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The Income Implications of Rising U.S. International Liabilities

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Although the United States has seen its net liabilities surge in recent years, its investment income balance has remained positive—largely because U.S. firms operating abroad earn a higher rate of return than do foreign firms operating here. The continuing buildup in liabilities, however, should soon push the U.S. income balance below zero. In that event, net income flows will begin to boost the nation's current account deficit instead of reducing it.

Years of large current account deficits have left the United States with the world's largest stock of international liabilities. By the end of 2004, foreign net claims on the United States amounted to $2.5 trillion, equivalent to 22 percent of U.S. GDP. Normally, such a large net liability position would require substantial investment income payments to the rest of the world. Yet the reverse is true for the United States. In 2004, the nation earned $36 billion more on its foreign assets than it paid out to service its foreign liabilities.

This surprising state of affairs stems from the fact that the United States earns a higher rate of return on its large stock of international assets than it pays out on its even larger stock of international liabilities. In this edition of *Current Issues*, we explore the sources of this return differential by looking at returns for various classes of assets and liabilities. We find that there is barely any gap in rates of return on assets and liabilities for equities, debt securities, and bank claims. In contrast, there is a substantial gap in returns on foreign direct investment (FDI): U.S. firms operating abroad are reportedly far more profitable than foreign firms operating in the United States.

In considering the long-term outlook, we argue that net investment income will not remain positive for much longer, given the ongoing buildup in net foreign liabilities. Moreover, a rise in U.S. and global interest rates from recent low levels helps bring forward the date at which the United States will have to make net income payouts.

These observations have important implications for the sustainability of the U.S. current account deficit. At present, positive net income receipts work to reduce the current account deficit, acting as a partial offset to the large U.S. trade deficit. A shift to growing net income payments would mean that the U.S. trade deficit would have to narrow merely for the current account deficit to stabilize. A shrinking trade deficit, in turn, would mean that the United States could no longer consume so much more than it produces.

The Evolution of U.S. Foreign Assets and Liabilities

A country's current account balance is equal to the difference between domestic saving and domestic investment spending.[1] A country that saves more than it invests at home sends its surplus abroad to purchase foreign assets. A country that saves less than it invests finances the

shortfall by issuing liabilities to foreign investors. A country's accumulated history of current account surpluses or deficits, along with capital gains and losses on past investments, determines its net international investment position.[2]

As an accounting identity, the current account balance is also equal to the sum of the trade balance, net investment income receipts, and net transfer payments such as workers' remittances sent abroad. A positive net income position pushes the current account balance toward surplus and a negative income position tends to push it toward deficit.

A little more than two decades ago, the United States was a significant international creditor, reflecting persistent current account surpluses in the period after World War II. Since then, persistent current account deficits have resulted in a significant buildup in net international liabilities. From 1982 to 2004, the U.S. net international investment position shifted from a net asset position of $0.2 trillion to a net liability position of $2.5 trillion (Table 1).

While the United States has been building up a large net liability position, both sides of its international balance sheet have been growing rapidly. All told, U.S. international assets rose from just $1.0 trillion in 1982 to $10.0 trillion in 2004. U.S. international liabilities rose from $0.7 trillion to $12.5 trillion over the same period.

International assets and liabilities can be classified as follows: fixed-income securities (government or corporate bonds), banking and other interest-paying claims, equities, and foreign direct investment. A foreign direct investment holding occurs when a single national investor has a stake of more than 10 percent in a foreign business.

A look at the U.S. international balance sheet shows that the United States has a sizable positive balance in FDI and equity assets: together, these two categories of assets exceeded liabilities by $1.2 trillion at the end of 2004 (Table 1). In contrast, the U.S. investment position for fixed-income assets is sharply negative, with assets falling short of liabilities by some $3.7 trillion.

Table 1
U.S. International Investment Position
Billions of U.S. Dollars, End of Period

	1982	2004	Change
Net position	236	-2,542	-2,778
Assets	961	9,973	9,012
Interest-sensitive	507	3,935	3,428
Fixed-income securities	67	959	892
Banking and other	440	2,976	2,536
Equities	17	2,520	2,503
Foreign direct investment	227	3,287	3,061
Miscellaneous	210	231	21
Liabilities	725	12,515	11,790
Interest-sensitive	473	7,550	7,076
Fixed-income securities	218	4,664	4,446
Banking and other	256	2,886	2,630
Equities	76	1,929	1,852
Foreign direct investment	130	2,687	2,557
Miscellaneous	45	350	305

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

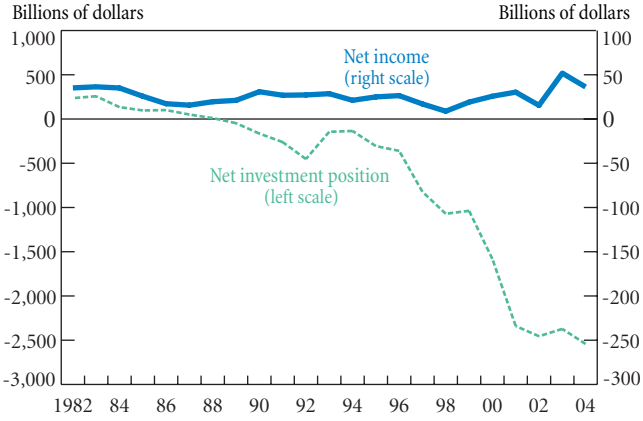
Notes: Miscellaneous assets include gold holdings and other assets of the U.S. government. Miscellaneous liabilities consist largely of U.S. currency circulating abroad. Foreign direct investment is calculated at market values.

Rates of Return on International Assets and Liabilities

International assets and liabilities generate income streams. International investors receive coupon payments on fixed-income securities, interest on bank debt, dividend payments on equities, and profits on FDI holdings. For convenience, we will refer to the ratio of income streams to the corresponding asset values as *rates of return*. Taken literally, this phrase would be somewhat misleading because the overall return to international investors also depends on capital gains and losses from changes in asset values. Note, however, that changes in asset values do not generate investment income flows across countries.

In 2004, the United States earned a rate of return of 4.5 percent on its foreign asset holdings, while foreign investors earned a rate of return of 3.2 percent on holdings in the United States.[3] This seemingly small gap in rates of return was enough to leave the United States with positive net income on its international portfolio, despite its large net liability position. Indeed, such differences in returns have kept net investment income fairly stable in the last twenty years, despite the steady buildup in net liabilities (Chart 1).

Chart 1
Net Investment Position and Net Income



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

To gain a better understanding of why the United States has continued to earn positive net investment income, we consider rates of return by asset class (see Box 1). To evaluate rates of return, we combine all interest-paying debt claims (including fixed-income securities and banking claims) into a broader category we call *interest-sensitive assets*. Our asset typology then matches the available investment receipt and payments data: interest, dividends on equities, and profits on foreign business operations.

Naturally, rates of return on interest-sensitive assets move up or down with interest rates. And for the United States, returns on interest-sensitive assets and liabilities tend to move closely together (Chart 2). One reason for the like behavior is that a high fraction of U.S. assets and almost all U.S. liabilities under this category are denominated in dollars:[4] returns thus move with dollar interest rates. Another reason is that remaining U.S. interest-sensitive assets are mostly held in Europe, where interest rates often move with U.S. rates.

As for equities, rates of return (dividends over market value) on assets and liabilities also tend to move in tandem (Chart 3). Both have remained in a fairly narrow range of 1.5 to 3.5 percent over the last decade.

In sharp contrast, the rate of return on U.S. FDI assets has consistently been higher than that on FDI liabilities (Chart 4). Since 1982, the rate of return on FDI assets has, on average, exceeded that on FDI liabilities by 5.6 percentage points,[5] and not once during this period has the differential dropped below 3.2 percentage points. Surprisingly, perhaps, there is no consensus about the reason for this large and persistent difference in rates of return (see Box 2).

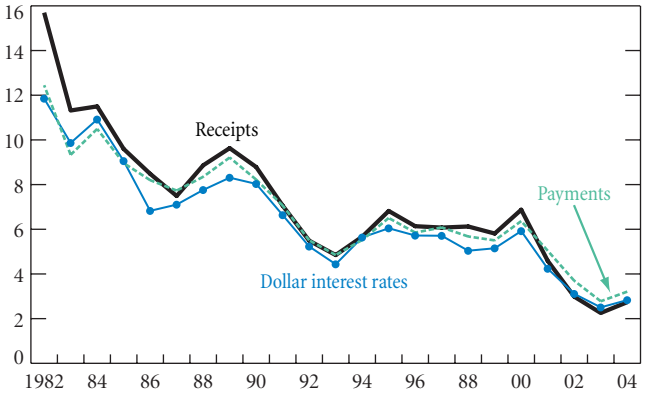
Of course, total U.S. net investment income depends on both the rate of return on the various asset classes and the distribution of the portfolio across assets. The large U.S. net liability position in interest-sensitive assets leads to substantial payouts under that category, despite the similarity of U.S. and foreign interest rates (Chart 5). The superior rate of return on FDI combined with a positive net asset position leads to substantial net FDI receipts. A smaller positive net position

Box 1: Data Sources

In calculating investment position and rates of return, we rely on data from the U.S. Bureau of Economic Analysis published in the *Survey of Current Business*. The values we use for foreign direct investment and equities are those reported in Table 1 of the International Investment Position data. For our grouping of interest-rate-sensitive assets held by U.S. investors, we use the sum of lines 9, 20, 22, and 23 in the same table. For our grouping of foreign-owned U.S. interest-rate-sensitive assets, we use the sum of lines 26, 37, 39, 42, and 43 minus line 30.

For income flows, we draw on Table 1 of the International Transactions data. Foreign direct investment flows are as reported. For non-FDI dividend flows, we subtract the FDI distributed earnings reported in the International Transactions Table 6a (line 3 plus line 68) from the cross-border dividend flows reported in the National Income and Product Accounts Table 4.1 (line 11 plus line 23). For interest-sensitive income, we subtract non-FDI dividend flows from the sum of lines 15 and 16 and the sum of lines 32 and 33 in the International Transactions Table 1.

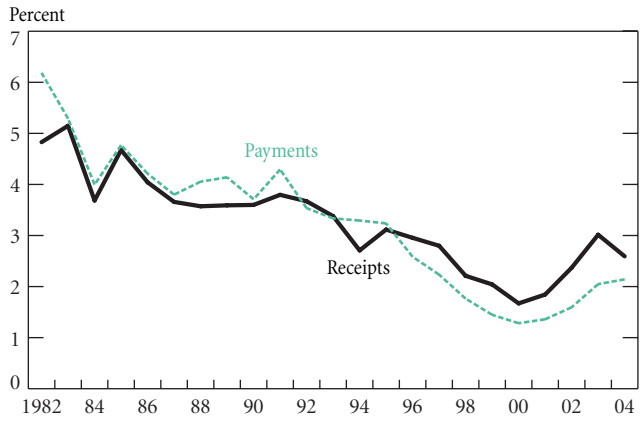
Chart 2
Interest-Rate-Sensitive Returns



Sources: U.S. Department of Commerce, Bureau of Economic Analysis; Bloomberg L.P.

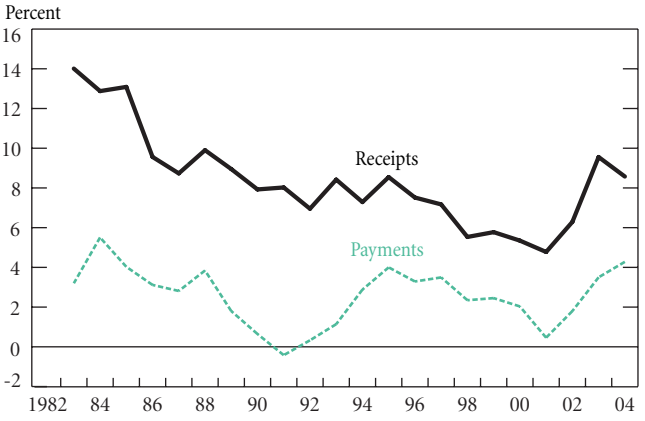
Note: Dollar interest rates are the average of three-month Treasury bill and ten-year Treasury bond rates.

Chart 3
Equities



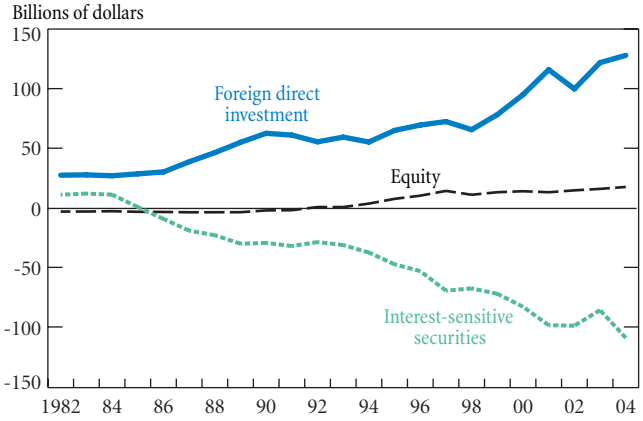
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Chart 4
Foreign Direct Investment



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Chart 5
Net Income by Asset Class



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

in equity assets combined with similar rates of return for assets and liabilities leads to small net dividend receipts.

Together, the net receipts for FDI and equities in 2004 more than offset net payments on interest-sensitive liabilities. As we will see, however, persistent U.S. current account deficits and a rise in interest rates suggest that U.S. net income receipts will not remain positive much longer, even if the United States retains its overall rate-of-return advantage.

High U.S. Income: A Series of Fortunate Events

From 2000 to 2004, U.S. net income receipts edged up, from $25 billion to $36 billion. Since the U.S. net liability position worsened over the period, rising from $1.6 trillion to $2.5 trillion, this increase in net income is surprising. However, our analysis indicates that only a series of fortunate—and possibly temporary—events prevented a substantial deterioration in U.S. net income receipts.

Lower interest rates. The divergence in the trends in net income and net position is especially striking for interest-sensitive assets. From 2000 to 2004, net interest-sensitive liabilities more than doubled, from $1.6 trillion to $3.5 trillion. Yet over the same period, net interest payments increased at a much more modest rate, advancing from $83 billion to $113 billion. The reason that the United States did not see a sharper rise in net interest payments is that U.S. and foreign interest rates fell sharply from 2000 to 2002 and remained relatively low for the next two years. Had interest rates remained at their 2000 values, net interest payments would have risen by another $59 billion in 2004, and total U.S. net income would have been negative.

We calculate further that a uniform rise of 1 percentage point across the yield curve in U.S. and foreign interest rates would have subtracted $32 billion from U.S. net income in 2004. While we cannot predict how interest rates will behave in the future, prevailing rates in 2004 were certainly at the low end of historical norms. Moreover, the potential drag from higher interest rates on net income is likely to grow over time, since most of the ongoing buildup in U.S. net liabilities is in interest-sensitive assets.

High returns from U. S. foreign operations. A second development that has boosted U.S. net income receipts has been the bigger increase in U.S. profits relative to foreign profits on foreign direct investment (Chart 4). Since 2000, the U.S. rate of return on FDI has risen from 5.4 percent to 8.6 percent, an increase of 3.2 percentage points; the foreign rate of return on FDI in the United States has risen from 2.0 percent to 4.3 percent, an increase of 2.3 percentage points. Had rates of return on FDI remained at their 2000 values, U.S. net income receipts would have been $33 billion lower in 2004.

Looking ahead, we calculate that a relatively modest fall in returns on FDI assets would have a substantial impact on net income. For example, if returns on FDI assets were to fall 1 percentage point, to 7.6 percent, income receipts would drop by $33 billion. Again, we cannot be certain how FDI returns will behave in the years ahead, but a decline of 1 percentage point would simply bring the differential between returns on FDI assets and liabilities near to the levels prevailing in the late 1990s.

A weaker dollar. A third recent development boosting U.S. net income has been the depreciation of the dollar. On a trade-weighted basis, the dollar declined 20 percent from the end of 2000 to the end of 2004. A weaker dollar automatically increases the value of income receipts denominated in foreign currencies. (While U.S. liabilities are denominated

Box 2: Puzzling FDI Returns

The positive U.S. balance in net income owes much to the higher reported profitability of U.S. firms operating abroad relative to foreign firms operating in the United States. The persistence of this rate-of-return advantage is a puzzle. If the profitability of foreign direct investment in the United States is so low, why do foreign investors continue placing substantial sums in the U.S. market?

Seeking to shed light on the puzzle, we examine FDI returns by industry and country. (For details, see Appendix Tables A1 and A2 in the online version of this article, at <http://www.newyorkfed.org/research/current_issues/ci11-12.html>.) Unfortunately, our analysis deepens the puzzle rather than solves it: with few exceptions, the U.S. rate of return advantage holds across industries and countries.

The available industry breakdown shows rates of return based on historical cost valuations for FDI in the manufacturing, wholesale trade, information, and financial industries. With the lone exception of the transportation equipment industry, foreign firms in the United States have much lower rates of return than U.S. firms operating abroad. The best return recorded for a foreign operation in the United States, 12.0 percent for wholesale trade in 2004, just matches the average return across all U.S. operations abroad.

A similar pattern is evident in the country breakdown. European and Japanese investors earn low rates of return in the United States, while returns for U.S. foreign operations are relatively high in all the major industrial countries. For example, one of the best returns in the United States, 9.7 percent for U.K. firms, is significantly below the 11.7 percent average rate of return for U.S. firms abroad. Similarly, for U.S. operations abroad, the weakest returns in our sample—6.9 percent and 9.2 percent, respectively, for U.S. firms in Germany and the United Kingdom—still exceed the 6.6 percent average return on foreign direct investment in the United States.

Other possible explanations for the higher reported profitability of U.S. firms' foreign operations are as follows:

- U.S. firms, on average, may simply be more efficient than foreign companies. There is some indirect evidence for this view: U.S. business sector output has consistently grown faster than business sector output in Europe or Japan, despite a much lower rate of business investment. However, the limited data that can be used to compare corporate profits across countries actually place the profitability of U.S. firms at about the advanced-economy average.
- U.S. investors may have been particularly successful at investing in well-governed firms, and may have abstained from momentum trading. Some recent research (Thomas, Warnock, and Wongswan 2004) supports this view.
- Foreign companies operating in the United States tend to be newer than U.S. firms operating abroad. To the extent that this is the case, foreign firms have had less time to work through initial start-up costs and to develop the market power in the United States that would boost their profits. Some research supports this argument (Laster and McCauley 1994). However, the explanation has been advanced for many years and should become increasingly less plausible as the accumulated stock of FDI assets in the United States matures.
- Foreign companies operating in the United States may face more competitive pressure than U.S. firms operating abroad and thus have lower margins.
- Differences in tax treatment may induce foreign firms to attribute profits on operations in the United States to the home country or a third country and induce U.S. firms to attribute profits on U.S. operations to activity abroad. However, most studies at best provide mixed evidence for this claim (Laster and McCauley 1994).

Whatever their source, the high reported profits of U.S. firms operating abroad provide a welcome offset to net interest payments in supporting U.S. net investment income.

almost entirely in dollars, a large share of U.S. assets is held in foreign currencies.) As a result, it leads directly to an improvement in U.S. net income receipts. According to our estimates, the decline in the dollar since 2000 added $27 billion to U.S. net income receipts in 2004.

Of course, these counterfactual calculations should be interpreted with caution, because they rely on the unlikely assumption that the accumulation of assets and liabilities would have been the same under the rates of return prevailing in 2000. Still, they illustrate how easily different paths for rates of return and exchange rates might have pushed U.S. net income below zero in 2004.

And indeed, the net income balance will likely soon turn to deficit. Preliminary data for the first three quarters of 2005 show a surplus of only $4 billion, with higher interest rates substantially increasing payments on the large stock of interest-sensitive U.S. liabilities.

Consequences of Growing U.S. Net Liabilities

Developing a net liability position with respect to the rest of the world can benefit a country by allowing it to maintain a higher rate of investment spending than would be possible by relying on domestic saving alone. But such a position also creates an offsetting burden, by giving foreign investors a

claim on future national income. In the United States, a favorable gap between rates of return on assets and liabilities has thus far obscured this consequence. However, the ongoing buildup in U.S. net liabilities to the rest of the world means that the United States is likely to begin making net payouts in the near future.

When this occurs, net income flows will begin to add to the U.S. current account deficit instead of working to reduce it. As the net income deficit grows, the U.S. trade deficit must narrow merely to prevent the current account deficit from increasing. Achieving an actual reduction in the current account deficit would require the trade deficit to decline even further.

To illustrate how the adjustment process might unfold, we consider three alternative scenarios. All three scenarios rely on the simplifying assumption that future current account deficits are financed entirely through liability issuance, with U.S. foreign assets remaining fixed. To provide a point of reference, the first scenario simply projects recent trends forward by assuming that

- the U.S. current account deficit remains at 6 percent of GDP, close to its current value,
- U.S. nominal GDP growth proceeds at 5 percent per year, close to its recent average, and
- exchange rates and rates of return on U.S. foreign assets and liabilities remain unchanged.

These assumptions are, of course, counterfactual. Changes in exchange rates, rates of return, and U.S. gross foreign assets will no doubt materially affect the adjustment process. Still, our calculations provide a useful benchmark.

Under this scenario, U.S. net foreign liabilities as a percentage of GDP would rise from 22 percent—their level in 2004—to 65 percent by 2015 and would continue to climb higher in subsequent decades (Table 2, Scenario 1).[6] Payments on the growing U.S. net liability position would near 1.2 percent of GDP by 2015. To accommodate the growing net income payments (under our assumption that the current account deficit remains constant as a share of GDP), the U.S. trade deficit would have to decline from 5 percent of GDP in 2004 to roughly 4 percent by 2015.

It might seem implausible that the actual U.S. net liability position could grow as large as this scenario implies. With this in mind, we proceed to our second scenario, which assumes that the U.S. current account deficit declines smoothly to 2.5 percent of GDP by 2015. The remaining assumptions are the same as in the first scenario. Under the new scenario, U.S. net liabilities would approach 50 percent of GDP by 2015 (Table 2, Scenario 2). The U.S. trade deficit would have to fall to 1 percent of GDP by 2015 to accommodate income payments to foreign investors of slightly below 1 percent of GDP.

A rise in the rate of return the United States pays on foreign liabilities would require still larger adjustments. In our third scenario, we assume that the rate of return on U.S. liabilities rises to equal the current rate of return on U.S. assets while the U.S. current account deficit, as in the second scenario, declines smoothly to 2.5 percent of GDP by 2015. Under this last scenario, the United States would need to run a small trade surplus by 2015 to make room for income payments to foreign investors of slightly more than 2 percent of GDP.

An increase in net payments means that a reduction in the U.S. current account deficit would entail significant changes in the structure of the U.S. economy. At present, U.S. imports are roughly 50 percent larger than U.S. exports, at 16.0 percent and 10.5 percent of GDP, respectively. As a result, exports have to grow much faster than imports to bring the trade deficit down.

Suppose, for example, that import growth through 2015 matches the 5 percent annual rate we have assumed for nominal GDP, keeping the ratio of imports to GDP constant. Exports would have to grow almost twice as fast, at a 9 percent

Table 2
Implications of Growing Net Liabilities
Percentage of GDP

	2004	2015	2025
Scenario 1			
Net position	-21.7	-65.0	-89.0
Trade balance	-5.3	-4.2	-3.2
Net income receipts	0.3	-1.2	-2.2
Scenario 2			
Net position	-21.7	-48.3	-49.9
Trade balance	-5.3	-1.1	-0.8
Net income receipts	0.3	-0.8	-1.1
Scenario 3			
Net position	-21.7	-48.3	-49.9
Trade balance	-5.3	0.2	0.3
Net income receipts	0.3	-2.1	-2.2

Source: Authors' calculations.

Notes: Scenario 1: Current account constant at 6 percent of GDP; rates of return at 2004 values. Scenario 2: Current account deficit falls to 2.5 percent of GDP by 2015; rates of return at 2004 values. Scenario 3: Current account deficit falls to 2.5 percent of GDP by 2015; rate of return on liabilities rises to meet 2004 rate of return on assets. All scenarios assume that nominal GDP growth is constant at 5 percent and that net transfer payments abroad are constant at 0.6 percent of GDP.

annual rate, to cut the trade deficit to 1 percent of GDP, as envisaged in our second scenario. Export production would then represent 15 percent of U.S. GDP, a fairly dramatic change in the composition of output for a ten-year period.

These are counterfactual simulations, not forecasts. However, the simulations highlight an important point: even if the U.S. current account deficit narrows substantially in the years ahead, income payments to foreign investors are likely to take up a growing fraction of U.S. income. The impact of higher income payments on U.S. consumers depends on how the associated foreign capital inflow is deployed. To the extent that the inflow goes to finance productive investments, future U.S. national income should be higher, even net of income payments to foreign investors. To the extent that the inflow goes to finance current consumption or the government budget deficit, future U.S. income will be lower, net of those income payments.

Conclusion

Large, ongoing current account deficits are leading to a steady buildup in U.S. net liabilities to the rest of the world. Thus far, the longer term implications of the buildup in net liabilities for U.S. net investment income have been masked by the superior rate of return the United States earns on FDI assets and the recent drop in global interest rates.

However, continued large current account deficits are likely to push the U.S. income balance below zero in the not too distant future. As a result, the United States will need to effect a sharper narrowing in its trade deficit to achieve any given narrowing in its current account deficit. Such an adjustment could be challenging for the United States, which now imports vastly more than it exports.

Notes

1. Higgins and Klitgaard (1998) discuss the accounting relationships linking savings, investment, the current account balance, the trade balance, and net income flows.

2. A number of recent papers discuss the role of capital gains and losses in determining a country's international investment position. See, for example, Gourinchas and Rey (2005), Lane and Milesi-Ferretti (2003), and Tille (2003).

3. In calculating returns, we divide income by asset or liability values measured at the end of the previous year.

4. See Table 8 in "Report on U.S. Portfolio Holdings of Foreign Securities," available at <http://www.treas.gov/tic/shc2003r.pdf>.

5. Profits on FDI do not actually have to cross national borders to be counted as investment income: total profits include reinvested earnings as well as repatriated earnings.

6. Over the very long run, with a constant current account deficit of c as a ratio to GDP and constant nominal GDP growth at the rate g, the ratio of net liabilities to GDP eventually stabilizes at $c(1+g)/g$. In the first scenario, net liabilities plateau at roughly 125 percent of GDP.

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Appendix Tables

Table A1
Rate of Return on Foreign Direct Investment, by Industry
Percent

	Payments: Rate Earned by Foreign-Owned Firms Operating in the United States	Receipts: Rate Earned by U.S.-Owned Firms Operating Abroad
All industries	6.6	11.7
Manufacturing	7.4	12.9
Chemicals	6.6	14.3
Computer and electric products	5.4	11.7
Transportation equipment	8.2	9.5
Machinery	2.9	13.6
Wholesale trade	12.0	19.8
Information	4.7	18.5
Depository institutions	5.3	5.2
Other financial institutions	4.6	8.3
Professional services	7.6	16.4

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Note: Returns are foreign direct investment income flows in 2004 divided by foreign direct investment position on a historical cost basis at the end of 2003.

Table A2
Rate of Return on Foreign Direct Investment, by Country
Percent

	Payments: Rate Earned by Foreign-Owned Firms Operating in the United States	Receipts: Rate Earned by U.S.-Owned Firms Operating Abroad
All countries	6.6	11.7
Canada	6.2	11.8
Europe	6.5	10.3
France	5.7	11.8
Germany	4.5	9.2
Ireland	3.7	17.6
Luxembourg	0.8	10.4
Netherlands	8.6	9.8
Switzerland	5.3	14.7
United Kingdom	9.7	6.9
Mexico	-3.2	12.8
Bermuda	-0.3	9.5
U.K. Islands, Caribbean	0.5	10.6
Asia and Pacific	8.5	15.8
Australia	13.4	11.4
Hong Kong	5.7	14.0
Japan	7.7	16.6

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Note: Returns are foreign direct investment income flows in 2004 divided by foreign direct investment position on a historical cost basis at the end of 2003.