C H A P T E R 4

The Benefits of Open Trade and Investment Policies

An open economy is characterized by receptiveness to foreign ideas, technology, products, services, and investment. The United States has one of the most open economies in the world, ranking very high in common measures of openness to trade and investment. As a large and diverse economy, the United States engages in more trade and investment than any other country in dollar terms, and it also has, on average, very low barriers to cross-border flows of goods, services, and capital.

In the long run, open economic policies generate many benefits. Trade and investment linkages with other countries increase competition in domestic industries; enhance the purchasing power of consumers; provide exposure to new products, services, and ideas from abroad; and give domestic firms wider markets in which to sell goods and services. In the short run, the interdependence among open economies generally provides benefits—open economies may rely on foreign borrowing or foreign demand for domestically produced exports to cushion an economic downturn—but may also create visible costs that obscure these benefits, as when foreign investment shifts abruptly out of certain sectors or when foreign demand for domestic exports falls. Nevertheless, any potential negative effects from our openness to trade and investment do not outweigh the enormous gains society has realized over decades from this openness.

This chapter begins with a discussion of key facts about trade and investment in the United States, followed by a discussion of the benefits of free trade and open investment, and the policies that the United States has taken to enhance both. These policies include an increased number of free trade agreements (FTAs) and the strong commitment of the United States to maintain openness to foreign direct investment (FDI) while still addressing legitimate national security concerns. The chapter continues with a discussion of international development assistance, and concludes with a review of issues that could affect future U.S. trade policy. The key points of this chapter are:

- Openness to trade and investment has boosted U.S. economic growth. Openness can also reduce the impact of shocks and increase the resilience of the U.S. economy.
- The number of U.S. FTAs has increased greatly during this Administration, and these agreements have contributed to the growth in U.S. exports.

- Portfolio and direct investment into the United States reached historic levels over the past decade, in part due to the depth, diversity, and openness of U.S. financial markets and the competitiveness of U.S. firms.
- The United States has maintained an open investment policy, facilitating FDI flows between the United States and the world while addressing legitimate national security concerns.
- U.S. development and trade initiatives, as well as U.S. engagement in multilateral institutions such as the World Trade Organization and the World Bank have helped increase growth and foster political and economic stability in developing countries throughout the world.
- Continued commitment to open economic policies throughout the world will help ensure continued economic gains for the United States and the rest of the world.

Trade and Investment in the United States

Trade in goods and services has played an increased role in the U.S. economy over the past decade. As seen in Table 4-1, in the first half of 2008, the United States exported goods and services equivalent to 13.0 percent of Gross Domestic Product (GDP), and imported goods and services equal to 18.1 percent of GDP. These figures are the highest on record, considerably above figures from 2000, when exports were equal to 10.9 percent, and imports 14.8 percent, of GDP. The *current account,* which measures the net value of the flow of current international transactions, is chiefly composed of the difference between exports and imports. The U.S. current account deficit widened over this period from 4.1 percent of GDP in the first quarter of 2000 to a peak of 6.6 percent of GDP in the final quarter of 2005. The current account deficit then narrowed to 4.8 percent of GDP at the end of 2007 before expanding slightly over the first half of 2008.

Table 4-1.—*U.S. Trade and Investment*

	2007 value (billion dollars)	Share of U.S. GDP (percent)		
		2000	2007	2008 Q1–Q2
Current account balance, (-) = deficit	**–731**	**–4.3**	**–5.3**	**–5.0**
Exports of goods and services	1,646	10.9	11.9	13.0
Imports of goods and services	2,346	14.8	17.0	18.1
Other	–31	–0.4	–0.2	0.0
Net capital inflows into the U.S.	**768**	**4.9**	**5.6**	**4.7**
Net inflows for foreign investments in the U.S.	2,058	10.6	14.9	6.8
Net outflows for U.S. investments abroad	1,290	5.7	9.3	2.1

Source: Department of Commerce (Bureau of Economic Analysis).

As a matter of accounting, the current account deficit is mirrored by net inflows of capital into the United States, which have provided the financing that has allowed us to purchase more in imports than we sell in exports. From Table 4-1, we can see that net capital inflows into the United States were equal to 4.7 percent of GDP in the first half of 2008, a figure that approximately matches the current account deficit, with a discrepancy caused by measurement errors, omissions, and the exclusion of certain types of capital flows for which only partial data are available. The increase in net capital inflows looks modest compared with the huge increase in capital inflows to and outflows from the United States from 2000 to 2007, although the data for 2008 imply a sharp decline to levels lower than those of 2000 as a percentage of GDP.

Openness to Trade and Investment Has Substantially Contributed to U.S. Growth

Many studies have shown that greater openness to trade and investment is associated with faster growth in the long run. There are many ways to measure openness, including by looking at both the extent of trade and investment and the size of barriers to these flows. By either measure, countries that increased openness have grown faster and have had greater increases in living standards than countries that have remained less open. Research has not yet conclusively determined the incremental gain in income that a country receives from a specific increase in trade because the exact change can depend on particular policies and circumstances.

In the current U.S. downturn that began at the end of 2007, trade has improved the resiliency of the U.S. economy. Strong global demand for U.S. goods and services in 2007 and the first half of 2008 boosted U.S. GDP growth in this period. As the trade deficit declined, the improvement in net exports (exports minus imports) became a sizeable contributor to U.S. growth in this period. Chart 4-1 shows real GDP growth and the contribution of net exports to that growth since 2001. Net exports have accounted for over half of real GDP growth in the past 2 years. Some of the recent U.S. strength in net exports has likely been driven by the depreciation of the dollar. The value of the dollar declined fairly steadily from its peak in 2002 to the summer of 2008, when it reached a level last seen in the mid-1990s. The depreciated dollar contributed to the increase in exports and the decline in real imports. In the second half of 2008, however, the value of the dollar increased, in part reflecting increased international demand for U.S. Treasury bonds in a time of global turmoil and rapidly deteriorating global growth.

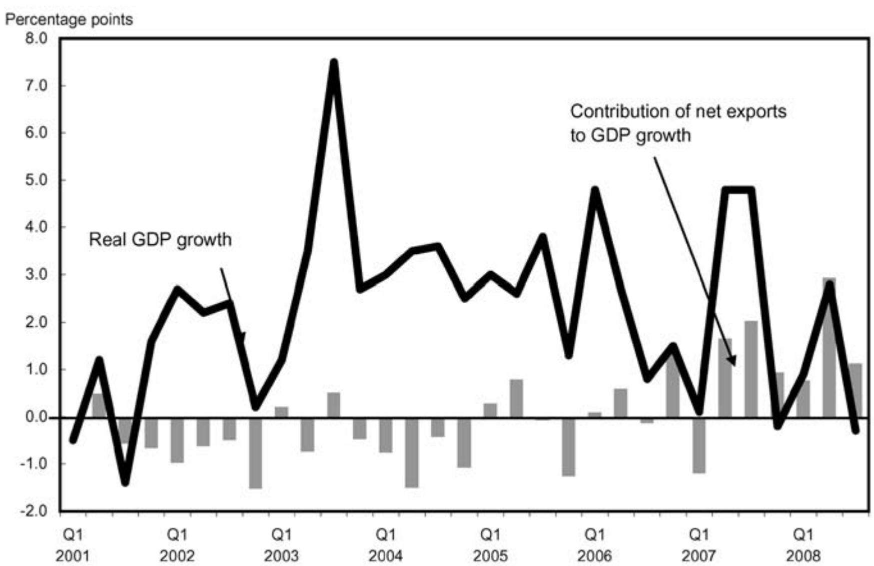
The deteriorating performance of foreign economies in the second half of 2008 has recently reduced demand for U.S. exports. In the most recent U.S. data through October, both imports and exports have begun to decline, as they did during the global slowdown of 2001–02. The decline in exports will likely reduce the contribution of trade to GDP growth in the short term, and net exports may provide no boost to growth in the fourth quarter of 2008. Trade may still hold up better than other components of GDP, however, as consumption and investment are expected to decline enough to make overall GDP growth negative in the short term (see the discussion of the near-term macroeconomic environment in Chapter 1).

Strong global demand for goods drove up prices of a broad range of commodities through the middle of 2008, but global weakness in the second half of the year has reversed most of these gains. This is good news for users, both consumers and producers, but raises some concerns for the exporters that had benefited from the higher prices. However, the broad-based decline in prices of oil, food, and agricultural commodities has considerably eased earlier fears of inflation.

The Benefits of Free Trade

Free trade contributes to economic prosperity in many ways. One of the greatest benefits of trade is that international differences in prices allow countries to utilize their *comparative advantage,* because trade gives a country access to goods and services at relatively low prices, while simultaneously

Chart 4-1 **Contribution of Net Exports to Real U.S. GDP Growth**
Net exports have accounted for more than half of U.S. growth in the last two years.



Source: Department of Commerce (Bureau of Economic Analysis).

allowing domestic producers to find profitable export markets in which to sell goods that can be produced at lower prices at home than abroad. Trade allows a nation to achieve higher overall consumption of goods and services than would be possible if no trade occurred. Trade also benefits consumers by increasing the number and variety of goods available domestically.

Trade raises the productivity of domestic firms in multiple ways: (1) Trade shifts production toward goods in which the country has a comparative advantage, so that over time, capital and labor will become concentrated in relatively more productive sectors, raising national income; (2) trade connects domestic producers to new technology and a greater variety of inputs, and it exposes them to more competition; and (3) firms that gain access to new markets can increase average productivity as unit costs fall, thus benefiting from what economists call *economies of scale* in production. Because trade allows the most productive firms and sectors to increase their share of U.S. production, trade makes possible increases in productivity, profitability, and wages that raise national standards of living.

Firms engaged in export trade provide important benefits to the economy. Exporting firms are a large engine of growth and employment in the U.S. economy. In 2006, 20 percent of manufacturing jobs were generated directly or indirectly by exports. Not only do exporters play a major role in job creation, but on average, productivity per worker is up to one-quarter higher in exporting firms than in nonexporters, and exporters pay each worker 13–18 percent more. Some of this exceptional performance occurs because exporters tend to concentrate in productive industries, but exporters also have higher productivity and higher wages than nonexporting firms in the *same* sector.

Among exporting firms, multinational enterprises, which own and control business operations in more than one county, account for an important share of U.S. trade and productivity growth. In the United States, U.S.-owned multinationals account for over one-half of total exports, and over 90 percent of U.S. exports to manufacturing affiliates were inputs for further processing. The extent of trade in intermediate inputs is an indication that trade is part of an increasingly complex chain, and companies have substantially improved productivity through the development of these global supply chains. Research shows that multinationals in the United States, both U.S.-owned and U.S. affiliates of foreign companies, were responsible for more than half of the increase in U.S. nonfarm labor productivity between 1977 and 2000.

Trade, while broadly beneficial, does not reward all people equally, and changes in trade can negatively affect some workers. In some cases, workers can receive lower wages when trade liberalization reduces the price of goods and services that they produce, and workers can lose jobs when imports reduce domestic production or jobs are relocated overseas. Over time, however, increased trade has made the United States more productive and has contributed to large increases in the U.S. standard of living. Estimates of the gains to the United States from the postwar increase in global trade and the reduction in global trade barriers range up to $1 trillion dollars per year, or about $10,000 per household. In other cases, the use of global supply chains has led to the displacement of some U.S. workers, but as noted above, multinational companies generate considerable benefits for U.S. workers, generating high-wage jobs, substantial employment, and considerable improvements to U.S. productivity.

Although some jobs are lost due to trade, there are many other reasons for job loss in the United States, such as technological change and domestic competition. The United States has several programs to help workers adjust to displacements caused by trade. Chief among these programs is Trade Adjustment Assistance (see Box 8-2 in Chapter 8), which provides benefits and training to workers whose jobs are affected by trade and promotes their rapid reemployment.

Free Trade Agreements

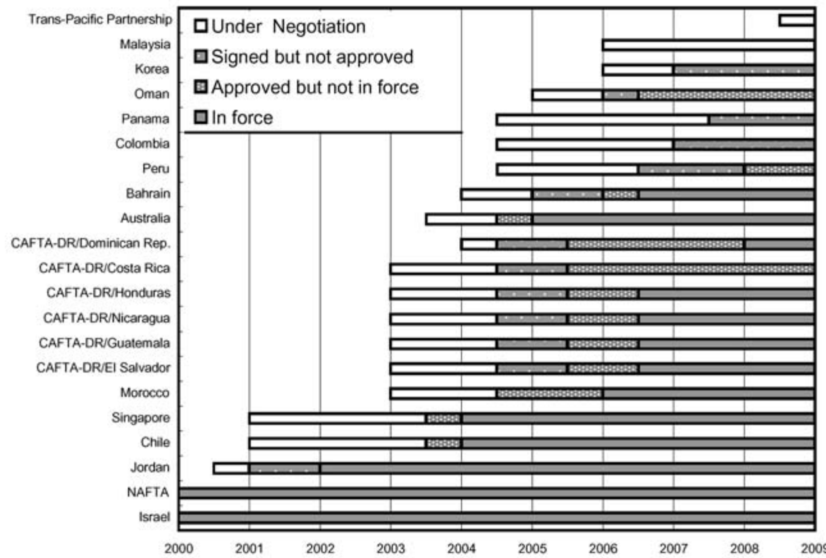
Trade policy is an important determinant of a country's openness to trade, and hence of its growth. In the past 8 years, U.S. policy has supported engagement in global free trade, which has been most evident in the increase in the number of U.S. free trade agreements (FTAs). FTAs are agreements that eliminate tariffs on substantially all trade between two or more countries; U.S. FTAs also reduce other barriers, such as restrictions on services trade and investment. Before 2001, the United States had implemented FTAs with three countries. To date, the United States has concluded FTAs with 20 countries, including 16 in force, one approved by Congress but not yet in force, and three concluded but not yet approved by Congress. The United States has concluded FTAs with trading partners on five continents and with three of our top 10 trading partners. In addition, the United States is currently negotiating FTAs with Malaysia and the members of the Trans-Pacific Strategic Economic Partnership. Chart 4-2 illustrates the progress of U.S. FTAs since 2000, from negotiation to the President's signature to enactment by Congress to being fully in force.

FTAs can dramatically increase trade. U.S. exports to countries whose FTAs came into force during this Administration increased 61 percent from 2000 to 2007, while U.S. imports from these countries increased 26 percent. Recent research shows that, on average worldwide, FTAs increase trade among member countries by about a third after 5 years and more than double trade after 15 years. Because many U.S. FTAs have been in force for less than 5 years, the experience of other countries suggests that these FTAs may continue to expand trade for another decade.

Increased duty-free trade has substantially reduced costs to U.S. importers and exporters and also lowered prices for U.S. consumers. In 2007, 41 percent

Chart 4-2 **U.S. FTA Progress, 2000-2009**

The number of FTAs at all stages in the process has increased since 2000.



Note: U.S. FTAs with Costa Rica and Oman entered into force on January 1, 2009.
Source: Office of the United States Trade Representative.

of U.S. exports went to FTA partners, and over 98 percent of U.S. products were eligible to enter these foreign markets duty free. In the same year, 31 percent of U.S. imports came from FTA partners, and 95 percent of these imports entered the United States duty free. The reduction in tariffs and quantitative limits, such as quotas, on goods trade in FTAs provides important benefits. Countries gain over time when they liberalize their own market, because capital and labor relocate to sectors in which they will be used more efficiently. Countries also gain immediately when FTA partners liberalize, because this liberalization lowers trade costs and improves the competitive position of exporters.

The size of initial foreign trade barriers is an important determinant of potential export gains from FTAs. One reason that U.S. exports to recent FTA partners increased more than imports from them did, is that in most cases, prior to these agreements, foreign tariffs were higher than U.S. tariffs. Many of these countries apply relatively high tariffs to imports from non-FTA partners, so U.S. FTAs considerably reduced costs to U.S. exporters and improved their competitive position. In contrast, goods from these countries were often already eligible to enter the United States duty free. Several FTA partners also had prior preferential access to the U.S. market under programs such as the Andean Trade Preferences Act and the Generalized System of Preferences, which are discussed in the development assistance section below.

U.S. FTAs also contain many beneficial nontariff provisions; particularly important are investment and services liberalization. Because of investment provisions in U.S. FTAs, U.S. companies that operate abroad benefit from more transparent and less burdensome regulation and greater certainty for investors. Developing countries can benefit from an improved legal framework at home and from the stability of permanent preferential access to U.S. markets, which can make the countries more attractive to international investment in all sectors. Liberalization of foreign services markets can improve access to the telecommunications, financial services, professional services, and other sectors. This access can generate large trade and welfare gains because of the high barriers to services trade in many countries.

Reducing barriers to investment and services can have large effects on trade and even greater effects on economic welfare than tariff liberalization does. FTAs have dramatically increased trade in some sectors with preexisting low, or even zero, tariff rates, demonstrating the positive effects of nontariff liberalizations. International data on barriers to services trade and investment flows are less precise than data on goods trade, so estimates vary, but recent research on U.S. FTAs shows that increased investment and reductions in services barriers can each provide more than twice the gains in purchasing power than can tariff liberalizations alone.

Quantifying the gains from FTAs is difficult because of the many uncertainties involved in estimating the effects that these agreements have on trade flows and on the behavior of producers and consumers, and because data limitations make some benefits currently unquantifiable. One series of reports that has focused on only the gains from tariff liberalizations under all U.S. FTAs finds that U.S. consumers gain about $22 billion in increased purchasing power annually. Other studies, though necessarily more speculative, have also included the gains from greater economies of scale, more product variety, long-run gains from capital accumulation, and reduced services barriers. These studies suggest that cumulatively, U.S. FTAs, both those in force and those pending, could increase U.S. purchasing power by about $150 billion, equivalent to about $1,300 per U.S. household, annually.

Reductions in Tariffs

The United States has one of the lowest average tariff rates in the world. U.S. average tariff rates have been steadily decreasing as duty-free imports from FTA partners have increased in the past decade. The trade-weighted average tariff rate, which gives each of over 11,000 tariff rates a weight equal to the value of U.S. imports in that sector, has been below 2 percent since 1999, and has now fallen below 1.4 percent. Trade-weighted averages can be misleading, however. Because high tariffs reduce trade, sectors with high tariffs are counted less when weighting by trade. The restrictiveness of U.S.

tariffs is better measured by calculating a single, "uniform" tariff that would produce the same volume of trade (or the same purchasing power for U.S. consumers) if applied to all sectors. Recent estimates of such a uniform tariff have been near 5 to 6 percent for the United States. This higher value captures a number of relatively high U.S. tariffs, particularly in agriculture, that are not well represented by the average rate.

The U.S. "uniform" tariff rate of 5 to 6 percent is lower than comparable estimates of tariff protection in major U.S. trading partners, both developing and developed. As in the United States, agricultural tariffs are a major source of other countries' high rates of protection. Because high agricultural protection is a global concern, efforts to reduce it are best negotiated in multilateral institutions such as the World Trade Organization (WTO), which is currently negotiating the Doha Round of trade liberalizations (initiated in Doha, Qatar). The United States and numerous other countries have proposed ambitious reductions in both agricultural tariffs and trade-distorting agricultural subsidies (see Box 4-1) that are critical to a successful market-opening outcome of the Doha Round.

Box 4-1: Farm Subsidies

Government payments to the farm sector have been part of U.S. farm policy since the 1930s, with the goal of increasing the standard of living of American farmers. Although they benefit some farmers, government payments can induce economically wasteful overproduction by encouraging production of higher-cost goods that would be unprofitable without subsidies. Thus, subsidies can generate costs to taxpayers that exceed the benefits received by U.S. producers and consumers. Due to the rise of large commercial farms, subsidies have also become increasingly directed toward high-income farmers. In 2006, farm households with an income over $100,000 received the majority of government payments (compared with the median U.S. household income of approximately $48,000). In addition to monetary costs, farm subsidies can also raise other concerns. Some subsidies require that land be reserved for specific crops, potentially limiting the variety of foodstuffs in local communities, and subsidy-induced production may raise fertilizer use, which contributes to environmentally damaging runoff.

Despite the fact that farm income in the United States is forecast to reach record levels in 2008, taxpayers will provide a projected $13 billion in payments to U.S. farmers this year. In real terms, direct government payments have come down by over half since 2000, when they were the highest ever, even exceeding payments during the farm debt crisis

continued on the next page

Box 4-1 — continued

of the 1980s. This decline was driven primarily by higher market prices for agricultural commodities, rather than by policy initiatives to reduce support. For example, government payments under several programs that provide support when commodity prices drop below a threshold level have declined over 80 percent since 2005, while farm bills, such as the Food, Conservation, and Energy Act of 2008, continue most existing support programs.

Agricultural subsidies are widespread in developed countries, although they represent a lower share of gross farm receipts in the United States than in the EU and in many other countries, including Japan, Korea, and Canada. Because subsidies can impose greater costs than benefits, reducing subsidies would increase incomes and economic welfare; indeed, research suggests eliminating agricultural subsidies in developed countries would increase U.S. welfare by several billion dollars per year. In developing countries, reducing subsidies would raise agricultural prices and improve the lives of producers, although it could also raise the cost of some food for consumers. Given the prevalence of agricultural support, multilateral agreements are the single most effective way to address this issue. The Doha Round of the WTO trade talks has included negotiations on limiting subsidies with the greatest potential to stimulate overproduction and distort trade. In July 2008, as part of the Doha talks, the U.S. Trade Representative announced that the United States was prepared to limit this subset of subsidies to $15 billion annually, down from the $22 billion limit offered in 2005. In the United States, these subsidies have exceeded the proposed new $15 billion limit in seven of the last 10 years.

The Benefits of Open Investment

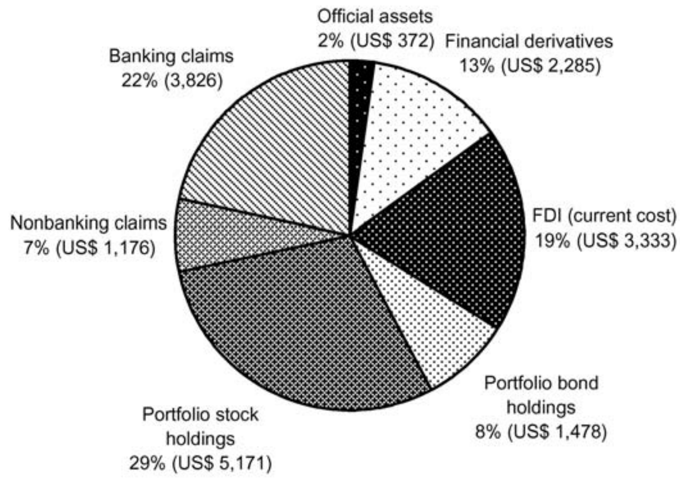
The ability to either export excess savings in return for foreign assets or to borrow savings and invest more than is saved within the country can allow nations both to achieve higher income growth than would otherwise be possible and to cushion temporary shocks to the economy. Over time, the United States has benefited in both ways. For example, foreign demand for secure investments has lowered borrowing costs for the U.S. Government. There have also been benefits from accumulating assets overseas: U.S. businesses and investors have been able to make use of their foreign asset holdings to diversify, reduce risk, and raise overall returns on investments.

Economic growth has likely been supported by openness to foreign investment in a variety of ways, including an increase in the amount of capital available for investment; greater transfer of technology; increased employment; and greater access to global capital, goods, and services by domestic firms. Although still a matter of debate among economists, foreign direct investment is generally considered to convey all of these benefits in a particularly straightforward fashion. According to the latest data available from the Commerce Department, in 2006, U.S. affiliates of foreign companies accounted for 6.1 percent of U.S. nonbank private sector production, provided more than 5.3 million jobs to American workers (4.6 percent of the U.S. workforce), spent $34.3 billion on research and development (14 percent of U.S. expenditure on R&D), and accounted for 19 percent of U.S. exports.

The benefits that a country receives are related to the volume and composition of its investment flows. The net flow of investment across borders is equal to the gap between the value of goods and services that a nation exports and the value of the goods and services it imports. This is also equal to the difference between a nation's savings and its domestic investment. Nations that save more than they invest domestically invest these extra savings in the rest of the world, and in the process purchase foreign assets, including bonds, equities, and FDI. Nations whose domestic investment exceeds their savings receive investments from abroad and, in doing so, sell assets to foreign residents.

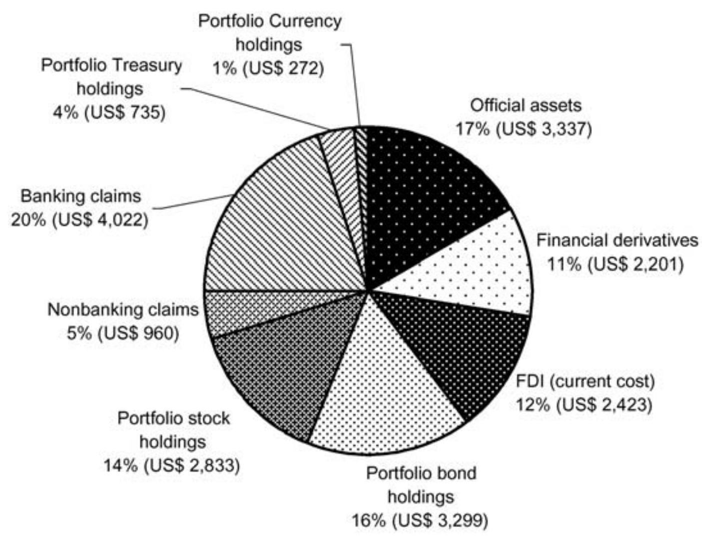
The composition of investment flows is in part determined by the willingness of the investor to accept greater risk in exchange for a potentially higher return. Chart 4-3a provides a breakdown of types of foreign assets accumulated by U.S. investors (including the government), and Chart 4-3b shows the types of U.S. assets accumulated by foreign investors. Relative to foreign investors in the United States, U.S. private investors have been relatively risk-tolerant in their holdings of foreign assets, particularly in holdings of private *portfolio* stocks and FDI. Portfolio stocks constituted 30 percent of total private foreign investment by U.S. investors in 2007, whereas they constituted 17 percent for foreign investors in the United States. Likewise, U.S. investors allocated 19 percent of their foreign holdings to FDI, whereas private foreign investors only allocated 14 percent of their U.S. investments to FDI. In keeping with their lower risk appetite, foreign private investors held twice the share of bonds, including U.S. Treasury bonds, in their U.S. asset holdings (24 percent of private investment) than U.S. investors held in their foreign asset holdings (9 percent of private investment). There was also a pronounced difference in official government holdings. Foreign governments and official institutions held 17 percent of all U.S. assets owned by foreigners, whereas the U.S. Government held only 2 percent of the total foreign assets in U.S. residents' possession. The majority of foreign official holdings of U.S. assets in 2007 were U.S. Treasury bonds and bonds issued by government-sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac.

Chart 4-3a **U.S. Holdings of Foreign Assets, 2007 (US$ bil)**
U.S. investors abroad are relatively risk-tolerant.



Source: Department of Commerce (Bureau of Economic Analysis).

Chart 4-3b **Foreign Holdings of U.S. Assets, 2007 (US$ bil)**
Foreign investors in the United States are relatively risk-averse.



Source: Department of Commerce (Bureau of Economic Analysis).

U.S. Investment and Investment Policy

Since the early 1980s, the United States has received more capital from foreign investors than U.S. residents invested abroad. Table 4-2 provides capital flow data for the years 2000 through 2007, the latest available data. There are many aspects about the United States that have proved attractive to foreign investors, including the size, diversity, liquidity, and depth of U.S. financial markets. According to one estimate, U.S. financial markets accounted for approximately one-third of the world supply of financial assets in 2006 (the latest year for which data are available). The U.S. share of the world supply of securities available to investors may even be much higher, given that in many countries the fraction of a company's shares available on the market may be much lower due to the large controlling stake in the company held by the government, a financial institution, or a family. In addition, U.S. markets offer strong minority shareholder rights and other property rights, a large domestic market, opportunities to invest in technological innovation, and demographic trends that result in a younger and faster-growing population than in most other advanced nations.

Much attention has been given to the large purchases of U.S. assets by foreign governments (primarily central banks and sovereign wealth funds; see Box 4-2). Although official flows (primarily foreign exchange reserves invested in the United States) are important, private flows are much larger. In 2000, for example, total foreign capital inflows into the United States were $1,038 billion of which private capital flows were $995 billion, or 96 percent of the total. Since then the share of *private* flows has not fallen below 68 percent, and it stood at 80 percent in 2007, the last year for which data are available. FDI and other investment flows are likely to be affected, even if only in the short to medium term, by the current financial crisis. This is the subject of Box 4-3.

Table 4-2.—*Capital Flows into and out of the United States (billions of U.S. dollars)*

	2000	2001	2002	2003	2004	2005	2006	2007
Foreign Capital Inflow	$1,038	$783	$795	$858	$1,533	$1,247	$2,061	$2,058
Of Which: Private Flows	995	755	679	580	1,135	988	1,573	1,647
U.S. Capital Outflow	561	383	295	325	1,001	547	1,252	1,290
Net Capital Inflow into the U.S.	417	385	461	523	625	729	788	731

Note: The net capital inflow figures are equal to those reported as the current account. This series differs from a straight subtraction of outflows from inflows due to omissions of certain types of financial transactions and statistical discrepancies.
Source: Department of Commerce (Bureau of Economic Analysis).

Box 4-2: Sovereign Wealth Funds

A *sovereign wealth fund* (SWF) is a state-owned investment fund. While there is no widely recognized definition of a SWF, typical hallmarks include that it holds foreign financial assets; makes some long- or medium-term investments that are riskier than the safe, liquid assets that make up official foreign currency reserves held for balance of payments or monetary policy purposes; and has few or no defined obligations, such as paying pension benefits or other specific liabilities. Nations may create SWFs for many purposes, including to earn higher returns on foreign currency holdings in excess of desired reserve assets, stabilize fiscal revenues, save wealth across generations, or fund development projects. SWFs are typically funded through commodity exports such as oil, gas, or diamonds, or through transfer of official foreign reserves accumulated as a result of large trade surpluses. Examples of some large SWFs include the United Arab Emirates' Abu Dhabi Investment Authority, Norway's Norges Bank Investment Management, the Government of Singapore Investment Corporation, and the China Investment Corporation.

Sovereign wealth funds have existed at least since the 1950s, but the amount of money estimated to be in such funds has increased dramatically in the past 10 to 15 years. One recent study estimates that SWFs currently manage $3.6 trillion in assets, and that total could rise to $10 trillion by 2015, although recent decreases in commodity prices will lower this projection. In 2006–2007, the amount of assets held by SWFs was large compared to the amounts held by private equity ($0.8 trillion) and hedge funds ($1.9 trillion), but was dwarfed by the assets held by insurance companies, mutual funds, and pension funds (on the order of $20 trillion each).

Sovereign wealth funds have the potential to promote global financial stability by acting as long-term, stable investors that provide significant capital to the system. They are not typically highly leveraged and would therefore not be under pressure to sell off assets for the purpose of meeting debt obligations. At the same time, the performance incentives that SWFs face remain opaque, and like all large, concentrated investors, SWFs could cause market volatility by abruptly shifting their asset allocations to avoid losses. The extent to which SWFs act as a stabilizing force in financial markets is an open empirical question that may be difficult to answer due to the lack of transparency of many SWFs.

Foreign investment, including investment by SWFs, provides capital to U.S. businesses, improves productivity, and creates jobs. The United States is currently the largest recipient of SWF investment. Investment

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Box 4-2 — continued

from SWFs has helped to shore up financial institutions during the credit crisis: sovereign wealth funds invested an estimated $92 billion in global financial institutions from January 2007 to July 2008.

The increasing size of SWFs in global financial markets has prompted some concern, however. For recipient countries, ownership of sensitive assets by foreign governments may pose national security concerns. High-profile investments by SWFs may also provoke a protectionist backlash against foreign investment. In April 2008, the Organization for Economic Co-operation and Development (OECD) published investment policy principles for countries that receive SWF investment, endorsing long-standing OECD principles against protectionist investment barriers and for nondiscriminatory treatment of investors. The principles stress that when additional investment restrictions are required to address legitimate national security concerns, then investment safeguards by recipient countries should be transparent and predictable, proportional to clearly identified national security risks, and supportive of accountability.

Countries that own SWFs have also raised concerns about the governance and accountability of these funds, and recognize that it is in their interest to ensure that their money is invested well. In October 2008, a group of 23 countries with SWFs published the Generally Accepted Principles and Practices, known as the "Santiago Principles," for sovereign wealth funds. The voluntary principles stress that SWFs should be transparent and accountable and should make investment decisions based on commercial principles. Adherence to these principles not only will help ensure that SWFs are well managed, but will have the additional benefit of reassuring recipient countries that SWF investments are financially stable and are economically and financially motivated.

Box 4-3: The Effect of the Current Economic Slowdown on Foreign Investment into the United States.

The large capital inflows into the United States over the past decade have led to many benefits described in this chapter. It is too early to say definitively how the financial crisis will affect these inflows. There are two aspects to this issue. First, there is the question of whether the supply of credit that net-saver nations provide to the rest of the world will be reduced. This credit has primarily flowed from Asian economies

continued on the next page

Box 4-3 — continued

(including Japan's), whose combined current account surplus (a measure of capital outflows) was $608 billion higher in 2007 than it was in 1997, and Middle East economies, whose combined current account surplus was $253 billion higher in 2007 than in 1997. To the extent that the recent slowdown in global economic activity reduces demand for Asian exports and petroleum products (as well as other commodities), the net savings available from these nations may fall if savings rates do not rise sharply. Moreover, foreign countries' savings are also likely to decline if governments decide to engage in higher spending to boost their flagging economies, thereby lowering the amount of government saving. Such spending would reduce the gap between national saving and domestic investment and reduce the supply of credit to the rest of the world, raising world interest rates.

The second question is whether the cost of foreign savings to the United States will rise. This depends on U.S. demand for foreign savings and the relative desirability of U.S. assets for foreign investors. The rising U.S. demand for foreign savings over the past decade is evident in Table 4-2. To add further evidence, the current account *deficit* of the United States (equal to net capital inflows) was $591 billion higher in 2007 than in 1997, and the United States received net investment from the rest of the world equal to 1.3 percent of world GDP in 2007, compared with average net foreign investment in the United States equal to 0.7 percent of world GDP from 1994 to 2001. Although predictions vary, U.S. imports and exports are both anticipated to fall sharply, likely leading to continued high levels of net capital inflows, and therefore high demand for foreign savings. If other nations that have relied on net capital inflows also maintain their same level of demand for foreign savings as well, unchanged demand in the United States for a potentially shrinking supply of global savings would tend to raise the cost of obtaining these inflows.

Yet the cost of foreign savings has not increased for the United States, and this primarily reflects an increase in the relative desirability of U.S. Treasury bonds for global investors. The net inflow of foreign savings into U.S. Treasuries has permitted the U.S. Government to borrow at a relatively low cost, and this has so far helped cushion the impact of the crisis on the U.S. economy. The relative desirability of U.S. Government bonds reflects a seismic decrease in global investors' appetite for risk. This has generated enormous demand for low risk assets such as U.S. Treasuries. If global investors' appetite for risk returns, demand for Treasuries will likely fall and whether the cost of foreign savings will rise for the United States will depend on the relative attractiveness of U.S. investments compared to opportunities abroad.

Foreign Direct Investment into the United States

For statistical purposes, the United States defines foreign direct investment (FDI) as the acquisition of at least 10 percent of an existing U.S. business, or the establishment of a new business, by a foreign person. The business acquired or formed as a result of the FDI is known as a U.S. affiliate of the foreign *parent*. Outlays for new FDI into the United States rose in 2006 and 2007, and the rate of increase of spending for new FDI greatly exceeded the rate of increase of U.S. merger and acquisition activity. Of total new FDI outlays into the United States of $277 billion in 2007, $255 billion (92 percent) was for the acquisition of existing U.S. firms, while $22 billion (8 percent) was for the establishment of entirely new businesses, according to preliminary data. In 2006, the three countries with the greatest production (or *value added*) by U.S. affiliates as a share of total U.S. affiliate production were the United Kingdom (19.6 percent), Japan (12.3 percent), and Germany (11.0 percent). The three biggest industry recipients of FDI new investment outlays in 2007 were manufacturing (49 percent), finance and insurance (9 percent), and real estate and rental and leasing (7 percent).

U.S. affiliates of foreign businesses are a large force in the U.S. economy, and their importance has increased in certain ways. Over the past 20 years, U.S. affiliates have increased their contribution to U.S. production from 3.8 percent of U.S. private sector production in 1988 to 6.1 percent of production by 2006 (the latest year available). The employment share of U.S. affiliates reached 4.6 percent in 2006. In 2007, newly acquired or established U.S. affiliates employed 487,600 people (including 147,500 in manufacturing and 143,600 in retail).

Although U.S. affiliates of foreign businesses are distinguished by relatively high wages and productivity, these attributes may reflect the nature of the industries to which FDI is attracted rather than any special attribute of foreign ownership itself. However, the ability to sell a business to foreign investors interested in acquiring new technology creates an incentive for entrepreneurs to innovate by increasing the potential rewards. There are other benefits as well. Studies that investigate the unique benefits of FDI, as opposed to other forms of foreign financing, typically claim that FDI can introduce new technologies to domestic industries and increase the nation's growth rate as these new technologies are adopted and spread throughout the economy.

Efforts to measure *technological spillovers* have often come to conflicting conclusions about the extent of these benefits. Many studies indicate that the benefits of FDI for the host country depend heavily on context. One recent study, for example, finds results that are sensitive to the level of worker education in the region where the investment is being made. Its findings indicate that FDI stimulates economic growth most for U.S. States where worker education exceeds certain threshold levels.

U.S. affiliates may be most productive if they are located near other firms with similar technical and knowledge requirements, or near a large number of workers with specialized skills and suppliers with specialized inputs. A recent study that finds that U.S. affiliates tend to cluster in specific areas (often with other U.S. affiliates with parents from the same country). For example, Connecticut and South Carolina tied for the largest U.S. affiliate share of private industry employment at 7.1 percent. Most of the U.S. affiliates in Connecticut were controlled by Dutch businesses, whereas the U.S. affiliates in South Carolina were heavily associated with German businesses.

Foreign Investment Policy

The perception that openness to foreign investment must be traded off against security is misguided. Foreign investment gives investors in other countries an economic stake in the prosperity of the United States, creating an incentive to support policies that are good for U.S. growth and stability. Nonetheless, foreign acquisition of assets or businesses may create a risk to national security if production of key resources could be disrupted or if sensitive information or technologies may be disclosed. The Exon-Florio provision of the Defense Production Act of 1950, which became law in 1988, provides for the President or the President's designee to review certain foreign investments in the United States. If a transaction threatens to impair national security, the President is authorized to prohibit the transaction.

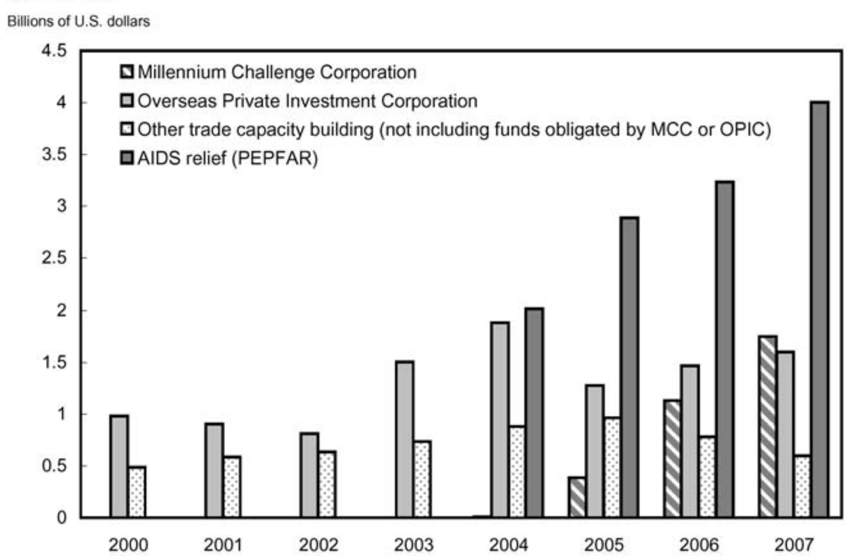
In October 2007, the Foreign Investment and National Security Act of 2007 (FINSA) became effective, amending Exon-Florio in various ways, including by codifying the structure, role, process, and responsibilities of the interagency Committee on Foreign Investment in the United States (CFIUS), which has been designated by the President to undertake Exon-Florio reviews since 1988. Although FINSA expands government oversight of some foreign acquisitions, it also increases the transparency and predictability of the CFIUS process. With the publication of final regulations in November 2008, FINSA is now fully implemented.

Development Assistance Initiatives

The United States benefits from increased trade as other economies grow and become more open, but the main benefits of development assistance programs include improving the lives of disadvantaged populations, increasing economic and political stability abroad, and fostering closer ties to the United States. The United States has many long-standing economic assistance commitments, including those funded through the United States Agency for International Development (USAID), the Departments of State and Defense, and funding for multilateral development institutions such as the World Bank. Under this Administration, the United States has initiated and expanded specific economic assistance programs in developing economies, particularly those that practice good governance; make trade a prominent feature of their development plans; and demonstrate a commitment to taking ownership of the reforms, planning, and logistics required for the success of development programs and projects. Economic assistance programs, including trade capacity building (TCB) programs, are provided primarily by the Millennium Challenge Corporation (MCC) and USAID, and investment promotion programs are provided by the Overseas Private Investment Corporation (OPIC). The United States offers developing countries, particularly the least developed, preferential access to the U.S. market through several preferential trade programs. The United States also has health and education initiatives such as the President's Emergency Plan for AIDS Relief (PEPFAR).

To put these programs in context, U.S. spending on four of these initiatives from fiscal year 2000 to 2007 is shown in Chart 4-4. MCC has had a steady increase in funding since its inception in 2004. Spending on "Other TCB" in Chart 4-4 does not include TCB funds that are already included in spending by MCC and OPIC; overall, TCB funding rose to $2.3 billion in 2008. The highest spending from 2004 through 2006 was on PEPFAR, reaching $4 billion in 2007. The MCC, TCB, and OPIC, in addition to trade preference

Chart 4-4 **U.S. Obligations on Select Development Assistance Initiatives, 2000-2007**
Spending on innovative new development initiatives such as PEPFAR and the MCC has increased significantly.



Sources: U.S. Agency for International Development, President's Emergency Plan for AIDS Relief, Millennium Challenge Corporation, and Overseas Private Investment Corporation.

programs, are each discussed below, while PEPFAR is described in the section on health programs in Chapter 7.

Millennium Challenge Corporation

In 2002, the President announced the creation of the Millennium Challenge Account (MCA), a new bilateral initiative aimed at reducing poverty through investment programs, or *compacts*, of up to five years with countries that practice good governance, provide economic freedoms, and invest in their people's health and education. The Millennium Challenge Corporation (MCC) was set up to administer the MCA, and the importance of the MCC's focus on reducing poverty through economic growth is supported by research showing that economic growth is an important precursor for poverty reduction. In recognition of this relationship, before approving projects, MCC gathers evidence that the problems to be addressed by potential MCC-funded projects are indeed critical constraints to a country's growth. The strong commitment by MCC to near-universal application of cost–benefit analysis and rigorous, state-of-the-art project evaluation will allow the development community to better understand and learn important lessons about the effectiveness of various types of aid projects. Without making advances in knowledge about which projects are effective, U.S. efforts to improve the lives of targeted populations may not ultimately succeed. Given that most of MCC's compacts are currently in progress, it is too early to evaluate whether MCC has met its objectives.

Trade Capacity Building

An important goal of U.S. trade policy is to create opportunities for individuals and companies in developing countries. Trade capacity building (TCB), also called Aid for Trade, helps developing countries build capacity so that they can take advantage of global markets and implement trade rules. Top priorities for this aid are to develop infrastructure, strengthen financial markets, improve customs operations, develop sound business environments, and facilitate trade. The United States is the largest single-country donor of TCB assistance, spending $2.3 billion in the 2008 fiscal year, and it has committed to provide $2.7 billion in annual spending by 2010.

A key component of TCB is improving key physical infrastructure needs—such as transportation, ports, telecommunications, electricity, and water—in developing regions. In recent years, the United States has supported road building in rural Colombia, pipeline rehabilitation in Georgia, and the construction of a new international airport in Ecuador. TCB funds also strengthen developing countries' financial infrastructure. A number of programs are aimed at improving the productivity and business practices in micro-, small-, and medium-sized businesses, and at improving lending to these businesses.

Trade facilitation is another important part of TCB. Trade facilitation funds are used chiefly to modernize customs practices, promote exports from developing countries, and provide business support and training to help firms participate in global markets. Improvements in these areas are often key to generating new trade and investment flows in these countries. For example, trade may increase because improved customs practices reduce costs and shorten delivery times. The United States has supported projects to improve the flow of goods at the Kenya-Uganda border and along the route from coastal Namibia to South Africa. Investment may increase because trade facilitation addresses areas of chief concern to many international investors; a 2007 survey reported that customs and ports improvements are the highest priority for international investors in some emerging markets.

Recent U.S. trade agreements, such as the Dominican Republic-Central America-United States Free Trade Agreement, include a formal Committee on TCB to help trading partners implement the agreement and to smooth the transition to new trading regimes. The United States also promotes TCB more broadly. For example, the United States supports efforts by the WTO and the OECD to expand worldwide funding for Aid for Trade. This aid helps developing countries, particularly least-developed countries, enhance trade-related skills and improve infrastructure needed to expand trade and benefit from trade agreements. Along these lines, the Africa Global Competitiveness Initiative, announced by the President in 2005 to build on the African Growth and Opportunity Act, provides technical assistance to bolster the trade competitiveness of African countries. This initiative has been credited with supporting $35 million in exports by African Growth and Opportunity Act beneficiaries in 2007. The United States also supports the Integrated Framework that coordinates efforts by six multilateral organizations (including the International Monetary Fund, the World Bank, the WTO, and other organizations) to reduce poverty in developing countries by better integrating trade into national development strategies.

Investment Promotion Programs

The United States also facilitates investment in emerging and developing countries by U.S. companies through the Overseas Private Investment Corporation. According to the corporation's 2007 annual report, it has supported over $177 billion in U.S. investment abroad through its pioneering use of U.S. Government-backed political risk insurance, direct loans, guaranties, and equity funds. These investments, which help provide crucial opportunities to households and firms in developing economics, also contribute to increased foreign asset holdings of U.S. residents.

In addition, *bilateral investment treaties* foster market-oriented investment policies in partner countries, and support international standards for investment protection. In February 2008, the Administration signed a bilateral investment treaty with Rwanda. When implemented, it will bring the number of U.S. bilateral investment treaties in force to 41. The U.S. Government is pursuing investment treaties with key emerging markets, as demonstrated by the 2008 announcements of treaty negotiations with China, India, and Vietnam.

Trade Preference Programs

Four U.S. preference programs are among the central elements of U.S. trade policy to promote growth and stability in developing countries. These programs provide preferential duty-free access for thousands of products that would otherwise be subject to duty upon entry to the United States. The U.S. Generalized System of Preferences, for example, provides duty-free access to the U.S. market for over 3,400 products from 132 beneficiary developing countries, and provides even broader duty-free access for products from 44 least developed countries. In addition to the Generalized System of Preferences, U.S. preferential trade programs include the African Growth and Opportunity Act, the Caribbean Basin Initiative, and the Andean Trade Preference Act. These programs have been successful in increasing and diversifying developing countries' exports, which better integrates these countries into the global trading system and expands choices for U.S. manufacturers and consumers. These programs have also improved economic stability, promoted internationally recognized labor rights, and provided adequate and effective means to secure and enforce property rights, including intellectual property rights. Researchers have cautioned that preference programs can have negative consequences if preferences divert limited resources in developing countries to sectors that would not otherwise be competitive. Research on specific U.S. programs, however, suggests that in general these programs have increased exports and improved welfare.

These programs have generated many successes. The Generalized System of Preferences has a large and geographically diverse impact. For example, for 15 beneficiary countries, more than one-third of their exports to the United States received preferential duty-free access under the program in 2007. Under the Caribbean Basin Initiative and the associated Haiti Hope Act, Haiti—the poorest country in the Western Hemisphere—increased apparel exports to the United States by 75 percent between 2000 and 2007. These benefits helped to preserve an important sector of the Haitian economy. The African Growth and Opportunity Act has also been successful in increasing trade. For January to October 2008, exports from the original African beneficiary countries to the United States increased over 250 percent compared to the same period in 2001, and exports that entered the United States duty free under the program exceeded $50 billion, up almost 700 percent. U.S. exports to sub-Saharan Africa more than doubled in the same period, totaling over $15 billion in 2008 through October.

Trade Policy Going Forward

Notwithstanding the rapid increase in U.S. regional and bilateral trade and investment agreements, the multilateral trading system remains at the heart of U.S. trade policy. The rules-based multilateral system of the WTO is the essential foundation of an increasingly integrated global economy, and the WTO remains the single best forum to generate progress on many global trade and investment issues. Such issues include reducing trade-distorting support and protection for agricultural sectors maintained by many countries, both developing and developed; and liberalizing trade barriers and burdensome restrictions on FDI in services sectors in developing countries.

The United States must continue to lead international efforts to address these and similar issues in order to expand the benefits of open markets and economic integration. In particular, the WTO Doha Round remains a top U.S. trade policy objective, with the goal of concluding an agreement that creates new trade flows in agricultural, industrial, and services markets that will expand global economic growth, development, and opportunity. The United States and many other countries remain committed to reaching a successful final agreement that achieves an ambitious market-opening outcome for both developed and developing countries.

In the history of global trade liberalization, there has not been smooth and uniform progress toward ever lower barriers. There have been long periods of inactivity or, worse, periods of rising protectionism. Previous periods of economic hardship have often coincided with an increase in protectionism and economic isolationism; for example, the use of nontariff barriers such as quotas rose in the 1970s and 1980s. In the current troubled economic environment, an increase in protectionism at home or abroad could further slow global economic progress. Limiting trade would jeopardize the strongest engine of growth of the past 2 years in the U.S. economy. In the short term, the United States must provide global leadership to oppose any resurgence of protectionism, while continuing to recognize and support the extensive benefits that an open trade and investment environment conveys.

In the longer term, the forces of greater global economic integration appear strong. During this Administration, as the United States implemented FTAs with 13 countries, more than 100 other countries put more than 75 other FTAs into force. Other nations will press forward and so must the United

States to avoid becoming economically disadvantaged in foreign markets. The United States should continue to pursue free trade agreements and, in particular, put into force those that have already been negotiated. The growth in bilateral agreements further emphasizes the importance of multilateral initiatives such as the WTO Doha Round, which can magnify gains by simultaneously reducing barriers in many countries, ensure that the benefits of market access are shared more widely among nations, and lead to transparent and less complex global trading rules.

Conclusion

The United States' commitment to openness in trade and investment and promotion of open markets abroad has led to a greater diversity in consumer choices, more exposure to new technologies and ideas, and higher levels of investment and economic growth than would otherwise have been possible. Openness to trade and investment has contributed to higher U.S. standards of living and has allowed the United States some structural flexibility to cushion economic shocks. On balance, strong links to other economies are likely to increase the resilience of the U.S. economy in the short and long term, even taking into account the potential for negative shocks, such as a decline in demand for U.S. exports. Short-run hardships will surely occur, and it may take some time for current weaknesses to be resolved, but the U.S. commitment to openness provides substantial benefits in both the short and long run.

With regard to trade, the U.S. commitment to openness has been most evident in the increased number of U.S. free trade agreements. These agreements have improved the competitiveness and performance of U.S. producers abroad and have provided substantial savings for U.S. producers and consumers at home. In investment, the United States has benefited from inflows of capital from abroad. Although it is unclear how future flows will be affected by the current crisis, U.S. investors have historically earned high returns on their investments abroad. The recent reform of the Committee on Foreign Investment in the United States represents a careful effort to remain open to foreign investors while safeguarding national security.

U.S. development assistance has supported openness in developing and emerging economies through investment in infrastructure, trade capacity building, trade preference programs, and investment promotion. U.S. efforts to relieve poverty and promote economic growth and stability have helped numerous developing countries. In addition, the United States' continued promotion of trade with developing countries will improve their access to, and ability to benefit from, global markets.