The Capital Kindness of Strangers

Foreign direct investment might not be recognized clinically as a cause of schizophrenia, but it should be economically. Everyone benefits from having someone invest in their country, in their company or in their career, and yet if that investor carries a different passport, the "no vacancy" signs start to sprout.

This certainly was the case when it was American corporations buying up European assets during the 1950s and 1960s; a French writer and politician Jean-Jacques Servan-Schreiber made a lot of hay, literally and figuratively, with his 1967 *Le Défi Américan* (The American Challenge) decrying how the barbarians were through the gates. The U.S. in turn feared an influx of Middle Eastern oil money in the 1970s, of Japanese investment in the 1980s, and most recently blocked China from acquiring Unocal and Dubai Ports World from taking over the management of a handful of port facilities.

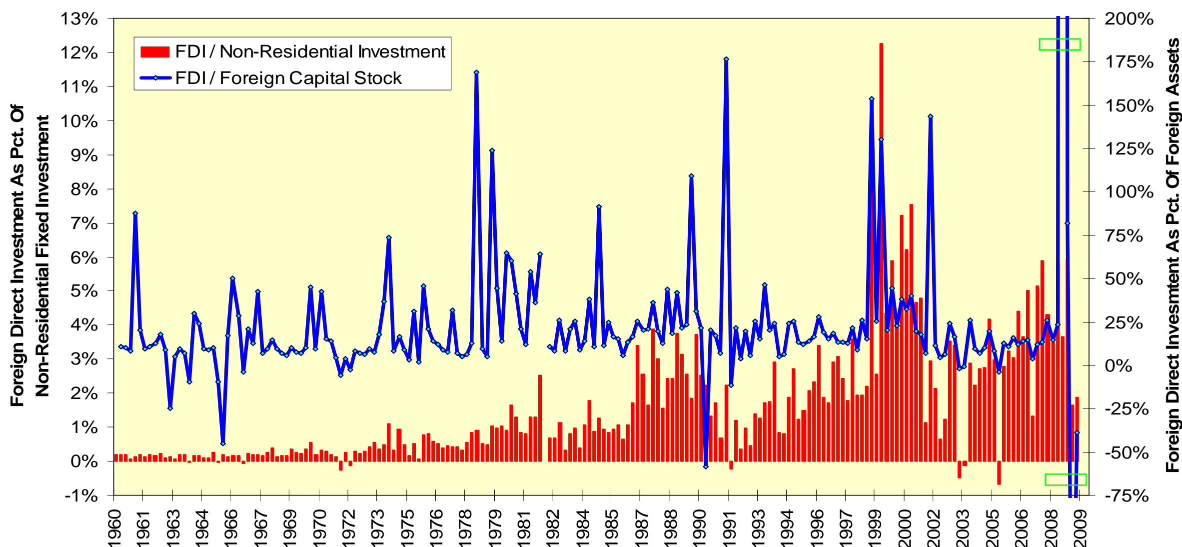
This is all so silly: Export-dependent economies with current account surpluses such as China, Japan, Taiwan and Korea must run corresponding capital account deficits. This is a simple national income accounting identity; the dollars earned from exports are claims on U.S. assets. As the dollar remains a reserve currency, our best efforts at ruining it notwithstanding, these claims might get exercised somewhere other than the U.S. first, but they eventually must be exercised in the U.S. More important, the U.S. has proven itself to be an inveterate debtor to the rest of the world and must receive those capital inflows in one form or another to finance its own consumption. This statement is made without value judgment.

These foreign capital inflows can come in one of two forms, portfolio investment such as bonds and equities or direct investment, such as plant and equipment. Portfolio investment is the easiest to execute; all you need is a industrial strength investment management team with scaled-up equipment and technology from what you, the reader, have already. Of course, this investment can leave instantly at the click of a mouse, as many emerging markets have discovered over the years to their sorrow and as the U.S. endured during the financial crisis of 2007-2009. Direct investment, therefore, is preferable. It not only is more enduring, but it creates real jobs and real ancillary support industries in a way portfolio investment and misguided government "stimulus" programs based on borrowing, taxation and monetary creation cannot.

The Investment Picture

The U.S. foreign direct investment picture seen in Chart 1 is negative. As a percentage of total non-residential fixed investment, the 1.9% total is below the post-1986 average of 2.9%; 1986 was chosen as the starting point here as this is when the U.S. engaged in direct intervention against its own currency. However, as percentage of foreign-owned assets at the end of the previous quarter it turned both negative and highly volatile in early 2009 as foreign investors sold assets and the denominator oscillated around zero.

Chart 1: Foreign Direct Investment In The United States

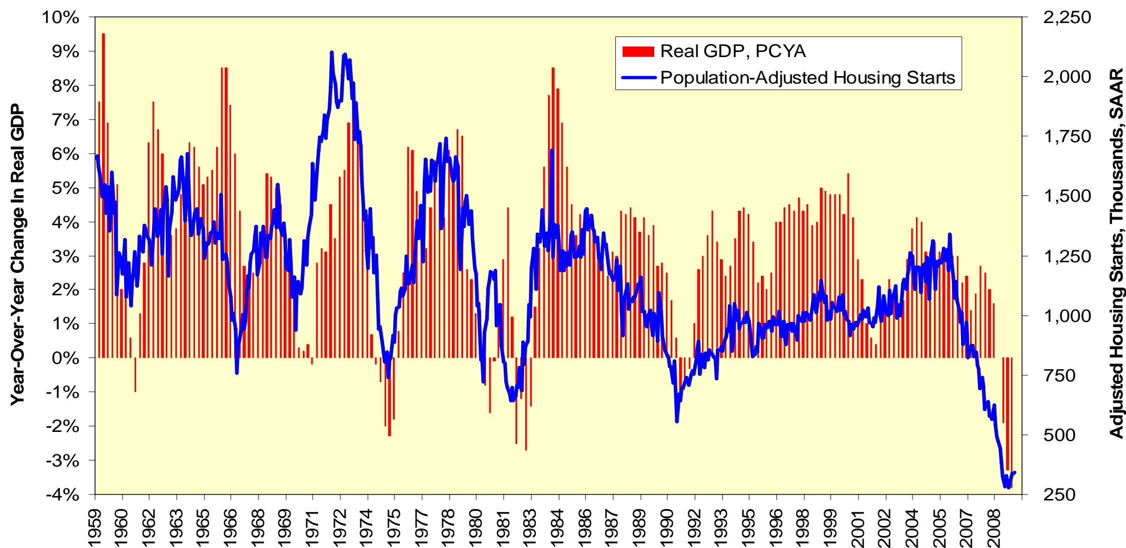


It is important to understand the money apparently lost during the credit crunch really was lost economically during the misallocation of investment capital during the boom years. Too much investment was allocated to residential construction and too little to non-residential fixed investment. The credit crunch simply forced the accounting.

As an aside, this is why the various Treasury and Federal Reserve programs are doomed to fail in the long run; lost in the din is past losses really are sunk costs and are not remediable. Efforts to pretend the losses are not real always involved throwing good money after bad, and when was the last time you found that to be a successful trading strategy?

Once the investment adjustment began, the requisite decline in housing starts adjusted for changes in population seen in Chart 2 compounded the recession. For this to have been otherwise, non-residential fixed investment would have had to have increased both to offset the decline in residential fixed investment and to the frictional costs always involved in any major economic transition.

Chart 2: Adjusted Housing Starts And GDP Growth

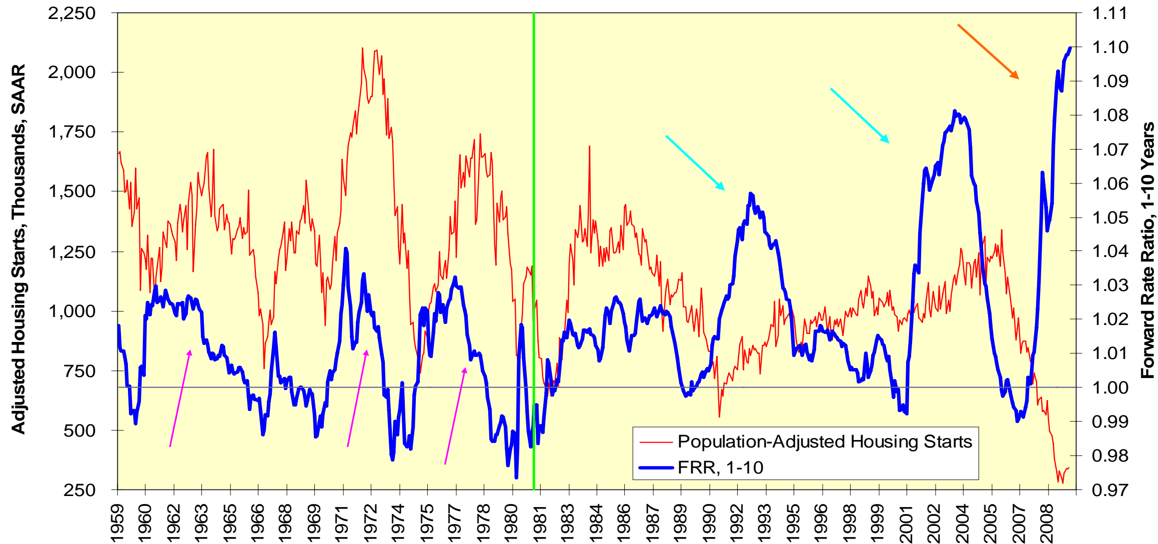


Monetary Policy Ineffective

The impossibility of eliminating sunk costs has not prevented the Federal Reserve from trying to do so, and with predictable consequences. Prior to 1980, a regulation on what banks and savings & loans could pay in interest meant the Federal Reserve could choke off the flow of funds to housing, automobiles and other interest rate-sensitive sectors by raising short-term interest rates over these ceilings. This "Regulation Q" was eliminated in the Depository Institution Decontrol Act of 1980; this law allowed lenders to get creative in maintaining the flow of credit to borrowers and to render the Federal Reserve ineffective. Between 1982 and 2007, we had but two small recessions, one related to the Persian Gulf War of 1990-1991 and the other to the dotcom bust of 2000; such is the value of neutering central bankers. Of course, we now know they caused greater damage through serial bubble inflation than they ever did with gratuitous rate increases, but that is a story for another day.

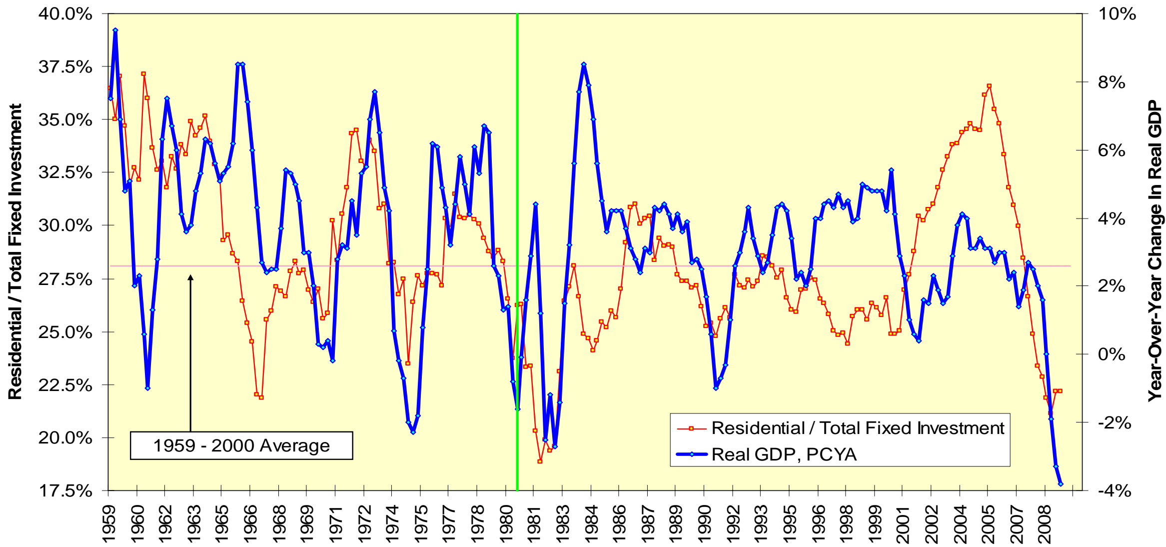
If we look at previous credit tightening episodes as measured by the forward rate ratio between one and ten years, the rate at which you could lock in borrowing for nine years starting one year from now, divided by the ten-year rate itself, you would see prior to the elimination of Regulation Q interest rate ceilings in 1980 (green line, here and in Chart 4) a pattern, marked with magenta arrows, of population-adjusted housing starts falling in response. After 1980, loosening of credit, marked with turquoise arrows, led to an increase in population-adjusted housing starts. The current episode, marked with an orange arrow in Chart 3, shows how a massive steepening of the yield curve has been met with a major decline in population-adjusted housing starts. Restated, monetary policy is ineffective in resuscitating housing.

Chart 3: Yield Curve Response To Housing



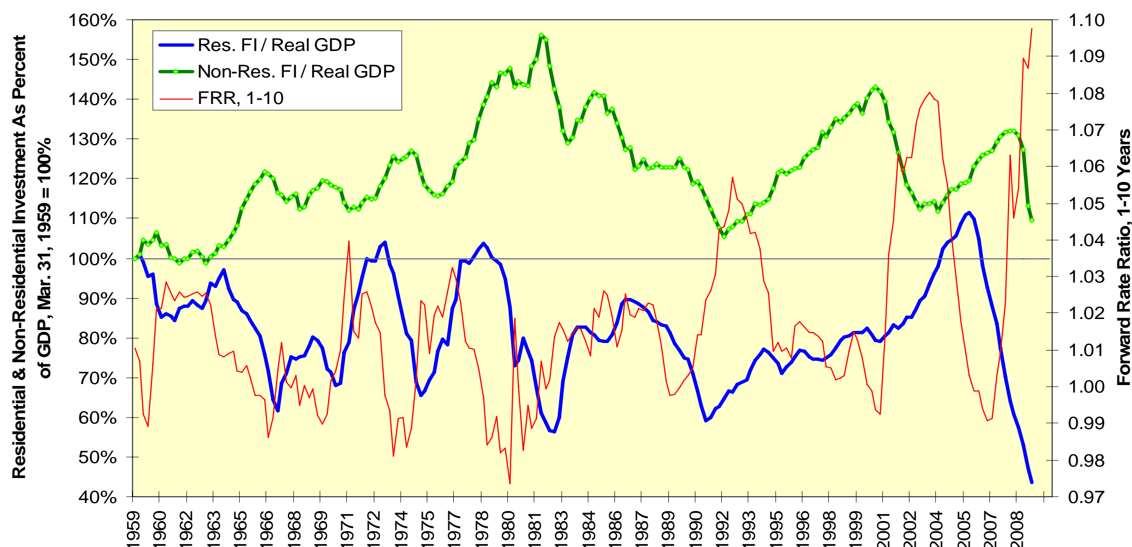
The importance of housing to GDP growth is greater than many believe. As can be seen in Chart A, the year-over-year changes in real GDP have tracked the share of residential fixed investment relative to total investment closely since Regulation Q was lifted. The 22.2% share of fixed investment claimed by residential construction is the lowest since the third quarter of 1982 and is well below the 1959-2000 average of 28.1%. This share bottomed in the fourth quarter of 1981 at 18.8%; real GDP did not turn higher until the first quarter of 1983, and that was during the very pro-growth Reagan administration. Even if we could repeat that turnaround, unlikely given the circumstances, the first quarter of 2010 would be the earliest when we should expect positive changes in real GDP.

Chart A: Housing Investment And GDP Growth



As noted above, all of this would change if non-residential fixed investment rose enough to offset the loss of residential fixed investment. This has not been the case even though non-residential fixed investment has been on the rise since the first quarter of 2005. As can be seen in Chart B, this measure is almost completely insensitive to monetary stimulus.

Chart B: Investment Patterns And The Yield Curve



A Simple Conclusion

Economic nationalists should ask themselves why the next dollar of fixed investment should be made in the U.S. as opposed to China or another low-cost producer in the dollar bloc. As the late Walter Wriston noted, capital goes to where it is welcomed and treated well, and the Chinese Communist party seems to be giving the alleged free market capitalists on this side of the Pacific Ocean a lesson in how that is done.

The real solution for redressing the global economic imbalance of Asian countries running massive trade surpluses and capital deficits is to increase Asian consumption and American non-residential investment. The dollars reinvested here would create jobs and real economic value here, and as the Japanese automakers have shown vis-à-vis Detroit, they can improve American productivity. The long-term growth of the United States in the 19th century was enabled by direct British investment. The time has come to repeat the experience.