3-D economics: Debt, deficits, and the dollar

While the United States undoubtedly has a significant amount of foreign debt, those numbers don't tell the entire story. In fact, a closer look shows how the U.S. deficit actually reveals the strength of the U.S. and its economy.

BY MARC CHANDLER

A compelling and pessimistic outlook prevails in some economic circles: The United States continuously runs large current account deficits that must be financed by foreign investment. The accumulation of these deficits is the U.S. foreign debt.

The growing international indebtedness of the U.S. exerts downward pressure on the U.S. dollar and increases the risk premium global investors demand for holding the assets of the world's largest debtor. In turn, the high interest rates that will result may pop the housing market bubble and undermine consumer spending, driving the U.S. into a recession.

Many observers are fond of comparing the U.S. state of affairs with highly indebted emerging market economies that have been wracked by financial crisis in recent years. One economist has compared the U.S. deficit and debt with the San Andreas Fault: The "big one" (i.e., a capital strike against the U.S.) is coming, but we just don't know when.

While many otherwise insightful people seem to subscribe to some permutation of this view, it is based on a mistakenly naive view of the U.S.'s net international investment position. More profoundly, it misunderstands the nature of power by seeing the U.S. debtor status only as a sign of weakness and dependency. It simply does not comprehend the U.S. expansion strategy.

Flows and stock

Economists draw an important distinction between a "flow" measure and a "stock" measure. A flow is something that occurs over time and is measured in simple terms (e.g., dollars). A stock is something that has been accumulated in the past and would be on hand at any time. For example, the budget deficit is a flow measure. It reflects how much the government's expenditures outstrip its revenues. The government debt is a stock measure. It reflects the accumulation of budget deficits. In a similar fashion, the U.S. current account deficit is typically understood as a flow measure and the U.S. international investment position as a stock measure.

The U.S. Bureau of Economic Analysis (BEA) published the U.S. international position as of the end of 2004 in the July issue of the *Survey of Current Business.* On a preliminary basis, it estimated the U.S. was a net international debtor to the tune of $2.48 trillion. This represented an increase of $327.5 billion from the revised 2003 figure, when the U.S. recorded a current account deficit of almost $666 billion.

The U.S. has been consistently experiencing current account deficits for more than a quarter of a century. If we add up the annual current account deficits since 1992, it would come to a staggering sum of $3.59 trillion. However, the U.S. net international debt position has grown "only" by $2.05 trillion. Clearly, the relationship between the current account deficit and the net U.S. investment position is more complicated than the conventional flow and stock relation-

ship suggests.

Understanding the data

To appreciate why the accumulation of current account deficits does not directly translate into the U.S. net international investment position requires looking beyond the headline number and acquiring a more detailed view of its composition.

The net international investment position consists of two main categories: U.S. ownership of foreign assets, and foreign ownership of U.S. assets. In turn, there are four main asset classes: equities, fixed income, bank and non-bank (largely security houses) claims, and direct investment.

On a current-cost basis, foreign investors owned nearly $11.54 trillion of U.S. assets at the end of 2004. This represented an increase of nearly $1.74 trillion last year alone. About $1.44 trillion was accounted for by new foreign investment in the U.S. Although the dollar was falling throughout the year and many market observers worried that foreign demand for U.S. assets was drying up, new foreign investment actually accelerated by more than half a trillion dollars over 2003.

In addition to the new investment, foreign assets in the U.S. also rose because of valuation. The BEAestimates the largest influence was the price appreciation of U.S. equities, which boosted the value of foreign investment. All told, the valuation adjustment increased the dollar value of the stock of foreign investment in the U.S. by almost $300 billion.

The devil is in the details

The other side of the ledger — U.S. ownership of foreign assets — is often underappreciated by market observers. On a current cost basis, U.S. investors owned a little more than $9.05 trillion worth of foreign assets at the end of 2004. This represented a $1.41 trillion increase on the year.

Purchases of foreign assets rose by $855.5 billion last year, a marked increased from the $328.4 billion purchased in 2003. The bulk of the increase can be traced to claims by U.S. banks, non-bank concerns, and foreign direct investment.

The valuation adjustment boosted the dollar value of U.S. investments abroad by another $556.3 billion. BEA figures suggest this reflected the price appreciation of foreign stocks and the foreign exchange appreciation of most foreign currencies against the U.S. dollar in 2004.

Therein lies one critical reason why many comparisons between the U.S. and most other countries are misleading: U.S. liabilities are priced in U.S. dollars. That means U.S. liabilities do not increase if the dollar falls. This was not the case for many countries in East Asia during the 1997-98 financial crisis, or in Latin America. On the other hand, a depreciation of the dollar tends to boost the dollar value of the substantial foreign assets U.S. investors own and the income those investments generate.

Asset preferences

Another important consideration frequently overlooked is the different asset preferences of U.S. and foreign investors. U.S. investors tend to prefer somewhat riskier foreign assets than foreign investors do in the U.S.

In terms of portfolio investment, non-American investors show a clear preference for U.S. bonds over equities. Of the roughly $11.54 trillion of U.S. assets in foreign hands, nearly 46 percent is invested in fixed income or cash, and a little less than 17 percent in equities.

Of course, the dollar's role as a reserve asset and the tendency of foreign central bank to hold of U.S. Treasury and agency bonds exacerbates the bias toward fixed income. But the propensity is clear among private investors as well. At the end of 2004, the BEA's figures show private foreign investors held a little more than $3.03 trillion in U.S. fixed income instruments and cash, compared with U.S. equity holdings of almost $1.93 trillion.

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The asset preference of U.S. investors is the opposite. Of the roughly $9.05 trillion of foreign investments, equities accounted for almost 28 percent, or $2.52 trillion. Fixed income instruments, on the other hand, accounted for a little more than 10 percent, or nearly $917 billion.

U.S. investors, in the form of multinational companies, have demonstrated a greater appetite than foreign investors for direct investment. At the end of 2004, on a current cost basis, U.S. direct investment abroad was worth almost $2.37 trillion and accounted for a little more than 26 percent of U.S. foreign assets. In contrast, foreign direct investment in the U.S. was valued at almost $1.71 trillion, accounting for a little less than 15 percent of their U.S. assets.

Returns on investments

To compensate investors for the additional risk, riskier assets ought to generate a higher expected return. Accordingly, despite the U.S. net international debt position, the U.S. recorded a surplus of $30 billion on its investment income balance in 2004.

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U.S. income from foreign investment amounted to $379.5 billion in 2004. This is equivalent to a 4.2-percent return on its foreign assets. Foreign investors received $349.1 billion in income payments from the U.S., equivalent to a 3-percent return on its U.S. assets.

This spread, between what the U.S. pays to service its liabilities and what it earns on its foreign investment, is close to the average of the first half of this decade. On average, the U.S. has paid 3.35 percent to foreign investors and received an average annual return of 4.46 percent.

Yet the superior rate of return on U.S. foreign investments is not just a function of asset allocation. For example, U.S. foreign direct investment generated a return of 9.37 percent and 9.84 percent in 2003 and 2004, respectively. In contrast, foreign direct investment in the U.S. generated an annual return of 4.51 percent and 6.15 percent during the same years.

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Historically, despite its status as a net international debtor, the U.S. records a net surplus on its investment income balance. In fact, in 2003, the surplus of nearly $52 billion was a record. While deficits on the investment income balance have been recorded occasionally on a quarterly basis, it has always been in surplus on an annual basis.

However, because of the growing U.S. indebtedness and cyclical considerations — namely, that U.S. interest rates have risen to multi-year highs relative to many other countries and regions, including Europe and Japan — there is an increasing likelihood the investment income balance will record a deficit this year. In the first quarter of 2005, the U.S. recorded a $500 million surplus on the income balance, but this was offset with a $600 million deficit in the second quarter.

Many economists will wring their hands and point to an investment income deficit as evidence the U.S. debtor status has finally reached a tipping point. Yet, the most striking thing is how little it costs to service the U.S. debt, which by the end of this year is likely to be close to $3 trillion. Provided the rate of return the U.S. earns on its foreign-owned assets outstrips the rate it pays on its liabilities, the U.S. role as the global financial intermediary appears secure.

Central banks

Foreign central banks held approximately $1.98 trillion worth of U.S. assets at the end of 2004. This exceeded the value of foreign direct investment in the U.S. by about $280 billion. This fuels fears of the U.S. dependency on foreign central banks and is thought to demonstrate America's vulnerability to political pressure or a slowing of reserve accumulation.

Yet the role of central banks in financing the U.S. current account deficit is often exaggerated. Private capital flows into the U.S. outstrip official flows by a large margin. In 2004, private investors put more than $800 billion of their savings in the U.S., while central bank purchases of assets rose by a little less than $400 billion.

Of course, because central banks have a clear and understandable preference for the least risky and most liquid securities as reserve assets, their investment in the U.S. is heavily concentrated in U.S. Treasury and government-sponsored debt instruments. But to claim, as some observers do, that this means foreign central banks are financing the U.S. budget deficit, confuses the issue. As Federal Reserve officials have pointed out, U.S. Treasury (and agency) securities are a modest part of the overall U.S. securities market and a small part of the overall capital inflows into the U.S.

A look at the Treasury Department's monthly portfolio flow report (Treasury International Capital or TIC) illustrates this point. This data series is not reconcilable with the U.S. quarterly current account reports or the BEA's net international investment report, but it is nevertheless revealing and the financial markets, especially the foreign exchange market, pay close attention to it.

As of late September, the latest TIC data available covers July 2005. In that month, private foreign investors bought roughly $105 billion worth of U.S. securities. By contrast, foreign central banks bought $10.4 billion worth of mostly U.S. Treasuries and agencies. And in the three-month period through July, private investors bought about $262 billion worth of U.S. securities, while central banks bought almost $42 billion.

Foreign central banks and private investors purchase U.S. securities month in and month out. Ironically, the most fickle investors are Americans themselves, and the group of primarily U.S. hedge funds located in the tax havens in the Caribbean. Moreover, foreign investors, both public and private, do not invest their savings in the U.S. out of altruism or generosity. The depth, breadth, and transparency of the U.S. market are second to none.

There continues to be hope that the advent of the Euro will improve the depth, breadth, and liquidity of the European capital markets. While there has indeed been some improvement, the sovereign bond market is more like the U.S. municipal bond market, with various issuers, each issue being relatively small, and each country having different tax schedules. The secondary corporate bond market and the high-yielding bond market are also small compared to the U.S., which continues to lead in various financial innovations.

Asia's capital markets have been under-developed and, although reforms are evident there as well, the capital markets remain too small to absorb the region's excess savings.

The dollar's demise is exaggerated

Arguments that the U.S.'s persistent cur-

rent account deficit and growing indebtedness would undermine the role of the dollar in the international capital markets have been exaggerated. Central banks slowed their accumulation of reserves recently, which was supposed to tip the dollar, but this has not happened because private sector investors have more than filled the void.

The role of the dollar as the key reserve asset was supposed to be weakened by the deterioration of its international balance sheet and challenged by the advent of the Euro. Various central banks, from Asia to eastern and central Europe to Canada, have diversified their reserves, but the dollar's role as the key reserve asset continues.

In fact, according to the most recent data by the International Monetary Fund, the dollar's share of global reserves actually increased in 2004 for the first time in three years. The dollar's share of global reserves stands at almost 60 percent. The Euro's share has grown since its introduction in 1999, but most of the growth simply reflected the substitution of the German deutsche mark and French franc's reserve role. In 2004, the Euro's share actually slipped to 24.9 percent from 25.3 percent.

Japan enjoys a substantial current account surplus and is the world's second largest economy. Yet in 2004, the yen's share of global reserves continued its multi-year decline to stand at 3.9 percent, down from 4.1 percent at the end of 2003. Despite being backed by a large trade deficit, the British pound gained the most as a reserve currency, accounting for 3.3 percent of global foreign exchange reserves in 2004, up from 2.6 percent.

Pax Americana

Of the three factors of production — land (natural resources), labor, and capital — the U.S. has always enjoyed an abundance of the first and has traditionally been an importer of the latter two. It has often been a refuge for those suffering from religious persecution, political suppression, and economic or social distress. And there does appear to be a demographic component to the relatively low U.S. savings rate, which many economists argue is the source of the U.S. current account deficit.

During most of its 230-year history, the U.S. has been a net debtor. As has been the case for many, if not most, other developing countries, foreign capital helped finance U.S. industrialization, including the infrastructure, which during the 19th century were railroads, canals, waterways, and the telegraph. Becoming a net creditor had a great deal to do with the financing of the Allies in World War I.

Its emergence as an international debtor late in the 20th century fulfills an important structural role in the modern political economy. Because of demographic considerations, especially the aging populations of Europe and Japan, and structural challenges, especially the under-developed capital markets and export-oriented developmental models in Asia, there are an excess savings in the world. The U.S. absorbs the world's surplus capital.

While many pundits seemingly never tire of repeating how the U.S. needs to import more than $3 billion each working day to finance its current account deficit, few recognize that a group of countries are, in fact, generating more than that in excess savings and must export it or face domestic crisis.

Just as it would have been impossible for Europe and Japan to recover from the destruction of World War II without access to the U.S. market on favorable terms, so too has the relatively open U.S. market for goods and its ability to absorb excess savings been critical to the global recovery from the series of emerging market crises from Latin America to Russia to East Asia. While domestic reforms in China since the late 70s have been important, access to the U.S. market for both its goods and capital provided the second pillar upon which China's push for rapid development rests.

Therein is America's contribution to the history of empire. Rather than solve *its* problem of surplus capital through exporting it, as Great Britain did, Pax Americana (a term used to describe relative peace in the Western world since the end of WWII) is predicated on allowing the world to export its surplus capital to the U.S. The U.S.'s highly developed capital markets can absorb the world's surplus capital.

In the 19th and early 20th centuries, the U.S. acted as a safety valve for Europe's (and to a lesser extent Asia's), surplus population, and for Latin America's surplus population in the late 20th and early 21st centuries; it now serves as a safety valve for the world's excess savings. Without this safety valve, the return on capital would fall, investment would suffer, and standards of living would decline. This in turn could lead to political and social instability, and possibly wars.

To understand its significance requires severing the pre-modern link of debt and vulnerability. That the U.S. could become the world's largest debtor and not see an erosion of its credit rating, or the dollar slip as the key reserve asset, or an undermining of the attractiveness of its liberal economic model, is a testimony to the country's strength, not its weakness.

There are limits to the U.S. strategy. It is far from the ideal solution. But it is not obvious where those limits are. Some economic historians note that on the eve of WWI, the peak of an earlier version of globalization, the median current account imbalance of the major countries was more than 5 percent of their GDP. Now it is closer to half that despite the incredible growth of cross-border movement of capital and goods.

It is not clear if any other country has the capability or desire to replace or supplant the U.S. as the safety valve for the world's surplus capital. Nor do the many critics have a realistic alternative to the U.S. strategy. The development of capital markets, especially in Asia, and boosting world consumption to absorb the surplus savings may help, but it will take a long time, as cultural as well as institutional changes are required.

In the meantime, the U.S. debt and deficits are likely to grow, and the dollar will move according to the vagaries of cyclical forces and the whims of the nearly $2-trillion-a-day foreign exchange market.

For information on the author see p. 10.