

The Overstretch Myth

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Can the Indispensable Nation Be a Debtor Nation?

Would-be Cassandras have been predicting the imminent downfall of the American imperium ever since its inception. First came Sputnik and "the missile gap," followed by Vietnam, Soviet nuclear parity, and the Japanese economic challenge—a cascade of decline encapsulated by Yale historian Paul Kennedy's 1987 "overstretch" thesis.

The resurgence of U.S. economic and political power in the 1990s momentarily put such fears to rest. But recently, a new threat to the sustainability of U.S. hegemony has emerged: excessive dependence on foreign capital and growing foreign debt. As former Treasury Secretary Lawrence Summers has said, "there is something odd about the world's greatest power being the world's greatest debtor."

The U.S. economy, according to doubters, rests on an unsustainable accumulation of foreign debt. Fueled by government profligacy and low private savings rates, the current account deficit—the difference between what U.S. residents spend abroad and what they earn abroad in a year—now stands at almost six percent of GDP; total net foreign liabilities are approaching a quarter of GDP. Sudden unwillingness by investors abroad to continue adding to their already large dollar assets, in this scenario, would set off a panic, causing the dollar to tank, interest rates to skyrocket, and the U.S. economy to descend into crisis, dragging the rest of the world down with it.

Despite the persistence and pervasiveness of this doomsday prophecy, U.S. hegemony is in reality solidly grounded: it rests on an economy that is continually extending its lead in the innovation and application of new technology, ensuring its continued appeal for foreign central banks and private investors. The dollar's role as the global monetary standard is not threatened, and the risk to U.S. financial stability posed by large foreign liabilities has been exaggerated. To be sure, the economy will at some point have to adjust to a decline in the dollar and a rise in interest rates. But these trends will at worst slow the growth of U.S. consumers' standard of living, not undermine the United States' role as global pacesetter. If anything, the world's appetite for U.S. assets bolsters U.S. predominance rather than undermines it.

PRIME NUMBERS

Discussion of the United States' "net foreign debt" conjures up images of countries such as Argentina, Brazil, and Turkey, evoking the currency collapses and economic crises they have suffered as models for a coming U.S. meltdown. There are key differences, however, between those emerging-market cases and the current condition of the global hegemon.

The United States' external liabilities are denominated in its own currency, which remains the global monetary standard, and its economy remains on the frontier of global technological innovation, attracting foreign capital as well as immigrant labor with its rapid growth and the high returns it generates for investors.

The statistic at the center of the foreign debt debate is the net international investment position (NIIP), the value of foreign assets owned by U.S. residents minus the value of U.S. assets owned by nonresidents. Until 1989, the United States was a creditor to the rest of the world; the NIIP peaked at almost 13 percent Of GDP in 1980. But chronic current account deficits ever since have given the United States the largest net liabilities in world history. Since foreign claims on the United States (\$10.5 trillion) exceed U.S. claims abroad (\$7.9 trillion), the NIIV is now negative: -\$2.6 trillion at the start of 2004, or-24 percent Of GDP.

Unpacking the NIIP gives a better sense of the risk it actually poses. It has two components: direct investment, the value of domestic operations directly controlled by a foreign company; and financial liabilities, the value of stocks, bonds, and bank deposits held overseas. At the start of 2004, foreign direct investment in the United States was \$2.4 trillion, while U.S. direct investment abroad was about \$2.7 trillion. (Direct investment is relatively stable, changing mostly in response to changes in expected long-term profitability) Removing direct investment from the equation leaves \$5.1 trillion in U.S.-held foreign financial assets versus \$8.1 trillion in U.S. financial assets held by foreign investors.

This last figure represents a whopping 74 percent of U.S. GDP--a statistic that would seem to give ample cause for alarm. But considering foreign ownership of U.S. financial assets as a percentage of GDP is less enlightening than comparing it to the total available stock of U.S. financial assets. At the start of 2004, total U.S. securities amounted to \$33.4 trillion (some 50 percent of the world total). Foreign investors held more than 38 percent of the \$4 trillion in U.S. Treasury bonds, but only 11 percent of the \$6.1 trillion in agency bonds (such as those issued by Fannie Mae and Freddie Mac); 23 percent of the \$6.5 trillion in corporate bonds; and 11 percent of the \$15.5 trillion in equities outstanding.

These foreign liabilities are the result of a string of current account deficits that have grown from 1.5 percent Of GDP in the mid-1990s to an estimated 5-7 percent of GDP---about \$650 billion--in 2004. Economists at the Organization for Economic Cooperation and Development estimate that ongoing deficits of 3 percent of GNI would bring the U.S. NIIP to -40 percent of GDP by 2010, and that it would eventually stabilize at around-63 percent. If the deficit remains at today's level, they foresee the NIIP growing to -50 percent of GDP by 2010 and eventually to -100 percent.

These estimates, however, fail to consider that future dollar depreciation and market adjustments in interest rates and asset prices will likely check the increase of the NIIP. Dollar depreciation against the euro and the yen in 2002 and 2003 kept the NIIP flat despite large current account deficits. The same result is likely for 2004 (final numbers will not be available until the end of June). Thus, although the NIIP will surely continue to grow for many years to come, its increase will be far less dramatic than many economists fear.

FALSE ALARM

The real question is just how much the United States' deteriorating NIIP threatens to undermine the economic foundations of U.S. hegemony. The precise answer depends on whether you explain current account deficits in terms of trade, domestic savings and investment, or the composition of global wealth. In each case, though, the risks are far less dire than they are made out to be. And in many ways, chronic current account deficits reflect strong economic fundamentals rather than fatal structural flaws.

A trade-oriented approach to current account deficits views them as a byproduct of robust economic growth, reinforced by a still overvalued currency and the U.S. economy's powerful structural import bias. In this view, the U.S. has a stubborn current account deficit because it grows faster than its trading partners and spends a disproportionate share of its growing income on imported goods and services.

An alternative perspective takes as its point of departure the accounting identity that equates the current account deficit with the difference between total investment in the United States and U.S. domestic saving. Low domestic saving, according to this view, is to blame for deficits. The fear is that a sudden reluctance by foreigners to continue exporting their excess savings to the United States would choke off the investment needed to sustain economic growth, sending the U.S. economy into crisis.

This explanation becomes less alarming, however, when you consider that both savings and investment are seriously undervalued in U.S. economic accounts. Capital gains on equities, 401(k) plans, and home values are excluded from measurements of personal saving; when they are added, total U.S. domestic saving is around 20 percent Of GDP--- about the same rate as in other developed economies. The national account also excludes "intangible" investment: spending on knowledge-creating activities such as on-the-job training, new-product development and testing, design and blueprint experimentation, and managerial time spent on workplace organization. Economists at the National Bureau of Economic Research estimate that intangible investment grew rapidly during the 1990s and is now at least as large as physical investment in plant and equipment: more than \$1 trillion per year, or 10 percent of GDP. Consequently, the size and growth rate of the U.S. economy

have been seriously underestimated. In fact, when tangible and intangible investment are both counted, the apparent (and much decried) increase in consumer spending as a share of GDP turns out to be a statistical artifact.

A third approach to the current account deficit focuses on the growth and composition of global wealth. In this framework, international capital movements drive the current account balance, rather than vice versa. With the United States expected to grow faster than Europe and Japan over the next several decades and wealth growing rapidly in Asia--especially in China and India--it makes sense that foreign investors will continue to flock to U.S. financial markets. This could generate a sequence of U.S. deficits as high as 5 percent of GDP, causing the NIIP to balloon. But such an increase would not mean an end to the foreign appetite for U.S. assets; NIIP ratios that appear dangerously high relative to U.S. GDP would be sustainable because of the rapid growth of global wealth.

U.S. financial markets have stayed strong even as the financing of the U.S. deficit shifts from private investors to foreign central banks (from 2000 to 2003, the official institutional share of investment inflows rose from 4 percent to 30 percent). A large percentage of the \$1.3 trillion in Asian governments' foreign exchange reserves is in U.S. assets; central banks now claim about 12 percent of total foreign-owned assets in the United States, including more than \$1 trillion in Treasury and agency securities. Official inflows from Asia will likely continue for the foreseeable future, keeping U.S. interest rates from rising too fast and choking off investment.

In a series of recent papers, economists Michael Dooley, David Folkerts-Landau, and Peter Garber maintain that Asian governments--pursuing a "mercantilist" development strategy of undervalued exchange rates to support export-led growth--must continue to finance U.S. imports of their manufactured goods, since the United States is their largest market and a major source of inward direct investment. Only a fundamental transformation in Asia's growth strategy could undermine this mutually advantageous interdependence--an unlikely prospect at least until China absorbs the 300 million peasants expected to move into its industrial and service sectors over the next generation. Even the widely anticipated loosening of China's exchange-rate peg would not alter the imperatives of this overriding structural transformation. Ronald McKinnon of Stanford argues that Asian governments will continue to prevent their currencies from depreciating too much in order to maintain competitiveness, avoid imposing capital losses on domestic holders of dollar assets, and reduce the risk of an economic slowdown that could lead to a deflationary spiral. According to both theories, there should be no breakdown of the current dollar-based regime.

Official Asian capital inflows, moreover, should soon be supplemented by a renewal of private inflows responding to the next stage of the information technology (IT) revolution. Technological revolutions unfold in stages over many decades. The IT revolution had its roots in World War II and has proceeded via the development of the mainframe computer, the integrated circuit, the microprocessor, and the personal computer to culminate in the union of computers and telecommunications that has brought the Internet. The United States--thanks to its openness, its low regulatory burden, its flexible labor and capital markets, a positive environment for new business formation, and a financial market that supports new technology--has dominated every phase of this technological wave. The spread of the IT revolution to additional sectors and new industries thus makes a revival of U.S.-bound private capital flows likely.

A SOFTER LANDING

Whichever perspective on the current account one favors, the United States cannot escape a growing external debt. The "hegemony skeptics" fear such debt will lead to a collapse of the U.S. dollar triggered by a precipitous unloading of U.S. assets. Such a selloff could result--as in emerging-market crises--if investors suddenly conclude that U.S. foreign debt has become unsustainably large. A panicky "capital flight" would ensue, as investors raced for the exits to avoid the falling dollar and plunging stock and bond prices.

But even if such a sharp break occurs--which is less likely than a gradual adjustment of exchange rates and interest rates--market-based adjustments will mitigate the consequences. Responding to a relative price decline in U.S. assets and likely Federal Reserve action to raise interest rates, U.S. investors (arguably accompanied by bargain-hunting foreign investors) would repatriate some of their \$4 trillion in foreign holdings in order to buy (now undervalued) assets, tempering the price decline for domestic stocks and bonds. A significant repatriation of funds would thus slow the pace of the dollar decline and the rise in rates. The ensuing recession, combined with the cheaper dollar, would eventually combine to improve the trade balance. Although the period of global rebalancing would be painful for U.S. consumers and workers, it would be even harder on the European and Japanese economies, with their propensity for deflation and stagnation. Such a transitory adjustment would be unpleasant, but it would not undermine the economic foundations of U.S. hegemony.

The U.S. dollar will remain dominant in global trade, payments, and capital flows, based as it is in a country with safe, well-regulated financial markets. Provided U.S. firms maintain their entrepreneurial edge--and despite much anxiety, there is little reason to expect otherwise global asset managers will continue to want to hold portfolios rich in U.S. corporate stocks and bonds. Although foreign private demand for U.S. assets will fluctuate--

-witness the slowdown in purchases that precipitated the decline in the U.S. dollar in 2002 and 2003-rapid growth of world financial wealth will allow the proportion of U.S. assets held by foreigners to increase.

For foreign central banks (as well as commercial financial institutions), U.S. Treasury bonds, government-supported agency bonds, and deposits in highly rated banks will remain, for the foreseeable future, the chief sources of liquid reserve assets. Many analysts have pointed to the euro as a threat to the dollar's status as the world's central reserve currency. But the continuing strength of the U.S. economy relative to the European Union's and the structure of European capital markets make such a prospect highly unlikely. On the basis of likely demographic and productivity growth differentials, Adam Posen of the Institute for International Economics estimates that the U.S. economy will be at least 20 percent larger than that of the EU in 2020. The United States will maintain its 22 percent share of world output, but Europe's share will, in the absence of serious structural reforms, shrink by 3 to 5 percent. Moreover, European government bond markets, although larger than the U.S. Treasury market, are divided among five large countries and a host of smaller ones, greatly reducing liquidity, and European corporate bond and equity markets are smaller than their U.S. counterparts. With Asian capital markets still in their infancy, it will be a very long time before the pre-eminence of the dollar and U.S. capital markets is challenged.

At the peak of its global power the United Kingdom was a net creditor, but as it entered the twentieth century, it started losing its economic dominance to Germany and the United States. In contrast, the United States is a large net debtor. But in its case, no plausible challenger to its economic leadership exists, and its share of the global economy will not decline. Focusing exclusively on the NIIP obscures the United States' institutional, technological, and demographic advantages.

Such advantages are further bolstered by the underlying complementarities between the U.S. economy and the economies of the developing world--especially those in Asia. The United States continues to reap major gains from what Charles de Gaulle called its "exorbitant privilege," its unique role in providing global liquidity by running chronic external imbalances. The resulting inflow of productivity-enhancing capital has strengthened its underlying economic position. Only one development could upset this optimistic prognosis: an end to the technological dynamism, openness to trade, and flexibility that have powered the U.S. economy. The biggest threat to U.S. hegemony, accordingly, stems not from the sentiments of foreign investors, but from protectionism and isolationism at home.

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By David H. Levey and Stuart S. Brown

DAVID H. LEVEY recently retired after 19 years as Managing Director of Moody's Sovereign Ratings Service. STUART S. BROWN is Professor of Economics and International Relations in the Moynihan Institute of Global Affairs at Syracuse University's Maxwell School of Citizenship and Public Affairs.