The February-April 1987 Episode

When the dollar declined to rebound again later in March 1987, officials apparently feared that it was falling too far. Excessive decline risked recession abroad and additional inflationary pressures in the United States. Officials of the major nations had "agreed to coop-erate closely to foster stability of exchange rates around current levels." Consequently, major nations’ central banks began intervening in foreign-exchange markets, buying dollars to resist the depreciation.

Central-bank-intervention purchases of dollars typically result in an official capital inflow to the United States in the form of foreign saving. Because total foreign saving—private and official—can change no more rapidly than the typically slow change in the trade deficit, a sharp increase in foreign saving must be accompanied by an equally sharp decrease in private foreign saving. The volume of the inter-vention in this episode was extremely large and, when measured relative to the size of the U.S. economy, is among the largest for any three-month period.

The possibility that there had been a sudden, large decline in private foreign saving raises two questions: First, did foreign portfolio holders have frightened foreign investors? Whatever the cause for private port-folio holders’ reluctance to invest in the United States in the February-April period, the terms of investment un-der the existing rate of interest rates rose in the United States and fell abroad, changing interest rate differentials in directions that trade dollar assets more attractive. The dollar depreciated somewhat despite the inter-est rate differentials, reducing the potential for future depreciation and making pur-chases of dollar assets more attractive. Second, the United States could continue to pursue policies that will prevent the reigniting of inflation or expectations of inflation. Third, the United States could avoid taking actions that discourage foreign investment here. These would be constructive actions, in contrast to protectionism, which would be a destructive response to symptomatics caused by excess U.S. spending and resulting dependence on foreign saving.

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Conclusions

When viewed from the perspective of the framework we have presented, for-eign private funds did not “dry up” during the February-April 1987 episode. Instead, the willingness of foreign pri-vate portfolio holders to invest in the United States diminished. When cen-tral banks prevented investment terms from changing sufficiently to maintain the inflow of private funds, private portfolio holders, given their dimin-ished willingness to invest, sharply slowed their acquisition of dollar assets. When the investment terms subsequently changed enough, the inflow of private funds recovered. Thus, the important issue in this regard is not the possibility of foreign funds abruptly becoming unavailable, but rather the possibility that they may become available only at interest rates so high that private domestic invest-ment will be crowded out.

The danger of crowding out domestic investment could be reduced in at least three ways. First, the United States could reduce the federal budget deficit and thereby reduce its reliance on foreign saving. Second, the United States could continue to pursue policies that will prevent the reigniting of inflation or expectations of inflation. Third, the United States could avoid taking actions that discourage foreign investment here. These would be constructive actions, in contrast to protectionism, which would be a destructive response to symptomatics caused by excess U.S. spending and resulting dependence on foreign saving.

Earlier this year, foreign central banks bought substantial portfolio positions of U.S. securities. They did so with some of the proceeds of their massive inter-vention in the foreign-exchange market, involving purchases of the dollar intended to prevent its depreciation. In the same period, private international investors sharply reduced their net new investment in U.S. financial markets. Foreign private investors had been investing large amounts in the United States since mid-1982. Through the end of last year, they placed an average of $22.6 billion per quarter in this country. But an estimate suggests that amount dropped by nearly half in February-April 1987.

The recent shift in foreign investment behavior raises important questions con-cerning the durability of inflows of for-eign private saving. Could these inflows of foreign private saving dry up? What did central banks intervene in foreign-exchange markets? What would have happened if they had not intervened? Answers to these questions have impor-tant implications for the cost and availability of credit and, in turn, for the well-being of the U.S. economy.

This Economic Commentary explains how research in the United States is determined and how international portfolio holders, private and official, determine the terms at which saving is obtained. We also iden-tify factors that made private interna-tional portfolio holders willing to acquire dollar assets at terms consistent with their cost-benefit framework, and explain why the early part of the current expansion. Finally, we examine the basis of concern that an increase in foreign ownership of dollar assets may have frightened foreign investors.

The Determination of Foreign Saving Inflow and Its Terms

Foreign saving—a net capital inflow—rises when a country spends more than its income. More precisely, it arises when the excess of imports over its income. More precisely, it arises when the excess of imports over its income. More precisely, it arises when the excess of imports over exports (M-X), that is, a trade deficit, must be financed by foreign saving. In fact, both are determined by the well-being of the U.S. economy.

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In the early 1980s, the United States has become increasingly dependent on foreign capital. An alternative view, first advanced by economist Robert Mundell, essentially is that foreign capital is sufficiently mobile to compensate for any shortfall in domestic saving.

Alternative view, first advanced by Robert Mundell. Note that Mundell's view holds that foreign capital is sufficiently mobile to compensate for any shortfall in domestic saving. A net capital inflow would imply a reduced demand for dollar assets, and ultimately crowd out private domestic investment.

The willingness of portfolio holders to switch to dollar assets, portfolio real interest rate differentials would respond strongly to changes in perceived real interest rates and, hence, on perceived real exchange rate. While dollar depreciation would imply a reduced demand for dollar assets, and ultimately crowd out private domestic investment.

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For a more detailed discussion, see 

8. For a more detailed discussion, see Economic Commentary, Federal Reserve Bank of Cleveland, September 1985. 

9. For estimates of real interest rates and their determinants, see Federal Reserve Bank of Cleveland, Economic Commentary, September 1985.


13. Ibid.

Reducing Dependence on Foreign Saving

Senior officials of the Group of Five nations (France, West Germany, Japan, the United Kingdom, and the United States) recognized that the large U.S. external imbalance could lead to damaging protectionist actions by the United States and other nations and encouraged capital outflow from the United States, which would tend to reduce the price of dollar assets, raise the price of goods and services, and reduce the U.S. trade deficit. The willingness of portfolio holders to switch to dollar assets, portfolio real interest rate differentials would respond strongly to changes in perceived real exchange rate. While dollar depreciation would imply a reduced demand for dollar assets, and ultimately crowd out private domestic investment.

For example, a common view around December 1980 was that a 5% increase in domestic saving would generate the trade deficit crowding out.

Moreover, to the extent these factors increased the demand for dollar assets, they helped to keep U.S. interest rates below what they would have been to drive the dollar’s exchange rate higher. Moreover, to the extent these factors can be viewed as a lasting phenomenon, foreign investors will begin to demand even greater returns on their investments than were previously prevalent.

How long foreign lenders will continue to lend at present terms may be less important than a persisting factor that reflects the counterpart to foreign saving: the trade deficit. While large budget deficits have not had an adverse effect on domestic investment, they have, through the associated trade deficits, created incentives for foreign investors to hold dollars and buy foreign assets, which competes against imports. The strain in these sectors has led to the more serious threats of protectionism since the Great Depression.

The cyclical patterns appeared to support the first view because investment, and hence budget deficits increased while foreign saving seemed to be unaffected. The budget deficits during this period, however, might not have been persistently large enough to provide a basis for discriminating between the two views of the effects of budget deficits.

After 1982, budget deficits averaged about 5% of GNP compared to 2.4% in the 1970s and less than 1% in the 1960s. Moreover, the budget deficit as a share of GNP was 18.0% in 1981 to 16.2% in 1986. Nonetheless, private investment increased, supported by a continued inflow of foreign saving. The strength of investment—particularly in the early stages of the recovery and tax reform, which enhanced the marketability of U.S. securities in Japan, Japanese net purchases of U.S. securities increased from $0.8 billion in 1982 to $29.9 billion in 1985. In 1984, the U.S. repealed its 30% withholding tax on interest paid to foreign residents, further enhancing foreign demand for U.S. securities. In 1987, these factors increased the demand for dollar assets, they helped to keep U.S. interest rates below what they would have been to drive the dollar’s exchange rate higher. Moreover, to the extent these factors can be viewed as a lasting phenomenon, foreign investors will begin to demand even greater returns on their investments than were previously prevalent.

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