

Underlying Determinants of Global Currency Usage

Kristin Forbes

MIT-Sloan School of Management

Peterson Institute for International Economics

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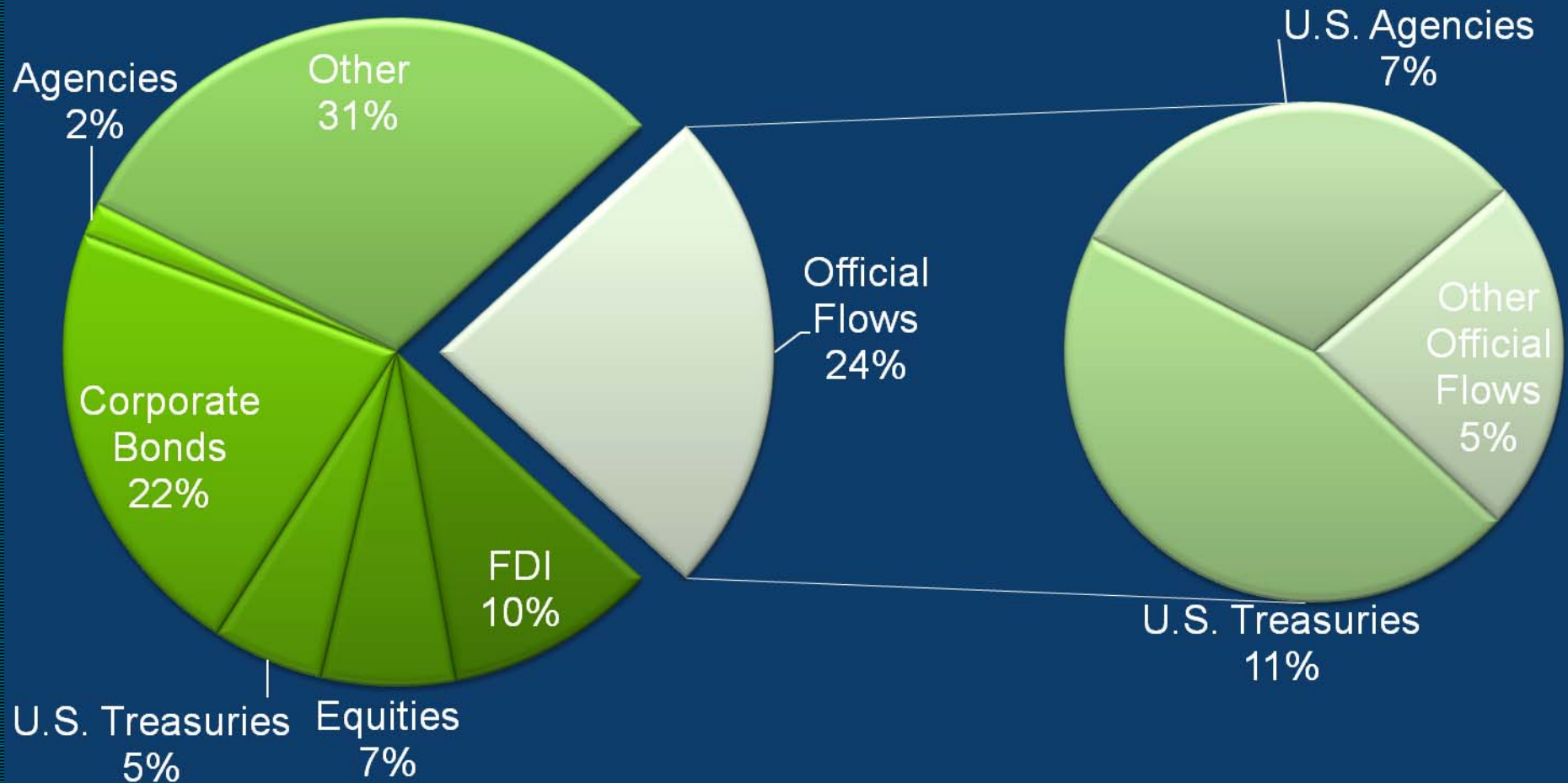
Motivation

- Many determinants of global currency usage
- My comments will focus on one: demand for a country's financial assets
- Three main topics:
 - Insatiable demand for investment in US
 - Determinants of foreign investment in US
 - Lessons for investment in Euro zone

Insatiable Demand for US Assets

- In 2007, \$2.1 trillion of gross capital flows into the United States (BEA)
 - Funded U.S. gross capital outflows of \$1.3 trillion and U.S. current account deficit of \$731 billion
 - \$7.8 trillion in total gross capital inflows into U.S from 2003-2007
 - Over \$5bn per day
- Even after subprime crisis, capital inflows continued
 - \$411 bn in 1Q 08 (versus \$693 bn in 1Q07)
- This demand for financial assets is a key driver of demand for the US\$

U.S. Foreign Capital Inflows: 2003-7



Based on data from Bureau of Economic Analysis, *Survey of Current Business* (July 2008), U.S. International Transactions table.

Share Foreign Holdings (June 2007)

	Equity	U.S. Treasuries	Agencies	Corporate Debt	Total
Outstanding Total (bn)	\$27,768	\$3,454	\$6,105	\$11,391	\$48,718
% Foreign Owned	11.3%	56.9%	21.4%	24.0%	18.8%

Source: UST, June 2008.

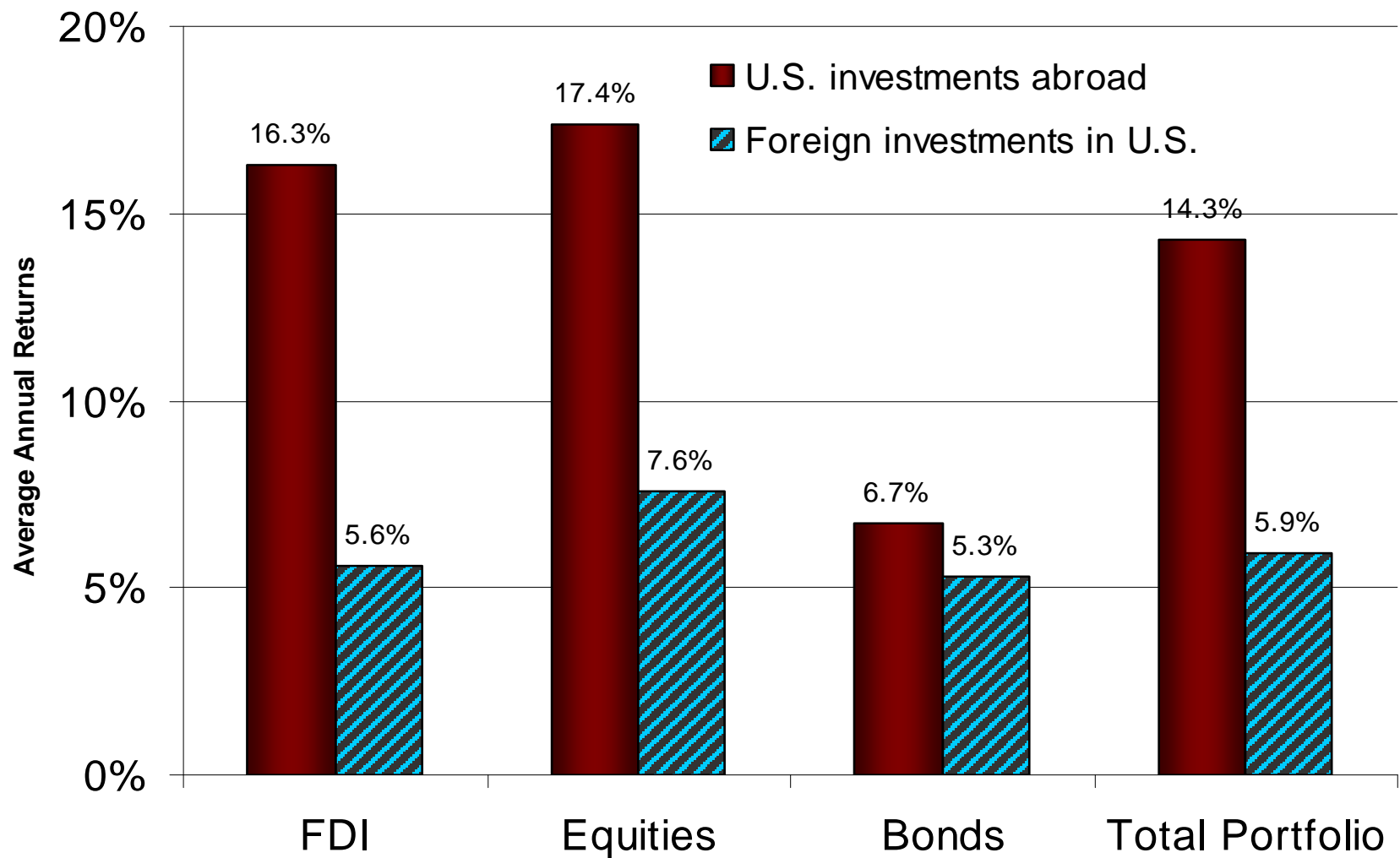
Note: U.S. Treasuries are Marketable Treasuries and exclude Central bank holdings.

Determinants of Investment: I

- Do foreigners earn high returns on their US investments?
- U.S. Treasury Secretaries—argue the US is an attractive place for foreign investment
 - Treasury Secretary Paulson: “We have deep and liquid capital markets and a growing economy that provides opportunities for foreign investors to earn an attractive return on their capital.” (3/1/07)
 - Former Treasury Secretary John W. Snow: “Today we are in a situation where sound, growth-enhancing policies in the United States have made it an extremely attractive place to invest.” (11/17/04)
- History of high returns would support continued capital inflows
 - Academic evidence that investors chase returns

Returns on Private Sector Investment

(in %; 2002-6)



Determinants of Investment II

- Reduction in home bias and standard diversification of risks
 - But are countries over- or under-weight the United States?
 - Compare share of foreign investment in the US versus the global market portfolio weight
- 

Country Exposure to U.S.

	Equities	Debt
Global Market Share	35.8%	38.2%
Mean	4.3%	11.8%
Median	1.3%	7.0%
Minimum	0.0%	0.0%
Maximum	27.8%	62.8%
# countries	82	53

Notes: Based on analysis in Forbes (2008). Debt includes corporate, government and agency debt. Foreign holdings include foreign official holdings.

Potential Factors Driving US Capital Inflows

Demand for U.S. Investments

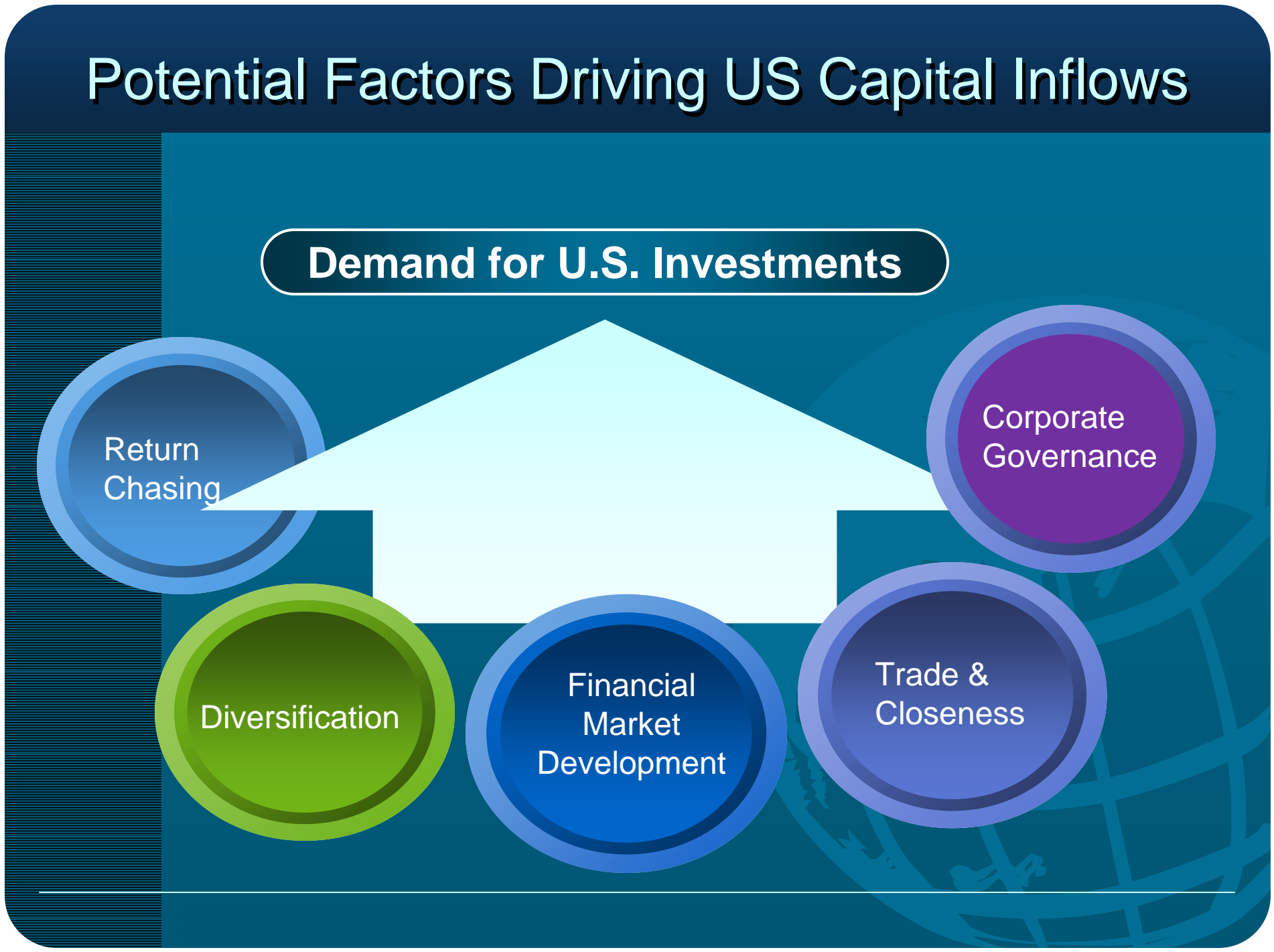
Return
Chasing

Corporate
Governance

Diversification

Financial
Market
Development

Trade &
Closeness



Results of Formal Analysis I

- Forbes (2008), “Why do Foreigners Invest in the United States?”, NBER WP #13908
- Key factor driving foreign investment in US: **Financial market development**
 - Countries hoped to take advantage of the more developed, liquid and efficient US financial markets
 - China example: Held \$894 bn in US bonds at end 2007
 - if China increased its private bond market capitalization/GDP to the level of South Korea, estimates suggest China’s holdings of US bonds fall by about \$250 billion

Potential Factors Driving US Capital Inflows

Demand for U.S. Investments

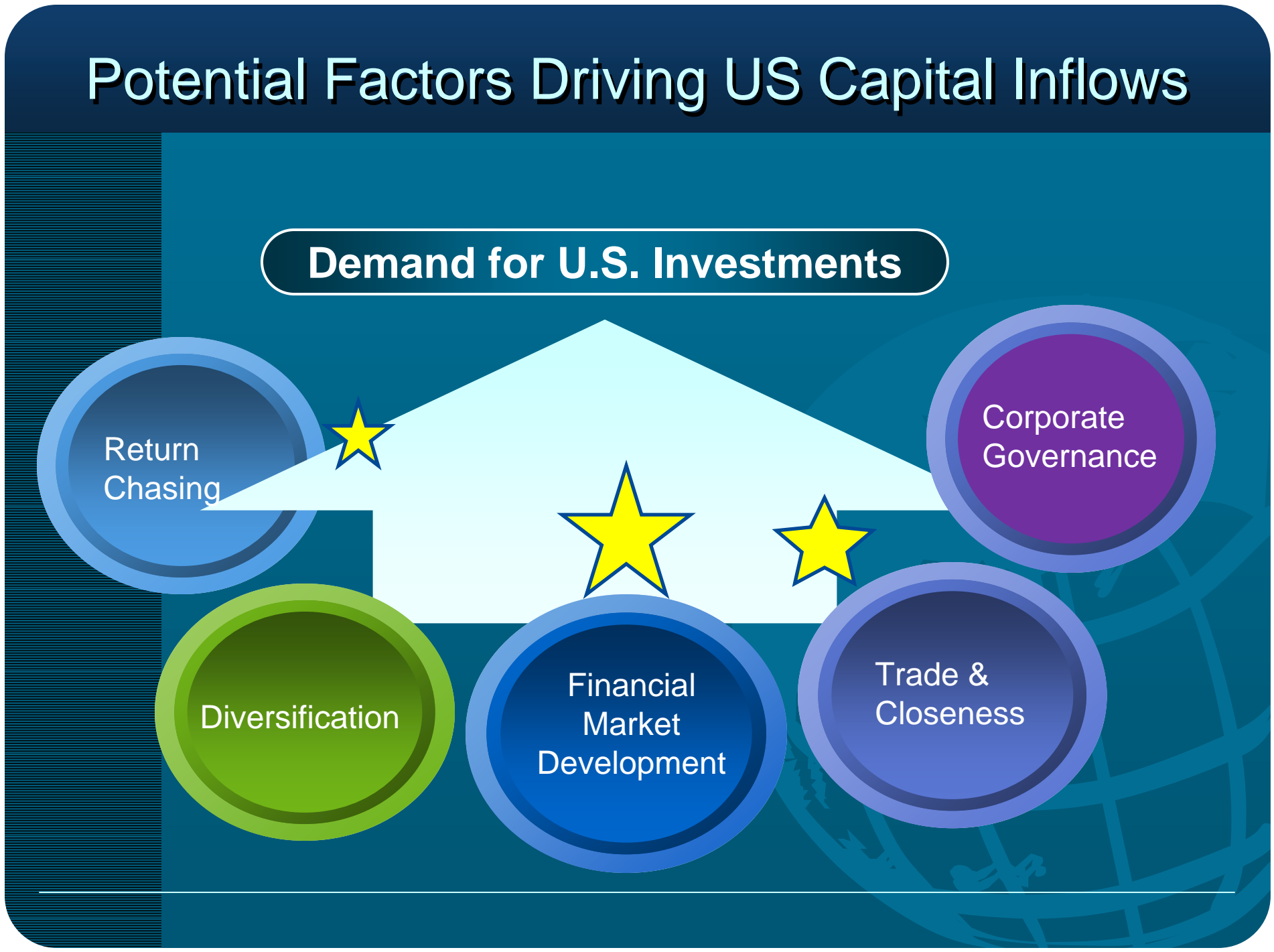
Return Chasing

Diversification

Financial Market Development

Trade & Closeness

Corporate Governance



Implications for Euro

- Financial market development
 - Euro bond markets closing gap with dollar markets in size
 - But equity market capitalization of euro zone roughly $\frac{1}{2}$ of U.S.
 - Implications of current crisis?
 - Trade and closeness
 - Hard to see major changes
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Implications for the Euro

- Role of return chasing
 - May have played some moderate role in increasing demand for euro equitiesuntil recently.....

	1/1/06-1/1/08	2008 YTD (10/06)
Eurofirst 300	+25.8%	-31.0%
S&P 500	+22.2%	-28.0%

- Reduction in home bias/diversification motives not important
 - Exposure to European markets already much closer to market portfolio weights

Country Exposure to U.S. & Europe

		Global Mkt Wt	Mean	% Global Mkt Wt
France	Equity	4.5%	1.3%	28.3%
	Debt	4.9%	2.0%	41.5%
Germany	Equity	3.0%	1.0%	33.6%
	Debt	5.9%	4.2%	71.7%
<i>U.S.</i>	<i>Equity</i>	<i>35.8%</i>	<i>4.8%</i>	<i>13.5%</i>
	<i>Debt</i>	<i>38.2%</i>	<i>9.5%</i>	<i>24.9%</i>

Notes: Based on analysis in Forbes (2008). Data for year end 2006. Debt includes corporate, government and agency debt. Foreign holdings include foreign official holdings.

Bottom Line

- How Europe's financial markets emerge from the current crisis will be a key determinant of future investment demand for the euro
 - Size, liquidity, efficiency
 - Important role for policymakers to show this is “one market”, not a collection of smaller markets with different regulations, backstops, etc.