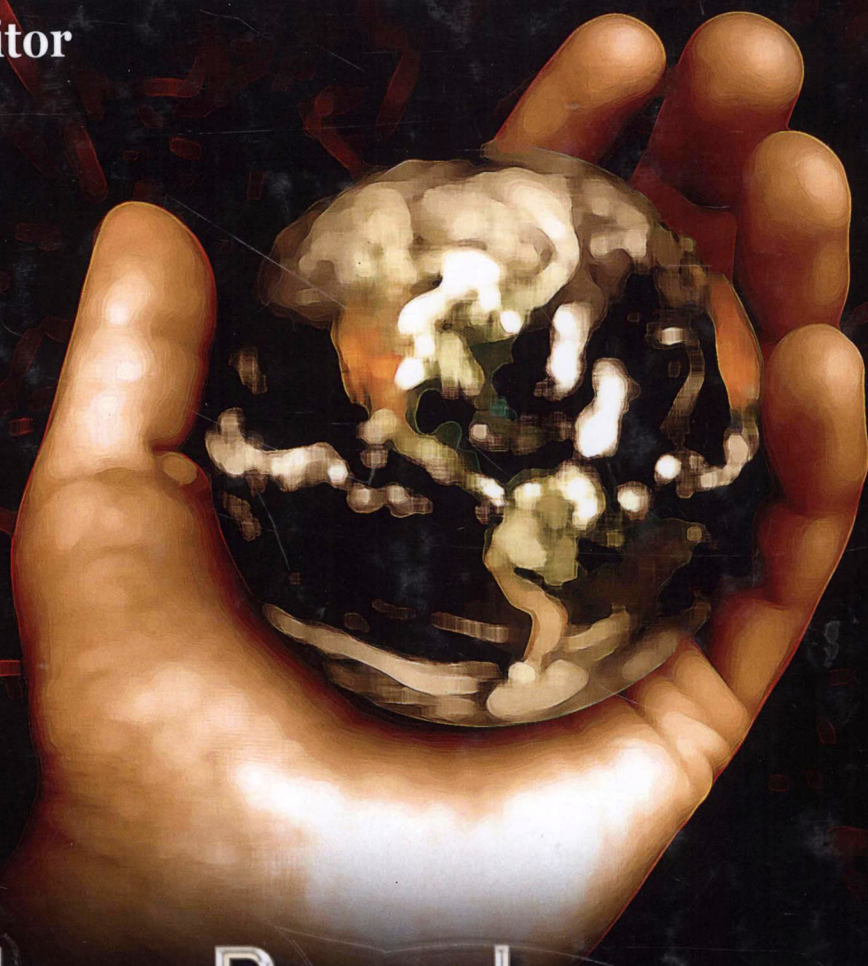


Andreo Lamorena  
Editor



# New Developments in Globalization

*Agreements and Negotiations*

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Global Economic Studies

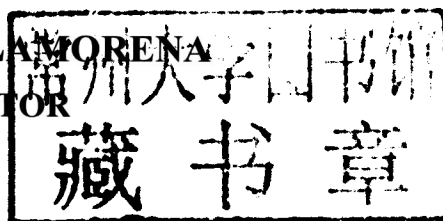
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NOVA

GLOBAL ECONOMIC STUDIES

**NEW DEVELOPMENTS  
IN GLOBALIZATION  
AGREEMENTS AND NEGOTIATIONS**

**ANDREO LAMORENA**  
**EDITOR**



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*New York*

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## **PREFACE**

This book presents current research findings in the study of globalization. Topics discussed include foreign investment in U.S. securities; dispute settlement in the World Trade Organization (WTO); the Overseas Private Investment Corporation; the Trans-Pacific Strategic Economic Partnership Agreement; transatlantic regulatory cooperation; nuclear cooperation with other countries; status of the Copenhagen climate change negotiations; changes in the arctic and trafficking in persons.

Chapter 1- Foreign capital inflows are playing an important role in the U.S. economy by bridging the gap between domestic supplies of and demand for capital. In 2008, as the financial crisis and global economic downturn unfolded, foreign investors looked to U.S. Treasury securities as a “safe haven” investment, while they sharply reduced their net purchases of corporate stocks and bonds. In the first two quarters of 2009, foreign capital inflows dropped sharply, reflecting an increase in savings by households and businesses and a continued decrease in U.S. liabilities to foreigners reported by U.S. banks and securities firms. Foreign investors now hold more than 50% of the publicly held and traded U.S. Treasury securities. The large foreign accumulation of U.S. securities has spurred some observers to argue that this large foreign presence in U.S. financial markets increases the risk of a financial crisis, whether as a result of the uncoordinated actions of market participants or by a coordinated withdrawal from U.S. financial markets by foreign investors for economic or political reasons.

Chapter 2- From its inception in 1947, the General Agreement on Tariffs and Trade (GATT), signed by the United States and ultimately by a total of 128 countries, provided for consultations and dispute resolution, allowing a GATT Party to invoke GATT dispute settlement articles if it believes that another Party’s measure, whether violative of the GATT or not, caused it trade injury. Because the GATT did not set out a dispute procedure with great specificity, GATT Parties developed a more detailed process including ad hoc panels and other practices. The procedure was perceived to have certain deficiencies, however, among them a lack of deadlines, a consensus decision-making process that allowed a GATT Party against whom a dispute was filed to block the establishment of a dispute panel and the adoption of a panel report by the GATT Parties as a whole, and laxity in surveillance and implementation of panel reports even when reports were adopted and had the status of an official GATT decision.

Chapter 3- The Overseas Private Investment Corporation (OPIC) was established in 1969 and began operations in 1971 as a development agency to promote and assist U.S. business

investment in developing nations. Today, OPIC is a U.S. government agency that provides project financing, investment insurance, and other services for U.S. businesses in over 150 developing nations and emerging economies. To date, OPIC has funded, guaranteed, or insured over \$180 billion in investments.

Chapter 4- The economic and strategic architectures of Asia are evolving. One part of this evolving architecture is the Trans-Pacific Strategic Economic Partnership Agreement (TPP), a free trade agreement that includes nations on both sides of the Pacific. The TPP, which originally came into effect in 2006, currently includes Brunei, Chile, New Zealand, and Singapore. The United States, Australia, Peru, and Vietnam have also expressed interest in joining. On November 14, 2009, President Obama committed to engage with current and potential future members of the TPP to shape a broad-based regional agreement.

Chapter 5- The United States and the European Union (EU) share a comprehensive, dynamic, and mutually beneficial economic relationship. Transatlantic markets are among the most open in the world and are deeply integrated. Although the global economic crisis has had a significant negative impact on the transatlantic economy, the great stake each side has had in the other's economy has afforded both sides the ability to withstand the worst of each other's current economic downturn. The key measure of the strength of the transatlantic relationship has been the ability of both sides to work with each other to weather the financial storm.

Chapter 6- A comprehensive nuclear-test-ban treaty (CTBT) is the oldest item on the nuclear arms control agenda. Three treaties currently bar all but underground tests with a maximum force equal to 150,000 tons of TNT. The Natural Resources Defense Council states the United States conducted 1,030 nuclear tests, the Soviet Union 715, the United Kingdom 45, France 210, and China 45. The last U.S. test was held in 1992; Russia claims it has not tested since 1990. In 1998, India and Pakistan announced several nuclear tests. Each declared a test moratorium; neither has signed the CTBT. North Korea conducted a nuclear test in 2006.

Since 1997, the United States has held 23 "subcritical experiments" at the Nevada Test Site to study how plutonium behaves under pressures generated by explosives. It asserts these experiments do not violate the CTBT because they cannot produce a self-sustaining chain reaction. Russia reportedly held some since 1998.

Chapter 7- In order for the United States to engage in civilian nuclear cooperation with other states, it must conclude a framework agreement that meets specific requirements under section 123 of the Atomic Energy Act (AEA). The AEA also provides for exemptions to these requirements, export control licensing procedures, and criteria for terminating cooperation. Congressional review is required for section 123 agreements; the AEA establishes special parliamentary procedures by which Congress may act on a proposed agreement.

Chapter 8- The United States and almost 200 other countries are negotiating under the United Nations Framework Convention on Climate Change (UNFCCC) to address climate change cooperatively [1] beyond the year 2012. Parties agreed to complete those negotiations by the 15th meeting of the Conference of the Parties (COP-15), held December 7-18, 2009, in Copenhagen. President Obama and leaders of many other nations are attending, hoping to produce "a comprehensive and operational accord." [2] Rather than a new treaty containing quantitative, legally binding GHG obligations, many predict the outcome will be a political mandate for pursuit of a later, more inclusive and enforceable agreement.

Chapter 9- Under the 2007 “Bali Action Plan,” countries around the globe sought to reach a “Copenhagen agreement” in December 2009 on effective, feasible, and fair actions beyond 2012 to address risks of climate change driven by human-related emissions of greenhouse gases (GHG). The Copenhagen conference was beset by strong differences among countries, however, and (beyond technical decisions) achieved only mandates to continue negotiating toward the next Conference of the Parties (COP) to be held in Mexico City in December 2010. The COP also “took note of” (not adopting) a “Copenhagen Accord,” agreed among the United States and additional countries (notably including China), which reflects compromises on some key actions.

Chapter 10- The diminishment of Arctic sea ice has led to increased human activities in the Arctic, and has heightened concerns about the region’s future. The United States, by virtue of Alaska, is an Arctic country and has substantial interests in the region. On January 12, 2009, the George W. Bush Administration released a presidential directive, called National Security Presidential Directive 66/Homeland Security Presidential Directive 25 (NSPD 66/HSPD 25), establishing a new U.S. policy for the Arctic region.

Chapter 11- Trafficking in persons (TIP) for the purposes of exploitation is believed to be one of the most prolific areas of international criminal activity and is of significant concern to the United States and the international community. The overwhelming majority of those trafficked are women and children. According to Department of State estimates, roughly 800,000 people are trafficked across borders each year. If trafficking within countries is included in the total world figures, official U.S. estimates are that some 2 to 4 million people are trafficked annually. However, there are even higher estimates, ranging from 4 to 27 million for total numbers of forced or bonded laborers. As many as 17,500 people are believed to be trafficked to the United States each year. Human trafficking is now a leading source of profits for organized crime syndicates, together with drugs and weapons, generating billions of dollars. TIP affects virtually every country in the world.

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## *Chapter 1*

# **FOREIGN INVESTMENT IN U.S. SECURITIES**

*James K. Jackson*

## **ABSTRACT**

Foreign capital inflows are playing an important role in the U.S. economy by bridging the gap between domestic supplies of and demand for capital. In 2008, as the financial crisis and global economic downturn unfolded, foreign investors looked to U.S. Treasury securities as a “safe haven” investment, while they sharply reduced their net purchases of corporate stocks and bonds. In the first two quarters of 2009, foreign capital inflows dropped sharply, reflecting an increase in savings by households and businesses and a continued decrease in U.S. liabilities to foreigners reported by U.S. banks and securities firms. Foreign investors now hold more than 50% of the publicly held and traded U.S. Treasury securities. The large foreign accumulation of U.S. securities has spurred some observers to argue that this large foreign presence in U.S. financial markets increases the risk of a financial crisis, whether as a result of the uncoordinated actions of market participants or by a coordinated withdrawal from U.S. financial markets by foreign investors for economic or political reasons.

Congress likely would find itself embroiled in any such financial crisis through its direct role in conducting fiscal policy and in its indirect role in the conduct of monetary policy through its supervisory responsibility over the Federal Reserve. Such a coordinated withdrawal seems highly unlikely, particularly since the vast majority of the investors are private entities that presumably would find it difficult to coordinate a withdrawal. The financial crisis and economic downturn, however, have sharply reduced the value of the assets foreign investors acquired, which may make them more hesitant in the future to invest in certain types of securities. As a result of the financial crisis of 2008, foreign investors curtailed their purchases of corporate securities, a phenomenon that was not unique to the United States. In a sense, the slowdown in the U.S. economy and rise in personal savings have eased somewhat the need for foreign investment. The importance of capital inflows may well change as the federal government’s budget deficits rise over the course of the economic downturn.. This chapter analyzes the extent of foreign portfolio investment in the U.S. economy and assesses the economic conditions that are attracting such investment and the impact such investments are having on the economy.

Economists generally attribute this rise in foreign investment to a number of factors, including “safe haven” investment during times of uncertainty; comparatively favorable

returns on investments, a surplus of saving in other areas of the world, the well-developed U.S. financial system, and the overall stability and rate of growth of the U.S. economy. Capital inflows also allow the United States to finance its trade deficit because foreigners are willing to lend to the United States in the form of exchanging the sale of goods, represented by U.S. imports, for such U.S. assets as U.S. businesses and real estate, stocks, bonds, and U.S. Treasury securities. Despite improvements in capital mobility, foreign capital inflows do not fully replace or compensate for a lack of domestic sources of capital. Economic analysis shows that a nation's rate of capital formation, or domestic investment, seems to have been linked primarily to its domestic rate of saving.

This chapter relies on a comprehensive set of data on capital flows, represented by purchases and sales of U.S. government securities and U.S. and foreign corporate stocks, bonds, into and out of the United States, that is reported by the Treasury Department on a monthly basis.

Foreign capital inflows play an important role in the U.S. economy by bridging the gap between domestic supplies of and demand for capital. The importance of these flows has been underscored by the financial crisis in 2008, when international capital markets essentially shut down for a period of time. International capital flows and international capital markets also generally give the owners of capital the ability to reduce their risk by diversifying their investments. Oversight of these markets likely will change as a result of the financial crisis. Foreign investors currently own more than 50% of the publicly held and traded U.S. Treasury securities and hold large amounts of U.S. corporate stocks and bonds, although the value of these assets has dropped markedly. Capital inflows help keep U.S. interest rates below the level they would reach without them and have allowed the nation to spend beyond its current output, including financing its trade deficit. Some observers have expressed concerns about the extent of these foreign holdings, because they argue that this exposure increases the overall risks to the economy should foreign investors decide to withdraw from the U.S. financial markets for political or economic reasons. At the same time, the funding requirements of the U.S. economy may temper the criticism of some foreign investors, especially if capital flows should shrink and U.S. funding requirements increase.

Inflows of capital into the U.S. economy are not new, although they grew sporadically over the last decade, as indicated in Table 1. By 2007, before the global economic recession, total foreign capital inflows to the United States reached over \$2 trillion.

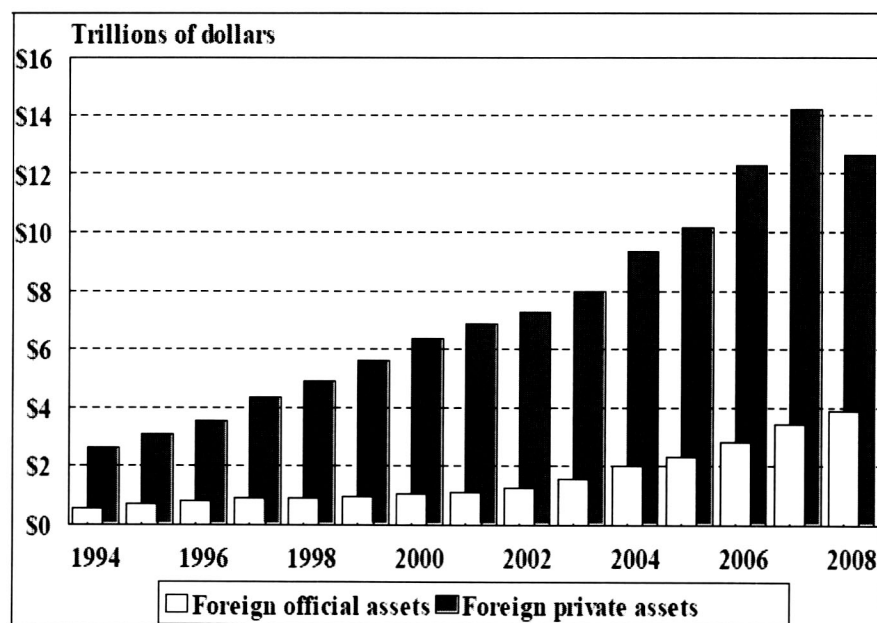
As Figure 1 shows, these capital inflows are comprised of official inflows, primarily foreign governments' purchases of U.S. Treasury securities, and private inflows comprised of portfolio investment, which includes foreigners' purchases of U.S. Treasury and corporate securities, and financial liabilities, and direct investment in U.S. businesses and real estate. By 2008, total foreign capital inflows totaled about \$600 billion, or down by two-thirds from 2007. Such inflows were reduced in the first and second quarters of 2009, reflecting the sharp slowdown in the rate of economic growth and reduced demands for foreign capital in the economy. Private capital inflows, which generally comprise more than three-fourths of the total capital inflows, fell to about \$177 billion, down nearly tenfold from the \$1.6 trillion they accounted for in 2007 as foreign investors pared back their holdings of corporate securities. In 2008, official inflows offset the large net outflows by private investors. Other private capital inflows are associated with U.S. liabilities to foreigners reported by U.S. banks and securities firms. These accounts registered a decrease for the fifth consecutive quarter in the second

quarter of 2009, mostly as a result of a large reduction in foreign banks' deposits at banks in the United States.

**Table 1. Capital Inflows of the United States, 1996-2009 (in billions of dollars)**

Total		Official assets	Total	Direct investment	Treasury securities	Corporate securities	U.S. currency	Other
1996	\$551.1	\$126.7	\$424.4	\$86.5	\$147.0	\$103.3	\$17.4	\$70.2
1997	706.8	19.0	687.8	105.6	130.4	161.4	24.8	265.5
1998	423.6	-19.9	443.5	179.0	28.6	156.3	16.6	62.9
1999	740.2	43.5	696.7	289.4	-44.5	298.8	22.4	130.5
2000	1,046.9	42.8	1,004.1	321.3	-70.0	459.9	5.3	287.6
2001	782.9	28.1	754.8	167.0	-14.4	393.9	23.8	184.5
2002	768.2	114.0	654.3	72.4	100.4	285.5	21.5	174.4
2003	829.2	248.6	580.6	39.9	113.4	251.0	16.6	159.7
2004	1,440.1	394.7	1,045.4	106.8	107.0	369.8	14.8	477.0
2005	1,204.2	259.3	995.0	109.0	132.3	450.4	19.0	234.3
2006	1,859.6	440.3	1,419.3	180.6	-35.9	592.0	12.6	670.2
2007	2,057.7	411.1	1,646.6	237.5	156.8	573.9	-10.7	689.1
2008	599.0	411.1	177.7	325.3	307.6	-123.6	35.0	-367.0
2009-I	-68.8	70.9	-139.7	22.8	53.7	-56.0	11.8	-172.0
2009-II	18.6	125.0	-106.4	28.3	-22.7	14.2	-2.0	-124.2

Source: Weinberg, Douglas B., U.S. International Transactions, Second Quarter of 2009, Survey of Current Business, October, 2009. p. 74.



Source: Department of Commerce.

Figure 1. Foreign Official and Private Capital Inflows to the United States, 1994-2008.

Capital flows are highly liquid, can respond abruptly to changes in economic and financial conditions, and exercise a primary influence on exchange rates and through those on global flows of goods and services. Economists generally attribute recent rise and fall in foreign investment to a number of factors, including a “safe haven” effect during times of uncertainty; comparatively favorable returns on investments relative to risk, a surplus of saving in other areas of the world, the well-developed U.S. financial system, and the overall stability of the U.S. economy. Net capital inflows (inflows net of outflows) bridge the gap in the United States between the amount of credit demanded and the domestic supply of funds, likely help keep U.S. interest rates below the level they likely would reach without the foreign capital. These capital inflows also allow the United States to spend beyond its means, including financing its trade deficit, because foreigners are willing to lend to the United States in the form of exchanging goods, represented by U.S. imports, for such U.S. assets as stocks, bonds, and U.S. Treasury securities.

## **CAPITAL FLOWS IN THE ECONOMY**

Table 2 shows the net flow of funds in the U.S. economy. The flow of funds accounts measure financial flows across sectors of the economy, tracking funds as they move from those sectors that supply the sources of capital through intermediaries to sectors that use the capital to acquire physical and financial assets [1]. The net flows show the overall financial position by sector, whether that sector is a net supplier or a net user of financial capital in the economy. Since the demand for funds in the economy as a whole must equal the supply of funds, a deficit in one sector must be offset by a surplus in another sector. Generally, the household sector, or individuals, provides funds to the economy, because individuals save part of their income, while the business sector uses those funds to invest in plant and equipment that, in turn, serve as the building blocks for the production of additional goods and services. The Government sector (the combination of federal, state, and local governments) can be either a net supplier of funds or a net user depending on whether the sector is running a surplus or a deficit, respectively. The interplay within the economy between saving and investment, or the supply and uses of funds, tends to affect domestic interest rates, which move to equate the demand and supply of funds. Shifts in the interest rate also tend to attract capital from abroad, denoted by the rest of the world (ROW) in Table 2.

As Table 2 indicates, from 1996 through 1998, the household sector ran a net surplus, or provided net savings to the economy. The business sector also provided net surplus funds in 1996, or businesses earned more in profits than they invested. The government sector, primarily the federal government, experienced net deficits, which decreased until 1998, when the federal government and state and local governments experienced financial surpluses. Capital inflows from the rest of the world rose and fell during this period, depending on the combination of household saving, business sector saving and investment, and the extent of the deficit or surplus in the government sector.

Starting in 1999, the household sector began dissaving, as individuals spent more than they earned. Part of this dissaving was offset by the government sector, which experienced a surplus from 1998 to 2001.



**Table 2. Flow of Funds of the U.S. Economy, 1996-2009 (in billions of dollars)**

Year	Households	Businesses	Government			
			Total	State and Local	Federal	ROW
1996	175.2	19.8	-196.8	-1.2	-195.6	137.9
1997	47.4	-18.3	-116.6	-47.5	-69.1	219.6
1998	128.0	-45.7	64.8	48.8	16.0	75.0
1999	-132.7	-62.6	115.3	9.9	105.4	231.7
2000	-371.0	-82.9	252.5	54.5	198.0	476.3
2001	-494.4	-82.9	233.4	35.4	198.0	485.4
2002	-304.0	8.7	-382.6	-95.6	-287.0	501.7
2003	-79.3	30.3	-546.3	-70.2	-476.4	529.4
2004	-52.4	121.9	-469.3	-32.8	-436.5	533.7
2005	-448.1	-27.2	-372.9	7.6	-380.5	712.1
2006	-530.0	-185.4	-244.2	10.4	-254.6	805.2
2007	130.0	-231.4	-392.4	-54.7	-337.7	661.7
2008	713.3	-152.4	-833.1	-99.9	-733.2	506.0
2008 I	503.5	-234.5	-620.7	-123.3	-497.4	663.8
2008 II	1148.3	-266.2	-678.3	-107.8	-570.5	425.2
2008 III	744.1	-87.8	-964.1	-118.4	-845.7	584.4
2008 IV	457.4	-20.9	-1069.0	-50.0	-1019.0	350.6
2009 I	581.9	61.9	-1172.7	-110.7	-1062.0	138.7
2009 II	425.8	153.8	-1655.6	-98.4	-1557.2	230.3

Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States, Flows and Outstandings Second Quarter 2009, September 17, 2009.

As a result of the large household dissaving, however, the economy as a whole experienced a gap between domestic saving and investment that was filled with large capital inflows. Those inflows were particularly large in nominal terms from 2000 to 2006 as household dissaving continued and government sector surpluses turned to historically large deficits in nominal terms.

Capital inflows in 2008 were \$506 billion, about \$160 billion less than that recorded in 2007. This drop in capital inflows reflected a sharp reversal in the behavior of households from dissaving to saving, an increase in business sector dissaving, and an increase in the deficits experienced by state and local governments as the effects of the slowdown in the economy became more pronounced. Households turned from a dissaving of \$530 billion in 2006 to a net saving of \$700 billion in 2008, reflecting tight credit conditions and concern among households over the state of the economy. The Federal Reserve reported that in 2008, households experienced a drop in their net worth of more than \$11 trillion, or about 20% [2].

Foreign capital inflows augment domestic U.S. sources of capital, which, in turn, keep U.S. interest rates lower than they would be without the foreign capital. Indeed economists generally argue that it is this interplay between the demand for and the supply of credit in the economy that drives the broad inflows and outflows of capital. As U.S. demands for capital outstrip domestic sources of funds, domestic interest rates rise relative to those abroad, which tends to draw capital away from other countries to the United States. During periods of uncertainty, foreign investors often turn to U.S. Treasury securities as a “safe haven” investment, as was the case at times in 2008 and into 2009.

The United States also has benefitted from a surplus of saving over investment in many areas of the world that has provided a supply of funds and accommodated the overall shortfall of saving in the country. This surplus of saving has been available to the United States, because foreigners have remained willing to loan that saving to the United States in the form of acquiring U.S. assets, which have accommodated the growing current account deficits. Over the past decade, the United States experienced a decline in its rate of saving and an increase in the rate of domestic investment, as indicated in Table 3. The large increase in the nation's current account deficit would not have been possible without the accommodating inflows of foreign capital.

As Table 3 indicates, compared with the 2002-2007 period, world saving in 2008 increased by 1.6% of gross domestic product (GDP), while investment increased by 1.3% of GDP. This shift toward greater saving relative to investment made it possible for the United States to invest more as a share of its GDP than its own saving could support through accommodating capital inflows.

Among other advanced economies saving in 2008 fell relative to investment. In the emerging developing economies of Asia and the Middle East, saving increased faster than investment in 2008, which supplied the excess saving to the rest of the world. In the developing economies of Asia (which includes China), and the Middle East, saving as a share of GDP increased faster, and in some cases much faster, than did investment, which also increased in these areas.

Capital inflows also allow the United States to finance its trade deficit, because foreigners are willing to lend to the United States in the form of exchanging the sale of goods, represented by U.S. imports, for such U.S. assets as businesses and real estate (referred to as direct investment), and stocks, bonds, and U.S. Treasury securities.

In 2008, the value of many of those assets dropped sharply, as the financial crisis eroded the value of financial assets and the economic downturn reduced profits and the value of on-going businesses. Capital inflows, however, put upward pressure on the dollar, which tends to push up the price of U.S. exports relative to imports and to reduce the overall level of exports. Furthermore, foreign investment in the U.S. economy drains off some of the income earned on the foreign-owned assets that otherwise would accrue to the U.S. economy as foreign investors repatriate their earnings.

Some observers are particularly concerned about the long-term impact of the U.S. position as a net international investment debtor on the pattern of U.S. international income receipts and payments [3]. In 2008, the United States received \$765 billion in income receipts on its investments abroad and paid out \$646 billion in income payments on foreign-owned assets in the United States for a net surplus of \$119 billion in income receipts, up from the \$82 billion net surplus in income receipts experienced in 2007.

Considering the overall negative balance of the U.S. net investment position, it is surprising that the net surplus of income receipts continues to be positive. As the annual amount of foreign investment in the U.S. economy continues to exceed the amount of U.S. investment abroad, however, it seems inevitable that U.S. payments on foreign-owned assets will rise relative to U.S. receipts.

A net outflow of income payments would act as a drag on the national economy as U.S. national income is reduced by the net amount of funds that are channeled abroad to foreign investors.

**Table 3. Saving and Investment in Selected Countries and Areas; 1994-2001, 2002-2007, and 2008 (percentage of Gross Domestic Product)**

Area/Country	Average, 1994-2001	Average, 2002-2007	2008	Change
World				
Saving	22.1	22.4	24.0	1.6
Investment	22.4	22.2	23.5	1.3
United States				
Saving	17.0	14.3	12.6	-1.7
Investment	19.6	19.2	17.5	-1.7
Other Advanced Economies				
Saving	21.6	19.9	19.6	-0.3
Investment	21.8	20.7	20.7	
Eurozone				0.1
Saving	21.4	21.5	21.8	0.3
Investment	21.0	20.8	22.2	1.4
Japan				
Saving	29.3	27.1	27.4	0.3
Investment	26.9	23.4	23.4	0.0
Newly Industrialized Asian Economies				
Saving	33.0	31.5	31.6	0.1
Investment	29.9	25.6	26.9	1.3
Emerging Developing Economies				
Saving	24.2	30.3	33.7	3.4
Investment	25.0	27.2	29.7	2.5
Developing Asia				
Saving	32.7	39.8	44.6	4.6
Investment	32.4	35.7	39.2	3.5
Middle East				
Saving Investment	25.5	37.7	47.4	9.7
	22.4	23.7	24.5	0.8

Source: World Economic Outlook, International Monetary Fund, October 2009. p. 286-289.

Note: the change indicated in the final represents the change between the value of the respective line in 2008 and the average amount in the preceding five-year period.

Foreign capital inflows, while important, do not fully replace or compensate for a lack of domestic sources of capital. Capital mobility has increased sharply over the last twenty years, but economic analysis shows that a nation's rate of capital formation, or domestic investment, seems to be linked primarily to its domestic rate of saving. This phenomenon was first presented in a paper published in 1980 by Martin Feldstein and Charles Horioka [4]. The Feldstein-Horioka paper maintained that despite the dramatic growth in capital flows between