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Foreign Investment's Flip Side

U.S. Trade Deficit Swells Along With Consumption, Debt

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Every other night or so, the calls start pouring in from Asia to the homes of Peter Leonard and several traders he supervises at Nomura Securities in New York, jolting them awake sometimes as often as five times a night.

The calls come from places such as Tokyo, Shanghai, Hong Kong and Singapore, where investors want to buy U.S. mortgage-backed securities, which are essentially giant packages of mortgages on thousands of American homes. Such sleep disturbances have roughly doubled in the past year, according to Leonard, reflecting the sizzling demand among Asian money managers for a piece of the U.S. mortgage market.

The interrupted slumber of Nomura's New York mortgage traders is one small facet of the rapidly rising flow of foreign money into U.S. financial markets. This torrent of capital from overseas has become indispensable fuel for the U.S. economic engine, helping to keep interest rates low.

But the influx of capital has an ominous flip side -- the ballooning U.S. trade deficit, which soared 24 percent in 2004, to \$617.7 billion. The dollars spent by Americans on Japanese cars, Chinese televisions and other imported goods end up in the hands of foreigners, who plow them into U.S. Treasury bonds and other securities like the ones sold by Leonard and his fellow traders.

Therein lies a serious worry for many economists: As the deficit mounts, so does America's overall indebtedness to foreigners, which now totals about \$3 trillion. That would be less troubling if the money streaming in from overseas were helping to finance a boom in productive assets such as factories and machinery.

But to the contrary, economic data show historic highs in the proportion of U.S. spending on consumption and housing. Not only is the United States piling up debt, it is doing so while consuming at record levels.

"It's like, 'I'm going to Bermuda with the credit I'm racking up on my credit card,' rather than, 'I'm going to school and putting my school books on my credit card,'" said Catherine L. Mann, a scholar at the Institute for International Economics.

That dark perspective is at odds with the position often taken by Bush administration officials, among others, about the trade deficit (or current account deficit, as its broadest measure is called). The gap, according to the administration, should be viewed in a more positive than negative light, given the eagerness with which foreigners supply funds to the United States.

As Treasury Secretary John W. Snow put it in an op-ed piece in the Financial Times a few months ago: "The deficit reflects foremost the strengths of the U.S. economy -- high productivity, strong U.S. growth relative to growth abroad, and the relative attraction of investing in our robust, dynamic economy, which has the deepest and most resilient capital markets in the world."

America's attraction for foreign capital can be readily discerned in the streets of Washington, where a number of buildings have been sold to foreigners in recent months. A group funded by Middle Eastern investors recently bought 901 F St. NW for \$56 million, German money was behind the purchase of 2100 M St. NW for \$95 million, and other foreign investors bought a portfolio of properties, including 5225 Wisconsin Ave.

NW, for a sum in the \$200 million range, according to Bill Collins of Cassidy & Pinkard, a real estate services firm involved in some of the transactions. A survey of global real estate investors last year showed that the United States continues to rank as the No. 1 country for "stable and secure" property investments, with Washington as foreign investors' top city.

But the administration's critics see plenty of reason to be uneasy about the trade deficit, which is approaching 6 percent of gross domestic product as measured by the current account, the highest percentage of any major industrial country in modern times.

"There's always the question when you look at a current account deficit -- is it a sign of strength, because capital is pouring into your country, or is it a sign of concern?" Lawrence H. Summers, Snow's predecessor during the Clinton administration, told a panel at the World Economic Forum in Davos, Switzerland, last month. "If you look behind the 6 percent of GDP deficit, there's a lot to make you worry," because foreign money "is financing consumption, not investment" in plants and equipment.

Furthermore, he added, much of the investment by businesses in the United States is going into real estate, which does not generate the production of goods for export that are needed to help shrink the trade gap. At some point, he warned, sentiment among foreign investors could turn against America's deteriorating fundamentals, triggering a sharp sell-off in U.S. stocks and bonds that would threaten to throw the economy's expansion into reverse.

"Will those risks ever come home to roost? One can't predict with great confidence," said Summers, who is now president of Harvard University. "Will they come home very soon? Probably not. If you keep taking them, will they eventually catch up with us? I worry that they will."

An analysis by economists at Goldman, Sachs provides data to bolster Summers's point: Consumption and spending on residential buildings are a much larger share of the U.S. economy "than has historically been the case," the firm noted in a report to clients last month. Taken together, spending on consumer goods and housing has totaled nearly 76 percent of GDP in the past couple of years, compared with an average of about 69 percent of GDP over the past half-century. Given that the trade deficit is also at an all-time high, "these imbalances place the economy on a path that is ultimately unsustainable," the report said.

Among the factors helping to spur spending on housing is the same factor causing sleep deprivation among the Nomura traders -- the surge in demand from Asia for U.S. mortgage-backed securities, which has been led by China's central bank. As Asians buy these packages of mortgages from U.S. financial institutions, they effectively add to the pool of capital available for Americans to finance their homes.

"If you think about it, there are a lot of homeowners who are having money lent to them by Beijing," said Steven Abrahams, a senior managing director at Bear, Stearns & Co. who specializes in the mortgage market. "These are big, complex markets, but the involvement of the non-U.S. investor in the mortgage market has certainly helped keep mortgage rates lower than they would be without their presence. It means that American homeowners end up paying a little less to own a home."

That is no cause for worry, maintained Arthur B. Laffer, one of the gurus of the supply-side economics movement. "You would clearly rather have capital lined up on our borders trying to get into our country than trying to get out," Laffer wrote in an article on the Wall Street Journal's editorial page last month. "Growth countries, like growth companies, borrow money, and the U.S. is the only growth country of all the developed countries. As a result, we're a capital magnet. . . . That's why we have such a large trade deficit."

But other economists argue that it all depends on how the influx of capital is used. The large trade gap the United States ran in the late 1990s posed relatively little concern because the money being borrowed from abroad was helping to fund a major surge in investment by business, said Nouriel Roubini, an economist at

New York University.

In 1999 and 2000, spending on buildings, structures and equipment -- the portion not spent on residential housing -- was about 13.5 percent of GDP. By contrast, in 2002 through 2004, that figure fell to about 10.25 percent of GDP.

Also crucial, Roubini and others contend, is the type of capital the country is attracting.

Direct investment by foreigners in U.S. companies and operations -- the building of auto plants in the South, for example, or the takeover of Chrysler Corp. by Daimler-Benz AG -- has dropped precipitously. In 1999 and 2000, foreign direct investment averaged about \$300 billion annually; in 2003, it shrank to about one-tenth that amount, and in 2004, it rebounded only to \$91 billion in the first three quarters.

Replacing much of the private foreign capital during the past few years has been the purchase of hundreds of billions of dollars in U.S. Treasury bonds by foreign central banks, especially Japan's and China's. Their buying of Treasuries has been motivated in large part by financial operations aimed at keeping their currencies from rising, thereby ensuring that their nations' exports remain competitive.

"Far from saying the external deficit is a sign of strength, given that it is going primarily to finance consumption, it is primarily a sign of weakness," said George Magnus, chief economist with UBS Investment Research in London. "And given that roughly half of the financing has come from foreign central banks, it's a classic sign of weakness."

Administration officials counter that the data for the past few months suggest that all these worrisome factors are starting to create a trend in a healthier direction.

"Investment growth has been quite strong in the U.S. over the past year," said Kristin J. Forbes, a member of the Council of Economic Advisers, noting that although business spending on plants and equipment still isn't where it was in the late 1990s, the previous period was inflated somewhat by the technology bubble. As for capital inflows, she added, the most recent figures show that "over two-thirds of the inflows have come through private purchases, not official sources like central banks."

Economists like Magnus remain unimpressed. "A lot of people think this is courting some sort of financial crisis at some point," he said. "When that will happen, of course, is hard to say."

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