PENN WHARTON
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Budget Model

The Trade War Trade-Off: Foreigner Ownership of American Business Actually Rises

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Summary: We project that, although a trade war initially lowers the share of U.S. capital owned by foreigners, the trade war will actually *increase* the amount of American business capital owned by foreigners, by almost $1 trillion by 2028. Over time, the foreign owned share of business capital rises from about 29 percent today to over 34 percent in 2049.

Foreign Ownership of Capital and Capital Movement

Economies grow by increasing the production of goods and services. Investment in capital is a key ingredient for economic growth. While foreign investment can help an economy grow, foreign capital has a higher chance of suddenly flowing out of a country ("capital flight"). Real world evidence reveals that investors have a strong and persistent home bias. During a panic, foreign-owned capital has a high risk for capital flight.[1] However, even without a direct panic, barring capital controls, foreign-owned capital can move fairly easily in response to changes in trade and tax policy, including a trade war.

Trade War Scenarios

Previously, we examined the relationship between tariffs and the effective openness of the U.S. economy to foreign investment flows. We modeled stylized outcomes of five "trade-war" scenarios and found that, after a short-run boost to the economy, the U.S. economy was smaller in the long run. We compared five alternative trade-war scenarios to a scenario where openness remained at the 21st century average of 37 percent.[2]

1. *Small trade war, short*: The U.S. economy is 21 percent open until 2021 and then reverts to the 21st century average of 37 percent.
2. *Small trade war, long*: Same as (1), except the reversion to 37 percent open begins in 2026.
3. *Small trade war, permanent*: The U.S. economy is 21 percent open indefinitely.
4. *Big trade war, short*: Average tariff rates are increased another 3 percentage points to 6.27 percent. The U.S. economy is 13 percent open in 2021 and then reverts to the 21st century average of 37 percent over the course of 3 years.
5. *Big trade war, long*: Same as (4), except the reversion to 37 percent open begins in 2026.

Our projections reflect changes in the openness of the U.S. economy to foreign investment flows. These projections do not account for other effects of changes to trade policy, such as adjustment costs from reallocating productive capital and labor and how trade can reduce the market power of domestic firms. Accounting for these effects would likely reinforce our results.

Trade and Foreign Capital

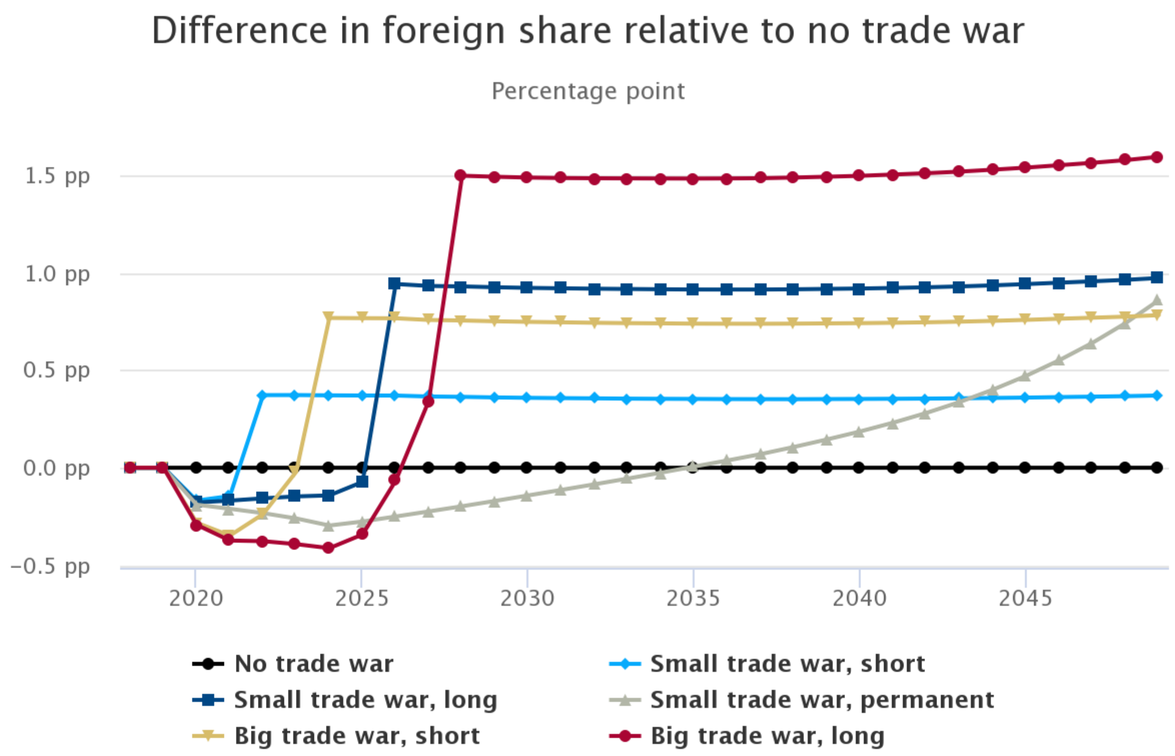
Reduced openness results in lower U.S. capital from two effects: (1) the reduction in foreign capital inflows and (2) the reduction of foreign purchases of U.S. government debt, which shifts domestic savings toward holding more U.S. government debt and less private capital -- that is, capital crowd out. This reduction is mitigated somewhat by the higher returns to capital which incentivize both U.S. households and foreigners to invest in U.S. capital. Figure 1 shows the level and the share of U.S. capital owned by foreigners under each scenario.

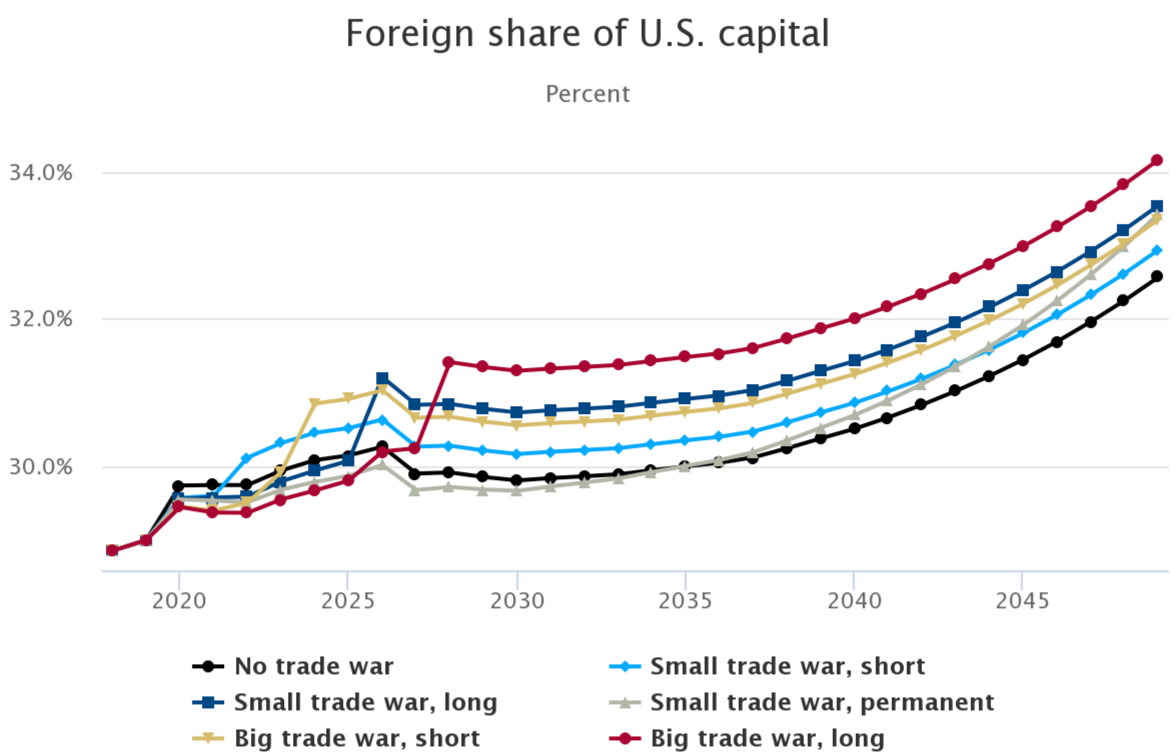
Figure 1: Level of U.S. Capital and the Level and Share of U.S. Capital Owned by Foreigners Under Alternative Trade War Scenarios. Total U.S. capital is indexed to 100 in 2018.

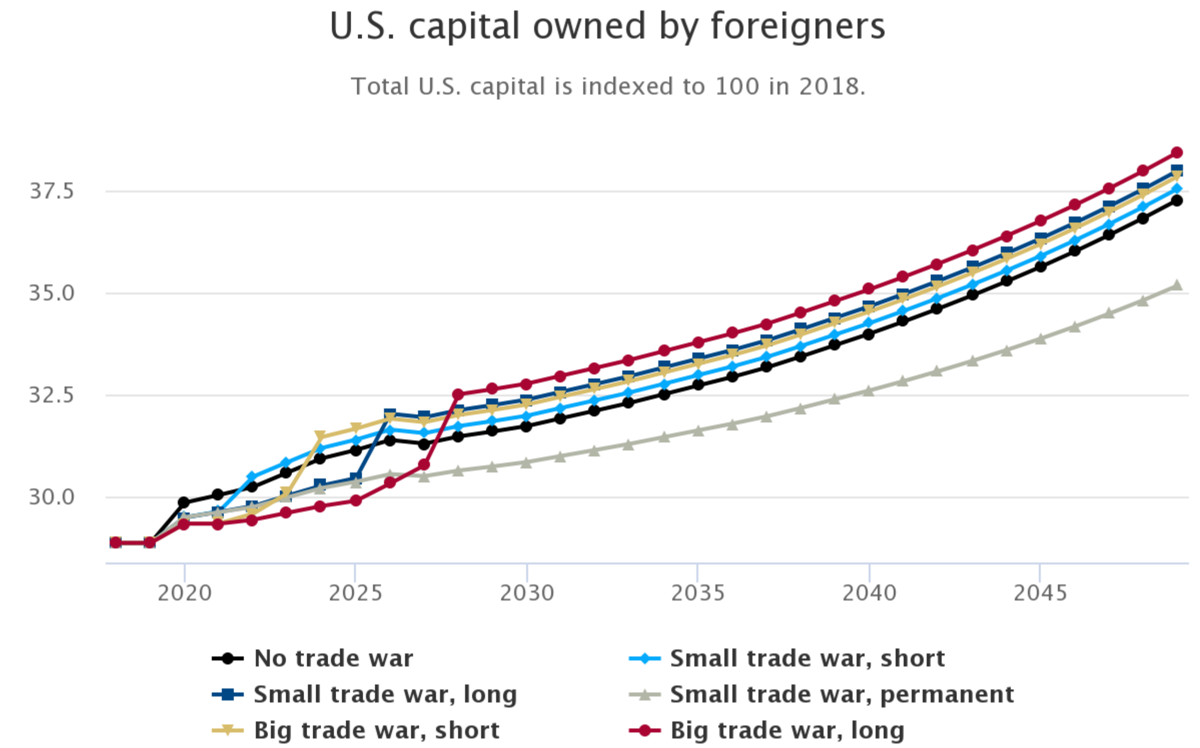
DOWNLOAD DATA

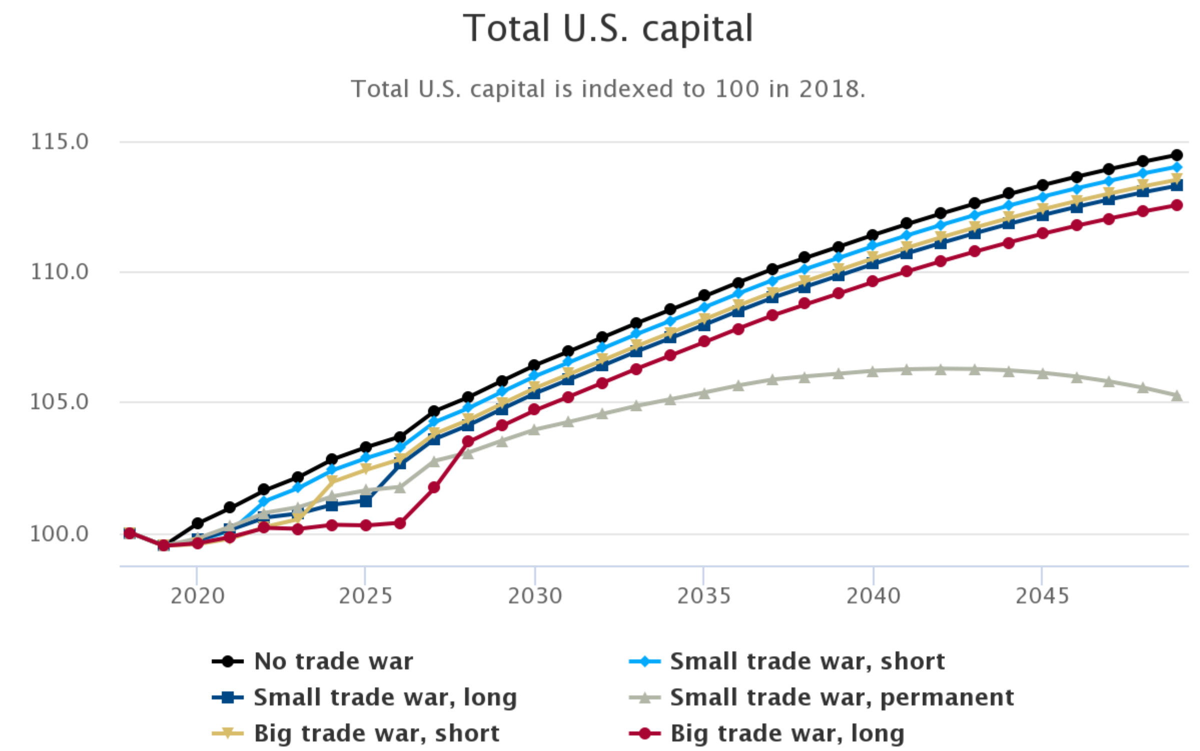
Metric

Difference in foreign share relative to no trade war ▼


Difference in foreign share relative to no trade war
Percentage point
1.5 pp
1.0 pp
0.5 pp
0.0 pp
−0.5 pp
2020
2025
2030
2035
2040
2045
No trade war
Small trade war, short
Small trade war, long
Small trade war, permanent
Big trade war, short
Big trade war, long


Foreign share of U.S. capital
Percent
34.0%
32.0%
30.0%
2020
2025
2030
2035
2040
2045
No trade war
Small trade war, short
Small trade war, long
Small trade war, permanent
Big trade war, short
Big trade war, long





Note: We calculate the foreign share of U.S. capital in 2018 using data from the Federal Reserve.

Source: Board of Governors of the Federal Reserve System. Financial Accounts Matrix – Levels. Available at: https://www.federalreserve.gov/apps/fof/DisplayMatrix.aspx?t=Levels_matrix. The projections for the shares in future years are made using Penn Wharton Budget Model's dynamic model.

Unsurprisingly, in the short-run, lower openness to foreign investment flows leads to a lower share of U.S. capital owned by foreigners. When the previous level of openness is restored, foreign capital investment flows increase. However, because of lower domestic capital, in the long-run, foreigners end up permanently owning a *greater* share of U.S. capital than if there had been no trade war. Longer trade war scenarios lead to foreigners owning a larger share of U.S. capital.

Intuitively, a trade war causes foreign capital to leave the U.S., increasing the amount of debt that must be purchased by U.S. households. This shift reduces the amount of total saving available for productive capital investment (the "crowd out effect"), thereby lowering GDP. As the trade-war subsides, foreign capital re-enters a U.S. economy that has less productive capital relative to the baseline economy without trade war. Domestic household saving does not increase nearly as quickly as the rise in foreign capital flows.

In a small, short trade war, the foreign ownership share is about 0.4 percentage points higher than the baseline no-trade war scenario in 2022. In a big, long trade war, the foreign share is about 1.5 percentage points higher in 2028: the amount involved is on the order of $1 trillion based on our calculations using data from the Federal Reserve.[3] These share differences persist in the long run as the foreign ownership share rises from 29 today to 34.2 percent in 2049 in the case of a big, long trade war versus 32.6 percent for the no-trade war scenario.

Xiaoyue Sun contributed to this article.

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1. Instances of capital flight include the Asian Financial Financial Crisis in 1997, Argentina in 2001, Greece and Spain in 2012 and Britain in 2016. ↩

2. We assume that tax policy is held fixed at 2018 rates. In reality, numerous tax provisions under current law expire or phase-out in future years. This assumption avoids explaining interaction effects but does not change the key insights. ↩

3. Board of Governors of the Federal Reserve System. Financial Accounts Matrix - Levels. Available at: https://www.federalreserve.gov/apps/fof/DisplayMatrix.aspx?t=Levels_matrix. ↩