

Comments on Kristin Forbes:
Why do Foreigners Invest in the United States?

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Context: the BIG Question

Is the US Current Account Deficit Sustainable?

- Answer depends on foreigners' willingness to finance the deficit.
- Optimistic line of argument points to eroding home bias (increasing globalization), plus return differentials favoring the US.
- Pessimistic line of argument follows Obstfeld-Rogoff:
 - Long term trade balance would likely require dollar depreciation.
 - Depreciation would likely reduce foreigners' demand for US assets.

So: Why do Foreigners Invest in the United States?

- Broad title - invites speculation about motives (What do YOU think?)
- Distinctions:
 1. **What does investing mean?** This paper: US equities and bonds.
 2. **Which foreigners?** This paper: Private *and* public.
 - Matters for the 'Why': **Risk&return vs. exchange rate objectives?**
 3. **Partial or General equilibrium reasoning?**
 - Partial: Who wants to invest at current risks and expected returns?
 - General: Why do we have a world equilibrium with asset prices and exchange rates such that the US attracts capital imports?
 - This paper: Partial. Mean-variance optimization.

Key Contribution: Empirical

- Set of panel regressions – across countries and over time (Tables 7-9)
- Dependent variables: Share of US equities in each country's world stock portfolio. Share of US bonds in each country's world bond portfolio.
- List of determinants (with effects):
 - **Financial development**. Key findings: **Negative** for stocks & bonds.
Interaction effect: Impact greatest at low per-capita GDP.
 - **Capital controls**. Find: **Negative** for stocks [Note: 0.90 corr. w/ GDP]
 - **Corporate governance index**. Find: **Positive** for stocks and bonds.
 - **Lagged local-US return difference**. Find: Negative for stocks.
 - **Correlation with US market**. Find: weak effects.
 - **Trade with the US**. Find: **Positive** for stocks & bonds.
 - **Closeness to US**. Find: often insignificant when **Trade** is included.
 - **Lagged per-capita GDP**. Find: **Negative** for stocks & bonds.

Most Insightful Regressions

- Combine results for equities and bonds. Distinguish income levels.

	Equities Middle/Low	Equities High Inc	Bonds Middle/Low	Bonds High Inc
Capital Controls	- 0.28	- 0.10	ns+	ns-
Financial Development	- 1.18	- 0.17	- 1.70	- 0.91
Corporate Governance	ns-	+0.79	ns-	+0.38
Returns	ns-	- 0.03	ns+	ns+
Correlation	+0.19	ns-	ns-	ns+
Closeness	ns+	ns-	ns+	- 0.48
Trade	+3.19	+1.48	+3.72	+6.21

(ns = not significant values, omitted to avoid clutter. Source: Tables 7 & 9.)

- Robust findings: **Financial Development (-)** and **Trade (+)**.
- Governance (+) only at high income. Capital controls (-) only for equities.

Observations and Questions

1. Capital inflows provide limited information about each investor

- US stocks & bonds only. Both scaled by portfolio totals from other sources.
- Inflow data differ from capital outflow data: Outflows allow construction of US investors' worldwide portfolio (Bohn-Tesar 1996, 1998)
- Question: **Why examine stocks and bonds separately?**
 - Are countries high US stock holdings also holding more US bonds?
 - IMF data provide matrix of each country's holdings everywhere.

2. Panel regressions include fixed country effects & time effects

- Most regressors are country characteristics – likely stable over time
- Are estimates dominated by countries undergoing structural change?

Observations and Questions

3. What do we learn about investor motives?

- Candidates: Home bias. Diversification. Return chasing.
- **Home bias** – immediate from portfolio shares, but begs explanation.
- **Diversification** – testable implication: **Are investors rebalancing in response to disturbances to their desired portfolio shares?**

Requires analysis of portfolio dynamics & identification of disturbances (unexpectedly high/low returns; public offerings) – see Bohn/Tesar ('96,'98).

- **Return chasing** – ambiguous: **Chasing actual or expected returns?**

Also requires analysis of portfolio dynamics, variations in risks & returns.

=> **Paper examines “US-bias.”** Not clear if due to differential home bias or diversification motives; not designed for dynamic analysis.

4. Concern about underlying model ...

Modeling International Investment

- This paper: static mean-variance analysis (CAPM)
 - Additional simplifying assumptions: equal return variances; zero correlations; equal shadow values of risk in all countries.
 - Focus is on differences in investment cost.
- Concerns: missing non-negativity constraints; omission of domestic cost; obvious: role of intertemporal factors; simplifications.
- Conjecture: Domestic cost is a key source of variations.
(Broadly interpreted: intermediation cost; political risk; taxes...)
 - Extreme case: suppose the cost of investing in the US + US cost of sending funds back is less than cost at home => Intermediation.

Final Thoughts (Food for discussion)

- Given the paper's answers: What are the macro implications?
 - Investment in the U.S. correlated with underdeveloped financial markets.
 - Supports notion that the U.S. has operated as the world's investment banker.
- If the U.S. has benefited from high intermediation cost abroad, will borrowing cost rise if/when foreign financial systems improve?
- How is the U.S. liquidity crisis affecting its role as intermediary?

References

- Bohn, Henning and Linda Tesar (1996) “U.S. Equity Investments in Foreign Markets: Portfolio Rebalancing or Return Chasing?” *American Economic Review*, May 1996, 77-81.
- Bohn, Henning and Linda Tesar (1998) “U.S. Portfolio Investment in Asian Markets” in: Reuven Glick (ed.) "Managing Capital Flows and Exchange Rates" Cambridge University Press, 43-72.