FDIC Outlook

SUMMER 2005

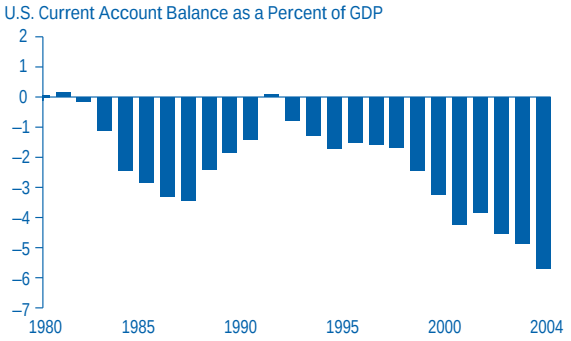
In Focus This Quarter: U.S. Banking in a Global Economy

Global economic integration continues to reshape the U.S. economy and banking industry. While international trade and financial flows make the world richer over the long run, in the short run they introduce both opportunities and risks to the U.S. economy and individual sectors—including FDIC-insured depository institutions. Many of the perceived risks associated with globalization relate to the large imbalances in trade and finance that have arisen between the United States and its major trading partners. The implications these imbalances might have for the U.S. economy and banking industry are among the issues addressed in this issue of ***FDIC Outlook.***

Unraveling the U.S. Current Account Deficit

The *current account* measures the net flow of current transactions between countries, including payments for goods, services, and interest. As the U.S. current account deficit has reached record levels in recent years, analysts have continued to debate both its causes and implications. This article explores the key concepts underlying this debate by discussing what makes up the current account, how the U.S. current account deficit has grown so large, how it is being financed, and whether the situation is sustainable over the long run. *See page 3.*

The U.S. Current Account Deficit Reached a Record 5.7 Percent of GDP in 2004



Note: GDP = gross domestic product.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

In Person: Two Perspectives on Global Financial Imbalances

FDIC Chief Economist Richard A. Brown recently spoke with two prominent experts on international finance and asked them to discuss the future implications of a U.S. current account deficit that reached a record $666 billion in 2004. Stuart S. Brown discusses the "benign" scenario for resolving this imbalance, while Roger M. Kubarych addresses the "adverse" scenario. The resulting transcript shows that either position can be argued persuasively, and that the present situation represents a unique challenge for global policymakers. *See page 13.*

The Globalization of the U.S. Banking Industry

FDIC-insured U.S. banks have steadily grown their international operations, while foreign banks have expanded their profile in the U.S. marketplace. At the same time, consolidation in the U.S. banking industry is having a profound effect on the structure of its international operations, as the vast majority of the foreign assets of U.S. banks are held now by just a few large institutions. This article discusses the structure and strategies of U.S. banks with international activities and compares their financial performance to that of banks with primarily domestic operations. *See page 25.*

Opportunities and Risks Facing Community Lenders That Support International Trade

Although smaller firms (those with fewer than 500 employees) accounted for almost one-third of U.S. exports in 2001, many of them face considerable challenges in financing the production and sale of export goods. This circumstance presents opportunities for community banks that are looking for ways to increase small business fee income and strengthen loan demand. This article examines those opportunities as well as the risks facing community lenders in supporting small and mid-sized enterprises engaged in international trade. *See page 34.*

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The ***FDIC Outlook*** provides an overview of economic and banking risks and discusses how these risks relate to insured institutions nationally and in each FDIC region.

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Unraveling the U.S. Current Account Deficit

Much has been said and written in recent months about the growth of the U.S. current account deficit, which reached a record $666 billion in 2004 (see Chart 1). But to many, the concept remains abstract and hard to understand. This article is intended to explain the current account to non-economists and help assess the implications of the large global financial imbalances that have arisen in recent years between the United States and its major trading partners. It outlines the factors that underlie the recent growth in the U.S. current account deficit and describes how this deficit is being financed. Ultimately, the concerns over the current account deficit relate to its long-term sustainability and whether it could lead to a sudden adjustment that would create problems for the U.S. economy.

Defining the Current Account

The *current account* is an accounting concept that measures the net flow of current transactions between countries, including payments for goods, services, and interest. It represents one of many measures of a country's trade with the rest of the world and includes imports of goods, such as cars and clothing, as well as services, such as the sale of insurance, real estate, and shipping. For the United States, it also includes income and unilateral transfers into and out of the country, but these factors play a minor role.

On a net basis, an increase in exports pushes the current account toward a surplus, while an increase in imports pulls it toward a deficit. A current account deficit occurs when the total value of goods and services a country imports is more than the total value it exports. (For more information regarding U.S. international transactions, see "U.S. International Accounting Basics" on page 11.)

Although the U.S. current account deficit has been the subject of heightened discussion in recent months, shifts in exports and imports have been behind the growing U.S. deficit since 1991. At that time, when the United States last had a current account surplus, the economy was recovering from a recession, and weakened domestic consumption limited the appetite for imports (see Chart 1). From 1994 to 1997, the deficit was relatively stable at around 1.6 percent of gross domestic product (GDP). After 1997, however, the U.S. current account went into a sustained decline, and by 2004 the deficit had reached 5.7 percent of GDP.

Factors Contributing to the U.S. Current Account Deficit

Although the United States has run current account deficits in the past, the persistent deterioration in the U.S. net trade position since the early 1990s is unprecedented. Today, not only is the current account deficit nearly twice as large as the 1980s deficit relative to the size of the U.S. economy, it has shown few signs of changing direction and contracting. One reason for this situation is that net imports of consumer goods have been the largest single contributor to the widen-

Chart 1

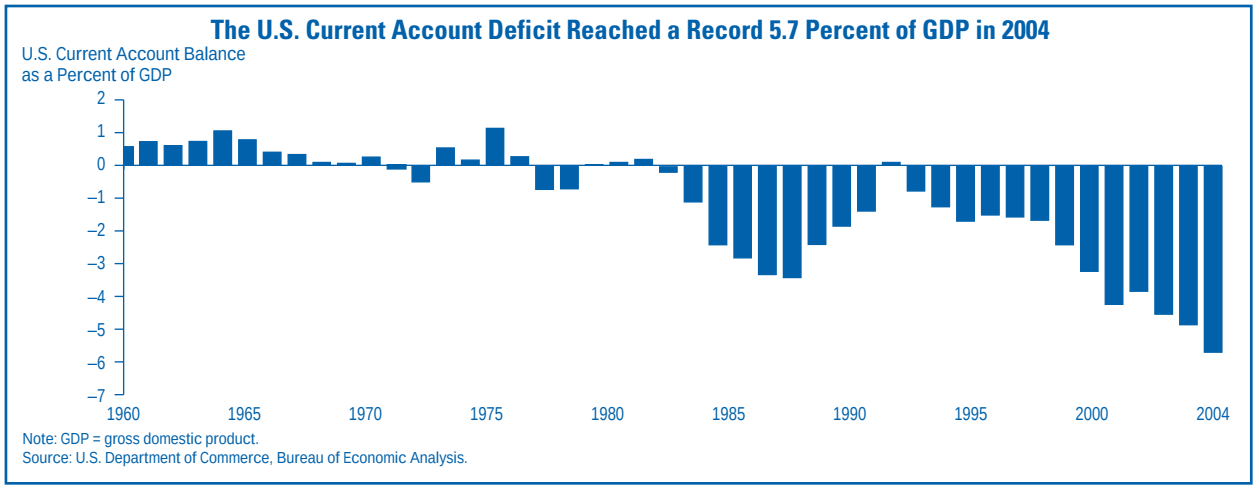
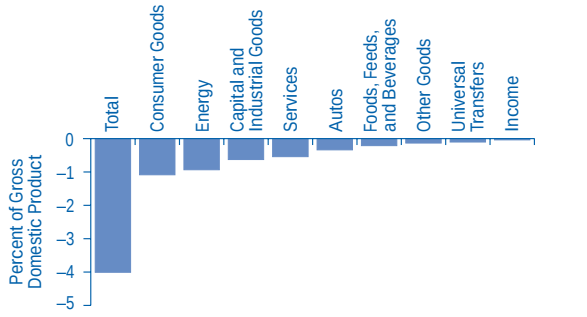


Chart 2



Note: Current account components are on a net basis. Capital and Industrial Goods excludes energy and autos.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

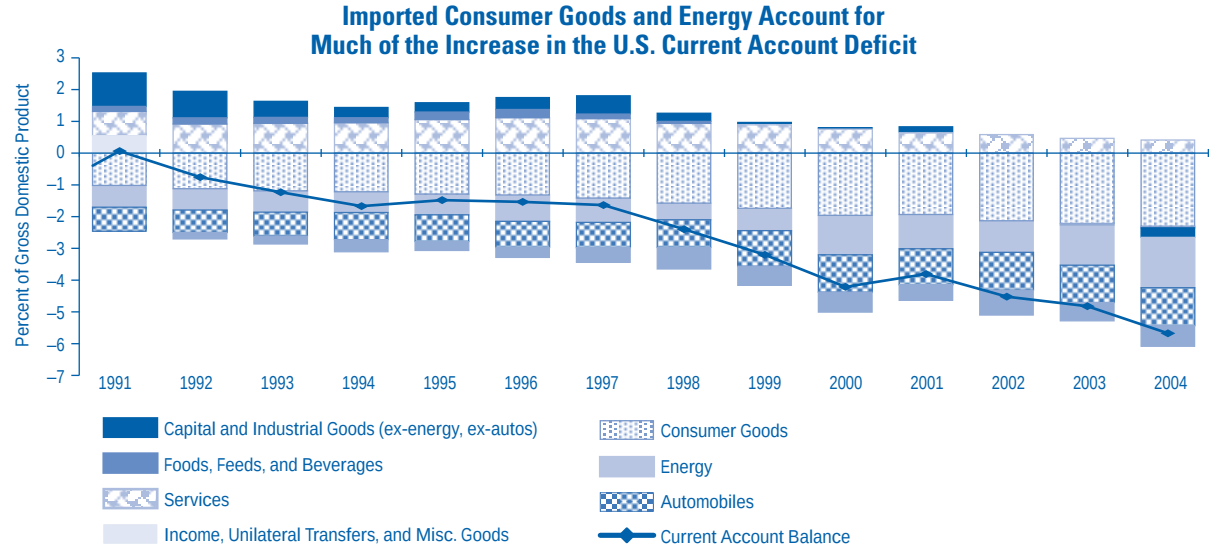
ing current account deficit, and alternatives for many imported products are neither readily available in the United States nor produced domestically in sufficient quantities to accommodate American demand. Consequently, much of the U.S. deficit is expected to remain.

From 1994 to 2004, the current account deficit grew by about 4 percentage points, from approximately 1.7 to 5.7 percent of GDP. This increase can be broken down mainly in terms of consumer goods imports, energy, and exports. The largest component of the increase has been imports of non-automobile consumer goods—particularly furniture, appliances, and televisions—which have grown almost 10 percent per year on average. Overall, larger net imports of consumer goods have expanded the U.S. current account deficit by 1.1 percentage points of GDP over the last decade (see Chart 2).

Energy demand also has contributed to the growing deficit. The United States has long been a net importer of oil and other energy products, and it has had to continue importing energy products even as the price of energy commodities and nominal oil prices have risen during the past decade. As a result, the cost of U.S. net energy imports has contributed almost a full percentage point of GDP to the widening current account deficit since 1994 (see Chart 2).

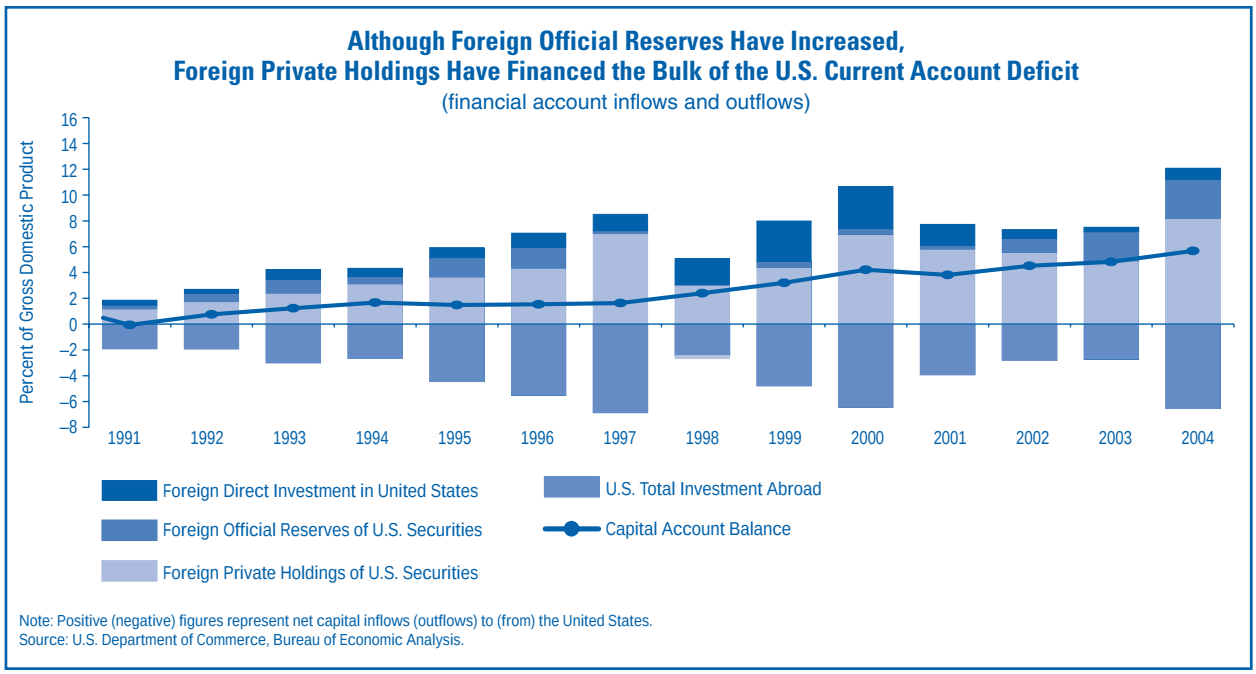
The deterioration in the deficit has not been solely due to the United States' increased appetite for imports—a reduction in sales of certain U.S. exports has also contributed. Historically, the United States has been a net exporter of capital goods, food, and services, but in recent years, net exports of foods and services slipped relative to the size of the U.S. economy (see Chart 3). In 2002 the United States became a net importer of capital goods (excluding automobiles and energy products) for the first time since 1986. Taken together, the relative contraction of the three net export items of capital goods, food, and services added 1.3 percentage points to the current account deficit during the past decade.

Chart 3



Note: Current account components are on a net basis.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Chart 4



Note: Positive (negative) figures represent net capital inflows (outflows) to (from) the United States.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Financing the Current Account Deficit

If individuals spend more than they earn, they have to find a way to make up the difference. Similarly, when a country runs a current account deficit, it has to finance the deficit by borrowing from abroad. In international accounting, the financial transactions offsetting the current account are collectively known as the financial account (previously known as the capital account; see "U.S. International Accounting Basics").

Historically, most of the support for the U.S. current account deficit has come from foreign private investors purchasing U.S. securities rather than official investments or foreign direct investment in U.S. companies. In 2004, total inflows of financing capital reached a record 12.2 percent of GDP, compared with 4.3 percent ten years ago (see Chart 4). And foreign private investment inflows amounted to more than 8 percent of GDP—far more than the 3 percent originating from foreign official investment—despite the widely publicized risk of additional dollar depreciation and very low U.S. interest rates.[1] (For more on dollar depreciation, see the box entitled "Dollar Depreciation Alone Will Not Balance the Current Account.") Foreign official investment has also expanded considerably from near zero in 2001 to 3 percent of GDP in 2004 (see Chart 4).

Partially offsetting these foreign inflows have been outflows by U.S. entities, predominately investments by private individuals and companies overseas. These international cross-flows of capital represent international portfolio diversification activities, as U.S. investors are able to realize a better mix of return and risk by investing a portion of their capital in foreign countries, and foreign investors do the same by investing in the United States. The recent growth of U.S. capital outflows also reflects the global growth of financial markets and the active participation of U.S. investors in those markets. Similarly, the breadth, legal protections, stability, and overall liquidity offered by U.S. asset markets continue to support foreign investment interest in the United States.

Foreign Sources of Capital

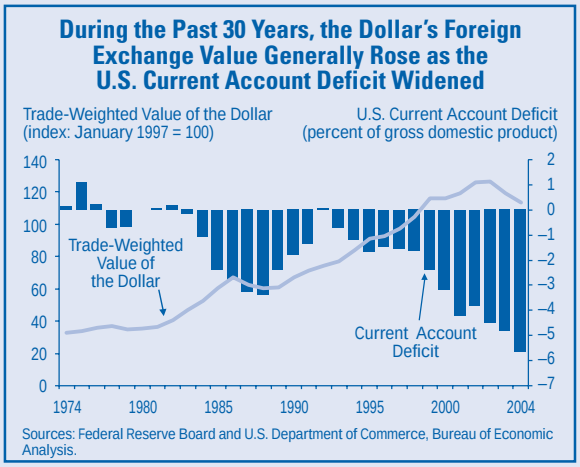
According to data collected by the ***U.S. Treasury,*** a notable shift in foreign investment occurred in 2004, when Asia overtook Europe for the first time as the largest net purchaser of long-term U.S. securities.[6] Over-

[1] The Economist Group. "USA: Currency Forecast," *Economist Intelligence Unit ViewsWire*, January 16, 2004.

Dollar Depreciation Alone Will Not Balance the Current Account

According to economic theory, if not conventional wisdom, the current account deficit will correct itself after the dollar declines sufficiently. The basic theory is straightforward: a decline in the dollar leads to a decline in the price of exports and an increase in the price of imports. As a result of these price shifts, U.S. exports increase while imports decline, leading in time to a balanced current account. As Chart 5 shows, over long periods, this generally has been the case. Since 1980, the dollar's foreign exchange value index has risen roughly threefold, while the current account has deteriorated from a position of balance to today's record deficit.

Chart 5



Unfortunately, over shorter periods, the real world is not so simple. For example, the current account deficit continued to widen, though at a slower pace, during a period of dollar weakness between 1985 and 1987. Moreover, the current account balance improved sharply, even posting a small surplus, as the U.S. economy entered a recession in the early 1990s, despite the fact that the dollar was strengthening. Although theory would suggest that this dollar strength should have led to a *deteriorating* trade position, instead the current account deficit was improving. In contrast, since 2002 the dollar has declined roughly 10 percent in value, yet the deficit has continued to widen. Although the recent decline in the dollar is comparable to the decline of the mid-1980s, if adjusted for inflation, the recent decline has only been half as large as it was then. Even so, the large deterioration of the deficit in 2004 in the face of a weaker dollar does not seem to reflect theory.

As one source notes, most empirical and theoretical models indicate that even large movements in exchange rates *by themselves* will have only a modest effect on narrowing a current account deficit as large as that generated by the United States.[2] This circumstance has been attributed to three primary factors: (1) the role of foreign pricing decisions, (2) the effects of transactions between parent companies and their foreign affiliates (also called intra-firm transactions), and (3) the relative economic strength of U.S. trading partners.

On the first point, foreign firms, especially the Europeans and Japanese, have not raised their U.S. prices at the same pace that the dollar has weakened in recent years.[3] Between 2002 and 2004, the dollar depreciated 30 percent against the euro, but the price in dollars of manufactured goods exported to the United States from the European Union rose only 9 percent.[4] This hesitancy to raise prices may have reflected a desire to maintain U.S. market share as well as the presence of dollar hedges. Although many exporters had dollar hedges in place as the dollar began to drop, most of these contracts have now expired, which has only delayed the pressure to raise U.S. prices.

[2] Maurice Obstfeld and Kenneth Rogoff, "The Unsustainable U.S. Current Account Position Revisited," National Bureau of Economic Research (working paper, no. 10869, October 2004), http://www.nber.org/papers/w10869.

[3] Import prices usually rise following currency depreciation, because if prices do not adjust, foreign firms receive a lower relative price in their own currency.

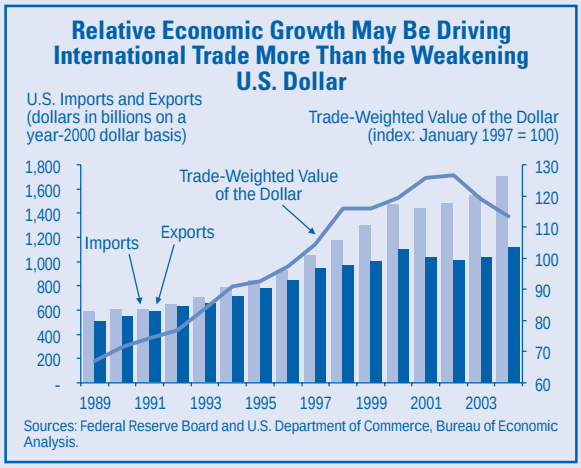
[4] Alan Greenspan, "Capital Account" (speech at Advancing Enterprise 2005 Conference, London, England, February 4, 2005), Federal Reserve Board, http://www.federalreserve.gov/boarddocs/speeches/2005/20050204/default.htm.

Second, intra-firm transactions are an important part of U.S. trade, and these transactions can sometimes cancel out the price effects of changing currency values. In 2003, intra-firm trade averaged 42 percent of total U.S. goods trade, with 47 percent in imports and 32 percent in exports. In some cases of intra-firm trade, currency effects can be muted, because a multinational corporation may simultaneously benefit and be harmed by changes in foreign exchange rates, depending on where its operations are located.

Intra-firm trade is a key issue with respect to imports from those nations against whose currencies the dollar has depreciated the most in recent years. For example, the dollar fell 32 percent against the euro from April 2002 to April 2005, but only 23 percent overall; however, 59 percent of U.S. imports from the European Union occur as intra-firm trade versus 47 percent overall. And almost 80 percent of imports from Japan are intra-firm transactions.[5] While a European multinational corporation's exports to the United States might have been harmed by the euro's rise against the dollar in recent years, if that corporation also had a U.S. subsidiary, the firm would have benefited from the depreciating dollar as it sold goods abroad.

Finally, the relative economic strength of the United States and its trading partners has a major effect on the current account balance by affecting the volume of U.S. imports and exports. Chart 6 highlights recent trends in inflation-adjusted U.S. imports and exports. Between 2002 and 2004, the U.S. economy has experienced fairly robust growth, with real gross domestic product (GDP) rising at a 3.7 percent average annual rate. This strong economic growth has kindled growth in the real value of U.S. imports, despite the weaker dollar. Likewise, since the dollar began its slide in 2002, average economic growth has been modest in the major export destinations for U.S. goods and services. Real GDP growth has averaged less than 3 percent in Canada, less than 2 percent in Japan, and just over 1 percent in the euro zone. Although the weaker dollar may have lowered the price of U.S. exports in these countries, the relatively weak economic growth of the U.S. major trading partners limited their appetite for all goods and services, including those purchased from the United States. As a result, the real value of U.S. exports has remained relatively stable during the past several years.

Chart 6

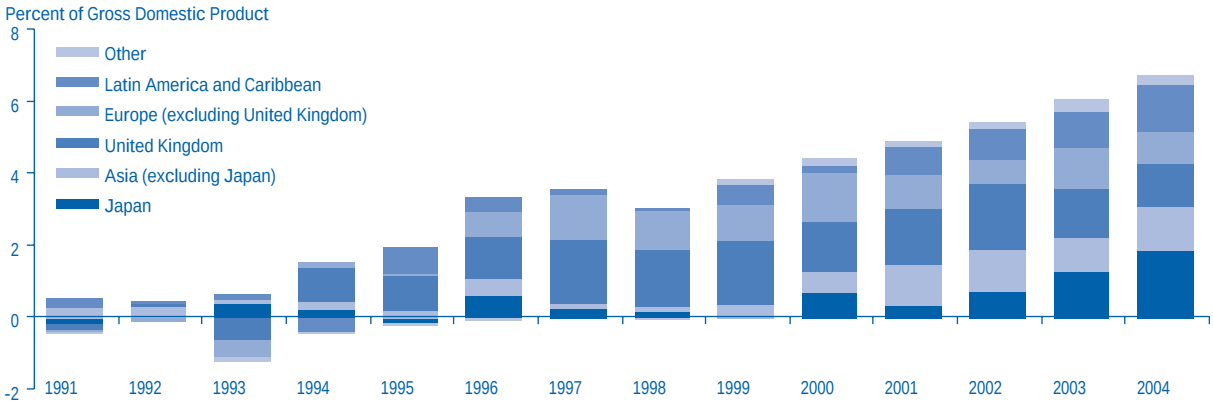


Only a few factors have been mentioned that could limit the declining dollar's ability to reduce the U.S. current account deficit. Another factor may be the lack of domestically produced substitute goods for those the United States currently imports, such as many consumer electronics. Something as simple as consumer tastes can also influence trade patterns—a preference by some Americans for French wines, for example. Given all of these considerations, changes in the foreign exchange value of the dollar, especially over the short run, are likely to have only limited effects on U.S. international trade patterns. Over a longer period, history suggests that U.S. import activity should come under pressure from a falling dollar while our export growth improves. In the interim, though, other factors may trump the declining dollar's ability to mitigate the expanding current account deficit.

[5] Purba Mukerji, "Is Intra-Firm Trade Limiting the Impact of the Weaker Dollar?" Dismal Scientist/Economy.com, April 5, 2005.

Chart 7

Japan and the Rest of Asia Provided the Majority of Financing for the U.S. Current Account Deficit during 2004



Note: Positive (negative) figures represent net capital inflows (outflows) to (from) the United States.
Source: U.S. Treasury.

all, Asia accounted for slightly less than half of all net foreign purchases, compared with slightly less than a third for Europe. Japanese purchases of U.S. Treasury securities, agency securities, corporate bonds, and equities expanded for the third year in a row and accounted for roughly 28 percent of all net purchases (see Chart 7). During the same period, investment from the United Kingdom, historically one of the largest purchasers of long-term U.S. securities, tapered off slightly.

In addition to Asia's growing role in funding the U.S. current account deficit, the makeup of other foreign investment has shifted since 2001. Typically, foreign governments and central banks have preferred to hold their reserves in U.S. Treasury debt, with less use of agency securities, corporate bonds, or stocks. Since the United States has been running current account deficits for more than ten years, a number of countries that export to the United States have accumulated significant holdings of dollar-denominated assets in their official reserves. Given that official investors prefer to hold U.S. Treasuries, the recent run-up in foreign official investment since 2001 has resulted in a marked increase in net foreign purchases of U.S. Treasury securities (see Chart 8).

Over time, these net purchases have resulted in an estimated 60 percent of U.S. Treasury securities now being held as official reserves of other countries. However, it is difficult to estimate the holdings of U.S. Treasury securities by particular foreign governments and central banks; for example, the Bank of Japan held roughly $700 billion in securities at the end of 2004 but did not disclose the types of securities.

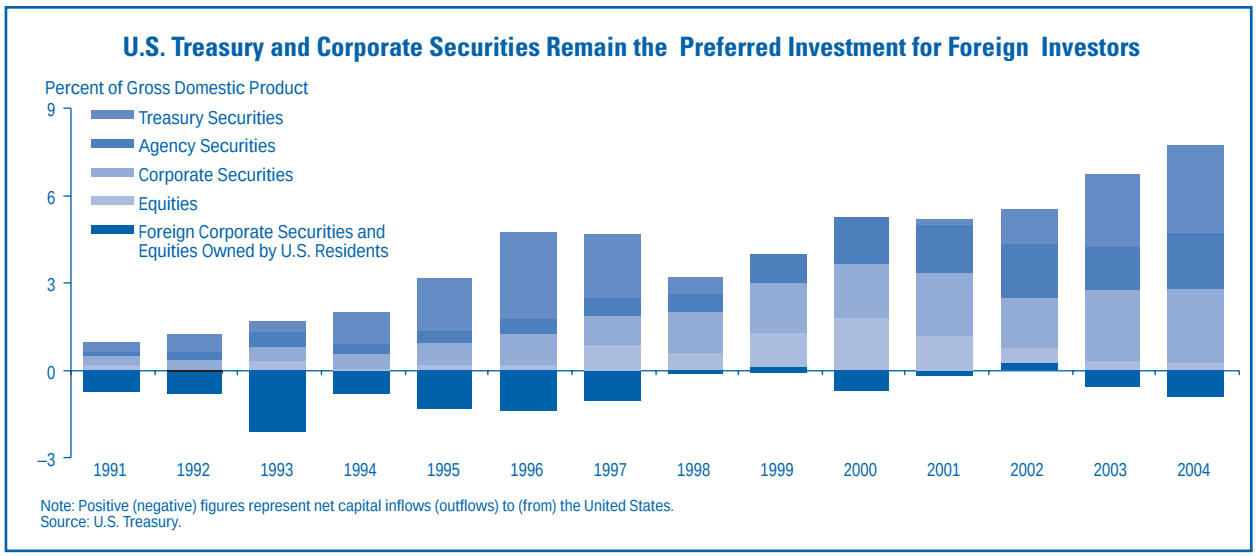
Long-Term Consequences

Economists are divided about the consequences of a long-term current account deficit. Some believe that a country that runs a persistent current account deficit is consuming more than it produces and living beyond its means. Others view this situation as neither good nor bad, but rather the result of a country realizing the economic benefits that accrue when other countries produce certain goods or services more cheaply. Although a country running a deficit may not generate as many new jobs, its citizens may benefit from lower prices.

Historically, large current account deficits have tended to unwind with varying degrees of speed and disruption to the macroeconomy. In the debate about how the current account deficit may unwind, two basic questions

[6] Data on the geographic origin of foreign capital flows produced by the Treasury International Capital (TIC) reporting system of the U.S. Treasury are not perfect. Within the TIC system, capital flows are assigned to the country of the foreign counterparty and not the country of the ultimate owner. For a thorough discussion of this and other TIC data issues, see: Francis E. Warnock and Chad Cleaver, "Financial Centers and the Geography of Capital Flows," Board of Governors of the Federal Reserve System (International Finance Discussion Papers, no. 2002-722, April 2002), http://www.federalreserve.gov/pubs/ifdp/2002/722/default.htm.

Chart 8



emerge: how soon might an adjustment occur, and how disruptive could that adjustment be?

How Soon Might an Adjustment Occur?

Some analysts suggest that the United States should be able to continue running a current account deficit for some time. These analysts believe that some of the inflows of foreign capital supporting the U.S. deficit are the result of conscious government and central bank strategies. As one analysis put it, "An array of central banks and finance ministries has emerged to resist, for their own local reasons, the adjustment [in the U.S. current account deficit] that the cyclical fundamentals seem to require."[7] This view puts most of the responsibility for the current account deficit on the export-led economic growth strategies of Asian countries, which rely on managed exchange rates and support the U.S. current account deficit with purchases of dollar-denominated assets.

Others disagree with this argument and note that little cooperation now exists among Asian countries on trade and exchange-rate issues. One Asian country could try to benefit at the expense of its neighbors by being the first to stop managing its currency against the dollar and sell its dollar reserves. The removal of capital controls in these nations during recent decades has compounded the problem by allowing private investors to move quickly from one currency into another. Large sales of dollar-denominated assets by private investors would raise the costs of maintaining a managed exchange rate, making it more tempting for Asian central banks to sell their reserves. These developments could accelerate the timing of a current account adjustment.

Risks of a Disorderly Adjustment

In contrast to the relatively mild adjustments experienced by industrialized countries in the past, some analysts have suggested that a U.S. current account adjustment is likely to be "disorderly," possibly involving a flight from dollar-denominated assets, a spike in U.S. interest rates and inflation, and a global recession.[8] These analysts believe that global imbalances—pronounced differences between countries' growth rates and current accounts—represent a source of economic fragility. It follows that the longer the U.S. current account deficit and other global imbalances continue to grow, the greater the odds of having a disorderly adjustment. Under this scenario, the enactment of protectionist trade legislation or a negative reaction

[7] Michael P. Dooley, David Folkerts-Landau, and Peter Garber, "The Revived Bretton Woods System: The Effects of Periphery Intervention and Reserve Management on Interest Rates and Exchange Rates in Center Countries," National Bureau of Economic Research (working paper, no. 10332, August 2004), http://www.nber.org/papers/w10332.pdf.

[8] Stephen Roach, "The Danger Zone of Global Rebalancing," paper presented at Morgan Stanley Global Economic Forum, April 11, 2005, http://www.morganstanley.com/GEFdata/digests/20050411-mon.html; Roach, "Close Your Eyes," paper presented at Morgan Stanley Global Economic Forum, February 14, 2005, http://www.morganstanley.com/GEFdata/digests/20050214-mon.html; and Roach, "An Unprepared World," paper presented at Morgan Stanley Global Economic Forum, January 31, 2005, http://www.morganstanley.com/GEFdata/digests/20050131-mon.html.

to tighter Federal Reserve monetary policy could trigger a sudden and disruptive adjustment. Other analysts, however, see many of the same imbalances but suggest that a more imminent adjustment in the current account deficit is likely.

Historical experience can help evaluate these differing perspectives and shed light on the current situation. A recent ***Federal Reserve Board*** study looked at more than 20 historical episodes in which an industrialized country unwound a significant current account deficit either in part or completely.[9] Overall, the results of the study suggest that current account adjustments tend to occur quickly. A deficit can substantially deepen within a year or two, and then significantly unwind in the same amount of time. In the historical episodes, most nations started with a modest current account deficit of about 2 percent of GDP. The deficit then expanded and peaked around 4 percent. In some cases, deficits grew to more than 6 percent of GDP before reversing direction. However, once current account deficits began to contract, they typically took about two years to shrink to between 1 and 2 percent of GDP. In another two years, many, but not all, of these countries moved into balance or surplus.

According to the Federal Reserve Board study, although current account deficits may unwind fairly quickly, the effects on economic activity typically have been mild for industrialized countries. During the episodes reviewed, median real GDP growth slowed by only about 3 percentage points. Increases in inflation and short-term interest rates were associated with current account adjustments, but the changes were not dramatic. After removing the effects of inflation, real exchange-rate depreciation also tended to be limited at around 8 percent. While all these adjustments occurred with only mild effects, there is no assurance that this must always be the case.

The results of this study also show that the magnitude of the effects of an adjustment hinges on how fast the economy is growing as it heads into the adjustment. Rapidly growing economies appear to slow more significantly and exhibit a greater tendency to enter recession. The jump in inflation and the decline in real exchange rates tend to be considerable in economies that are expanding rapidly before the adjustment. These results suggest that many rapidly growing economies may have been overheating before the current account adjustment and that their large current account deficits may have been part of a larger macroeconomic problem.

Conclusion

The U.S. current account deficit has been widening for more than a decade. Until now, net inflows of foreign savings have been adequate to fund the current account gap while offsetting the financing outflows resulting from U.S. residents and businesses investing abroad. However, at more than 6 percent of GDP, the U.S. current account deficit has entered uncharted territory. In past cases involving other industrialized countries, large current account deficits have eventually resolved themselves, usually with modest economic and financial market consequences. But the U.S. current account deficit is not typical, given the predominant global role played by the U.S. economy, its financial markets, and the dollar. The uncertainty posed by this situation, along with its far-reaching implications for economic performance, makes it worthy of ongoing attention and study.

J. Aislinn Bohren, Economic Research Assistant
Brian Lamm, Senior Financial Analyst

[9] Hilary Croke, Steven B. Kamin, and Sylvain Leduc, "Financial Market Developments and Economic Activity during Current Account Adjustments in Industrialized Economies," Board of Governors of the Federal Reserve System (International Finance Discussion Papers, no. 827, February 2005), http://www.federalreserve.gov/pubs/ifdp/2005/827/default.htm.

U.S. International Accounting Basics

The United States is both an importer and exporter of goods and services. But it is also an exporter and importer of investments, as U.S. investors seek to place their savings abroad while foreign savers seek to invest in U.S. assets, such as stocks, bonds, and real estate. These trading relationships are reflected in two international transaction accounts, the current account and the financial account, summarized below. In open economies—those without significant capital or trade controls—these two accounts must balance. In the case of the United States, it consumes more in imports than it sells in exports, and as a result it must pay for these net imports of goods by also being a net importer of foreign savings. Because these foreign savings inflows are credited to the financial account, they offset the U.S. net negative trade position (see Table).

The table also shows that the U.S. net trade deficit in goods dominates its current account deficit. Similarly, the biggest source of foreign savings supporting the net import position in 2004 came from private foreign investors.

J. Aislinn Bohren, Economic Research Assistant

Table

U.S. International Transactions
as of 2004 (dollars in billions)

Current Account				Financial Account			
Component:	**Exports**	**Imports**	**Net**	**Component:**	**Financial Outflows**	**Financial Inflows**	**Net**
Trade in Goods and Services	$ 1,147	$ –1,764	**$ –617**	Official Reserve Assets[d]	$ 3	$ 355	**$ 358**
Goods	808	–1,473	–665	Private Securities and Claims	–572	962	**390**
Consumer goods and autos	191	–601	–410	Direct Investment[e]	–249	116	**–133**
Capital goods and industrial supplies and materials[a]	510	–546	–35	Capital Account[f]	—	—	**–1**
Energy	24	–210	–186	Statistical Discrepancy[g]	—	—	**52**
Other goods	82	–116	–34				
Services	340	–291	48				
Interest Income[b]	369	–345	**24**				
Unilateral Transfers[c]	—	—	**–73**				
Balance on Current Account			**$ –666**	**Balance on Financial Account**			**$ 666**

Notes:

[a] The industrial supplies and materials component excludes autos and energy.

[b] Interest income is domestic investors' interest receipts on foreign investments (export column) and interest payments to foreign investors (import column).

[c] Unilateral transfers include gifts, foreign aid, nonmilitary economic development grants, government pensions, and private remittances.

[d] Official reserve assets are foreign currency assets held by a central bank.

[e] Direct investment is investment made by a foreign individual or company (source) to acquire or construct physical capital in the host country.

[f] In 1999, what was previously known as the capital account was renamed the financial account in the U.S. balance of payments. The capital account was redefined as a component of the financial account, which includes non-produced, non-financial assets such as debt forgiveness.

[g] Although the balance on the current and financial accounts sum to zero in theory, in practice differences invariably arise due to measurement and estimation errors. The statistical discrepancy represents these differences.

Source: Bureau of Economic Analysis Balance of Payments. (See the Bureau of Economic Analysis U.S. International Transactions Accounts Data tables (http://www.bea.gov/bea/international/bp_web/list.cfm?anon=71&registered=0) for more information.)

U.S. Trade Demographics in 2004

Goods and Services by Country

Chart 1

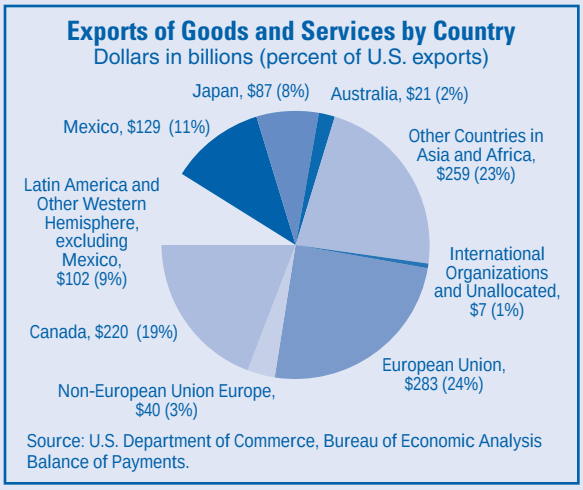
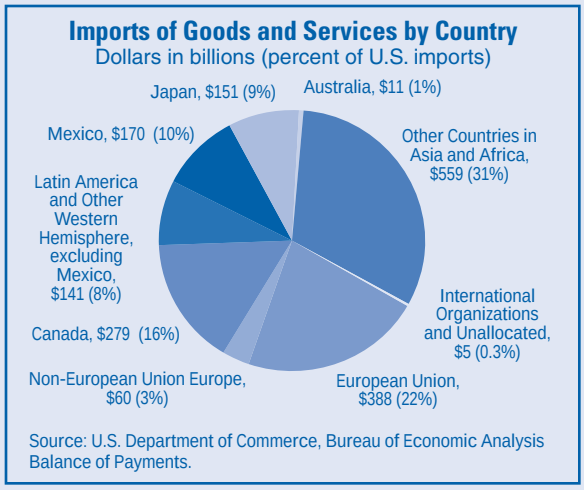


Chart 2



U.S. Trade Demographics in 2004

Goods and Services by Industry

Chart 3

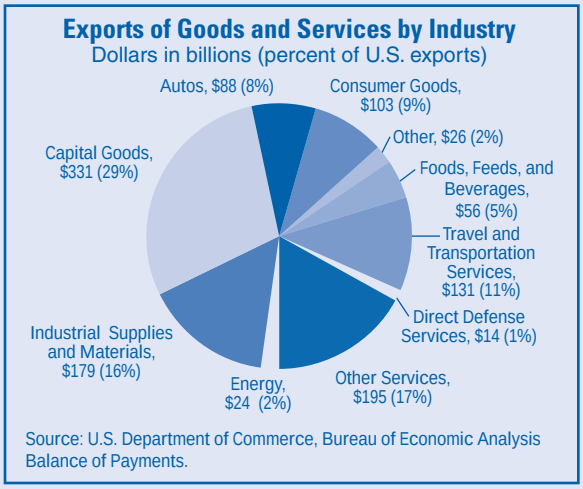
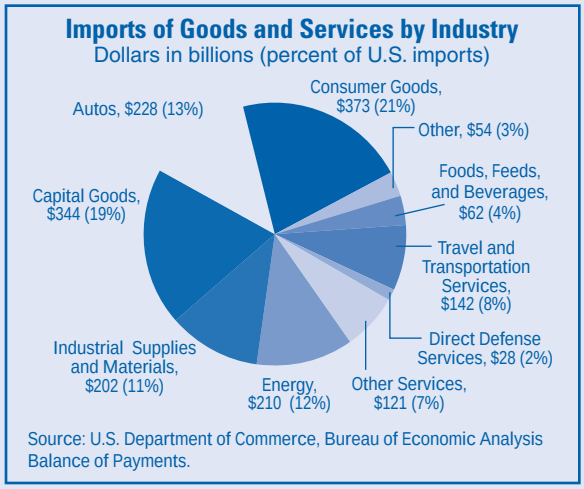


Chart 4



In Person: Two Perspectives on Global Financial Imbalances

The far-reaching changes being driven by globalization naturally lead to questions about where the process is leading us. At a personal level, job security surely ranks first as a concern in the minds of most. But individuals also face uncertainty about the new types of financial risks they face and what investment strategies make the most sense in a changing world. At a policy level, it is generally appreciated that globalization is making the world richer, but that there are winners and losers in the short run. In addition, the emergence of unprecedented global financial imbalances—perhaps best exemplified by the large and growing U.S. current account deficit—have led many to express worries about the future of the world's largest economy.

During the week of May 2, 2005, FDIC Chief Economist Richard A. Brown conducted a pair of interviews with prominent experts on international financial trends. He asked these experts to look into America's economic future and discuss the implications of a U.S. current account deficit that reached $666 billion in 2004. Brown posed a specific set of questions to each expert regarding either the "adverse" scenario or the "benign" scenario for resolving this large financial imbalance. Edited transcripts of both interviews appear below.

Outlining the benign scenario is Stuart S. Brown, Professor of Economics and International Relations at the Maxwell School of Citizenship and Public Affairs and Senior Research Associate at the Moynihan Institute of Global Affairs at Syracuse University. Addressing questions about the adverse scenario is Roger M. Kubarych, Senior Economic Adviser for HVB Group, Henry Kaufman Adjunct Senior Fellow in International Economics and Finance at the Council on Foreign Relations, and former Chief Economist of the New York Stock Exchange.[1] (See "Other Opinions on the Current Account Deficit" after this article for views besides those of Dr. Brown and Mr. Kubarych.) We begin with Professor Brown.

Stuart Brown: "This is a global economic problem, and we all have to do our part."

MR. RICHARD BROWN: Good afternoon, Stuart. We're going to ask you to outline what a benign scenario might look like with regard to the current account deficit. What are some of the developments that need to come into play to reduce these imbalances in a way that does not damage the performance of the U.S. economy?

DR. STUART BROWN: First of all, when we talk about an adjustment to the current account imbalance, we're not talking about going back to a surplus or even a zero balance. I think many would agree that if the United States eventually achieved annual current account deficits of something like 2.5 to 3 percent of gross domestic product (GDP), that would probably constitute a reasonable, medium-term equilibrium. This reflects the fact that the U.S. economy is dynamic and fast growing owing largely to superior productivity growth, with a labor force being boosted by immigration that is more rapid than in, let's say, Europe.

Stuart S. Brown

That gives you a sense of the type of adjustment—an admittedly large one—that would be needed over time to reach a new equilibrium, although in the case of financial markets there is a tendency to overshoot during the adjustment process. But we're certainly not going to see the current account deficit fall from 6 percent of GDP to zero. So that's number one.

[1] HVB Group is the parent organization of Hypo Vereinsbank, Germany's second-largest bank, and Bank Austria-Creditanstallt.

> ***"I think many would agree that if the United States eventually achieved annual current account deficits of something like 2.5 to 3 percent of GDP, that would probably constitute a reasonable, medium-term equilibrium."***
>
> ***Stuart Brown***

Second, one needs to recognize that part of that solution involves actions that are the responsibility of a variety of actors in the world, not just the United States. With respect to Asia, I think it is reasonable to think that a revaluation of currencies is at some point going to be likely. And this is going to contribute to an overall solution to the problem of global imbalances.

But it's not just about China revaluing its currency. It is also about the indirect impact that a Chinese revaluation would have on other Asian countries, which would be less reticent about allowing their currencies to appreciate against the dollar if the Chinese move first. That is to say, Asia must gradually move to greater reliance on domestic demand-led growth. Such developments aren't going to completely eliminate the U.S. deficit, but they might reduce it by $75 billion to $100 billion of the $660 billion current account deficit we have now. So it's that order of magnitude.

Third—and this is hugely important—Europe and Japan have to grow. And that is going to require all of the systemic changes to their economies that economists have been talking about for a very, very long time. Ultimately, the current account deficit in the United States is a reflection more than anything else of a more rapidly growing U.S. economy compared to the other major economies of the world, obviously excluding China, which is also playing a significant role in stimulating global demand.

Although a decline in the value of the U.S. dollar is part of the solution as well, you can't expect the entire burden to be taken on by the dollar, and it won't be. There are other elements required for a gradual adjustment, some of which I've described.

Also, I should add that as far as the United States is concerned, more serious attention needs to be paid to the federal budget deficit both over the next few years and—more importantly—in terms of the critical, longer-term challenge of maintaining the solvency of entitlements, notably Medicare, Medicaid, and Social Security. On that issue, however, my problem with the pessimists is that they tend to think that a budget deficit reduction in the United States by itself is going to have a dramatic effect on the current account deficit, and I think the evidence does not bear that out. In fact, I would cite an authoritative ***Federal Reserve*** study published earlier this year that concludes that for every dollar in fiscal deficit reduction, we can expect to get 20 cents of improvement on the current account balance.[2]

So, the benign scenario I am outlining depends in part on everybody realizing that this is a global economic problem, and we all have to do our part. Ultimately, the major countries, indeed the entire world, have a vested interest in promoting policies that contribute to reducing global trade imbalances. As I said, this includes the United States, which has ample reason—in addition to the current account deficit—to address its fiscal challenges.

The benign scenario also involves a gradual rise in interest rates in the United States, which would be what one would expect in any event given where we are in the business cycle, along with a gradual decline in a still-overvalued dollar. In addition, a benign scenario presupposes a fairly stable long-term dependency between Asia and the United States. In particular, the Asian countries are extremely interested in maintaining market openness with the United States, the largest consumer of their products.

In my view, proponents of the "hard-landing" scenario overemphasize the concern that the Asian central banks harbor over the potential for so-called capital losses on their dollar holdings. The concern is that if the dollar declines—and, even worse, if it declines rapidly—that would cause the Asian central banks to suffer increasingly stiff capital losses on their foreign exchange reserves. Furthermore, as the story goes, the fear of a rapidly declining dollar will lead those central

[2] Christopher J. Erceg, Luca Guerrieri, and Christopher Gust, "Expansionary Fiscal Shocks and the Trade Deficit," Federal Reserve Board (International Finance Discussion Papers, no. 2005-825, January 2005), http://www.federalreserve.gov/pubs/ifdp/2005/825/default.htm.

banks to cut back on their purchases of U.S. assets, which, of course, finance the current account deficit.

"It's not just about China revaluing its currency. It is also about the indirect impact that a Chinese revaluation would have on other Asian countries, which would be less reticent about allowing their currencies to appreciate against the dollar if the Chinese move first."

Stuart Brown

I think this reflects a misunderstanding of how central banks view foreign exchange reserves, particularly in Asia. We're still not that far removed from the Asian financial crisis of the late 1990s, where insufficient foreign exchange reserves contributed to the crisis. Central bankers in China, Taiwan, Thailand, Malaysia, and elsewhere are very cognizant of the need to build up foreign exchange reserves—even to levels that one might typically regard as "excessive"—as a buffer to defend themselves against potential future speculative attacks. Furthermore, these reserves do not represent claims against domestic output—that is, the reserves are not used to buy domestic goods and services. So to compare this notional capital loss on foreign exchange reserves (arising from a decline in the value of the dollar) to GDP in these Asian economies, as the adherents of the hard-landing view tend to do, makes little economic sense to me. The only exception to this view—that Asian central banks should be less worried about a medium-term decline in the U.S. dollar—would involve a scenario in which the U.S. economy and the dollar were headed for a longer-term systemic crisis, and I just don't see a realistic basis for attaching any significant weight to such a scenario.

I think that the overriding concern of Asian governments is to be able to continue with their fundamental export-led growth strategy. By exporting manufacturing goods to the United States, these economies can employ the sizeable surplus labor force coming from the agricultural sector to the cities. They need a reasonably competitive exchange rate to do that. If they have to accumulate foreign exchange reserves as part of that process, that's a secondary issue, as is the changing value of those reserves.

The actual fiscal cost for China of buying all these foreign exchange reserves and maintaining the peg between the renminbi and the dollar is that the Bank of China has fewer resources to transfer to the budget. And that is a trivial matter in my view relative to employing hundreds of millions of peasantry from the countryside and exporting as much as they can.

But having said all that, I think that the Chinese recognize that protectionist pressure in the U.S. Congress is picking up steam. In light of that, a realistic way to stave off that all-out assault on Chinese imports to the United States is for the Chinese to allow some strengthening of their currency. And I think that is exactly what they will end up doing.

MR. RICHARD BROWN: In the sense that this situation has thus far remained "benign," and that it appears plausible that the benign scenario could continue going forward, let me ask you where things could go wrong. What are some of the factors that could derail an orderly resolution of the current imbalances?

DR. STUART BROWN: First, I would not want to suggest that an adverse scenario is impossible. I would simply say that in a probabilistic sense, the benign scenario is much more likely. The idea that there will be a sudden re-evaluation of U.S. assets leading foreign investors and central banks to dramatically curtail their purchases of Treasuries and the myriad of other official and private U.S. assets runs counter to the basic reality that underlying U.S. economic fundamentals are sound. I find that the more pessimistic assessments of the situation tend to exaggerate the vulnerabilities of the U.S. economy and underestimate its strengths.

If you look objectively at the United States, you see the deepest, most liquid, most sophisticated financial markets in the world. Above all, it's a politically stable country with unparalleled protection for property rights and, therefore, a great, safe place to put your money.

Second, you have more rapid economic growth in the United States than the rest of the industrialized world, grounded in much more rapid productivity growth led by increasingly inventive applications of information

and computing technology. So the notion that there is going to be a sudden, precipitous reversal of the net capital currently flowing into the United States does not appear credible. The one possible exception to this benign scenario I'm outlining would be a perception on the part of investors that the U.S. political process was ultimately too paralyzed to address the country's longer-term fiscal challenge. Perhaps there is a basis for such a perception, but I would still argue that it is premature.

"As far as the United States is concerned, more serious attention needs to be paid to the federal budget deficit both over the next few years and—more importantly—in terms of the critical, longer-term challenge of maintaining the solvency of entitlements, notably Medicare, Medicaid, and Social Security."

Stuart Brown

I understand that we've already seen private investors scale back on dollar holdings over the past few years. There is nothing confusing about that, as private investors operate strictly on the basis of expected real (currency-adjusted) returns. I would only add that as the dollar declines—and I would expect it to decline somewhat more over the next few years—there is a natural brake on the speed with which that adjustment happens. Private investors, who still think of the United States as a very dynamic, healthy economy, will continue to buy on dollar weakness.

I also think that central banks, particularly in Asia, will continue to buy dollar-denominated assets, including U.S. Treasuries, to limit the extent to which their currencies appreciate. So I don't identify with this basic fear of a massive slowdown in combined official and private capital inflow to the United States, which would force a precipitous, painful reduction in the U.S. current account deficit. That scenario just does not comport with the basic underlying strength of the U.S. economy and Asia's long-term dependence on our market.

MR. RICHARD BROWN: Does the presence of these global financial imbalances reflect, in your opinion, a fundamentally deflationary global economy, with oversupply in a number of manufacturing sectors? Is that one of the elements of the imbalances that we see right now?

DR. STUART BROWN: I essentially subscribe to the view that there is an oversupply of global savings. You can call it a global savings glut or you can call it a lack of investment opportunities relative to the existing supply of global savings. But I think that this is a big reason why there has been such a massive flow of money in the last few years to the United States, where there are opportunities to invest your money productively or safely. Part of the reason for the inflow has been the Asian financial crisis and its aftermath. I also think it's because of the relative lack of growth in places like Japan and Europe. I'm not saying that lack of growth is going to last forever, but I think that this is part of the reason why the United States attracts foreign capital.

"Central bankers in China, Taiwan, Thailand, Malaysia, and elsewhere are very cognizant of the need to build up foreign exchange reserves—even to levels that one might typically regard as "excessive"—as a buffer to defend themselves against potential future speculative attacks."

Stuart Brown

The other side of that net inflow of capital is, of course, our current account deficit. I see the current account deficit not completely, but largely, as an endogenous result of stronger U.S. economic growth and the desire of a variety of institutions and investors around the world to put their money in a safe, reasonably high-return place. As long as that continues at the same rate, it's difficult to see how the current account deficit can turn around decisively.

MR. RICHARD BROWN: Is it a "flight to quality" by international investors?

DR. STUART BROWN: I think it's fundamentally a flight to quality not just in terms of the safety of U.S. government paper, but in terms of the underlying productivity of the U.S. economy and the lack of sufficient investment alternatives in other places.

MR. RICHARD BROWN: In terms of risk management on the part of FDIC-insured institutions, you mentioned the likelihood of a transition toward higher interest rates and perhaps a weaker dollar. What sorts of things should financial institutions do to prepare for the adjustments that need to take place?

DR. STUART BROWN: I'm not an expert on financial institutions, but I would suspect that they're doing exactly what they should be doing. Chairman Greenspan and the Federal Reserve have long been signaling that we're at the point of the business cycle where the expansionary monetary policy of the last few years has to reverse—irrespective of the current account deficit—and that interest rates are going up to contain inflationary pressures. The Fed's strategy has been to avoid surprising the markets; they have not tried to camouflage this. They've signaled very transparently that rates in the United States are going to rise relative to rates in other major countries.

I don't think that the speed with which rates will rise is going to be accelerated markedly by the presence of a large current account deficit. In fact, what is extraordinary is that with all these rumors about central banks diversifying their foreign exchange reserves and running from the United States, why have long-term U.S. real interest rates been so low? They've been lower than you would think at this stage of the business cycle, and lower than last year and the year before that. So I don't see much evidence to suggest that the current account deficit is going to complicate the interest rate picture to any considerable degree.

I would imagine that bank earnings are going to suffer as rates rise, because it becomes tougher to raise loan rates commensurately with deposit rates, which will narrow spreads. That's a totally understandable issue. I would also think that equities could weaken due to rising interest rate expectations. But I don't see a basis for serious concern about some systemic financial challenge on the back of this.

MR. RICHARD BROWN: I just have one more question for you, Stuart. You mentioned the revaluation of the Chinese currency. Is there an issue there with regard to the convertibility of capital and the health of the Chinese banking system? There are some who say that the high level of problem loans at some Chinese banks is one of the impediments to creating a convertible currency and allowing that exchange rate to rise.

DR. STUART BROWN: Revaluation should not be confused with full convertibility of the currency, particularly on the capital account side of the balance of payments. There is no reason that a revaluation of the renminbi has to be accompanied by a very rapid reduction of capital controls in China. In fact, I think that that would be a mistake.

"The idea that there will be a sudden re-evaluation of U.S. assets…runs counter to the basic reality that underlying U.S. economic fundamentals are sound."

Stuart Brown

So the fact that China revalues its currency and then pegs it at a different rate, and even if they go, by the way, to a managed floating-exchange-rate system where they allow some greater flexibility in their exchange rate and thereby acquire greater control over their monetary policy, that doesn't mean that they have to remove all capital controls. One would expect very serious problems in China's financial sector if capital controls were completely removed before the huge problem of nonperforming loans in Chinese banks was addressed first.

MR. RICHARD BROWN: Thank you, Stuart, for sharing your insights on these issues with the readers of FDIC Outlook.

Stuart S. Brown *is co-author, with David H. Levey, of "The Overstretch Myth: Can the Indispensable Nation Be a Debtor Nation?" in the March/April 2005 edition of Foreign Affairs (http://www.foreignaffairs.org/2005/2.html). Brown and Levey will again be featured in the Review and Response section of the July/August issue of Foreign Affairs discussing their views on the U.S. current account deficit.*

Roger Kubarych: "What if foreign countries and central banks decide to change their minds?"

Roger M. Kubarych

MR. BROWN: Good morning, Roger. What we would ask you to do today is to describe for us an adverse scenario for resolving the U.S. current account deficit. That is, what does an adverse scenario look like, and what are some of the things that could bring it about?

MR. KUBARYCH: Looking back at past financial incidents—and there have been some nasty ones, like the stock market crash of 1987, the banking crisis and thrift crisis of the late 1980s and early 1990s, and the collapse of the high-tech bubble—the financial and the economic consequences get bigger if there is a kind of a feedback mechanism going through the international side. That certainly was the case in 1987 when much of the tension in the financial markets had to do with a series of confrontations between the United States and other countries, including Japan and Germany.

Certainly, the world is a little broader today, and there are more countries that are involved. But clearly I would think that an adverse scenario that could result from the current U.S. dependence on foreign savings would be a development that suddenly, dramatically, and in a lasting way stopped those savings from flowing into the United States. One way this could happen would be to block these flows, as occurred in the case of certain takeover bids by foreign companies back in the 1980s, or by a policy decision by foreign governments to discontinue the purchase of U.S. assets.

So how could this scenario develop? If you look through the various precedents, some sort of protectionist measures by the United States could provide the trigger.

Let me step back and say that it's a matter of logic more than anything else that in order to run a current account deficit of $700 billion, which is well over 6 percent of gross domestic product, it has to be financed. If you can't finance it, you can't run it. So the adverse scenario is one that forces the United States to have a smaller current account deficit, because it can't finance a bigger one. And the main risk scenario that I can see is that something interferes with the kind of flows of capital from abroad that we've become accustomed to.

MR. BROWN: If foreign investors move away from dollar-denominated assets, what sorts of assets would they move into? And what are some of the implications that that might have for U.S. long-term interest rates and equity prices?

MR. KUBARYCH: Well, first of all, there are basically two types of foreign investors that have been financing the U.S. current account deficit.

One type is foreign official institutions: central banks, government agencies, and private-sector agencies and financial institutions that are actually influenced or directed by the governments of their countries. These kinds of institutions are particularly common in Asia, and up to 75 to 80 percent of the U.S. current account deficit in the last two or three years has been financed by the combination of foreign central banks, government investment corporations, and others directly or indirectly controlled by foreign governments, mostly in Asia.

The second type of foreign investor is private investors, and they take two forms: portfolio investors that buy stocks, bonds, and other types of financial instruments; and direct investors, meaning corporations that make investments in existing companies through takeovers or stock purchases or create new greenfield investments in the United States.[3]

The direct investment activities of foreign private companies have diminished dramatically since 2000. They peaked in the late 1990s when the transplant factories were being established by the Japanese auto

[3] The World Bank Local Economic Development glossary (see www.worldbank.org) defines a greenfield investment as factories and offices being built on land that previously has not been developed. Greenfield investments also imply that facilities are designed and built for investors, rather than the investor buying a facility already built.

companies. In the last few years, those investments have diminished a lot and no longer represent a major part of the financing.

"The main risk scenario that I can see is that something interferes with the kind of flows of capital from abroad that we've become accustomed to."

Roger Kubarych

There appears to be much less interest on the part of foreign companies in being here in the United States right now. If they are here already, they're probably making money. But there's no real enthusiasm. Those same companies are now more interested in Brazil, Mexico, China, and Eastern Europe.

So the real question is this: What are those foreign central banks, government institutions, and other financial institutions going to do with their money? And the answer is that they're going to diversify it. They're going to move out of U.S. government securities at the margin either by selling securities they already have or, more likely, taking the bulk of their new acquisitions of dollars and selling them for euro, sterling, yen, or what you might call commodity-related currencies like the Australian dollar and Canadian dollar. There are plenty of other currencies and plenty of other bonds and stock markets for foreign investors to go into. Actually, they've become disproportionately invested in the dollar relative to their trade patterns.

MR. BROWN: What implications would that have for U.S. inflation and interest rates? Could we see another episode of stagflation similar to the late 1970s?

MR. KUBARYCH: There's no doubt that the ability to import cheap—that is, inexpensive—products from around the world has kept down U.S. inflation. The Chinese all by themselves are bringing down the U.S. inflation rate by several tenths of a percent. Import prices from China and some of the other Asian developing countries are actually lower today than they were a year ago. Japanese import prices from the perspective of the United States are up less than 1 percent from last year. It's only when you look at manufactured goods and import prices from Europe that you see a significant increase in price.

What's happened is that whatever exchange rate changes there have been in the last few years, the foreign producers are essentially bearing that burden themselves rather than passing it on in higher prices. And that's one reason why American consumers and businesses are buying foreign products, because their prices haven't gone up. In order to have a change in incentives that would reduce the current account and trade deficits, those import prices are going to have to go up. And those price increases, in turn, would be matched by domestic corporations that are competing with imported goods. Raising prices is always the easiest route to more profits.

So this big current account adjustment, the unfriendly one, would be inflationary. That rise in inflation will set off an increase in inflationary expectations that will lead to big sales in the bond market by traders and investors, so long-term interest rates will also go up. But how much? That depends on how sudden the shock is and, of course, on the political climate in which it is made. But there will be upward pressure on U.S. interest rates, and that will feed through into a reduced demand for housing, so the housing boom will cool off and housing prices will stop going up. Average housing prices in this country are up 11 and a half percent from a year ago. That rate of appreciation will slow quite a bit—and in a hurry—which will lead to lower consumer spending. The capital gains—both realized and unrealized—on housing in the last few years have spurred greater levels of consumption, leading to higher domestic economic activity and a higher level of imports as well.

"Looking back at past financial incidents…the financial and the economic consequences get bigger if there is a feedback mechanism going through the international side."

Roger Kubarych

"What are those foreign central banks, government institutions, and other financial institutions going to do with their money? The answer is that they're going to diversify it."

Roger Kubarych

So there will be a reversal of the process that we've benefited from in the last few years, which is low interest rates, facilitated by low inflation, which has been kept down by a high level of imports. Low inflation has led to the big housing boom, where prices on average have been going up far faster than incomes. And people have been drawing on that elevated level of housing wealth to consume more. As a result, the U.S. savings rate has been very low, in some quarters barely above zero. And the United States has enjoyed a high rate of economic growth compared to any other industrial country.

MR. BROWN: If there were one or two policy initiatives that the United States could undertake to mitigate the possibility of these adverse consequences, what might they be?

MR. KUBARYCH: Well, the United States is out there right now trying to get the exchange-rate adjustment mechanism to work better, but government officials are doing so in a "kind and gentle" way. They're trying to get exchange-rate flexibility into the Asian system so that there will be a gradual increase in these currencies rather than a sudden, disruptive one. And they would naturally welcome some increase in import prices that would provide an incentive for Americans to switch out of imports and into domestically produced products. That would be part of the process of adjusting the trade deficit.

You don't want to adjust the trade deficit by running a recession. For one thing, nobody benefits from a recession, and it's not a sustainable policy. You can't run a sustained recession just to hold down the trade deficit. The only countries that have done that have been countries that were facing a loss of access to the capital markets. For example, Argentina went through a terrible recession in the late 1990s. But that's not something that's going to happen to the United States, and it's not wanted.

So basically the administration's stated policy is to create the benign scenario. But the administration is not living in a vacuum, and the Congress is capable of forcing protectionist measures onto an unwilling administration if it gets irritated enough by what is seen as unfair competition from abroad. That could thwart the administration's policy of creating the conditions for a benign adjustment.

MR. BROWN: So protectionism would be the one policy to avoid?

MR. KUBARYCH: It would do the most damage.

And that protectionism can be in two basic types, one of which is trade protectionism. The most extreme form of that is a movement backward from the kind of system we have now—where consumers choose—to where governments choose how the trade patterns work.

But you can also have protectionism on the investment side. If you go back to 1987, one of the triggers for a lot of the concern in both the foreign exchange markets and then the bond markets, which spilled over into stocks later that year, was the denial of an application by a Japanese company to buy Fairchild Semiconductor. That really left a bad taste in the mouths of not only the Japanese, who were denied from making the acquisition, but also many other foreign investors. Eventually Fairchild was sold to Schlumberger, a French oil-field services provider. But the damage was done.

"This big current account adjustment, the unfriendly one, would be inflationary."

Roger Kubarych

What do you think would happen if the Chinese decide that they are going to take some of their $700 billion in reserves and buy an American company, and then Congress says no, we don't want China owning that company, and they pass a special law forbidding it?

Well, that's protectionism on the investment side, and it can be very damaging.

To look at the flip side, the chairman of United Airlines, which is struggling to try to get out of bankruptcy and become a regular shareholder-owned company again, has complained about American protectionism as to who can own a U.S. airline. If you didn't have limits on foreign ownership of U.S. airline companies, there is more than one foreign airline that might be a natural bidder for a United Airlines coming out of bankruptcy.

"[Foreign governments and their agencies] have been running a classically mercantilist policy by using the exchange rate to make their goods more competitive on a global basis, not just against the United States. And they're getting away with it."

Roger Kubarych

We don't have a totally pure system either in the trade area or in the investment area, so it is very easy to see how a tightening or a broadening of such restrictions could have a negative effect.

MR. BROWN: One last question. Financial institutions manage risks according to the quantitative relationships they can measure in the world as it is today. It is sometimes difficult to prepare for a big sea change—such as the dollar falling from its status as the world's de facto reserve currency—that can profoundly affect inflation and interest rates. What sort of risk management strategies can financial institutions use to insulate themselves from the possibility of such a big change in the macroeconomic environment?

MR. KUBARYCH: Well, I have a few things to say here. The key is that foreign governments and their agencies are preventing exchange-rate changes that would be associated with reducing the dollar share in world reserves and in the use of the dollar internationally. They have been the ones keeping the dollar as the main currency, not the United States.

Now, why are they doing that? They're doing that for trade advantages, because they see the United States as the only fast-growing major industrial country, and they're trying to build their market share. So they have been running a classically mercantilist policy by using the exchange rate to make their goods more competitive on a global basis, not just against the United States. And they're getting away with it.

The international monetary system is really not governed in any explicit way. The International Monetary Fund has essentially been relatively passive, if not negligent, in monitoring the situation. Because there are short-term benefits to the United States from this situation, the United States hasn't really pushed the issue very much either. The Europeans, who are irritated at the United States because of Iraq, have been tardy in recognizing that they are among the ones that are most hurt.

So the interesting question is, what if foreign countries and central banks decide to change their minds? Well then, of course, there would be a substantial systemic change. That's happened before. We had a major realignment in currencies in 1971 and again in 1973. And we've struggled with the Japanese for 30 years in terms of the relationship between the yen and the dollar. Anybody managing funds in an international context, knowing this history, has to know that there will be a major change. Not whether there might be, but that there will be. So how do you prepare for that? Well, you assume that it is going to happen, and you act ahead of it; you diversify before everybody else does. That's lesson number one.

Another way to prepare efficiently and quietly, anonymously, is by using modern techniques in the financial derivatives markets. If I wanted to protect myself against a really big systemic change in the world's financial markets, I would be a buyer of deep out-of-the-money options. This is basically saying that I'll pay a certain premium, like an insurance premium, to insure myself against a big change. I would look at the values of those deep out-of-the-money options today and find that they were quite cheap, because, in fact, markets are being kept unrealistically steady. The degree of volatility in the markets has been essentially suppressed by all of this activity. So I would be a buyer of volatility. That's how you would do it.

MR. BROWN: Very good. Roger, this has been really useful to us to get the benefit of your long experience and your insights into how the markets work.

Roger M. Kubarych *is the author of numerous recent articles published by the Council on Foreign Relations, including "Paradox of Plenty" (April 2005, http://www.cfr.org/pub7987/roger_m_kubarych/paradox_of_plenty.php).*

Mary Ledwin Bean provided editorial assistance for this article.

Other Opinions on the Current Account Deficit

Stephen Roach, Chief Economist and Director of Global Economic Analysis, Morgan Stanley

In a U.S.-centric global economy, that spells one thing—over-reliance on the over-extended American consumer. Should the U.S. consumer cave—a distinct possibility in the event of a long overdue current account adjustment—
Asia would be toast."

Source: "Asia's Only Hope," *Global Economic Forum*, Morgan Stanley, April 29, 2005.

Nouriel Roubini, Associate Professor in the Department of Economics and International Business at the Stern School of Business, New York University

"Investors should worry about such concentration [of U.S. government bonds in the hands of foreign central banks] and the possibility of foreign exchange diversification out of U.S. dollar assets. If such diversification were to occur, there would be a significant risk of a hard landing for the U.S. and the global economy."

Source: "Does Overseas Appetite for Bonds Put the U.S. Economy at Risk?" *Wall Street Journal*, March 29, 2005.

Barry Eichengreen, George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley

"The United States has little incentive to precipitate the consequent adjustment. To the contrary, it is happy living beyond its means. Rather, adjustment will have to be forced by Asia…Doing so will require allowing the real exchange rate to rise."

Source: "Global Imbalances and the Lessons of Bretton Woods," National Bureau of Economic Research (working paper, no. 10497, May 2004).

Maurice Obstfeld, Professor of Economics, University of California, Berkeley; and Kenneth Rogoff, Thomas D. Cabot Professor of Public Policy and Professor of Economics, Harvard University

"That global capital markets may have deepened (as emphasized by U.S. Federal Reserve Chairman Alan Greenspan) does not affect significantly the extent of dollar decline in the wake of global current account adjustment. Rather, the dollar adjustment to global current account rebalancing depends more centrally on the level of goods–market integration. Whereas the dollar's decline may be benign as in the 1980s, we argue that the current conjuncture more closely parallels the early 1970s, when the Bretton Woods system collapsed."

Source: "The Unsustainable U.S. Current Account Position Revisited," National Bureau of Economic Research (working paper, no. 10869, October 2004).

Michael Dooley, Special Advisor, Deutsche Bank; David Folkerts-Landau, Managing Director, Global Markets Research, Deutsche Bank; and Peter Garber, Global Strategist, Deutsche Bank

"Moreover, it is very hard to find any hint of a crisis in the non-price financial data. While the official statistics show that the U.S. is a net debtor to the tune of $2.5 trillion, the U.S. continues to earn more on its assets abroad than it pays on its liabilities. Net investment income earnings are positive and have actually increased in H2 2004 relative to H1 2003. In part, the official numbers are just wrong. The U.S. has made a whopping capital gain on the dollar value of its foreign liabilities that is not captured in the statistics."

Source: "The Revived Bretton Woods System: Alive and Well," Deutsche Bank, December 2004.

David Altig, Vice President and Associate Director of Research, Federal Reserve Bank of Cleveland, and Adjunct Professor of Economics, Graduate School of Business at the University of Chicago

"First, I don't think anyone is arguing about whether an adjustment in U.S. external balances is coming. They are big, to be sure, and cannot continue to grow. But those observations alone aren't sufficient to support a hard-landing scenario."

Source: "Does Overseas Appetite for Bonds Put the U.S. Economy at Risk?" *Wall Street Journal*, March 29, 2005.

Ben S. Bernanke, Governor, Federal Reserve Board

"…[T]he underlying sources of the U.S. current account deficit appear to be medium-term or even long-term in nature, suggesting that the situation will eventually begin to improve, although a return to approximate balance may take some time. Fundamentally, I see no reason why the whole process should not proceed smoothly."

Source: "The Global Saving Glut and the U.S. Current Account Deficit," speech, Virginia Association of Economics, Richmond, Virginia, April 14, 2005.

Quotes compiled by Nathan Powell, Financial Economist.

The Globalization of the U.S. Banking Industry

Following the overall economic trend of the past several decades, the banking industry has become increasingly global. U.S. banks insured by the Federal Deposit Insurance Corporation (FDIC) have steadily grown their international operations over time, while foreign banks also have expanded their profile in the U.S. marketplace. At the same time, consolidation in the U.S. banking industry is having a profound effect on the structure of its international operations, as the vast majority of the foreign assets of U.S. banks are held now by just a few large institutions.

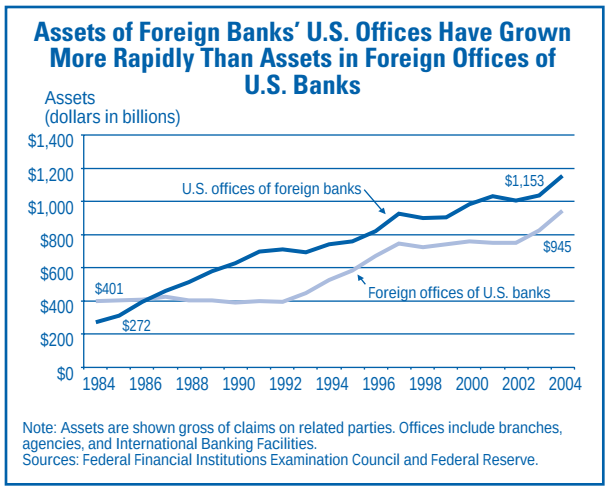
U.S. banking companies tend to share a similar objective in building an international banking presence—namely, to increase revenue growth. However, the strategies they employ in pursuit of this goal differ widely. Some institutions seek to establish a significant market presence in potentially high-growth international markets, while others employ narrower strategies such as servicing the global financing needs of their banking customers or leveraging their existing product expertise in a single line of business. U.S. banks have also been eager to expand their nonbanking business lines and capital markets activities overseas.

This article summarizes how globalization is affecting the U.S. banking industry. It focuses, in turn, on the structure of U.S. banks with international activities, the global strategies of U.S. banks, and performance differences between banks that are internationally focused and those with primarily domestic operations.[1] (See the box entitled "International Operations of U.S. Banks and U.S. Operations of Foreign Banks" for more information on the regulatory reporting structure of foreign banking operations.)

Global Banking Assets Are Growing Larger and More Highly Concentrated

During the past 20 years, international banking—measured in terms of both overseas banking assets held by U.S. banks and foreign bank assets in the United States—has expanded steadily (see Chart 1).[2]

Chart 1



Foreign-owned banking assets in the United States have exceeded international assets of U.S. banks since the mid-1980s. Overall, foreign banking assets in the United States have grown at a rate roughly consistent with that of assets held by domestic institutions, remaining at approximately a 4 to 5 percent share of total U.S. banking assets.[3]

As the banking industry has become more consolidated over the past two decades, so too have the international activities of FDIC-insured U.S. banks.[4] In 1984, Citibank NA held the largest share of international assets (17 percent) of any U.S. bank, while the top five banks together held slightly more than half of all international assets reported by U.S. banks.[5] Twenty years later, the share of international assets held by the top five banks had increased to 87 percent, and the single largest bank share, again held by Citibank NA, had increased to 42 percent (see Table 1).

[1] Data for foreign banking operations of U.S. banks and bank holding companies and foreign banks operating in the United States were obtained from various reports required by U.S. banking regulations.
[2] If assets owned in bank subsidiaries with foreign ownership were included, the trend would be more pronounced. At year-end 2004, an additional $661 billion of assets was reported by foreign-owned institutions in the United States, compared with some $275 billion in foreign banking subsidiaries owned by U.S. companies.
[3] Adrian E. Tschoegl, "Who Owns the Major U.S. Subsidiaries of Foreign Banks? A Note," Wharton Financial Institutions Center, April 2003.
[4] The FDIC released a series of studies in 2004 describing consolidation and other long-term changes in banking. See *FDIC Future of Banking Study,* http://www.fdic.gov/bank/analytical/future/.
[5] Data from FFIEC 031, Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices.

International Operations of U.S. Banks and U.S. Operations of Foreign Banks: Organizational Structures and Regulatory Reporting

U.S. banking activities in overseas markets take a number of legal forms, ranging from representative offices, shell branches, Edge Act corporations, and foreign subsidiaries to arrangements with affiliated and nonaffiliated foreign banks.[6] The choice of structure is influenced not only by an institution's international strategy and specific banking activities, but also by the needs of its clients and the legal framework and banking culture of the host country. In addition, a bank's accounting and tax framework, as well as the powers associated with its particular banking charter, will affect how it structures its international operations.

Banks engaging in international business often accommodate the needs of their foreign banking customers through foreign branches or agencies, which are typically less costly to operate than foreign subsidiaries. Many banks may be able to satisfy their clients' international banking needs without establishing a separate office or subsidiary outside the United States. These banks typically offer more limited international financial services, such as commercial lending relationships, trade letters of credit, foreign exchange services, and other capital markets services, to foreign customers from their U.S. offices.

In compliance with U.S. banking regulations, reporting of foreign banking operations is based on the structure of the banking entity. For regulatory purposes, a U.S. bank may engage in international operations within the bank itself or through a bank holding company subsidiary. For instance, international operations of U.S. banks can be housed in foreign offices, branches, and subsidiaries, while U.S. bank holding companies can conduct international operations through either foreign banking or nonbanking subsidiaries. Similarly, U.S. operations of foreign banks may be housed in U.S. offices and branches, in nonbanking subsidiaries, or through ownership of U.S.-based banks or bank holding companies.

Balance sheet and income statement information that describes the international activities of U.S. and non-U.S. banks and bank holding companies is collected through the following regulatory reports:

- Federal Reserve (FR) Form Y-9C, Consolidated Financial Statements for Bank Holding Companies
- Federal Financial Institutions Examination Council (FFIEC) Form 031, Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices; and Form 041, Consolidated Reports of Condition for a Bank with Domestic Offices Only
- FFIEC Form 030, Assets of Foreign Branches of U.S. Banks
- FR Form 2314, Assets of Foreign Banking and Nonbanking Subsidiaries of U.S. Banking Organizations
- FFIEC Form 002, Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks
- FR Form 7-N, Financial Statements of U.S. Nonbank Subsidiaries Held by Foreign Banking Organizations

[6] Edge Act corporations refer to section 25(a) of the Federal Reserve Act of 1919, which enabled U.S. banks to create limited-purpose "Edge" corporations to participate in international banking. These corporations were named after the original sponsor of the legislation, New Jersey Senator Walter Edge. For more information, see Ernest T. Patrikis, "The Federal Reserve System's Supervision and Regulation of the Foreign Operations of United States Banking Organizations," speech given in Miami, Florida, April 2, 1998, http://www.cemla.org/pdf/pub-di-col-patrikis.PDF.

Table 1

FDIC-Insured U.S. Bank Share of Foreign Office Assets
1984 versus 2004 (dollars in billions)

December 31, 1984				December 31, 2004			
Bank	Foreign Office Assets	Share of All U.S. Bank Foreign Office Assets	Cumulative Share	Bank	Foreign Office Assets	Share of All U.S. Bank Foreign Office Assets	Cumulative Share
Citibank NA	$ 67	17%	17%	Citibank NA	$ 395	42%	42%
Chase Manhattan Bank NA*	46	11%	28%	JPMorgan Chase Bank NA	326	34%	76%
Bank of America NT&SA	40	10%	38%	Bank of America NA‡	56	6%	82%
Morgan Guaranty Trust Co.*	33	8%	46%	State Street Bank & Trust Co.	25	3%	85%
Manufacturers Hanover Trust Co.*	25	7%	53%	Bank of New York	24	3%	88%
Bankers Trust Co.	21	5%	58%	Wachovia Bank National Association	22	2%	90%
Chemical Bank*	18	4%	62%	MBNA America Bank NA	18	2%	92%
First National Bank of Chicago*	13	4%	66%	Fleet National Bank‡	17	2%	93%
Continental Illinois NB&T†	10	2%	68%	Northern Trust Co.	13	2%	95%
Security Pacific National Bank†	9	2%	70%	HSBC Bank USA National Association§	10	1%	96%
Total	**$ 281**			**Total**	**$ 906**		

*Now part of JPMorgan Chase Bank NA.
†Now part of Bank of America NA.
‡ Subsidiaries of Bank of America Corporation.
§A foreign-owned bank.

Source: Federal Financial Institutions Examination Council Bank Call Reports.

Similarly, the share of foreign offices operated by U.S. banks also has become more concentrated in fewer large institutions. The number of U.S. banks operating foreign offices has steadily declined from 266 banks in 1984 to 122 banks at year-end 2004.[7] Three banks dominate the list of U.S. banks with foreign offices. At the end of 2004, Citigroup, JPMorgan Chase, and Bank of America collectively owned 651 (or 84 percent) of the 777 total foreign branches of U.S. banks.

International Strategies of U.S. Banks

Financial institutions, continually on the hunt for new sources of revenue, have increasingly looked beyond domestic borders for new business. For example, Citigroup and JPMorgan Chase, the two largest U.S. banks in terms of total assets, earned 53 percent and 48 percent, respectively, of their net income from operations outside of North America in 2004.[8] And Citigroup's international net income increased

[7] Fifty-nine of the 266 U.S. banks with foreign offices in 1984 remained in operation at year-end 2004; of these, only 7 banks no longer had foreign offices, according to data from banks filing FFIEC Call Report Form 031, Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices, for December 31, 2004. Foreign offices include branches and subsidiaries in U.S. territories and possessions, Edge Act or Agreement subsidiaries (Agreement corporations are state-chartered counterparts of Edge Act corporations, which are federally chartered), foreign branches, consolidated foreign subsidiaries, and International Banking Facilities (IBFs). (IBFs allow depository institutions in the United States to offer services to foreign residents and institutions free of some Federal Reserve requirements and some state and local income taxes; IBF operations are under the jurisdiction of the Federal Reserve and other federal and state regulators.)

[8] Citigroup, "Citigroup Net Income: Regional View," 2004 Annual Report; and JPMorgan Chase, "Note 30: International Operations," 2004 Securities and Exchange Commission form 10K.

43 percent in 2004 over 2003, outpacing growth in its U.S. businesses.[9]

International banking strategies may differ across banks in terms of geography or product choice. Several key objectives drive foreign expansion by U.S. banks, including

- increasing profits by expanding distribution channels into new, potentially high-growth geographic markets and across demographic groups;
- providing commercial lending and capital markets products and services to support global expansion plans of corporate and commercial clients;
- increasing revenue diversification; and
- cross-selling and leveraging existing product expertise in foreign markets.

Some banks limit their international operations to certain areas of expertise, while others establish a physical presence in foreign markets to offer a wider array of products to their foreign customers.

Geographically, U.S. banks have increasingly focused their international activities in Europe and Asia, while U.S. bank assets in Latin America and the Caribbean have declined. For example, at year-end 2004, Europe represented roughly half the foreign branch assets of U.S. banks, and Asia represented approximately one-quarter of these assets (see Table 2). (For a discussion of foreign banking trends in America over the past 20 years, see the box entitled "Foreign Bank Presence in the United States.")

Table 2

Location of Foreign Branches of U.S. Banks
(dollars in billions)

	December 31, 1994		December 31, 2004	
Location	**Assets**	**Asset Share**	**Assets**	**Asset Share**
Asia	$76	23%	$104	23%
Canada	0	0%	11	2%
Europe	161	48%	245	54%
Latin America	13	4%	13	3%
Caribbean	63	19%	41	9%
Other	21	6%	41	9%
Total	**$333**	**100%**	**$456**	**100%**

Note: Assets are net of claims on related parties.
Source: Federal Financial Institutions Examination Council Call Reports (Form 030).

The Attraction of China

Attracted by the opportunity to develop a strategic foothold in one of the world's largest economies, interest in China among U.S. and foreign-owned financial institutions is intensifying. As part of its 2001 accession into the World Trade Organization, China committed to remove restrictions on foreign participation in its financial industry over a five-year period.[10] As the deadline for reform completion nears, reports suggest that interest from abroad in China's banking market has increased.[11] Likewise, indications are that the Chinese government is becoming more receptive to foreign investment in that country's banking sector.[12]

According to a 2004 special edition of ***The McKinsey Quarterly***, China, the world's most populous nation, will represent "a golden opportunity" for foreign banks to provide credit card loans once foreign lending restrictions are lifted. China's large, consumption-driven economy, potential deregulation of consumer lending laws, and a projected decline in demand for corporate banking products all point to consumer lending as the line of business with the largest intermediate-term potential. Credit card revenues from interest income and merchant fees in China are projected to increase 50 percent annually and reach $5 billion by 2013. According to the report, partnerships with existing Chinese banks may be the best way to enter China's consumer lending market during this period. Foreign banks will not be able to accept deposits or issue cards until 2007, and card holders currently place little value on credit cards issued by foreign banks.[13] The recent announcement of a strategic alliance between Discover Financial Services, issuer of Discover Network Cards, and ChinaUnionPay (CUP), China's only national bankcard association, exemplifies the importance of

[9] Citigroup, "Letter to Shareholders," 2004 Annual Report.
[10] *Business Daily Update,* "Foreign Banks Still Expanding," December 6, 2004.
[11] Financial Services Distribution, "Country Survey-China: Banks Going for Gold in China," May 27, 2005.
[12] RiskCenter.com, "Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government," May 25, 2005. The report indicates that foreign banks have invested in 11 Chinese banks, including Citigroup's 5 percent investment in Shanghai Pudong Development Bank.
[13] David A. von Emloh and Yi Wang, "Retail Banking in China," *The McKinsey Quarterly, 2004 Special Edition: China Today.*

Foreign Bank Presence in the United States

As foreign bank activity in the United States has steadily expanded over the past 20 years, some new trends have emerged. First, the *composition* of the foreign banking presence in the United States has shifted as Asian (primarily Japanese) investment has lagged and European investment has grown. At year-end 1984, European-owned banks represented about 45 percent of the assets of all foreign-owned U.S. commercial banks and savings institutions; by year-end 2004, that share had risen to more than 75 percent. Concurrently, the share of foreign-owned U.S. bank and thrift assets controlled by Asian banks declined from 40 percent to 10 percent.[14]

In addition, while the *number* of branches and agencies of foreign banks in the United States has declined (from 593 at the end of 1991 to 270 at the end of 2004), their *assets* have grown.[15] In fact, these banking vehicles have been the primary source of growth in the U.S. assets of foreign banks. Since 1991, gross assets of *foreign branches* in the United States have grown from $704 billion to $1.153 trillion, or roughly twice the growth in assets of *subsidiaries* of foreign banks and thrifts, which totaled $661 billion at year-end 2004 (see Table 3 for the ten largest foreign-owned financial institutions in the United States).[16]

Table 3

Ten Largest Foreign-Owned, FDIC-Insured Commercial Banks and Savings Institutions
December 31, 2004 (dollars in billions)

Name	City, State	Assets
HSBC Bank USA NA	Wilmington, DE	$138.3
LaSalle Bank NA*	Chicago, IL	63.7
Charter One Bank NA†	Cleveland, OH	50.9
Standard Federal Bank NA*	Troy, MI	39.1
Bank of the West	San Francisco, CA	38.8
Deutsche Bank Trust Co. Americas	New York, NY	33.3
Citizens Bank of Massachusetts†	Boston, MA	31.3
Citizens Bank of Pennsylvania†	Philadelphia, PA	29.8
Harris Trust & Savings Bank	Chicago, IL	21.5
RBC Centura Bank	Rocky Mount, NC	18.4
Total		**$465.1**

* Subsidiaries of ABN AMRO Holding N.V.
† Subsidiaries of Royal Bank of Scotland Group, PLC

Source: Federal Financial Institutions Examination Council Call Reports.

The predominant type of asset held in U.S. branches of foreign banks is commercial and industrial (C&I) loans. In fact, some 54 percent of total loans held by U.S. *branches* of foreign banks are C&I loans, a share that is twice as high as the 26 percent C&I share in U.S. *subsidiaries* of foreign banks. However, recent trends suggest that foreign banks may be increasing their focus on the U.S. consumer banking market, as exemplified by HSBC's acquisition of Household International, Inc., in 2003.[17]

[14] Data from the Federal Reserve's National Information Center database and the FDIC.
[15] These figures represent the number of offices filing a consolidated branch report; multiple offices in a single metropolitan area can file on one consolidated report.
[16] If net of claims on related parties, these amounts would be $616 billion in 1991 and $797 billion in 2004.
[17] Tanya Azarchs, "Foreign Banks Use Acquisitions to Broaden U.S. Base," Standard & Poor's, March 31, 2005.

partnerships as a point of entry to China's credit card market. The agreement is designed to allow CUP card holders to use their credit cards while traveling in the United States while also providing access to the Discover ATM network. Similarly, Discover cards will be accepted in China.[18]

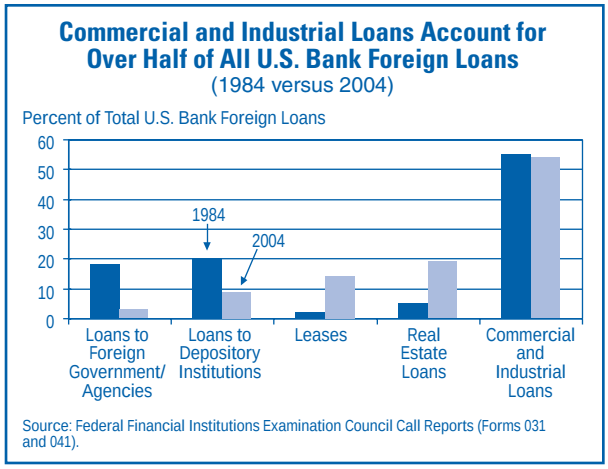
Despite the attraction of a rapidly growing economy and the relaxation of some banking restrictions, significant cultural and legal challenges remain that could constrain the realization of profits by foreign banks in China.[19] Nevertheless, although China may not be a direct source of banking profits for U.S. banks in the near term, that country is a key economic driver in Asia and represents considerable potential as an important strategic component of an institution's global banking presence.

Commercial and Industrial Lending Is a Key Component of Overseas Operations

C&I lending continues to be a significant part of the overseas operations of U.S. banks and the U.S. operations of foreign banks. As shown in Chart 2, C&I lending continues to represent a majority of foreign loans in U.S. banks, in spite of changes in the lending mix.[20]

Commercial lending relationships often open the door for additional banking services, and U.S. banks have responded to demand for commercial loans from corporate borrowers as a way to enter foreign markets. According to a recent survey by ***Greenwich Associates***, the establishment of a credit relationship is the key factor when companies and financial institutions determine banking partners for foreign exchange, interest rate derivatives, and other capital markets business.[21] Establishing foreign lending capabilities, in addition to offering other nonlending services to customers with an international scope, has been cited by U.S. banks of various sizes as a strategic priority.[22]

Chart 2



The benefits of leveraging commercial lending relationships into the ability to provide other types of financial services are evident in the growth of trading and derivatives activities of internationally active U.S. banks. Since 1984, the foreign offices of U.S. banks have reported an increase in trading assets from 22 percent to 36 percent of total assets. In addition, between 1994 and year-end 2004, these same foreign branches of U.S. banks reported a fivefold increase in their notional holdings of derivatives contracts, from $8.1 trillion to $43.6 trillion.[23] These changes reflect both the effects of a more integrated global economy and acceleration in the worldwide demand by U.S. bank corporate customers for investment banking and asset management services.

International Nonbanking Subsidiaries Also Generate Revenue for U.S. Banks

Nonbanking subsidiaries have been the fastest-growing source of foreign assets reported by U.S. bank holding companies over the past ten years. These subsidiaries engage in a variety of activities, including securities underwriting, real estate brokerage, and commercial

[18] Discover Financial Services, Inc., "Discover Financial Services and China UnionPay Announce Strategic Alliance," news release, May 26, 2005.

[19] *Business Daily Update,* "Foreign Banks Still Expanding," December 6, 2004.

[20] This is true at both of the largest U.S. banks. In 2004, C&I lending represented 79 percent and 71 percent, respectively, of Citigroup's and JPMorgan Chase's corporate and wholesale loans outside the United States. For more information, see Citigroup 2004 Annual Report, "Loans Outstanding," and JPMorgan Chase 2004 Securities and Exchange Commission form 10K, "Note 11, Loans."

[21] Jennifer Hughes, "Creditor Banks Have the FX Edge," *Financial Times,* April 14, 2005.

[22] Geeta Sundaramoorthy, "Nat City Plan: Act Locally, Grow Globally," *American Banker,* May 16, 2005.

[23] The share of foreign loans to all assets in foreign offices of U.S. banks declined from 63 percent in 1984 to 36 percent of foreign-office assets by the end of 2004. Adjusted for inflation, the share of all loans to foreign borrowers at U.S. banks (in both domestic and foreign offices) has declined 21 percent since 1984.

enterprises (see Chart 3).[24] The growth of these nonbanking subsidiaries underscores the long-term trend toward diversification of earnings beyond traditional banking products and services. The increase in nonbanking assets at U.S. bank holding companies also coincides with the enactment of the Gramm-Leach-Bliley Act of 1999, which removed domestic restrictions on certain nonbanking activities. Moreover, depending on the laws of the particular host country, a foreign bank subsidiary may be able to engage in a broader array of activities than its U.S. banking affiliates or even foreign branches of U.S. banks.

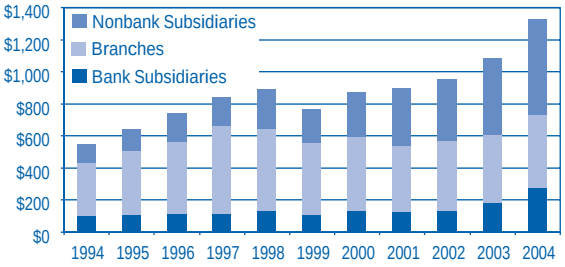
U.S. Banks Export Consumer Lending Expertise

International expansion also represents an important long-term trend among large U.S. credit card companies. As the American consumer lending market matures and becomes saturated, U.S. consumer lenders with expertise in information technologies and the development of products and services find foreign markets increasingly attractive. International operations provide an opportunity for successful domestic credit card lenders to leverage existing product or marketing expertise, take advantage of economies of scale, and expand their revenue base.

While the potential benefits are attractive, expansion into international consumer lending poses unique challenges. Before exporting consumer lending products, U.S. financial institutions must understand the host country's laws, particularly consumer protection laws, because interest rate ceilings and restrictions on the distribution of consumer credit histories can differ significantly across countries.[25] Limitations imposed by other countries on the sharing of consumer credit data can significantly reduce the usefulness of credit scoring models. In addition, local customs and cultures are important determinants of consumer borrowing behavior, the willingness to use consumer debt, and, ultimately, the demand for various types of consumer loans across international markets.

Chart 3

Nonbank Subsidiaries Have Driven Most of the Recent Foreign Asset Growth in U.S. Bank Holding Companies



Note: Claims on unrelated parties represent total assets less intercompany transactions.
Sources: Foreign Branch Reports of Condition and Financial Statements of Foreign Subsidiaries of U.S. Banking Organizations.

Foreign Banking Operations Underperform Domestic Operations

Despite the growth of international activities among U.S. banks, most available financial indicators fail to show a performance advantage accruing to institutions with overseas operations. In fact, performance measures specifically reported for the international operations of U.S. banks have tended to consistently lag indicators for domestic operations over the past decade (see Chart 4).[26] For example, in 2004, the average return on assets (ROA) specifically attributed to international operations was 0.96 percent, compared with an overall 1.26 percent at all banks with international operations.[27] Similarly, net interest income as a percentage of assets averaged 2.18 percent for international operations, compared with an overall average of 2.76 percent for domestic and foreign operations combined. While the average efficiency ratio reported for the international operations of these institutions was, at 59 percent, better than the 61 percent efficiency ratio for their combined operations for 2004, we note that the international efficiency ratio had been worse than the overall ratio in each of the previous seven years.[28]

[24] Data on assets of foreign banking and nonbanking subsidiaries of U.S. banking organizations were collected from Form FR 2314, Financial Statements of Foreign Subsidiaries of U.S. Banking Organizations.
[25] Moody's Investors Service, "U.S. Consumer and Commercial Finance Companies in Europe: Climbing the Learning Curve," April 2001.

[26] The downward spikes in the return on assets from international operations during the late 1980s reflect the impact of the Latin American debt restructuring that resulted in losses in foreign banking operations of several U.S. banks.
[27] Represents results for banks filing Call Report Form 031.
[28] The efficiency ratio is the noninterest expense as a percentage of net operating revenue (net interest income plus total noninterest income).

Chart 4

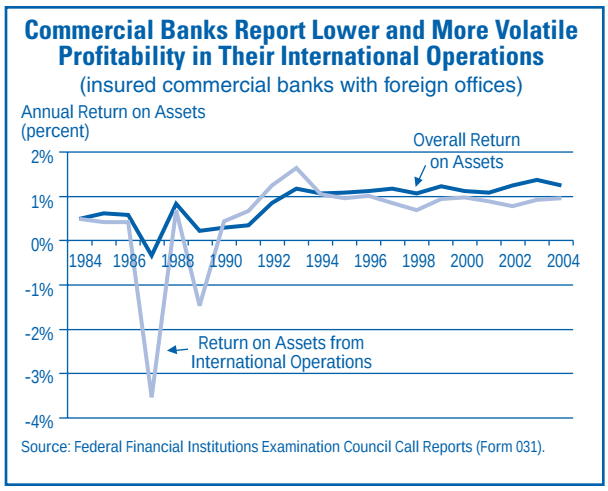
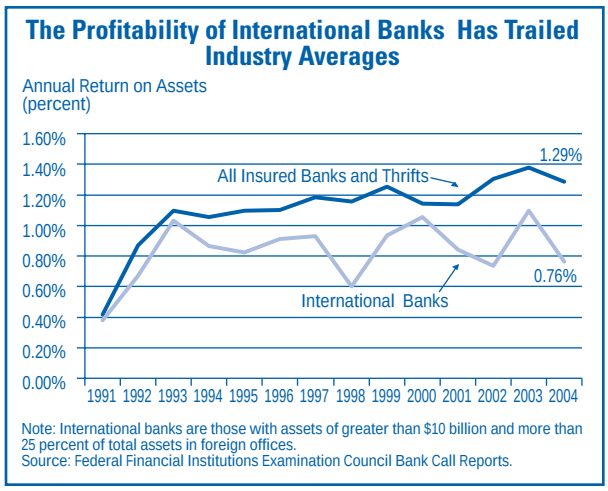


Chart 5



Similar performance differences exist between large U.S. banks with sizable international operations and purely domestic U.S. institutions. The performance of international banks (that is, U.S. banks with more than $10 billion in assets and at least 25 percent of their assets in foreign offices) relative to the overall performance of the U.S. banking industry fails to show that sizable international operations have given a significant boost to overall performance (see Chart 5). In fact, the international banks have earned less than the industry-average ROA in 14 of the past 15 years, and their return on equity has been below the industry average in eight of those years.

Traditional Performance Ratios May Understate Role of Foreign Banking Operations

While traditional performance measures suggest that international banking operations may not be as profitable as domestic operations, these metrics may not fully reflect their intangible contributions to overall banking performance. Several factors may limit the ability to accurately measure the contributions of foreign operations from an enterprise perspective.

First, some of the differences in performance may reflect the accounting treatment and tax consequences of allocating costs and profits among a financial institution's domestic and foreign operations. Second, performance measures may not fully capture all the benefits of maintaining a strategic position in a foreign banking market. These benefits may include cross-selling opportunities and the opportunity to manage an extensive relationship with existing domestic clients that have foreign operations. Although a U.S. bank's office in a foreign country may not report the same profitability as offices in other markets, its presence in that market may facilitate relationships such as lending, trading, and other banking services with clients that operate or are headquartered in its host country. Conversely, the lack of a foreign presence could lead to the loss of customers with global operations.

Performance comparisons between domestic and international banks underline the cultural challenge of achieving high performance in unfamiliar markets and raise the question of whether performance optimization should drive expansion into overseas markets. Domestic limits to growth in a bank's home market may be a contributing factor when large banks seek to expand internationally.[29] Research also indicates that banks are motivated by the foreign banking needs of their domestic client base, and tend to "follow the customer" to foreign countries where large corporate borrowers operate. However, establishing corporate banking relationships with mid-sized and smaller commercial customers in foreign markets may be more difficult than doing so with large corporations, as host-country lenders typically are more familiar with the local business community and borrowing culture. On the other hand, research also suggests that in developing or emerging banking markets that are credit-supply constrained, foreign lenders with technologically

[29] See note 3.

advanced credit underwriting capabilities may have a competitive advantage over local lenders.[30]

Global Integration of U.S. Banks Remains Incomplete

Notwithstanding the motivations favoring expansion into foreign markets, the results for U.S. banks in recent years suggest that the international integration of the U.S. banking industry may be following, rather than leading, the wider expansion of global commerce. Indications are that better performance may be more easily attained in the domestic U.S. market, and most U.S. banks remain satisfied with a purely domestic focus. Overseas, a few large institutions continue to dominate the foreign banking activities of U.S.-based banks. Data limitations make it difficult to draw definitive conclusions about the performance benefits of foreign banking activities of U.S. banks. Nevertheless, as globalization brings foreign markets ever closer to us, more U.S. financial institutions will be motivated to consider the benefits and drawbacks of conducting international banking activities.

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Kathy R. Kalser, Regional Manager, New York Regional Office

Ross Waldrop, Senior Financial Analyst

[30] Allen N. Berger, Iftekhar Hasan, and Leora F. Klapper, "Further Evidence on the Link between Finance and Growth: An International Analysis of Community Banking and Economic Performance," Federal Reserve Board, 2004.

Opportunities and Risks Facing Community Lenders That Support International Trade

The role of international trade in the U.S. economy is increasing. And although smaller firms (those with less than 500 employees) accounted for almost one-third of U.S. exports in 2001, they are continually challenged to obtain financing to produce export goods or to finance the sale of exports. This circumstance presents opportunities for community banks that are looking for ways to increase small business fee income and strengthen loan demand. This article looks at those opportunities as well as the risks facing community lenders in supporting small and mid-sized enterprises (SMEs) engaged in international trade.

Small and Mid-Sized Firms Play a Significant Role in U.S. Exports

Although only about 1 percent of the 23 million U.S. small businesses are involved in exporting, these enterprises play a surprisingly large role in U.S. trade.[1] As of 2001 (the latest data available), approximately 230,000 SMEs engaging in export operations accounted for about 97 percent of all U.S. exporters. This number reflects a doubling in the prior ten years and an almost two-and-a-half-fold increase over 15 years (1987–2001). California had the highest number of SME exporters (55,000 firms), followed by Florida, New York, Texas, and Illinois.

In 2001, SMEs accounted for $182 billion, or 30 percent, of U.S. export sales, a percentage that has held fairly constant since 1992.[2] But in some states the share was notably higher—for instance, SMEs in Wyoming accounted for 80 percent of that state's exports. In eight other states, including populous New York and Florida, they accounted for 40 percent or more of exports. (See the box entitled "A Regional Look at U.S. Export Activity" for information on merchandise exports.)

[1] Doug Barry, "From Appalachia to India: U.S. Small Businesses are Going Global," *Business Credit,* June 2000.

[2] Office of Trade and Economic Analysis of the International Trade Administration, "Small and Medium-Sized Exporting Companies, A Statistical Handbook: Results from the Exporter Data Base," October 2003. As more recent data are not available, assuming that the share of SME exports were to remain at 30 percent, 2004 U.S. SME exports are estimated to have totaled close to $245 billion, or 30 percent of total U.S. merchandise exports of $818 billion, based on the U.S. Census Bureau's origin-of-movement export series.

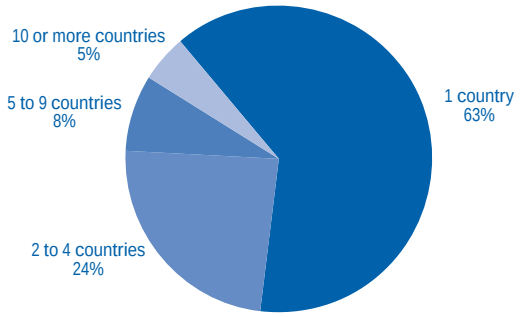
Lack of Overseas Affiliates and Foreign Market Expertise Creates Challenges for SMEs

Unlike large firms, SMEs tend to concentrate their business in fewer foreign countries. Nearly two-thirds of U.S. small-business exporters sold to only one foreign country in 2001, while more than half (54 percent) of large firms exporting sold to five or more foreign countries (see Chart 1). Nevertheless, SMEs exported goods worth $1 billion or more to 29 foreign countries and were responsible for at least half of all U.S. exports to 93 countries in 2001.[3]

Two reasons that explain why smaller businesses choose to export to a single country are the absence of major affiliates abroad and a lack of familiarity with foreign markets.[4] SMEs have, in fact, benefited from this concentration when their primary export countries have been the target of U.S. initiatives to reduce foreign barriers to U.S. exports. For example, the 1993 enactment of the North American Free Trade Agreement helped spur growth in U.S. exports to Canada and Mexico, and from 1992 to 2001 the share of U.S. SME exports to Canada and Mexico increased from 24 percent to 33 percent.

Chart 1

Nearly Two-Thirds of Small and Mid-Sized Business Exporters Sold Goods to a Single Country in 2001



Source: U.S. Department of Commerce.

[3] Ibid.

[4] Ibid.

A Regional Look at U.S. Export Activity

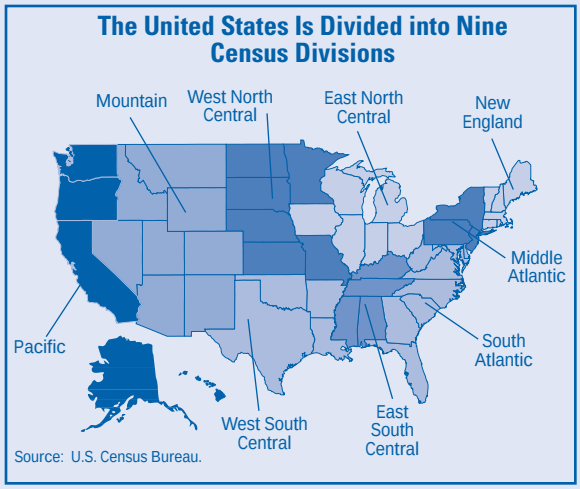
During 2004, U.S. merchandise exports totaled $818 billion with a growth rate of 13 percent, thanks to the lower value of the dollar and a robust global economy. More than half of these exports (56 percent) came from three of the nine U.S. Census Bureau divisions (see Map 1): the populous Pacific, the rapidly growing West South Central, and the industrial East North Central (see Chart 2). Approximately 25 percent of the exports originated from the South Atlantic and Middle Atlantic states, with the remaining 19 percent coming from the less densely populated New England, East South Central, West North Central, and Mountain Divisions. All except the Mountain Division had double-digit export growth rates last year—the East South Central Division had the fastest growth rate at 20.7 percent and the Mountain Division the slowest at 9.6 percent.

The major 2004 exports for each of the U.S. Census divisions are as follows:

Pacific (Alaska, California, Hawaii, Oregon, and Washington). The Pacific Division's lead exports were computers and electronics as well as transportation equipment (mainly aircraft). The division's relatively strong high-technology and aerospace sectors along with their many high-value-added, high-paying jobs generated half of the total value of its exports. In addition, the Pacific Division exported a large dollar volume of crops and processed foods, chemical and machinery manufactures, electrical equipment, and fabricated metals.

West South Central (Arkansas, Louisiana, Oklahoma, and Texas). Because of its location, the West South Central Division is a leading exporter of petroleum and coal products (nearly two-thirds of the nation's total last year) and chemical manufactures. Agricultural and livestock products were also major exports. As home to several high-tech centers such as Austin, Dallas, and Houston, large-dollar export items included computers, software, and telecommunications equipment.

Map 1

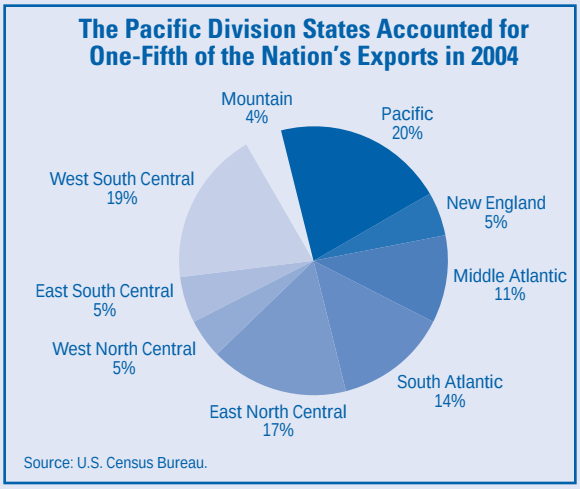


East North Central (Illinois, Indiana, Michigan, Ohio, and Wisconsin). In the heavily industrialized East North Central Division, transportation equipment (primarily motor vehicles) accounted for nearly a third of total exports. Because of the division's large industrial base, machinery, electrical equipment, fabricated metals, and plastics and rubber products were also leading exports.

Middle Atlantic (New Jersey, New York, and Pennsylvania). The Middle Atlantic Division's leading exports were chemical manufactures and computer and electronic products. It also contributed a high share (twice the national average) of printing products and primary metal exports.

South Atlantic (Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia, and West Virginia). The South Atlantic Division is undergoing a major transformation. Traditional export mainstays in nondurable goods manufacturing (apparel and textiles and wood and paper products) are facing mounting pressure from overseas competitors, particularly China. Replacing these exports in importance are the transportation equipment and high-technology industries (computers and electronics), which accounted for over one-third of the division's total exports.

Chart 2



New England (Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont). Nearly a third of all New England exports were computer and electronic products, and another third of exports consisted of chemical and machinery manufactures and transportation equipment.

East South Central (Alabama, Kentucky, Mississippi, and Tennessee). The East South Central Division exports a broad range of nondurable manufactured goods, including wood and furniture products, apparel and leather products, and printing and paper products. Also, the migration of automobile production from the higher-cost Midwest to the relatively lower-cost Southeast has increased the division's exports of transportation equipment and plastic and rubber products.

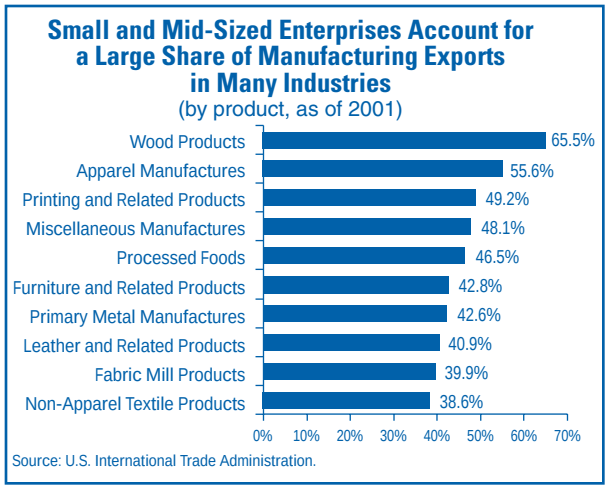
West North Central (Iowa, Kansas, Minnesota, Nebraska, North Dakota, and South Dakota). As it encompasses a large number of farm states, the West North Central Division was a leading exporter of crop production and processed foods. It was also a major exporter of transportation equipment, computers and electronics, machinery, and chemical manufactures.

Mountain (Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, and Wyoming). Although the Mountain Division's share of total U.S. exports was the smallest (4.1 percent) of the nine Census divisions, it accounted for the highest relative share of computer and electronic product exports than anywhere in the country. In fact, 42 percent of its exports were computers and electronics, followed by transportation equipment (10 percent) and primary metal manufactures (9 percent).

SME Manufacturers Account for More Than One-Third of All SME Exports

SMEs are responsible for a large share of exports from a wide range of industries. According to the ***U.S. International Trade Administration***, which divides exporting SMEs into the categories of manufacturers, wholesalers, and "other companies," manufacturers comprised slightly more than one-third of the total value of SME exports in 2001.[5] Wholesalers, or companies primarily engaged in the distribution of goods to businesses, accounted for another third of exports, and other companies totaled slightly more than one-quarter of all SME exports. SMEs accounted for a large share of total U.S. exports within several manufacturing industries (see Chart 3), which also generally paid below the average manufacturing hourly wage rate. However, when ranked by SME export values, the largest manufacturing industry groups in 2001 were computers and electronic products ($33 billion),

Chart 3



[5] These three categories are based on the North American Industry Classification System. The category of "other companies" includes resource extraction companies, retailers, freight forwarders, engineering firms, and miscellaneous service companies that often market goods abroad and act as exporters of record.

machinery manufactures ($22 billion), transportation equipment ($20 billion), chemical manufactures ($17 billion), and processed foods ($11 billion).[6] With the exception of the processed foods industry, these industries paid above the average manufacturing hourly wage rate.

Emerging Opportunities for Community Banks

Increased globalization creates intense competition for large and small businesses alike to develop new markets for their products and services. A major concern for these businesses is obtaining adequate trade finance either to produce the goods to be exported (for example, with working-capital loans) or to finance the sale of exports (as with letters of credit). Despite the tremendous opportunities for community banks in small business trade activities, only a small number of community banks actually provide trade financing. The ***Small Business Administration*** (SBA) estimated that in 1998, only about 150 to 200 U.S. banks out of approximately 9,000 engaged in any significant amount of trade financing. Although the number of banks engaged in international trade since then may have risen, their numbers are still believed to be quite low, primarily because of a lack of expertise.[7] One of the chief complaints among small businesses is the difficulties they face not necessarily in finding buyers for their products, but in helping buyers find financing for their purchases. As such, the growth in worldwide trade may provide innovative community banks an opportunity to generate additional loan demand and increase fee income.

Despite the low number of banks currently involved in global trade, more community banks are becoming interested in pursuing the matter. Some reasons include growth in their potential customer base, a nearby large bank's departure from the business line, an increase in experienced international managers due to the consolidation of larger institutions, and growing demand for trade finance services. Indeed, smaller institutions are now offering many business lines, services, and products once thought to be in the realm of large banks. In the Pacific Northwest, for example, financial institutions such as Banner Bank, Columbia Banking System, Inc., Washington Trust Bank, and Sterling Financial Corporation are reported to have either started or expanded international banking departments to serve that area's rapidly growing Asian population.[8] Some of the services that community banks are beginning to offer include issuing international letters of credit, providing trade financing loans, and facilitating or executing foreign currency transactions and wire transfers.

Technology Enables SMEs and Smaller Financial Institutions to Enter Global Markets

Advances in technology have facilitated the entry of SMEs and community banks into the international trade arena. For SMEs, the Internet is fast becoming an important tool for locating foreign purchasers of their goods and services. For community banks, the delivery of online services at a reduced cost is enabling them to offer products, such as letters of credit, that were previously available only from larger institutions.[9] The Internet can facilitate the exchange of trade data and documentation between cross-border parties and allow community banks to make more cost-efficient trade financing transactions.

Ways for Community Lenders to Gain Global Trade Expertise

There are several ways that community banks can obtain the expertise needed to succeed in global trade. For instance, as a result of ongoing consolidation in the U.S. banking industry, smaller community banks have gained competence quickly by hiring highly skilled bank professionals specializing in international trade finance.[10] As an alternative, many small community banks bolster their expertise by establishing a correspondent relationship with a larger institution. Other community banks develop their own proficiency in trade finance and then market their services to other community bankers.

According to a recent report, a few lenders with assets of less than $1 billion are considering offering trade finance services in-house, and several FDIC-insured institutions with assets of between $2.5 billion and $7 billion are already offering international services.[11]

[6] See note 2. The rankings are based on the North American Industry Classification System.

[7] Gordon Fairclough and Matt Murray, "Small Banks Expand Their Trade Financing for Exports—Still, Entrepreneurs Going Global Struggle to Get the Services They Need," *Wall Street Journal,* February 24, 1998.

[8] Katie Keuhner-Herbert, "Small Banks in Northwest Getting Into Trade Finance," *American Banker,* April 4, 2005.

[9] Ibid.

[10] Kuehner-Hebert, "Smaller California Players Gain in Trade Finance," *American Banker,* December 19, 2002.

[11] Alan Kline, "Small Southern California Bank Selling Trade Services to Its Peers," *American Banker,* April 20, 2000.

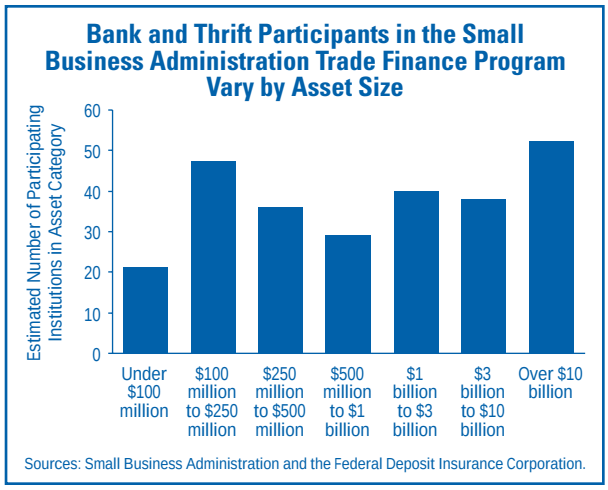
In fact, banks and thrifts that provide international financing for their customers range in size from small to very large, as illustrated by the asset distribution of financial institutions that participate in the SBA Trade Finance Program (see Chart 4).[12] This program helps small businesses enter export markets by providing such services as trade counseling, training, legal assistance, and export information.

The SBA and the Export-Import Bank of the United States offer other programs (for example, the Export Working Capital Program) that provide financing assistance to SMEs and help lower the risks of international banking transactions by guaranteeing commercial loans.[13] The SBA also offers an Internet-based service called Export Express to help bankers assess overseas credit risk and structure their loans so that they meet the government approval process.

Immigration Trends Bolster Export Business and Lending Opportunities

One explanation for the rapid growth of SME exports since the 1990s may be the strong role that immigration has played during that period. For example, much of the U.S. trade to and from Latin America is undertaken by Hispanic-American exporters. Similarly, Asian- and European-American immigrants often facilitate U.S. trade to and from their native countries.[14] The Asian and Hispanic populations, in particular, have been among the fastest growing in the United States. The ***U.S. Census Bureau*** is projecting these two ethnic groups to triple in size over the next half-century—the U.S. Asian population is estimated to increase from 10.7 million in 2000 to 33.4 million in 2050, and the U.S. Hispanic population is estimated to increase from 35.6 million in 2000 to 102.6 million in 2050.[15]

Chart 4



Community banks are taking notice of these expanding populations and their financial potential. Asia and Latin America are two of the world's largest emerging markets, and banks that specialize in foreign-trade financing are often located in gateway states that host these large immigrant populations. According to one report, community banks, particularly those in states that trade heavily and cater to Hispanic- and Asian-Americans such as Florida and California, find that "providing working capital or letters of credit is crucial to maintaining relationships with small business customers."[16]

The 1997 economic census on minority-owned businesses (the most recent available) showed immigrants to be highly entrepreneurial, with Asian and Hispanic small businesses growing four times faster than the rate of U.S. firms overall. Not surprisingly, then, traditional and new immigrant gateways, where many Asian and Hispanic people live and set up small businesses, often coincide with global gateways, where many of these ethnic small businesses engage in export activity (see Map 2).[17]

Lending to SMEs Engaged in Global Trade Has Unique Risks

Historically, community banks have been reluctant to lend to SME exporters because of the inherent risks involved. For example, if not familiar with the foreign country's customs, laws, and regulations, small

[12] The SBA's Trade Finance Program Web site (http://www.sba.gov/oit/finance/banks.html) lists banks participating in this program by state. A link on this site to the Office of International Trade homepage has additional information about the program.

[13] The Export-Import Bank is a federal agency that extends trade credits to U.S. companies to facilitate the financing of U.S. exports.

[14] Tom Coyle, "International Trade Financing, Community Banks Thinking Global: How to Play the World Trade Game," *Community Banker,* America's Community Bankers, June 1999.

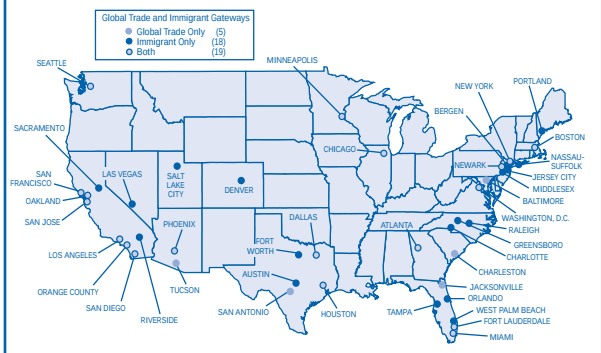
[15] U.S. Census Bureau, "Census Bureau Projects Tripling of Hispanic and Asian Population in 50 Years; Non-Hispanic Whites May Drop to Half of Total Population," news release, March 18, 2004.

[16] Alan Kline, "Why So Shy about International Trade Finance?" *American Banker,* January 13, 2004.

[17] Audrey Singer, "The Rise of New Immigrant Gateways," The Brookings Institution, Center on Urban and Metropolitan Policy, February 2004; and Economic Outlook Conference, Economy.com, November 2004.

Map 2

Global Trade and Immigrant Gateways Often Overlap



Sources: Beaverstock, Smith, and Taylor, *Cities* 16(6), 1999 p 445–458, as cited at Economy.com's Economic Outlook Conference, November 4–5, 2004; and Audrey Singer, "The Rise of New Immigrant Gateways," Brookings Institution, Center on Urban and Metropolitan Policy, February 2004.

lenders may be hesitant to extend credit to foreign customers of U.S. exports. Some of the factors that have hindered community bank interest in this line of business are a general lack of expertise in international finance, the complexities of international trade financing, and the belief that the market was too small to devote resources to it.

To successfully conduct international trade-related business, lenders must consider not only traditional *credit*, *operational*, and *management* risks when establishing a relationship with potential customers, but also factors specific to global activity, such as *political*, *foreign exchange*, *offshore-outsourcing*, and *import competition* risks. And when banking relationships cross international borders, even traditional risk areas can be harder to understand, monitor, and manage. These international banking risks are discussed below.

Credit Risk. Unlike lending to domestic companies, trade finance lenders face legal and cultural issues that make it more difficult to adequately assess the risk of extending credit to foreign borrowers. To some extent, lenders can mitigate this risk by using institutions that will guarantee the loan (e.g., Export-Import Bank). Moreover, smaller community banks tend to rely on correspondent banks that already have the expertise and established relationships in foreign countries, thereby lessening credit risk.

Operational Risk. Contingency plans are crucial to mitigate operational risk for customers who are heavily engaged in trade. If a U.S. firm enters into a joint venture with a foreign firm, legal and other considerations also come into play, such as if a U.S. company's foreign customers or suppliers abruptly terminate their relationship or fail to deliver per the contract terms. As appropriate, lenders can use covenants, differential loan pricing, and other steps to manage such risks.

Management Risk. Lenders must consider management risk when customers are heavily involved in foreign trade to determine whether they have grown into this line of activity over time and learned lessons along the way or are jumping into a new line of business with little knowledge of local conditions in the foreign country. Along with the risks that accompany any new line of business, firms operating across international borders face legal, shipping and transportation, communication, financing, quality control, marketing, and other challenges that may be significantly more complex than the same issues for domestic firms.

Political Risk. Political risk refers to instabilities in a foreign government that can lead to civil unrest, or a suspension of legal rights and recourse that can result in business disruptions and, occasionally, the seizure of private property. U.S. lenders can reduce this risk by engaging the services of international consulting firms that monitor many countries and provide ongoing assessments of country risk.[18]

Foreign Exchange Risk. More broadly, political risk can be related to foreign exchange risk. While many countries have freely floating exchange rates that can fluctuate over time, others attempt to peg, or fix, their exchange rate to one or more major currencies. However, even those arrangements can be difficult to sustain during periods of market turmoil, which can result in even more disruptive exchange-rate movements than those experienced by freely floating currencies. An example of a pronounced currency adjustment that negatively affected U.S. exporters occurred in 1997 when the Asian currency crisis caused a sharp realignment of exchange rates between the U.S. dollar and certain Southeast Asian currencies. Because of international financial market pressure and a lack of adequate foreign currency reserves, these Asian nations could not sustain their former currency exchange-rate targets, and, as a result, the

[18] Some of the firms that monitor country risk include: Control Risks Group, http://www.crg.com; Business Monitor International, http://www.businessmonitor.com; Countrydata.com and the International Country Risk Guide (by the PRS Group), http://www.countrydata.com; The Economist Intelligence Unit, http://www.eiu.com; and World Markets Research Centre (by Global Insight), http://www.wmrc.com.

Chart 5

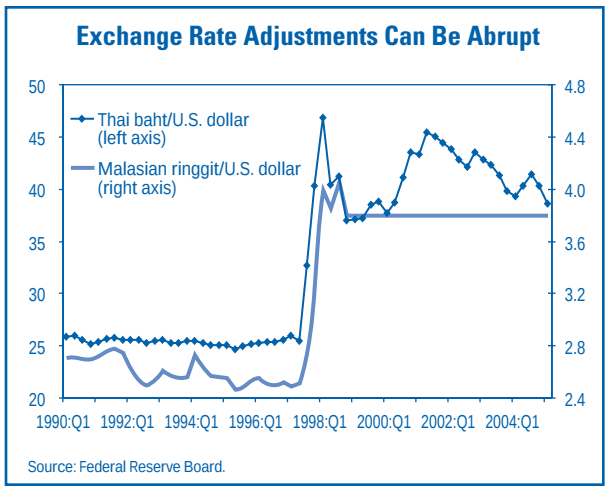
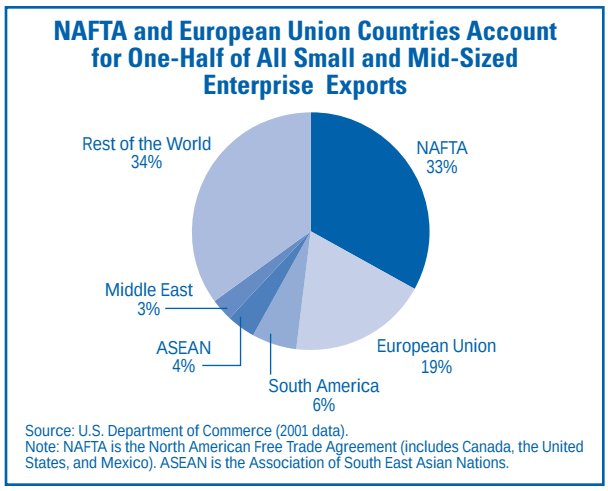


Chart 6



value of their currencies fell abruptly. Although this drop proved beneficial to U.S. importers doing business with these countries, it was significantly detrimental to U.S. exporters, as the local cost of their goods and services rose dramatically (see Chart 5). In other examples, crises related to international capital markets (such as Mexico in 1994, Russia in 1998, and Argentina in 1998 and 2000) triggered turmoil in currency markets and, in some cases, limited the ability of businesses to move funds across borders.

Shifts in currency exchange rates need not occur abruptly to affect SME exporters and their lenders, and the shifts need not always have ill effects. For example, between first quarter 2002 and first quarter 2005 the euro appreciated relative to the U.S. dollar by almost 49 percent. This decline in the value of the U.S. dollar relative to the euro had the effect of enhancing the competitive position of U.S. firms that export to the European market. In 2001, nearly 20 percent of SME exports were sold to European Union nations (see Chart 6). And American small businesses making items ranging from forklifts to computer security hardware to toothpaste are reporting gains in overseas sales in response to the declining dollar.[19]

Offshore-Outsourcing Risk. Often, domestic firms may opt to purchase goods and services from a cheaper foreign source, whether actively engaged in international trade or not. This practice is referred to as "offshoring," or "offshore outsourcing." Offshoring can be motivated by shifts in exchange rates that might make certain inputs more costly to acquire in one country than another. Generally, the more dependent a business is on foreign relationships—including U.S. firms that have set up production operations overseas, those that obtain a majority of their inputs from abroad, and those that sell the bulk of their outputs abroad—the more significant the potential impact from international trade and transactions on the firm's risk profile. In ***Industrial Distribution***'s 58th Annual Survey of Distributor Operations, manufacturers ranked "moving offshore" fifth as a concern, behind "economic conditions," "price competition," "customers going out of business," and "increased operating costs."[20]

Import Competition Risk. Finally, community lenders may be exposed to internationally driven credit risk even when lending to SMEs that do not engage in global trade. With today's trend toward globalization, the reality is that firms that produce and sell only within U.S. borders are not immune to what is happening in the rest of the world. Shifts in the U.S. dollar against other currencies and other economic factors overseas, such as productivity and wage–cost differentials, may significantly affect the competitiveness of domestically oriented SMEs. Several industries in the Southeast—including the apparel, furniture, and cotton industries—are feeling the effects of cheaper imports that are available in the United States. Such import competition can harm sales, profits, and the ability of some SMEs to service existing commercial credit lines.

[19] Mark A. Stein, "Export Opportunities Aren't Just for the Big Guy," *New York Times*, March 24, 2005.

[20] Victoria Fraza Kickham, "Making Inroads Overseas," *Industrial Distribution,* March 2005.

Conclusion

Recent trends suggest that international trade activity will continue to grow and that more and more SMEs and community banks may be looking to enter this marketplace in some fashion. However, lenders need to individually weigh the costs and benefits associated with offering products and services specifically tailored to their customers involved in international trade. Lending to internationally oriented small and mid-sized businesses carries some unique risks, including political risk and foreign exchange risk, while also changing the nature of more typical concerns, such as credit risk.

While the pace of globalization in coming years remains uncertain, the process itself is unlikely to reverse. Small and mid-sized internationally active firms can provide numerous and rewarding business opportunities for community lenders, including issuing international letters of credit, providing trade financing loans, facilitating or executing foreign currency transactions and wire transfers, and providing direct operating funds through traditional commercial loans. But lenders engaged in these activities also need to be cognizant of the unique risks that arise when their borrower is a small or mid-sized business active in global trade.

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