

The US, the world's hedge fund

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There are some strange facts about the asset and trade positions of the US economy in the globalizing economy. The United States runs massive and growing trade deficits, is borrowing at a clip that would arouse the suspicions of a casino pit boss, and has been selling its assets to anyone who will buy. In the past 24 months, the US balance on goods and services comes in just shy of negative-\$1.5 trillion. Across the same period, the US has sunk further into debt to the rest of the world.

For 2006, exports of US\$1.4378 trillion and imports of \$2.2014 trillion resulted in a goods and services deficit of \$763.6 billion, \$46.9 billion more than the 2005 deficit of \$716.7 billion. For goods, exports were \$1.0237 trillion and imports were \$1.8598 trillion, resulting in a goods deficit of \$836.1 billion, \$53.3 billion more than the 2005 deficit of \$782.7 billion.

As a result of that shortfall the US has been selling assets and borrowing. The net international investment position (NIIP) is the Bureau of Economic Analysis's broadest measure of US-owned foreign assets less foreign-owned US assets.

There has been a dramatic and sustained deterioration in the US NIIP over the past several decades. Between 1986 and 1988, the US transformed itself from creditor to the world to debtor extraordinaire. It has never looked back, nor has it been forced to.

The US has enjoyed positive net income from its increasingly larger negative total holding of foreign assets. This has partially insulated the US from instability, dollar plunges and rising interest rates. Declines in the US currency get help from those most hurt - foreign owners of US assets. As greenbacks fall, the US increases its positive income stream because the value of its assets rises and the value of the United States' liabilities falls.

US imports are linked closely to or pegged to the dollar and US export markets are less so. Thus falling dollars impose massive costs on asset holders and trading partners, reducing the regularity and severity of episodes. At least that has been true thus far. Spiking interest rates and falling dollars have neither regularly nor painfully recurred. There has been no forced rebalancing as economic theory suggests. Herein lies the source of much trouble, and many sound forecasts have gone awry.

Many have seen the growing negativity of net assets and predicted a coming dollar downdraft and violent rebalancing. Dollar slides have occurred - sometimes rapidly and to destabilizing effect. There have been episodes of rebalancing, but they are few and the trend is still clearly away from balance. The US NIIP has continued down, beyond the targets advertised as hard constraints. The US has avoided the forecast costs. How? Why?

There are many and complex answers to this question. Key among the factors is the United States' persistent ability to attract copious capital - at fairly low interest rates and with no risk premium associated with rising indebtedness. The US trade deficit's net outflow of dollars comes back as

purchases of US assets and loans to US borrowers. The world buys US debt, at low yields and across maturities. They don't just buy, they hold. [1] They hold come hell or high water. The United States' foreign friends also undertake direct investment in the US.

Their returns, even unadjusted for currency, are terrible. US returns on foreign investment are much, much higher. It is estimated that US assets overseas outperformed foreign assets invested in the US by 210 basis points between 1952 and 2004 and by just shy of 300 basis points between 1973 and 2004. [2] Thus the United States' dwindling net assets are more than offset by vastly superior yields. It has helped the US that it tends to acquire riskier assets, equities and foreign direct investment (FDI), while they snap up debt. Rather amazingly, over past decades, the return to US FDI is more than 400 basis points higher than the return to foreign FDI in the US. [3]

The US is also allowed to borrow in dollars. US foreign assets are more than 75% non-dollar-denominated. This means the United States' assets grow and its liabilities shrink in value as the dollar falls. [4] Most important, the US has managed to earn more with fewer and fewer net foreign assets than foreigners have managed to earn with more and more net US assets.

In other times and places, such arrangements have been referred to as tribute, and were not handled through global "free" asset markets. Today they are. It might be worthy of note that the more unstable floating-exchange-rate period has been very kind to the US. Money comes to the US for safety and to fund the world's consumer demand. Thus the US invests according to portfolio theory, getting maximum cash returns, and they maximize across a broad range of non-cash-return considerations.

The net capital the US has deployed abroad is ever smaller relative to the net capital foreigners have deployed in the US. Both are rising fast in absolute terms. It is more than \$2.6 trillion less as of the writing of this article. It was not until the fourth quarter of 2005 that US income receipts fell below US payments, despite trillions more in assets held by foreigners. There it has stayed for the last three quarters for which final data are available. The net income outflow remains tiny given the difference in size of net capital. The income shortfall was \$3.8 billion in the third quarter of 2006, up from \$2.2 billion in the second quarter of 2006. How can this be explained? What does it mean for it to end?

There are a few leading "explanations" for the superior returns of US assets abroad. The least interesting is called the "dark matter" theory and basically explains away the size of US NIIP as a failure to measure accurately complex and non-quantitative US assets held abroad. This merits little comment and recalls the classic line from Young Frankenstein, when the hunchback responds to the obvious question with, "What hump?"

On the more plausible side are explanations focused on the privileged and unique position of the US as the guarantor of liquidity and the printer of the global reserve currency. The US is able to borrow cheaply and lend dear with lower risk premiums attached to her debt. This allows the US to act as banker to the world, skimming off an "intermediation" fee that allows positive returns on portfolio maturity and quality composition. This has some explanatory power. However, it would seem the US is doing everything possible to cancel this advantage without appearing to lose the returns associated. A more rigorous and complex version of the history and measure of this oddity is well told with supporting data in "From World Banker to World Venture Capitalist" by Pierre-Olivier Gourinchas and Helene Rey. [2]

Gourinchas and Rey divide the reasons for persistent positive returns on declining US-owned assets abroad into two broad categories. The first source of positive returns has to do with the relative

composition of US- versus foreign-held assets. The second has to do with the returns on these assets. Here we discover that the US has a preference for equity and FDI, while the rest of the world has accumulated trillions in US government debt securities.

The US holds riskier assets as a much larger portion of its portfolio. In addition, US FDI investment abroad earns much higher returns than foreign FDI in the US. The US runs much more leverage. Higher risk earns higher returns. The US even enjoys superior returns on its FDI compared with foreigners' FDI in the US.

The US functions like a leverage-loving hedge fund, hunting down and eating alpha. What this says about the others in the global portfolio allocation game, I leave to you to decide. All are acting in self-interest and all are aware of what they are doing. None seem to see a palatable alternative.

Others have added valuable elements to our understanding of NIIP anomalies. Some suggest that profits are reported outside the US where taxes are lower, artificially reducing the reported returns here. Many hold that foreign firms buy in the US for political reasons or to gain access to the US market. I would add funding the United States' trade shortfall as a leading motivation. Many who buy and hold do so to defend favorable exchange rates, curry favor and provide credit to the US state and consumer. This is a payment to continue the world economic and political order.

Before leaving you to ponder all this, we need to address what it means that the US is no longer above water in terms of the income from its negative net assets. It likely means building pressure on the dollar. If and when this occurs, it means pain to foreign creditors and possible political risk.

The sheer size of the US negative NIIP is flirting with offsetting the past advantage of positive net income. Rebalance will occur, US relative returns will rise further, or this former support will stay a drag. This signals the end of a support for the United States' over-indebtedness, although that may take time to manifest.

It raises a bigger question for the rest of the world. Why is it so vital for them to subsidize the US so much and for so long? What will happen to their swollen positions in low-yielding dollar assets? Last but not least, if the US is a leveraged hedge fund among nations, should Uncle Sam really be casting stones at the private firms mirroring US macroeconomic strategy?

Notes

1. Recently a troubling thing has been happening. Official holdings of US Treasuries have not been growing so rapidly and private holdings have taken their place. This may signal less stability of ownership at a future point.
2. Pierre-Olivier Gourinchas and Helen Rey, From World Banker to World Venture Capitalist. Presented 2005, National Bureau of Economic Research Conference on G7 Current Account Imbalances. Appendix Table 1.
3. Alexandra Heath, "What Explains the US Net Income Balance?" BIS Working Paper 223. January 2007.
4. If we were interested in scaring the rest of the world, particularly the big holders of dollar assets in Japan and China, we would repeat that line again and ask, "Are we all in this thing together?"

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