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Thinking ahead for Europe

Foreign Investment in the US (II):

Being taken to the cleaners?

Daniel Gros

Abstract

The income account of the US balance of payments has so far remained in surplus because of a very large differential in reported earnings on direct investment – US firms seem to enjoy a much higher rate of return than foreign firms in the US. There is little difference in terms of the rate of dividend payments; the difference is due to what is called 'reinvested earnings' (earnings minus dividends). Foreign firms report almost no reinvested earnings on their direct investment in the US whereas US firms report substantial reinvested earnings from their direct investment abroad, on average over $100 billion more p.a. than foreign firms report on their US investment. This anomaly is probably due to the desire of foreign firms to minimise their US taxes, whereas US firms do not face tax liabilities if they report high foreign profits to the US authorities. The procedure used to generate the data for reinvested earnings thus has a built-in bias to improve the US current account and – over time – its international investment position. The true picture is likely to be much worse.

Reinvested earnings appear in the balance of payments because returns from FDI are measured in a different way than returns from portfolio investment. Returns from FDI are calculated from a mix of firm-level accounting data and broad stock market indices to infer an average capital gain. This procedure will be misleading if, because of the different tax treatment they face, foreign controlled firm in the US report earnings on a different base than other US-owned firms.

A more accurate method of measuring the returns from foreign direct investment in the US, by using the same procedure as for portfolio investment (i.e. using only stock market prices), leads to the result that the deficit of the US current account increases by over $100 billion per annum and the US net international debtor position worsens by over a trillion dollars. The latter amount is the sum that, if one believes the official statistics, foreign investors have been willing to forego compared to the alternative of investing in their home country.

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FOREIGN INVESTMENT IN THE US (II): BEING TAKEN TO THE CLEANERS?

DANIEL GROS

Introduction

Two peculiarities of the US balance of payments (BoP) have attracted a lot of comments over the last few years: the first is that the US continues to report small positive net income flows although it has accumulated a huge foreign debt. The second is that the US, despite its undoubtedly large net foreign debt, is still reported to have a substantial net creditor position in terms of FDI. What is less widely appreciated is that these two anomalies are due to one, crucial item in the US balance of payments, namely reinvested (or retained) earnings. On closer inspection, the flows reported for this item reveal an idiosyncrasy that suggests that it might be grossly miscalculated, thus distorting the published figures for both the US current account and its international investment position – the latter to the tune of a trillion dollars.

This paper starts from the hypothesis that it is unlikely that investors from all over the world would continue to pour hundreds of billions of dollars into foreign direct investment (FDI) in the US if they were really being constantly taken to the cleaners. It starts by giving the basic background, including a brief description of the way returns on FDI are measured for the purposes of the balance of payments. It then turns in section 2 to one potential explanation, namely transfer pricing, which cannot be a key factor given that it would have implied huge changes in the terms of trade. Section 3 then turns to the link between estimates of the returns from FDI and the net US international investment position. Section 4 presents an alternative estimate of the US net position by treating FDI essentially like portfolio investment (i.e. using only market prices), which result in a net deterioration of over $1 trillion. Section 5 concludes.

1. The mystery: Do foreigners waste their savings in the US?

The official data on reinvested earnings reported in the US balance of payments[1] cannot be taken at face value. This much is suggested by a simple comparison between the reinvested earnings reported on US direct investment abroad and those reported by foreign direct investment in the US. The former, i.e. what US firms report for their investment abroad, has amounted to over $1,100 billion over the last 20 years (1982-2004). The latter, i.e. what foreign firms report for their investment in the US, has amounted to less than $20 billion over the same period (on average less than $1 billion per annum)! It is difficult to accept this difference at face value, particularly since there is little difference in terms of distributed earnings between US FDI abroad and foreign FDI in the US and given that there is little difference in the reported returns on portfolio equity investment.

The purpose of establishing a balance of payments for a country is to show how different kinds of payment flows balance, i.e. how inflows and outflows offset each other. Traditionally a balance of payments recorded just the payments made for the acquisition of goods and services or capital. Reinvested earnings were added relatively recently as a pure accounting entry to the balance of payments although they do not represent a real flow of payments. They were added to reconcile the balance of payments data with the statistics on the international investment

[1] The US data of course are also used in the statistics issued by international financial institutions (IFIs), such as the IMF.

position, which is not immediately related to the flows of payments in the traditional balance of payments concept.

Inserting the item 'reinvested earnings' into the balance of payments does not change the fact that the balance of payments always adds up to zero because reinvested earnings are entered twice and with opposite sign: for the foreign assets owned by home residents, reinvested earnings increase the income account part of the current account and then enter the capital account with a negative sign as an increase in direct investment abroad. (And vice versa for foreign-owned direct investment at home.) Reinvested earnings thus do not lead to any increase in errors and omissions, but they can change the way the balance looks: higher reinvested earnings make the current account look better and, over time, increase the value of direct investment abroad.

The fact that reinvested earnings represent a pure accounting entry has a key implication for how the data are collected. Since reinvested earnings do not correspond to a payment flow, they cannot be collected in the way almost all other entries in the balance of payments are, namely to rely on data from cross-border payment flows. Instead, in the regular surveys used to establish the US international investment position, US firms are asked to report the profits of their foreign affiliates. The replies are then combined with information on repatriated profits (actual payments of dividends, etc.) to calculate reinvested earnings, which are defined as profits minus repatriations. The latter correspond to financial flows that actually take place and can thus be cross-checked. But the former represent just the numbers reported by US parents of foreign enterprises. Higher reported profits abroad do not engender any additional tax liability (US tax is deferred until repatriation).

The same procedure also applies to US affiliates of foreign firms: they are also asked to report their profits. However, in this case the replies can be cross-checked with the profits declared by these firms, which are usually incorporated in the US. This difference in the meaning of the profits declared for BoP purposes suggests the reason why the US affiliates of foreign firms declare regularly rather low profits; this way they minimise their US tax liabilities.

Reporting profits to the US authorities has thus different tax implications for foreign direct investment in the US than for US direct investment abroad. A further indication that declared retained earnings are strongly influenced by fiscal and regulatory considerations is that during 2005, retained earnings reported by US firms on their foreign direct investment fell to close to zero, compared to over $120 billion during the same period of 2004.[2] The changes in US tax regulations regarding the repatriation of profits earned abroad that were in force during 2005 thus had an immediate and strong impact.

These huge swings in the data should already constitute a reason not to rely on the accounting data used as the basis for official statistics. But there are also several other reasons for adopting a rather strong presumption that the rate of return on foreign direct investment in the US should not be too different from the average return of US corporations (which in turn has not been too different from the longer-run averages of dollar returns on major stock markets around the world).

The first reason derives from a simple comparison between FDI and portfolio investment. The official data imply that foreigners instantly start losing (compared to their US counterparts

[2] Before 2004, this item had mostly fluctuated around this order of magnitude. As will become clearer below, this much lower figure reported for reinvested earnings has as its accounting counterpart lower reported FDI abroad, but a difference in a flow of around $120 billion (at an annual rate) will take some time to have a measurable impact on the reported stock of US FDI, which is at present more than 20 times larger.

abroad) when they invest more than 10% into a US company. This conclusion seems unavoidable given that the rate of return on US portfolio assets has been the same as the rate on US portfolio liabilities (foreign investment in the US). Direct investment is any transaction under which a foreigner acquires more than 10% of the capital of an enterprise. It seems that foreign investors in the US are able to obtain a market rate of return (which can be objectively measure) if they own less than 10% of a US company. But the official statistics (based on accounting data) imply that their returns are much lower once the investment qualifies as direct, i.e. once it goes above the 10% threshold.

The second reason is that it is difficult to imagine that foreign investors would go to the trouble of making a direct investment in the US when there are much better profit opportunities at home. Apparently these opportunities have been exploited by US corporations, which report much higher profit rates on their direct investment abroad. This would not only be a gross violation of the general assumption of market efficiency, but also of the general assumption that consistent profit opportunities will in the long run be exploited.

Finally, if the official statistics were correct, foreigners would accept a rate of return on their direct investment in the US of only around 2.5%, which would be much lower not only of that on their US portfolio equity investment, but also lower than the 5.5% return earned on debt instruments. The official data based on accounting returns would thus imply a strongly negative equity risk premium (for FDI alone!).

2. Profit shifting through transfer pricing as a potential explanation

How could the owners of foreign direct investment in the US reduce their reported profits and thus minimise their US tax liabilities? The bulk of foreign direct investment in the US concerns large corporations and leads to 100% foreign ownership.[3] The foreign owner can thus shift profits easily in and out of the US. The key consideration about where to generate profits will thus be taxation. Since the US corporate income tax rate is higher than in most other countries, it follows that most owners of direct investment in the US have an incentive to shift profits from the US subsidiary level, to the mother company, or, even better, a holding company located in a tax haven.

One obvious means of shifting profits is via transfer pricing (see also Buiter, 2006). By charging the US subsidiary a high price for goods and services delivered by the foreign mother company, profits could be easily shifted out of the US.

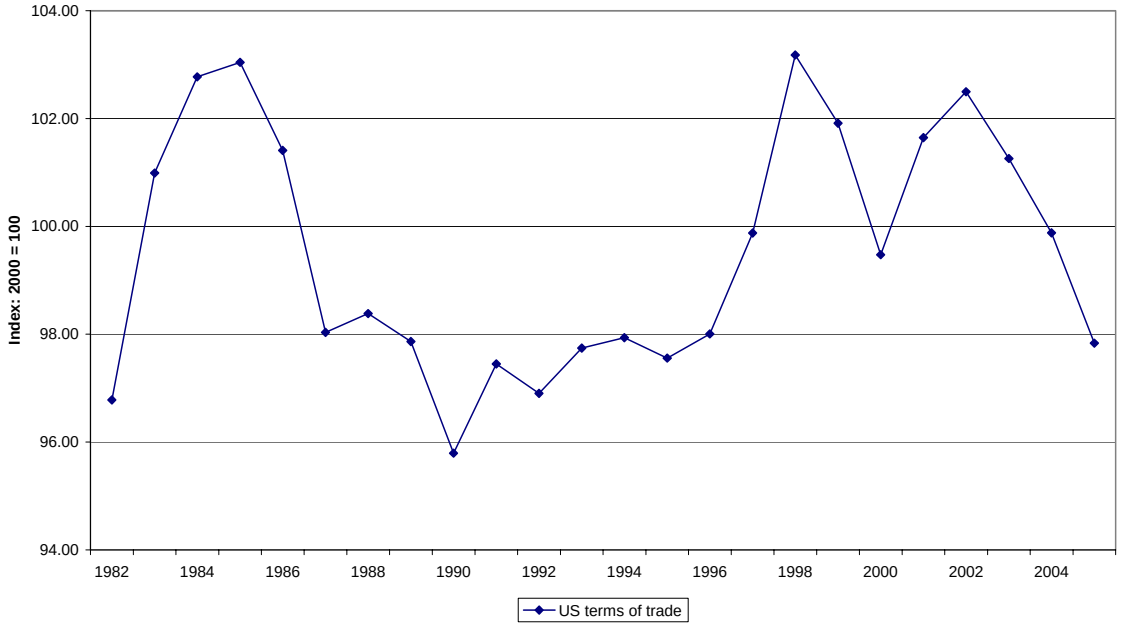
If transfer pricing had been the main reason for the low reported rates of return of foreign direct investment in the US, one would have to observe that reported export prices decline relative to import prices[4] – and the magnitude of this miscalculation of the terms of trade would have to be large. As shown in more detail below, the profits declared by foreign direct investors in the US are on average around $120 billion (annually) lower than one would expect if they earned a normal profit rate on their investment in the US. Given that US exports are worth about $1,100 billion, this implies that the US terms of trade should be distorted by transfer pricing by 10-11%. If transfer pricing had an important impact on measured profits, one should thus observe a trend deterioration of the US terms of trade over the last decades of about 10%. However, this

[3] This implies that the 10% threshold is not material for most of the FDI that actually takes place. The US internal revenue service (IRS) treats foreign-controlled companies differently from domestic companies. 'Foreign-controlled' is defined by the IRS as foreign ownership of 50% or more.

[4] For a given level of FDI and transfer pricing, the terms of trade can remain constant. But the volume of FDI has been constantly increasing over the last decades, which would imply that a growing part of the US economy would be subject to this phenomenon.

does not seem to have been the case. The US terms of trade have fluctuated around a constant value over the last 20 years (in line with fluctuations in the oil prices) without any discernible long-term trend as shown in Figure 1 below. The value for 2005 is almost exactly equal to the value for 1982, which is the start for many series on FDI.

Figure 1. US terms of trade



The available data thus do not contain any evidence that transfer pricing could have been used on such a massive scale as to explain $100 billion in missing profits. Moreover, several other studies have come to the same conclusion, namely that a bias in intra-group transfer pricing cannot be the main cause for the reported low earnings of foreign-controlled companies in the US (see for example CBO, 2005). This is an important finding since if the reported low earnings were due to distorted transfer pricing, the current account would not be affected: the trade account deficit would be increased by the same amount as the income account would be reduced if foreign owners were to charge excessive prices to their US subsidiaries.

It is thus likely that other factors contribute to the low reported earnings of foreign-controlled companies in the US. One such factor might be the amortisation of good will, which is easier for foreign-controlled companies than purely domestic ones. Most foreign takeovers are made at a price that exceeds the book value of the company, just leading to the creation of substantial goodwill, which then subsequently provides a useful tax shield for the foreign owner.

3. Reinvested earnings and estimates of the value of foreign direct investment

In principle it should make little difference for the measurement of the international investment position of a country whether its firms systematically repatriate profits from abroad or ‘reinvest’ them (or rather do not repatriate them). If profits are not repatriated, the value of the investment abroad should go up. When measuring the return from portfolio investment, there is therefore no entry for ‘reinvested’ earnings. One assumes that the difference between profits and dividends (and similar payouts) is simply reflected one for one in the share price. This is not

done for direct investment, however, because it might be impossible to establish the change in the market value of the investment (e.g. if, as is often the case, the foreign owner has acquired 100% of the equity and then de-listed the target).

In reality all investment that leads to the assumption of effective control, or any shareholding above 10%, is considered direct investment.[5] This implies that in many cases one could still determine the share price and hence the market value of the investment and could thus avoid using the concept of retained earnings. But this is not done because it is assumed that the direct investor can influence the size of the dividend.[6] While this may be true, it does not constitute a reason to treat investment that technically qualifies as 'direct' differently from portfolio investment as long as part of the firm is still traded.

One problem with the concept of retained earnings is that FDI is also supposed to be calculated at market value. However, since one cannot use a market value for direct investment, in practice the revaluation is done using stock market indices on the assumption that direct investment will be approximately distributed across the same sectors as the stock market indices. For US direct investment abroad, this is done by taking the beginning period value of the equity position and multiplying it by the change in the broadest stock market index of the country where this investment is located. *Ceteris paribus*, this stock market will also reflect the 'retained earnings' of the firms that are quoted on it. This will also apply to the value of the average US-controlled firm in that country, which is likely to have a similar financial structure and a similar payout ratio as domestically-controlled firms because it is subject to the same tax laws. Hence there will be clear double counting of profits when the value of foreign direct investment is calculated this way.

Stock markets reflect of course many factors besides dividend payout ratios. There are thus many reasons why stock prices might move. However, using the sum of the full increase in national stock exchange averages and 'retained earnings' to estimate the value of FDI is not appropriate. For example, if the return on equity is 10%, but all firms pay out only 2% as dividends, the value of all firms should go up by 8% (p.a.). For a foreign firm owned by a US parent, the current procedure would thus consist of recording a return on FDI of 10% (consisting of 2% dividends, assuming they are all repatriated plus retained earnings of 8%). However, at the end of each year, the market value of the firm should go up by 8%. As this applies to all firms, the stock market value should go up by 8% as well and the market value of the FDI would also be revalued by 8%. If US foreign direct investment was worth 100 units at the beginning of the year, it would be worth (in the international investment position statistics) 108 at the beginning of the next year. The total return would thus have been 18%, due to the double counting of the 8% of retained earnings.

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[5] A useful summary can be found in BEA (2005).

[6] According to BEA (2005), "One rationale for including reinvested earnings as a component of direct income is that, at the level of ownership required for direct investment, whether or not earnings are remitted often reflects a conscious choice on the part of the direct investor, and in either case, the earnings accrue to the benefit of the investor. By definition, a U.S. direct investor owns or controls 10 percent or more of the voting securities of its incorporated foreign affiliate (or has an equivalent interest in its unincorporated foreign affiliate). Reinvested earnings are included in "direct investment income receipts" because, at this ownership level, a direct investor is usually able to control or substantially influence the size and timing of dividends paid by its affiliate. Direct investment income receipts may be contrasted with "other private income receipts (table 1, line 15)". "Other private income receipts" includes dividends – but not the reinvested earnings – received from an unaffiliated foreign corporation, because, in the latter case, the investor does not have substantial influence over the size or timing of the unaffiliated foreign corporation's dividends."

In order to avoid this double counting, BEA adjusts the stock market indexes used to revalue investment by an average rate of retained earnings using the following formula:[7]

$$K_t = \frac{K_{t-1} \times \left(\frac{Peoy_t}{Peoy_{t-1}}\right) + I_t}{1 + RE_t}$$

where K_t is the equity investment in affiliates in year t, valued at year-end stock market prices; P_{eoyt} is the year-end stock market price index, in year t; I_t is the total equity capital flow in year t; and RE_t is the yearend ratio of retained earnings per share as reflected in the stock price index for year t. As the BEA says: "This formula revalues U.S. and foreign parents' equity in affiliates using end-of-year stock price indexes, while adjusting for changes in annual investment and correcting for the effect of retained earnings on stock market prices during the year. The stock market data are first converted into U.S. dollars, so exchange rate effects are reflected in the formula."

The problem with this formula is that it supposes that foreign firms have the same rate of retained earnings as domestically-owned firms. However, this is not the case in the US, where foreign-owned firms report on average zero retained earnings.

These difficulties suggest that it might be more appropriate to not record retained earnings in the balance of payments. In principle this would not change the picture radically for any country that has a more or less balanced position in terms of direct investment. However, presenting the US balance of payments without retained earnings yields a quite different picture, both in terms of stock and in terms of flows.

The balance of payments of the euro area does not contain the item reinvested earnings at all. This implies that the value of euro area foreign direct investment should be more precisely estimated. However, this also implies that it is not possible to cross-check the mirror statistic (i.e. outflows of reinvested earnings from Europe), which would be important since a large part of US direct investment abroad is located in Europe.

4. The US balance of payments without 'reinvested earnings'

Since the item reinvested earnings is likely to be affected asymmetrically by the way it is computed, one should look at the US balance of payments in the traditional way, i.e. looking only at actual payment flows, leaving out reinvested earnings. Doing this has important consequences for both the flows (in particular the current account) and the stocks (the US international investment position).

4.1 The US current account without reinvested earnings

The asymmetry in recorded reinvested earnings noted above has one simple, immediate implication for the US current account. It is likely to be about 1% of GDP larger than the official data suggest. Since the difference between what US firms report on their direct investment abroad and what foreign firms report on their direct investment in the US is around 1% of US GDP, the US current account deficit must be this much higher than the official data suggest. Without reinvested earnings, the US current account deficit in 2004 would have been close to $800 billion (about 6.6% of GDP), instead of the officially recorded $670 billion (5.6% of GDP). The data on reinvested earnings are not yet available for 2005, but if foreign-owned

[7] See Landeveld & Lawson (1991).

FDI in the US has not changed, it is likely that the true deficit was probably in excess of $850 billion for 2005 as well, or significantly above 2% of GDP.

The fact that the official US current account does not show any substantial deficit under income flows has attracted a lot of attention. The US income account has not moved into deficit basically because the net return on FDI has been positive and increasing, thus offsetting the increasing net payments on bonds, on which the US has a very large debtor position. However, it has never been noted that most of the positive net income from FDI results from the huge difference in reported retained earnings. Table 1 below summarises the relevant gross flows. This table uses the average over longer periods because income flows tend to be variable from year to year. This table shows that more than one-half of the reported (gross) income from US direct investment abroad consists of retained earnings. By contrast, the (gross) income paid to the parents of firms with direct investment in the US consists almost entirely of distributed earnings.

On average over the last six years, the US has reported a *net* income from FDI of about $120 billion per annum.[8] Almost $100 billion p.a. of this is due to the difference in reported reinvested earnings and only about $25 billion to the difference in distributed earnings.

Table 1. Income on US direct investment abroad: Annual averages, 1999-2004 ($ billions)

	(1) Total reported profits	**(2) Distributed earnings**	**(3)=(1)-(2) Reinvested earnings**
From US direct investment abroad	158.4	54.9	103.4
From FDI in the US	-38.9	-32.0	-6.9
Net US income	119.5	22.9	96.5

Source: BEA.

Eliminating retained earnings from the US current account would thus reduce the surplus of the US on direct investment income by almost $100 billion per annum (from $119.5 to $22.9 billion, thus still leaving a small surplus). Given the deficit on portfolio investment, this implies that the US is in reality already now running a substantial deficit on the income account equivalent to almost 1% of US GDP.[9]

The apparently higher rate of return on US direct investment abroad has so far been just taken as a given. Instead of questioning the official data, it has usually just been taken as a fact that that US firms are simply smarter than their foreign counterparts. If one takes the official data on the value of FDI stocks (as of end 2003), one arrives at a total reported profit rate for direct investment in the US of around 1.5% versus close to 6% on US assets held abroad.

It bears emphasising that the adjustment for reinvested earnings still leaves US direct investment abroad with a substantially higher return than the one from foreign direct investment in the US because, as shown in Table 1, the US is still reporting higher distributed profits on its direct investment abroad than do foreign firms on their direct investment in the US. Over the last 20 years, the compound rate of increase in stock market prices in the US has been very similar (at 6.7% p.a.) to that of the important destination countries for direct investment from

[8] In 2005 this increased to $128 billion, but the precise split between retained earnings and dividend payments is not available yet for this year.

[9] As shown in more detail in BEA (2005), a switch between reinvested earnings to repatriated dividends (as occurred apparently during 2005) would also have other second-order implications for the current account, mainly through withholding taxes. But this would not materially change the results reported here.

the US (e.g. France: 7.6%, Germany: 6.6%, Japan: 6.1%, Netherlands: 7%, all *in USD terms*). Even without retained earnings, US direct investment abroad thus shows a higher overall rate of return given its higher rate of distributed earnings, but similar trend price appreciation.

Given the large difference in reported profits on FDI, it has even been suggested by some that this implies that US foreign investment assets must be worth much more than reported.[10] However, the assumption that US investors are simply smarter than foreigners who invest in the US is difficult to maintain given that for portfolio investment the rate of return foreigners earn on US assets is rather close to that earned by US investors on their foreign assets. Moreover, as argued above, it would be difficult to explain why foreigners would continue to invest hundreds of billions of USD in the US (as documented below) when they earn there only about one-quarter as much as US firms do abroad. It is usually assumed that markets are efficient, but the assumption that foreigners are continuously making large investments in the US while leaving much higher return investments in their home country to their smarter US counterparts seems rather far-fetched.

The importance of fiscal considerations on reported profit rates on FDI can be vividly illustrated by comparing the US data to those for Ireland, which is a very low tax rate jurisdiction: Foreign firms with direct investment in Ireland have over the last years reported profit rates of around 20% p.a., more than ten times higher than the profit rate reported by firms that have direct investment in the US.[11]

4.2 The US international investment position without reinvested earnings

The impact of the flows on the stocks is even larger because they have been going for so long. As mentioned above, reinvested earnings are not included in the income from direct investment abroad; they are also counted as increasing the value of US direct investment abroad (to 'balance' the accounts). Table 2 below shows the importance of this item as one of the key sources of increases in US FDI abroad since 1982.

The total increases in US FDI abroad reported in the US balance of payments over this 22-year period amount to close to $2,000 billion (approximately 20% of today's US GDP). However, over one-half of this ($1,111 billion) came from accounting entries, namely reinvested earnings. Fresh capital invested abroad amounted to 'only' $865 billion.

Table 2. US direct investment abroad: Financial flows of new capital vs. accounting entries ($ billions)

	1982-98	1999-2004	Sum 1982-2004
New capital committed	412	453	865
Total reported in BoP	903	1073	1976
Reinvested earnings (accounting entry)	491	620	1111

Source: Author's own calculations from BEA data.

[10] See Hausmann & Sturzenegger (2005). Their hypothesis, namely that the US has a source of unexplained (and unexplainable) gains (dark matter), is not considered here since it is not 'scientific', i.e. it cannot be falsified. See Cline (2005) for a similar observation.

[11] These profit rates are obtained by dividing the total reported return on FDI by the officially reported value of FDI at the end of the preceding period. By contrast, firms resident in Ireland report a profit rate of 'only' about 9% on their direct investment abroad, still much higher than that reported for the US.

By contrast, the sources of foreign direct investment in the US seem to be completely different as shown in Table 3. Over the same period, the overall amount is very similar ($1,937 billion), but retained earnings contributed very little (less than $20 billion). New capital flowing into the US was at $1,920 billion – almost twice as large as that invested by US firms abroad ($885 billion). This also better corresponds to the image of the US as a much more dynamic economy with more attractive profit opportunities (at least since the emergence of the 'new economy' in the mid-1990s).

Table 3. Foreign direct investment in the United States: Financial flows of new capital versus accounting entries ($ billions)

	1982-98	1999-2004	Sum 1982-2004
New capital committed	929	991	1920
Total reported in BoP	905	1032	1937
Reinvested earnings	-23	41	17

Source: Author's own calculations from BEA data.

As an aside, one can see from these tables that the average age of foreign direct investment in the US cannot be much different from that of US investment abroad. This supposed difference in age has often been cited as a possible cause for the apparently superior US investment performance. Between 1982 and 1999, foreign firms committed over $900 billion in fresh money (mostly equity, but also some proportion in debt), more than twice as much as US firms committed to direct investment abroad ($412 billion over this same period).[12]

Leaving out retained earnings from the balance of payments would thus fundamentally change the US position in terms of the FDI component of its international investment position, as shown in Table 4. Instead of having a net positive position, as officially reported, the US is a probably a large debtor, even in terms of FDI.

Table 4. A more realistic US FDI net position? ($ billion)

		2004 without retained earnings	
	Official data	Simply sum of flows, 1982-2004	Including past retained earnings adjusted for compound return
US direct investment abroad	3287	2175.4	1743.7
FDI in the US	2687	2669.4	2659.3
Net US position in FDI	600	-494.0	-915.7

Source: Author's own calculations from BEA data.

Table 4 starts from the latest BEA estimate of the US FDI position as of end 2004, which shows (at market value – which should already contain reinvested earnings, as argued above) US assets

[12] The (certain) numbers on actual equity capital flows can be used to calculate the rate of repatriated earnings. This can be done in the following way. The post-1998 annual averages (to iron out cyclical fluctuations) of repatriated profits reported in Table 1 can just be divided by the sum of the additional capital committed between 1982 and 1998 reported in Tables 2 and 3, augmented by the initial capital stock as of end-1981. For the direct investment in the US, this gives a stock as of 1999 equal to $412+$400=$812 billion. With reported repatriated earnings equal to about $60 billion p.a., this implies a rate of about 7.4% (=60/812). For foreign direct investment in the US, the stock as of 1999 should be 1090=930+160(stock as of end-1981) and the corresponding rate of repatriated profits would be around 3% (=32/1090), less than one-half the rate on US FDI abroad.

abroad worth approximately $3,300 billion, and foreign assets in the US approximately worth about $2,700 billion, with a net creditor position for the US of $600 billion as shown in the first column. The next column then subtracts from these values the sum of the reported flows of reinvested earnings over the last 20 years (reinvested earnings are not available before 1982). This yields a US debtor position in terms of FDI of around $500 billion for the simple reason that US firms have reported almost $1 trillion dollars of reinvested earnings over the past 20 years (thus reducing the estimate of the value of US direct investment abroad from $3,287 billion to $2,175 billion, whereas the value of foreign direct investment is not much affected since foreign firms report almost no reinvested earning).

However, this seems to be the lower bound of the adjustment one has to make because the current methodology also applies the market value adjustment to past retained earnings, whose impact on the reported US position thus increases dynamically over time. The last column in Table 4 therefore assumes that past retained earnings had the same compounded return as the one reflected in the ratio of the official data on the value of US FDI at market value and at current costs. If this is done, the US net debtor position in terms of FDI increases to over $900 billion, which is not far from what one would expect given that this is also the difference in the amount of funds committed over the last 20 years. Indeed a US net debtor position of around $900 billion is what one would immediately expect given that, as ascertained above, foreign firms committed about $900 billion more in funds to direct investment in the US than US firms invested abroad. If both sides had a similar return over this 20-year period, the outcome should be that the difference in the value should also be approximately $900 billion.[13] The annex shows that one arrives at a similar result by simply cumulating past flows.

5. Concluding remarks

This note has shown that reinvested earnings constitute a crucial item in the US balance of payments because foreign companies with direct investment in the US report essentially none of it, whereas US companies report very large amounts. It is likely that this difference does not reflect different abilities to generate returns from capital, but rather fiscal and regulatory considerations that affect the amount companies report as profits. Moreover, the use of both market price adjustment for FDI and reinvested earnings is likely to lead to substantial double counting in the return on FDI. In calculating the US balance of payments, it might thus be better to ignore retained earnings on both US direct investment abroad and foreign direct investment in the US. If this is done, the US current account deficit worsens by $120 billion because the income account goes into a sizeable deficit. Making this adjustment also for past years leads to the conclusion that the net US international investment position is at least $1 trillion worse than commonly believed. Table 5 summarises these findings.

Table 5. US 2004 data adjusted and unadjusted

	Current account		**Net international investment position**	
	$ billion	**% of GDP**	**$ billion**	**% of GDP**
Official data	668	5.6	2,484	21.2
Without retained earnings	788	6.6	4,000	34.1

Source: Author's own calculations from BEA data.

[13] In 1981, the US had, at current cost, a net creditor position of around $250 billion. But this cannot change the 2004 values substantially since this value (and the gross stocks in 1982, of $400 and $164 billion, respectively) are so small relative to the subsequent flows.

What are the implications of this new view of the US current account and its international investment position? A first implication is that the US investment position already seems rather precarious. With a current account deficit of over 6% of GDP during 2005, the US foreign debt-to-GDP ratio is likely to have reached 40% of GDP by the end of 2005 (this corresponds to a debt equivalent to about 500% of exports of goods!).

The fact that the US current account deficit is larger than officially measured immediately implies that the need for a dollar depreciation to attain a sustainable situation is even greater than generally perceived (and calculated, for example, by Obstfeld & Rogoff, 2005. For a survey of a number of papers dealing with this issue, see OECD, 2005).

A more accurate estimate of the value of US direct investment abroad also implies that the widely shared view that the US operates like a hedge fund, i.e. short on debt and long on equity, especially FDI, is simply wrong. The US has already reached a large debtor position in terms of FDI. This will increase the required USD depreciation because with US assets smaller by about 10% of GDP, the benefit for the net US position from a dollar depreciation (emphasised inter alia by Lane & Milesi-Ferretti, 2004) will also be much smaller.

Another implication of the correction of the asymmetry in reinvested earnings is that the US GDP is being overstated (relative to GNP) by about 1%, since the returns from US FDI abroad are overestimated relative to the returns foreign firms earn on their direct investment in the US.

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Annex

I. The asymmetry in reinvested earnings over the long run

The first two tables below provide longer-term data on earnings (= declared profits) on US direct investment abroad (A1) and on direct investment in the US (A2).

Table A1. Income on US direct investment abroad ($ billions)

	1982-98	1999-2004	Sum 1982-2004
Income with current-cost adjustment, before deduction of withholding taxes	1079.5	984.1	2063.6
Earnings	1081.9	950.1	2032.0
Distributed earnings	590.8	329.7	920.5
Reinvested earnings	491.1	620.5	1111.6

Source: BEA.

This table shows that the relative importance of reinvested earnings has increased over time. Over the last five years reinvested earnings were almost twice as large as distributed earnings, compared to the previous period (1982-98) during which distributed earnings were larger than reinvested earnings.

Table A2. Income from foreign direct investment in the United States ($ billions)

	1982-98	1999-2004	Sum 1982-2004
Income with current-cost adjustment, before deduction of withholding taxes	-233.6	-345.5	-579.1
Earnings	-131.3	-233.3	-364.6
Distributed earnings	-154.9	-192.1	-347.0
Reinvested earnings	23.6	-41.2	-17.6

Source: BEA.

This table shows that over the 17 years between 1982 and 1998 (thus before the bursting of the internet bubble), foreign direct investors in the US on average reported *negative* retained earnings. Over the last five years, retained earnings were at least positive, but very small at around $8 billion reported per annum.

II. Alternative calculation for the US net position in terms of FDI

An alternative way to estimate the net US position in FDI would consist of using the data on the stock of FDI in 1982 (end 1981) and simply adding the flows shown in Tables 2 and 3. Simply cumulating past flows leads to a US net debtor position of around $300 billion, as shown in Table A3 below.

Table A3. The US FDI net position at historical cost ($ billions)

		2004 calculated as of: End 1981 plus sum of flows 1982-2004	
	End 1981	**With retained earnings**	**Without retained earnings**
US direct investment abroad	407	2383	1272
Foreign direct investment in the US	-164	-2101	-2084
Net US position	243	282	-812

Source: Author's own calculations from BEA data.

Using these data, which could be called 'at historical cost', one arrives for end 2004 at US FDI assets of close to $2,400 billion (starting from the end 1981 stock) when including retained earnings in FDI flows. Reported foreign direct investment assets would amount to $2,101 million (using the same procedure). Summing simply past flows (including reinvested earning), the US would still be a net creditor in terms of FDI by around $300 billion. However, if one computes the flows of FDI without taking into account retained earnings (which should be contained in the market value adjustment as argued above), one arrives at a completely different picture: the value of US FDI abroad is now much lower, at less than $1,300 million, whereas the estimate of foreign direct investment in the US is not much changed by eliminating retained earnings from the estimated capital flows. The result is that the US then appears to have a substantial net debtor position in terms of FDI of more than $800 billion. This value is not far from the one arrived at in the main text.

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Place du Congrès 1 · B-1000 Brussels
Tel: (32.2) 229.39.11 · Fax: (32.2) 219.41.51
www.ceps.be · info@ceps.be