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Their Money, Our Strength

By David Malpass

Dabblers in the dismal science are sounding the alarm: Foreigners are losing their enthusiasm for American securities, with potentially disastrous implications for funding the U.S. current-account deficit. But a closer look at the evidence presents a very different picture.

The U.S. is indeed running record trade and current-account deficits. This is associated with a record flow of capital to the U.S. from abroad, much of it from Asia. True, the most recent data from the U.S. showed that foreigners reduced their net purchases of long-term securities to \$56.4 billion in May, down 26% from April's figure—the lowest monthly total in seven months. But net purchases in May were weak only in comparison to their strength in the previous six months. Foreigners heavily increased their long-term commitment to the U.S. in late 2003 and early 2004, while lightening up in May.

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What those hitting the panic button fail to mention is that the excess of net long-term foreign financing over the current-account deficit had reached an *all-time* record \$302 billion in the 12 months through April (the widest point on the graph nearby). Because longer-term debt went up by more than the current account deficit, the effect was to lengthen the maturity of the U.S. external financing, adding to its stability. The strength of the dollar in recent weeks in the face of concerns, probably temporary, about a U.S. slowdown should help undercut the handwringing over the lower level of purchases in May.

The Big Questions are whether U.S. expansion is dependent on Asia's savings or at risk due to the trade imbalance. The answer to both is no. The expansion is driven primarily by domestic developments: the increasing flexibility of the economy and improvements since 2001 in the value of the dollar, interest rates and tax rates. America is in the early stages of a relatively long expansion, in which inflation and innovation will be more important variables than the trade deficit or foreign-capital flows.

Part of the foreign-funding concern rests on the view that the market for global capital flows is a "buyers' market," meaning the potential buyer of a U.S. Treasury sets the price and yield and has the power to disturb markets by selling, or even by reducing purchases. This argument has been made without confirmation since at least the twin deficits debate of 1984-5.

U.S. bond yields and the value of the dollar have fluctuated over a wide range in response to many factors—U.S. growth, inflation, tax policy, and, above all, expectations of Federal Reserve rate policy—but foreign buying and the trade deficit have simply not had much impact. Foreigners don't have much influence on key fundamentals such as Fed policy, growth, inflation, tax rates and return on investment, and aren't often a leading indicator of them.

Moreover, while it's true that foreigners own a big portion of U.S. government securities, they own a smaller, declining portion of overall U.S. assets—including Treasuries, perhaps \$2.5 trillion (the net debtor position of the U.S.) out of \$80 trillion in total U.S. assets. In essence, they have outbid Americans for Treasuries while giving up ownership share in other (faster-appreciating) assets.

As a result, their decisions account for only a small fraction of the swings in the dollar, interest rates and bond yields—swings that are primarily caused by other factors. For example, the dollar's super-strong phase began at the end of 1996 with monetary policy's concern with irrational exuberance, and ended with the post-9/11 shift to the Fed's considerable period of monetary accommodation. The trade deficit didn't play a role. Likewise, U.S. bond yields fell to an extreme low in June 2003 on belated concerns about deflation, not on some newfound ease in funding the already-record current-account deficit. And the ongoing rise in bond yields reflects 2003's dollar weakness and related inflation concerns, not problems in funding the current-account deficit.

Foreign investment is a welcome addition to the U.S. capital structure. And while there is much discussion of America's heavy use of foreign capital, there is not as much of the foreign need for investments in the U.S. One should remember that America's current-account deficit is matched by a capital surplus, while the rest of the world's current account surplus is matched by a capital deficit, a voluntary net

flow of capital to the U.S. Those foreign needs for investment in the U.S. are driven by the liquidity and transparency of U.S. markets, the aging of Japan's population, and Asia's fast-growing liquid assets, some of which logically end up being invested in the U.S.

The U.S. current-account deficit is a form of leverage in which foreigners finance the full spectrum of economic activity from consumption to home-building to R&D and capital investment. To look at heavy foreign ownership of Treasuries and the related interest expense as solely costs and risks ignores the gains the U.S. creates from incremental capital. The average transaction is a relatively

low-yield fixed-rate investment, say a Japanese purchase of a 3.5%-yielding U.S. government security. It becomes part of a U.S. capital structure that produces 5%-7% annual nominal growth. The trade makes good sense for the Japanese saver who faces a yield of only 0%-1.5% on assets invested at home, and good sense for the younger, faster-growing U.S. economy which makes use of inexpensive foreign capital.

The global trade imbalance presents a true problem, but not

the financial or dollar crisis often discussed. For years, U.S. growth and investment rates have exceeded that of most other countries. A more balanced global economy would see heavier investment and faster growth in less-developed economies. The best, and most likely, resolution of the U.S. trade deficit and capital surplus will be faster growth and heavier investment abroad, rather than capital flight from the dollar and U.S. government securities.

In the meantime, the fixation with the trade deficit encourages protectionism in the U.S. and leads to an underestimate of the power of the American economic model. It would be wise to spend less time analyzing trade deficits and more time removing obstacles to investment and innovation both in the U.S. and abroad.

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Increased Commitment

Net foreign purchases of long-term securities and the current-account deficit

12 mo. moving sum, \$ in billions



Sources: U.S. Treasury; Haver, Bear Stearns & Co., Inc.