlighted the role U.S. economic policies played in the short run in stemming a potentially serious economic slowdown in both the United States and the global economy. Over the long run, however, the IMF argues that the saving-investment imbalance in the U.S. economy threatens to affect global interest rates, productivity

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[10] Masters, Brooke A., Pondering the Bear Necessities, *The Washington Post*, June 7, 2006, p. D1; Samuelson, Robert J., Global Capital On the Run, *The Washington Post*, June 14, 2006, p. A23.

[11] *World Economic Outlook*, International Monetary Fund. Washington, DC, April 2006.

and income, and the growing deficits in the Nation's already large current account (exports, imports, and official capital flows) as a result of sustained high levels of capital inflows. These effects could be especially serious for many of the developing nations that rely on borrowing in global financial markets. Rising interest rates in the United States could raise interest rates globally, which would raise borrowing costs to developing countries. The IMF argues that, "over time changes in U.S. interest rates feed through about one-to-one to foreign interest rates, implying that, in the long run, the rest of the world is affected in a similar manner to the United States."[12]

In a May 2004 publication,[13] the OECD also questioned the feasibility of sustaining large trade deficits given that the deficits are accommodated by foreign investors who must remain willing to hold dollar-denominated assets. Foreign investors essentially engage in cross-border risk management and will assess their estimates of risk based on a broad range of factors, including the ability of the economy to support a potentially increasing level of debt. According to the OECD, "While the United States remains an attractive investment destination in many respects, it is uncertain for how long foreigners will continue to accommodate debt and equity claims against U.S. residents at the recent pace."[14]

The highly evolved state of financial and economic linkages between the United States and other foreign economies significantly reduces the prospects of a financial collapse in the United States should foreigners attempt a coordinated withdrawal from U.S. securities markets. A withdrawal by any single large foreign investor, or a group of investors, from the U.S. financial markets at a time when those funds are necessary for closing the gap between domestic demand and supply of funds would likely have significant short-run effects. Any such coordinated attempt to withdraw substantial amounts of funds abruptly from the U.S. markets would ordinarily be noticed quickly by domestic and international financial markets. As investors became aware of any large withdrawals, they likely would follow suit, driving the prices of the asset down sharply and causing U.S. interest rates to rise abruptly. Any investor selling assets at this point likely would experience a significant loss in the value of those assets.

A similar downward spiral would occur over the short-run in the value of the dollar if foreign investors attempted to convert their dollar holdings into foreign currency. The financial and currency markets likely would adjust quickly to the demands of foreign sellers of dollars by driving up the price of foreign currencies. This likely would result in a decline in the value of the dollar and a further erosion in the value of the assets of foreigners attempting to withdraw from the U.S. markets.

Over the long run, the economic and financial effects of a foreign withdrawal from U.S. financial markets would be limited because those factors which allowed

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[12] *World Economic Outlook*, International Monetary Fund. Washington, DC, April 2004. p. 69-70.

[13] The Challenges of Narrowing the U.S. Current Account Deficit. *OECD Economic Outlook* No. 75, May 2004. Available at [http://www.oecd.org/dataoecd/4/58/31920358.pdf]

[14] *Ibid.*, p. 31.

foreigners to withdraw would attract other foreign investors to the U.S. markets. As U.S. interest rates rose in response to the selling of securities, other investors likely would be attracted to the higher returns of the assets, which would curb the decline in the prices in the securities. Also, the rise in U.S. interest rates would attract foreign capital, which would limit the rise in interest rates. A decline in the value of the dollar against other currencies would also improve the international price competitiveness of U.S. goods. As a result, U.S. exports would increase, likely narrowing the gap between the earnings on U.S. exports and the amount Americans spend on imports, thereby reducing the amount of foreign capital the U.S. economy would need. Furthermore, those foreign investors who are successful in withdrawing their funds from the U.S. markets would have to find suitable alternatives. Even if they did not reinvest their finds in the United States, the infusion of capital back into foreign capital markets likely would have spillover effects on the United States and on U.S. securities.

It also seems unlikely that the Federal Reserve would sit on the sidelines watching while the U.S. economy suffered a financial collapse. In the immediate aftermath of the September 11, 2001 terrorist attacks, the U.S. financial and foreign exchange market activities were slightly out of the norm, but actions by the Federal Reserve and by other central banks helped head off a financial panic and a loss of confidence by ensuring that the financial system was supplied with liquidity through coordinated actions. Central bank coordination in times of crises is not uncommon, but the speed with which the coordination was reached and the aggressiveness of the banks to stem any loss of confidence in the financial system demonstrate the recognition that national economies have become highly interconnected and that a shock to one can create spillover effects onto other economies and markets.[15]

[15] Jackson, *International Capital Flows Following the September 11 Attacks*.