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*International Capital Flows Following the September 11  
Attacks: An Update*

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**Abstract.** The 2001 terrorist attacks raised concerns that foreigners would curtail their purchases of U.S. financial assets, thereby weakening the value of the dollar. The Federal Reserve responded aggressively on its own and in tandem with other central banks to supply liquidity and to take other actions in order to avert a potential crisis in the markets. These efforts were largely successful: by year-end 2001 U.S. equity markets slowly recovered their pre-attack values, and the exchange rate value of the dollar returned to its pre-attack rate after fluctuating within a fairly narrow range. A slower rate of economic growth in 2001 and 2002 reduced capital inflows to the United States and likely contributed markedly to the decline in the dollar in 2002 and 2003. By the first quarter of 2004, the exchange value of the dollar appeared to have stabilized somewhat, even if only temporarily. During the first quarter of 2004, an improved profit position in the United States among foreign-owned firms spurred those firms as a whole to repatriate a larger share of their income back home, and both U.S. and foreign-owned banks lent a record amount of funds to banks abroad in response to an increase in foreign demand for credit. Congress affects issues related to U.S. capital flows as a result of its direct role in fiscal policy and its indirect role in monetary policy and through the impact capital flows have on the dollar's exchange rate and on the U.S. trade balance.

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# CRS Report for Congress

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## International Capital Flows Following the September 11 Attacks: An Update

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### Summary

The 2001 terrorist attacks on New York and Washington raised concerns that foreigners would curtail their purchases of U.S. financial assets, thereby weakening the value of the dollar. The Federal Reserve responded aggressively on its own and in tandem with other central banks to supply liquidity and to take other actions in order to avert a potential crisis in the markets. These efforts were largely successful: by year-end 2001 U.S. equity markets slowly recovered their pre-attack values, and the exchange rate value of the dollar returned to its pre-attack rate after fluctuating within a fairly narrow range. A slower rate of economic growth in 2001 and 2002 reduced capital inflows to the United States and likely contributed markedly to the decline in the dollar in 2002 and 2003. By the first quarter of 2004, the exchange value of the dollar appeared to have stabilized somewhat, even if only temporarily. During the first quarter of 2004, an improved profit position in the United States among foreign-owned firms spurred those firms as a whole to repatriate a larger share of their income back home, and both U.S. and foreign-owned banks lent a record amount of funds to banks abroad in response to an increase in foreign demand for credit. Congress affects issues related to U.S. capital flows as a result of its direct role in fiscal policy and its indirect role in monetary policy and through the impact capital flows have on the dollar's exchange rate and on the U.S. trade balance. This report will be updated as warranted by events.

### Background

The September 11 attacks on New York and Washington raised concerns about the ability of the U.S. and international capital markets to absorb the financial and economic shocks.<sup>1</sup> Some observers were concerned that foreign investors might curtail their purchases of U.S. financial assets and reduce the inflow of capital into the U.S. economy as a result of doubts about the stability of the U.S. economy, thereby weakening the value of the dollar. Data closely following the attacks and in the period since indicate that the

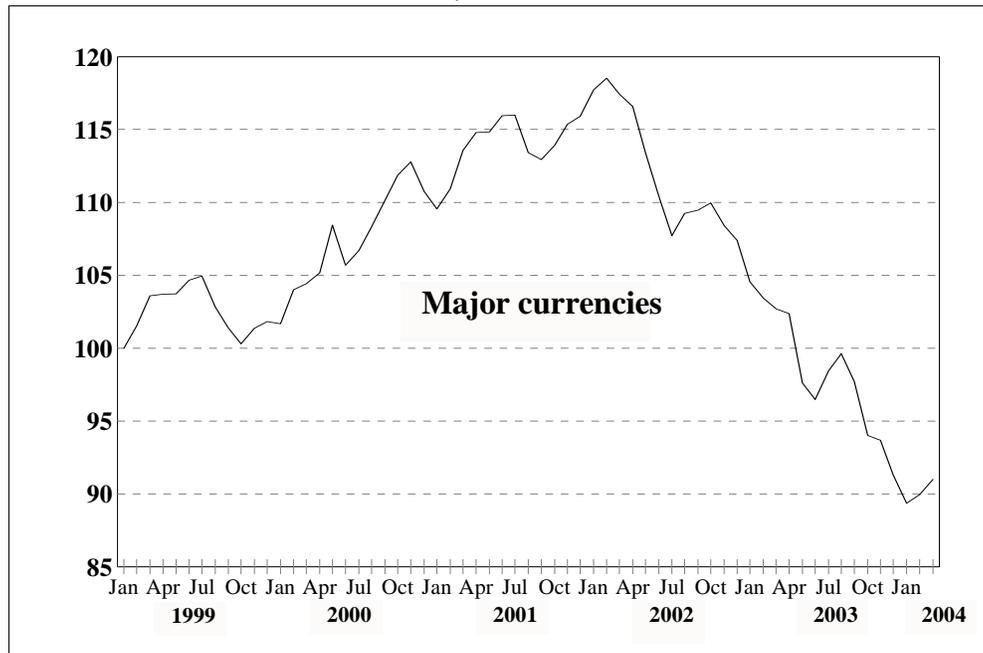
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<sup>1</sup> For additional information, see CRS Report RS21102, *International Capital Flows Following the September 11 Attacks*, by James K. Jackson.

attacks themselves had a short-term and limited impact on U.S. and international capital markets and on the value of the dollar. In part, the limited impact of the attacks on the financial markets can be traced to the swift actions of the Federal Reserve, which moved aggressively to supply the markets with capital and to reassure investors.

Economic and financial data since 2001 seem to indicate that a broad range of factors since September 11<sup>th</sup> have been more important in driving the capital markets and in determining the value of the dollar than any lingering effects related to the attacks themselves. In particular, a relatively slower rate of growth in the U.S. economy reduced the overall demand for capital inflows in 2001 and 2002, and international perceptions about the U.S. economy became less positive, thereby lessening the kinds of pressure that led to the sharp appreciation of the dollar from 1999 to 2002, as indicated in **Figure 1**. In 2003, demand for capital in the U.S. economy increased somewhat over the 2002 levels and capital inflows increased, but such inflows remained considerably below the peak inflows recorded in 2000.

**Figure 1. Nominal Index of Major Foreign Currency Price of the U.S. Dollar; Jan 1999 = 1000**



While a number of factors affect the international exchange value of the dollar, the lower level of capital inflows following 2000 likely was a key factor in contributing to the slide in the exchange rate for the dollar relative to that of other major currencies that began in 2002. Demand for U.S. assets, such as financial securities, translates into demand for the dollar, since U.S. securities are denominated in dollars. As demand for dollar-denominated assets rises or falls, the value of the dollar changes. These exchange rate changes, in turn, have secondary effects on the prices of U.S. and foreign goods, which tend to alter the U.S. trade balance.

International perceptions about the strength and pace of growth in the U.S. economy in 2002 and 2003 likely also worked to push down the dollar's exchange rate relative to that of other major currencies. In the first quarter of 2004, capital inflows and outflows

rebounded from the levels of 2003, although outflows increased more than inflows. The United States as a whole, however, remained a heavy net capital importer. During the quarter, foreign-owned firms repatriated a larger share of their profits than they previously had done and both U.S. and foreign-owned banks operating in the United States lent a record amount of funds to other banks abroad, sharply increasing U.S. private financial claims on foreigners. Foreign investors also sharply increased their purchases of U.S. Treasury securities during the quarter, acquiring \$66.4 billion in securities, the second highest amount on record.<sup>2</sup>

Inflows of capital into the U.S. economy are not new, but such inflows grew sharply over the last decade, as indicated in **Table 1**. In 1993, total foreign capital inflows to the United States reached nearly \$283 billion. These capital inflows are comprised of official inflows, primarily foreign governments' purchases of U.S. Treasury securities, and private inflows, which include direct investment and such portfolio investments as private foreigners' purchases of U.S. Treasury and corporate securities, and other private financial liabilities. By 2000, foreign capital inflows totaled more than \$1 trillion annually. Such inflows were reduced in 2001 and 2002 as the growth rate of the U.S. economy slowed down, but picked up to over \$856 billion in 2003 as economic growth improved. Private capital inflows comprise the largest share of total inflows, with foreign purchases of such corporate securities as stocks and bonds being the largest component of these inflows.

**Table 1. Net Capital Inflows to the United States, 1993 - 2003**  
(in millions of dollars)

	Total	Official assets	Private assets	Direct investment	Treasury securities	Corporate securities	U.S. currency	Non-banking liabilities	Banking liabilities
1993	282,040	71,753	210,287	51,362	24,381	80,092	18,900	10,489	25,063
1994	305,989	39,583	266,406	46,121	34,274	56,971	23,400	1,302	104,338
1995	438,562	109,880	328,682	57,776	91,544	77,249	12,300	59,637	30,176
1996	551,096	126,724	424,372	86,502	147,022	103,272	17,362	53,736	16,478
1997	706,809	19,036	687,773	105,603	130,435	161,409	24,782	116,518	149,026
1998	423,569	-19,903	443,472	179,045	28,581	156,315	16,622	23,140	39,769
1999	740,210	43,543	696,667	289,444	-44,497	298,834	22,407	76,247	54,232
2000	1,026,139	37,724	988,415	321,274	-76,949	455,318	1,129	170,672	116,971
2001	765,531	5,104	760,427	151,581	-7,438	406,633	23,783	67,489	118,379
2002	706,983	94,860	612,123	39,633	96,217	291,492	21,513	72,142	91,126
2003	856,660	207,665	648,995	81,982	139,863	238,652	16,640	77,352	94,506

**Source:** Department of Commerce

Worldwide, the dollar is heavily traded in international financial markets and, at times, plays the role of a global currency. Disruptions in this role have important implications for the United States and for the smooth functioning of the international financial system. This prominent role means that the exchange value of the dollar often acts as a mechanism for transmitting economic and political news and events across national borders. While such a role helps facilitate a broad range of international

<sup>2</sup> Sauer, Renee M. "U.S. International Transactions, First Quarter 2004." *Survey of Current Business*, July 2004. p. 68-81.

economic and financial activities, it also means that the dollar's exchange value can vary greatly on a daily or weekly basis as it is buffeted by international events. In part to blunt these effects, the Federal Reserve acted quickly to reassure capital and currency markets following the 2001 terrorist attacks. As a result of these actions and because currency traders agreed not to profit from the event, the dollar's value changed little immediately following the 2001 terrorist attacks and returned to its pre-September 11 value within a month.<sup>3</sup> Recent data indicate that the **daily** trading of foreign currencies totals more than \$1.2 trillion, or more than the **annual** amount of U.S. exports of goods and services or the net inflows of foreign capital. The data also indicate that 90% of the global foreign exchange turnover is in U.S. dollars.<sup>4</sup>

In the U.S. foreign exchange market, the value of the dollar is followed closely by multinational firms, international banks, and investors who are attempting to offset some of the inherent risks involved with foreign exchange trading. On a daily basis, turnover in the U.S. foreign exchange market<sup>5</sup> averages \$254 billion; similar transactions in the U.S. foreign exchange derivative markets<sup>6</sup> averages \$135 billion.<sup>7</sup>

## Recent Developments

A comprehensive set of data on capital flows, represented by purchases and sales of U.S. government securities and U.S. and foreign corporate stocks, bonds, into and out of the United States is collected by the Treasury Department on a monthly basis.<sup>8</sup> As indicated in **Table 2**, these data show that foreign investors buy and sell large amounts of U.S. financial assets, but that the annual accumulation, though large in dollar amounts, is relatively small compared with the large amounts of assets that are traded annually. For instance, in 2003, foreigners purchased \$19.3 trillion dollars in U.S. financial assets and sold \$18.6 trillion dollars in assets, for a net accumulation of \$708 billion in financial assets, or about 4% of the amount of assets that were traded. This large volume of transactions means, however, that relatively small changes in foreigners' transactions in U.S. securities could result in a large change in percentage terms in foreign investors' net accumulation of these securities and result in a potentially serious economic disruption in U.S. financial markets.

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<sup>3</sup> Downey, Jennifer, and Grainne McCarthy. "Dollar Movement is Limited on Decision by Traders Not to Overreact to Attacks." *The Wall Street Journal*, September 13, 2001. p. C 2.

<sup>4</sup> *Central Bank Survey of Foreign Exchange and Derivatives Market Activity in April 2001; Preliminary Global Data*. Bank for International Settlement, October 2001. p. 2-4. A copy of the report is available at [<http://www.bis.org/press/p011009.pdf>].

<sup>5</sup> Defined as foreign exchange transactions in the spot and forward exchange markets and foreign exchange swaps.

<sup>6</sup> Defined as transactions in foreign reserve accounts, interest rate swaps, cross currency interest rate swaps, and foreign exchange and interest rate options.

<sup>7</sup> *The Foreign Exchange and Interest Rate Derivatives Markets Survey: Turnover in the United States*. The Federal Reserve Bank of New York, April, 2001. p. 1. A copy of the report is available at [[http://www.newyorkfed.org/pihome/triennial/fx\\_survey.pdf](http://www.newyorkfed.org/pihome/triennial/fx_survey.pdf)].

<sup>8</sup> These data are available through the World Wide Web at Treasury Department's Treasury International Capital (TIC) reporting site: [<http://www.treas.gov/tic/>].

Marketable U.S. Treasury securities comprise the largest share of the securities acquired by foreign investors, whether in terms of the total amount of securities bought and sold, or in terms of the net accumulation of financial assets. The low risk associated with these securities makes them highly desired, especially during periods of market uncertainty and even with relatively low rates of return. Demand for Treasury securities remained strong even after the terrorist attacks of September 11, 2001, when important elements of the U.S. financial system were temporarily shut down.<sup>9</sup>

**Table 2. Transactions in U.S. Securities, 2003**  
(in millions of dollars)

<b>Total</b>	<b>Marketable Treasury Securities</b>	<b>U.S. Govt. Bonds</b>	<b>Corporate Bonds</b>	<b>Corporate Stocks</b>	<b>Foreign Bonds</b>	<b>Foreign Stocks</b>
<b>Gross Purchases by Foreigners</b>						
\$19,261,824	\$9,244,485	\$2,325,592	\$1,040,606	\$3,115,244	\$2,153,123	\$1,382,774
<b>Gross Sales by Foreigners</b>						
18,553,960	8,971,469	2,162,709	769,553	3,077,713	2,127,468	1,445,048
<b>Net Purchases by Foreigners</b>						
707,864	273,016	162,883	271,053	37,531	25,655	-62,274

**Source:** Treasury Department International Capital data system.

## Conclusions

The highly developed and broad-based nature of the U.S. financial system proved that it could weather one of the worst blows in decades. Events such as the September 11<sup>th</sup> terrorist attacks, which had a direct impact on the operations of important New York-based financial activities, can affect the short run behavior of the financial markets, but do not necessarily hamper their long-run operations. The aggressive actions of the Federal Reserve in the immediate aftermath of the attacks addressed the most pressing capital needs of the financial markets, thereby smoothing out the day to day operations of those markets. In addition, the Federal Reserve's actions addressed the immediate concerns of market participants by demonstrating its intent to intervene quickly to address any perceived or real impact on the financial and currency exchange markets.

In addition, the September 11<sup>th</sup> crisis demonstrated that the financial markets are highly efficient at processing information, a phenomenon which aids in spreading both good and bad news quickly. As a result, the markets absorbed the impact of the September 11<sup>th</sup> events quickly and likely moved on in a short time to assess the economic effects of other economic events and other economic news. This means that the overall course of the U.S. economy, rather than the events of September 11, likely determined the flows of capital into and out of the United States throughout the remainder of 2001 and beyond.

<sup>9</sup> For additional information, see CRS Report RS21102, *International Capital Flows Following the September 11 Attacks*, by James K. Jackson.

The September 11<sup>th</sup> attacks and other events have demonstrated that capital flows are highly liquid, can respond abruptly in the short run to changes in economic, financial, and political conditions, and exercise a primary influence on exchange rates. Through the exchange rates, capital flows influence global flows of goods and services. While a broad range of factors influence capital flows in the short run and in the long run, short run flows are more susceptible to daily news and events. Over the long run, however, capital flows into and out of the U.S. economy are determined by such factors as: the overall capital requirements of the economy combined with the well-developed and highly sophisticated U.S. markets that provide investors with an array of financial instruments; the stability of the U.S. economy and financial system; and by investors' profit expectations and assessments of risks. The net capital inflows (inflows net of outflows) the United States is experiencing bridge the gap between the amount of credit demanded and the domestic supply of funds, and likely keep U.S. interest rates below the level they would reach without the foreign capital. These capital inflows also allow the United States to spend beyond its means, including financing its trade deficit, because foreigners are willing to lend to the United States in the form of exchanging goods, represented by U.S. imports, for such U.S. assets as stocks, bonds, and U.S. Treasury securities.

Congress has rarely acted to intervene directly in U.S. capital market to affect U.S. capital flows or the dollar's exchange rate, but it is actively involved in overseeing and regulating those markets. In the period since the 2001 terrorist attacks, Congress has attempted to address various concerns about terrorist organizations using financial markets to transmit funds. For instance, during the 108<sup>th</sup> Congress, a number of bills were introduced to address concerns about tracking the overseas transfers of funds through the financial markets by requiring a greater disclosure of information concerning transfer of funds.<sup>10</sup> Other measures were introduced to address concerns about intervention in foreign exchange markets, primarily by foreign governments, to manipulate the exchange rate of the dollar relative to a particular currency to improve the cost competitiveness of foreign goods in the U.S. market. While some of these measures focus particularly on China's exchange rate policies, other measures are directed toward addressing the exchange rate policies generally of foreign governments.<sup>11</sup> Other measures were introduced to give Congress a more visible role in the conduct of U.S. exchange rate policy.<sup>12</sup>

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<sup>10</sup> Such measures include H.R. 2074, H.R. 2120, H.R. 2637, and S. 1359.

<sup>11</sup> Measures related to exchange rates include H. Con Res. 285, H.Res. 414, H.R. 3058, H.R. 3269, H.R. 3364, H.R. 4986, S.Res. 262, S. 1586, S. 1592, and S. 1758.

<sup>12</sup> These measures include H.R. 2782, H.R. 2783, and S. 2765.