

U.S. Investment Income Close to 'Tipping Point': John M. Berry

Oct. 13 (Bloomberg) -- The U.S. may be approaching a dangerous "tipping point" in its international transactions.

At the end of last year, foreign investments in the U.S. were worth \$2.5 trillion more than this country's investments in the rest of the world. Yet last year, those U.S. assets abroad remarkably still earned \$30 billion more than the foreign assets here.

That stunning disparity in returns is one of many reasons why the huge U.S. current account deficits of recent years have been so readily financed. The sagging net investment position wasn't being compounded by an ever higher interest bill -- as is the case with the mounting U.S. government debt.

This year the game has changed.

Net U.S. investment income turned negative by \$455 million dollars in the second quarter, marking a swift deterioration from a \$15 billion surplus in the first three months of 2004.

If this trend continues -- and there's no reason to think it won't -- the U.S. will be paying a steadily rising net amount to foreigners, and those payments will both increase the U.S. current account deficit and worsen the country's net investment position.

In a recently published analysis, economists Pierre-Olivier Gourinchas of the University of California at Berkeley and Helene Rey of Princeton University warned this situation could have serious consequences for the U.S.

The Dollar's Credibility

"Reaching the 'tipping point' where the U.S. for the first time since the second World War ceases to have a positive net return on its net assets could be seen by the market as a significant blow to the credibility of the dollar," the economists say.

"In a context where the external net worth of the U.S. is negative and the return on its net assets also turns negative, market participants could start demanding a higher premium on their dollar assets."

That the U.S. has been able to sustain financing for its international deficits up to this point is primarily due to the American dollar being the world's principal reserve currency, the center of the global monetary system.

Gourinchas and Rey's analysis traces how over the past half century U.S. investments abroad came to pay far greater returns than foreign investments here. The paper, published by the National Bureau of Economic Research in August, is "From World Banker to World Venture Capitalist: U.S. External Adjustment and the Exorbitant Privilege."

'Exorbitant Privilege'

The phrase "exorbitant privilege" was coined by French Finance Minister Valery Giscard d'Estaing in 1965. He used it to describe "the ability of the U.S. to run large direct investment surpluses, ultimately financed by the issuance of dollars held sometimes involuntarily by foreign central banks," the authors say.

In those days, economists regarded the U.S. as "the Banker of the World," lending for long and

intermediate terms and borrowing short, they say.

`` Since then, the U.S. has become an increasingly leveraged financial intermediary as world capital markets have become more and more integrated. Hence, a more accurate description of the U.S. in the last decade may be one of the 'Venture Capitalist of the World,' issuing short term and fixed income liabilities and investing primarily in equity and direct investment abroad," Gourinchas and Rey write.

U.S. Balance Sheet

Initially, U.S. assets shifted from long-term bank loans to direct investments, such as the purchase of foreign companies, and in recent years, toward equity investments. Meanwhile, foreign investment has favored low-yielding safer assets, including bank loans, trade credit and debt, particularly Treasury securities.

`` Hence the U.S. balance sheet resembles increasingly one of a venture capitalist with high return risky investments on the asset side," the economists say. `` Furthermore, its leverage ratio has increased sizably over time."

Nevertheless, all the advantages that accrue to the U.S. as the provider of the central currency in the global monetary system can't forever offset the impact of the country consuming more than it produces. What if a "tipping point" has been reached?

Gourinchas and Rey say their analysis `` does not imply that the current situation can be maintained indefinitely."

The Possible Repercussions

`` Foreign lenders could decide to stop financing the U.S. external deficit and run away from the dollar, either in favor of another currency such as the euro, or just as dramatically, require a risk premium on U.S. liquid assets whose safety could not be guaranteed any longer.

`` In either case, the repercussions could be quite severe, with a decline in the value of the dollar, higher domestic interest rates and yields, and a global recession," they caution.

`` In a world where the U.S. can supply the international currency at will, and invest it in illiquid assets, it still faces a confidence risk," they say.

Should confidence be lost, the value of the dollar could plunge, and a world financial crisis could ensue. At that point, even the U.S. could be forced to stop living beyond its means.

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