Comments on Kristin Forbes:

Why do Foreigners Invest in the United States?

Henning Bohn

Department of Economics
University of California, Santa Barbara

Federal Reserve Bank of San Francisco
2008 Pacific Basin Conference
Context: the B.I.G. 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.
  - 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.

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

(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
   • 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?**


- **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
