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Wall and Main: Foreign Money

A U.S. Addiction to Foreign Money Could Cause Trouble

By ELLEN SIMON

Dec. 9, 2005 — - It's an addiction. Every day, the United States sucks in more and more of it from abroad, just to keep the nation going.

We speak, of course, about foreign money.

At our current rate of trade and budget deficits, foreigners need to purchase $2 billion in dollar-denominated assets each day just to keep the dollar stable, said Axel Merk, who manages $60 million at Merk Investments and runs the Merk Hard Currency Fund.

Over half the national debt is now financed by foreigners, according to Roger Ibbotson, chairman of the financial consulting firm Ibbotson Associates in Chicago and a professor at Yale School of Management. That's been true since 1980, but the difference now, he says, "is the scale of the game."

"I guess everyone wants to keep this game going," Ibbotson said. But if one of the countries we're most dependent on drops out, it could be "like a bank run."

David Wyss, chief economist at Standard & Poor's, is also concerned. "If this money stopped coming, the dollar would take a dive and U.S. bond yields would have to come up. That would constrain capital spending and housing and slow down the U.S. economy."

Foreign investments in U.S. bonds and equities set a record in September, the last month for which data is available.

Foreigners bought $1.01 trillion in U.S. securities in the 12 months ending in September, up from $866.6 billion for the same period in 2004, according to U.S. Treasury International Capital, which tracks foreign purchases of U.S. securities.

Why did foreign investors' interest in the U.S. intensify?

For one thing, investors can get a better return on U.S. bonds than they can in their home countries. Yields in the United States have been near 4.5 percent, while yields on Euro bonds are closer to 3.2 percent and yields on Japanese bonds are near 1.5 percent.

Second, our massive trade deficit has sent tens of billions of dollars abroad, as imports increased while exports declined, which has helped foreign business owners sock away plenty of dollars. And our budget deficit means the federal government keeps issuing more debt.

Then, there's our personal savings rate, which has been hovering near zero.

"We need the money because we're not saving any," Wyss said. "We need it from anyone who has a spare yen to lend us."

At the same time, economic growth in Europe and Japan has been weak, Wyss said. "The U.S. was the only large safe market where the yield looked reasonable."

The gush of foreign money "is critical to keeping the U.S. dollar from collapsing, because we have a large trade deficit," said Daniel Katzive, foreign exchange strategist at UBS. "If the deficit wasn't financed, the dollar would fall until it reached a level where U.S. assets were more attractive to foreign investors."

It's simple accounting, he said: Cashflow in must equal cashflow out. "If it doesn't, you have a big adjustment until you reach equilibrium."

Some argue that the waterfall of foreign money has also prettied up U.S. Treasuries. A study released as part of the Federal Reserve Board's International Finance Working Papers Series asserts that the yield on 10-year Treasury notes would be a full percentage point less without abnormally high flows into bonds. That's because increased demand for U.S. Treasuries has pushed the yield on Treasuries lower than it would be otherwise.

Normally, Wyss said, foreign investors would be reluctant to stake so much on the Treasury market because they would be worried that a decline in the dollar would erode their returns.

But, in recent years, the Japanese and Chinese central banks have intervened to keep the dollar high.

"Central banks have trained investors that there's not much risk there," he said. "That scares me."