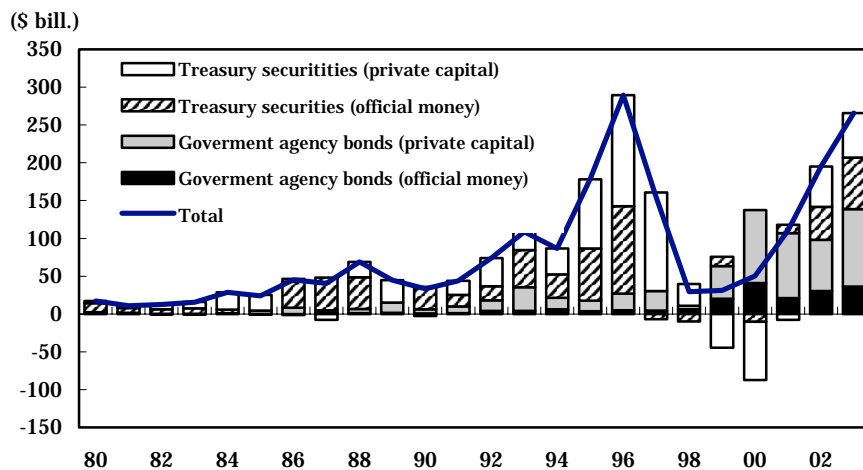


Foreign Capital Inflow Has Fueled U.S. Housing Markets¹

With the burst of the Information Technology (IT) bubble in 2000, foreign capital has been pouring into the government sector, a change from when the bulk used to flow into the U.S. corporate sector of bonds and equities. Foreign investors, primarily private ones, have expanded their investment in government agency securities.

Foreign capital inflow into the U.S. government securities by type



Note: The figure for 2003 is based on data from the first quarter.

Source: Federal Reserve

This shift is due primarily to the following three factors: First, the federal budget balance registered a surplus between fiscal year 1998 and 2001, and the volume of Treasury security issuances declined. Second, government agency bonds have offered a higher yield than the Treasury securities. Third, investors take an “implicit (government) guarantee” for granted regarding the government agency bonds, even though these securities are only guaranteed by the government agencies themselves.

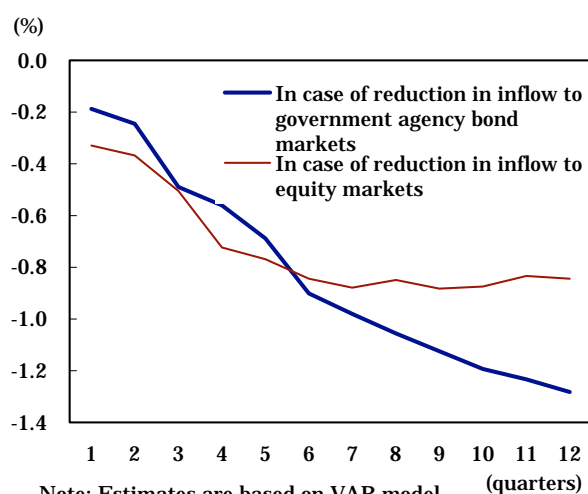
The Federal National Mortgage Association (FNMA, known as Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC, known as Freddie Mac) are the major issuers of the government agency bonds. These agencies supply funds to mortgage lenders in exchange for mortgage assets held by private financial institutions,

¹ This is an English summary of a report originally published on June 27, 2003. The full report is available only in Japanese, but the author will answer questions regarding the topic by e-mail.

while Fannie Mae and Freddie Mac raise funds by issuing mortgage-backed securities (MBS), guaranteed by them. The expansion of the government agency bond markets, thus, has enabled banks to lower mortgage rates and to increase the availability of mortgage loans. Due to favorable finance conditions, the housing markets have remained robust, supporting the economy through the wealth effects after the burst of the IT bubble.

Nevertheless, due to an accounting scandal involving Fannie Mae and Freddie Mac, investors could lose confidence, which could cause reduced foreign capital inflow to the government agency bond markets. According to our estimates based on the VAR model, a \$100 billion reduction in inflow to the government agency bond markets could cause a rise in interest rates and cut the GDP growth rates by 0.56% for the first year, by 1.06% through the second year, and by 1.28% through the third year. In comparison with capital inflow to stock markets being shed by the same amount, the effects would last longer in case of a reduction in investment in the government agency bond markets.

Accumulated effects of a \$ 100 billion reduction in capital inflow on the U.S. GDP



	for the 1st year	through the 2nd year	through the 3rd year
Reduction in inflow to government agency bond markets	-0.56	-1.06	-1.28
Reduction in inflow to equity markets	-0.72	-0.85	-0.84

Note: Estimates are based on VAR model.

Source: Own estimates.

Since the late '90s, the global economy has intensified its reliance on the U.S. economy. As a result, the outcome of the accounting scandal regarding the U.S. government agencies may affect the global economy. It is the time to correct the excessive reliance on the U.S. economy in order to maintain the stability of the global economy.

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*The information and the views contained herein are subject to change without notice.

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