Volume Title: Institutional Investors and Corporate Stock—A Background Study

Volume Author/Editor: Raymond W. Goldsmith, ed.

Volume Publisher: NBER

Volume ISBN: 0-870-14237-2

Volume URL: http://www.nber.org/books/gold73-1

Publication Date: 1973

Chapter Title: Appendix VII: The Measurement of Foreign Holdings and Transactions in United States Corporate Stock

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Chapter URL: http://www.nber.org/chapters/c3546

Chapter pages in book: (p. 456 - 459)

Appendix VII

The Measurement of Foreign Holdings and Transactions in United States Corporate Stock

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

THE largest variety and most comprehensive collection of data pertaining to portfolio investment is compiled by the U.S. Treasury Department in conjunction with the Federal Reserve System. Primary statistics on the principal types of data and the principal countries or areas involved in these capital transactions are published monthly in the *Treasury Bulletin*, and to a lesser extent in the *Federal Reserve Bulletin*. Pursuant to executive order and various administrative regulations, securities brokers and dealers, banks, and other nonbanking financial institutions (insurance companies, funds, and so on) are directed to report their international security transactions monthly to the Federal Reserve banks. "The existing regulations require that all U.S. residents report transactions in long-term securities with foreigners whether made in their own behalf or on behalf of their customers provided the total of purchases or sales is greater than a monthly average of $100,000 in the six months ending with the reporting date."[1] The S-form data are then consolidated and published by the Treasury. This is the raw material from which the Commerce Department's Office of Business Economics ultimately produces lines 34–36 and line 52 of the U.S. balance of payments account (adjustments to S-form data are discussed below).

In general, data on foreign purchases or sales of securities[2] are reported on the basis of the foreign country or geographic area in which the records of the reporting institutions show the transactor to be domiciled. Transactors are likely to be financial institutions acting as agents for the actual purchaser.

[1] Report of review committee for balance of payments statistics to the Bureau of the Budget, *Balance of Payments Statistics, Review & Appraisal*, April 1965, p. 77.

[2] Foreign purchases or sales of foreign securities should be equal to U.S. sales or purchases of foreign securities, respectively.

Because reporting institutions are not expected to go beyond the addresses shown on their records, they may not be aware of the actual country of domicile of their client. Thus, a beneficiary may not be domiciled in the same country as the transacting agent, and geographical classification cannot with certainty be said to reflect the amounts actually purchased by investors purported to be domiciled in a particular country or area. The year-to-year variations in a country's purchases, however, can probably be assumed to reflect the general trend of purchases in each geographical region, with the notable exceptions of transactions reported by agents located in Switzerland, the Bahamas, and Bermuda.[3] Dealings in securities in these countries overwhelmingly represent the interest of clients living elsewhere.

In addition to problems related to the geographical distribution of securities purchases and sales, problems arise from omissions in the data caused by the failure of transacting agents to file the appropriate reports. Most Treasury Department reporting forms are filed by banks, securities brokers and dealers, and major insurance companies. However, the growth of other financial intermediaries in recent years suggests that laxity in report filing may not be uncommon. Many U.S. investment funds, pension funds, or educational institutions may invest directly in foreign assets. Furthermore, transactions in foreign securities by individual U.S. citizens, especially those living abroad, are often made through foreign channels and hence go unrecorded.[4] The actual size of such omissions is not known, nor is there any rough indication of their magnitude. Current OBE estimates of U.S. holdings of foreign securities are calculated by adding the annual flows reported to the Treasury Department, with various adjustments to the benchmark statistics established by a census taken during World War II. Obviously, the accumulation of even small omissions in any direction over this twenty-year period could affect the totals significantly.

Estimation of foreign transactions in U.S. securities presents similar problems although omissions may well be smaller in this case. Until several years ago, foreign citizens purchasing or selling U.S. securities did so almost exclusively through American banks or brokers who were subject to strict reporting requirements. Omissions still occurred, however, when the transaction was executed by a U.S. financial intermediary

[3] See Fred Ruckdeschel, "Prospects for Foreign Purchases of U.S. Stocks," unpublished Federal Reserve study, July 1969.

[4] *Balance of Payments Statistics.*

and the sales agent was unaware that the beneficiary was a foreign resident. Prior to the mid-1960's, the reported annual flow of foreign investments in U.S. corporate securities was relatively small, and the absolute magnitude of possible omissions was probably correspondingly small. The record growth of foreign investment companies dealing largely, or in some cases exclusively, in U.S. securities increases the possibility of omissions inasmuch as these firms are not subject to reporting requirements required of U.S. transacting agents.

Some types of security purchases are inherently difficult to classify. Total long-term portfolio capital movements are entered in the balance of payments as collected by the Treasury Department, apart from adjustments made for reclassification of items that are actually direct investments.

To facilitate explanation of these adjustments, assume that an American company with a Canadian affiliate desires to purchase Canadian securities. This simple purchase can be accomplished in several different ways. It can be carried out as an investment of parent company funds, in which case the transfer is actually a portfolio investment; or the same firm can purchase the same securities as an investment of the foreign branch. In this second case, the acquisition is not to be regarded as an international transaction at all, but is a domestic Canadian investment by a Canadian company. If the same investment is effected through the use of funds transferred from the home office to the foreign branch, the purchase should properly be considered a direct investment by the U.S.-based parent firm. In many instances, the U.S. parent company may have reported the capital transfer in the third case as a direct investment, while the foreign subsidiary reports the same transaction as a portfolio investment. To avoid this double counting, the OBE finds it necessary to deduct this transfer of funds from the portfolio investment amount in the *Treasury Bulletin*.

The Treasury's reporting system covers only cash trading. But let us now assume that a foreign-based company purchases shares of an American enterprise by means of a stock transfer. This assignment of stock was made in lieu of a cash disbursement and will be reported by the U.S. company as a foreign direct investment, provided the foreign company acquires more than 10 percent of the voting stock of the American firm. If the foreign company purchases less than 10 percent of voting equity, it is assumed that the firm will not be participating in decisions affecting the management of the domestic company, and the acquisition will be considered a portfolio investment. Thus, in the latter case, an offsetting entry must be made by the balance of payments division (BPD) to remove this transaction from those direct investments already recorded and add it to those portfolio investments previously reported by the Treasury Department. Lastly, let us assume that a foreign owned U.S. subsidiary floats a new stock issue in the United States. If the foreign firm decides to exercise its rights in the new issue, the issue should appear both in the Treasury's portfolio investment report and in the BPD's Foreign Direct Investment Report. The entry must be dropped from portfolio investment to avoid double counting. These represent the most common adjustments performed by the Commerce Department to eliminate items properly considered direct investments in balance of payments terms from the capital movements data compiled by the U.S. Treasury.[5] To illustrate the extraordinary magnitude of adjustments in some years, the BPD found it necessary, in 1968, to exclude the purchase by Royal Dutch Shell Company, Ltd., of $210 million of stock newly issued by its U.S. subsidiary. The purchase was treated as a direct investment.[6] This is not meant to imply that individual adjustments commonly run into hundreds of millions of dollars. Actually, over the period 1952–66, total adjustments of data for most foreign stock purchases by the United States averaged only slightly more than $20 million per year, and adjustments to figures generated for net purchases by foreigners of U.S. stocks averaged less than $15 million per year.

[5] Examples of adjustments are the product of conversations which the author has had with Russel Scholl of the Commerce Department's Office of Business Economics.

[6] U.S. BPD: Second Quarter 1969, *Survey of Current Business*, September 1969.