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America's External Balances

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The U.S. dollar is supposed to have collapsed by now—fallen in value by at least 25 or 30 percent. The culprit is supposedly America's "unsustainable" external imbalances or its current account deficit—roughly the excess of U.S. expenditures over income, which is financed by rising liabilities to foreigners.

Americans cannot keep borrowing abroad without limit, the warning goes. Eventually, foreigners will be less willing to acquire claims on the United States on current terms, at current interest and exchange rates. They will lend less and, if the United States keeps emitting dollars into foreign exchange markets at the current rate, the dollar will fall, or U.S. interest rates will rise. Those adjustments would, in turn, shift foreign and domestic spending onto U.S. goods (more exports and fewer imports, given a weaker dollar), while higher U.S. interest rates would reduce U.S. spending relative to income. Both adjustments would lower the external imbalance.

Dollar Steady despite Rising U.S. Current Account Deficit

In fact, both the broad trade-weighted dollar and the dollar exchange rate against other major currencies such as the yen and the euro have been remarkably stable. Today, the real trade-weighted dollar is virtually at its average level for the past sixteen years and is slightly stronger than it was in 1991, when the U.S. current account deficit stood virtually at zero. More recently, after adjustment for relative inflation rates, the "real" trade-weighted dollar has actually strengthened against surplus countries, such as Japan, that are allowing markets to determine exchange rates.

Japan has not intervened in currency markets since 2004. During that time, Japan's lower inflation rate conferred a price advantage on its traded-goods that would have needed to be offset by yen appreciation to about 100 yen per dollar if the "real" yen-dollar exchange rate were to have remained fixed. The actual exchange rate of about 115 yen per dollar indicates a 15 percent real-dollar appreciation against the yen (a stronger dollar) over the past two years. A similar story can be told about the real dollar-euro exchange rate.

U.S. Wealth Storage Services

The explanation for the stability—strength, in fact—of the U.S. dollar, even as the current account deficit has since 1990 risen from zero to 7 percent of GDP, lies with the globalization of wealth storage by rapidly growing countries—both advanced and emerging. Wealth is increasing rapidly in emerging markets, China of course being the largest, but also in Europe and Japan, not to mention the oil-exporting countries. The United States offers the largest menu of wealth storage options, not only in terms of variety, but also in terms of liquidity (defined as the ability to move huge sums—tens of billions of dollars worth) with only a small impact on price.

At home, China's legendary savers of up to 40 percent of their incomes have open to them only low-paying savings accounts issued by shaky state banks as means of liquid wealth storage. Real estate offers another option, but the prices in that

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sector have ballooned as everyone has tried to store their rapidly rising wealth by buying land and buildings.

For its part, the Chinese government, on behalf of its savers and producers, has virtually pegged the Chinese currency at below-market levels so that foreign goods are artificially expensive while Chinese goods are less expensive in global markets. The currency pegging requires over $100 billion of foreign currency purchases annually by the Chinese (largely dollars), which are used to acquire assets in the United States and elsewhere: mostly U.S. government securities, mortgage-backed securities, and agency (e.g., Fannie Mae) securities. Japanese savers, long facing interest rates of virtually zero on yen assets, have become large buyers of foreign government securities to gain yield. Usually, the offerings in Japan consist of a blend of higher yielding bonds, including claims on governments in Australia, New Zealand, and Latin America, but U.S.-issued claims form the core of such offerings.

Today, U.S. cash equivalents, three- and six-month bills, yield over 5 percent, while similar assets in Japan pay about one-quarter of 1 percent, and in Europe about 3 percent. Add the yield pickup to the superior liquidity and efficiency of U.S. financial markets, and America becomes a very attractive place to store wealth. This is doubly true for Chinese savers and exporters of oil who enjoy huge inflows of funds that need safe storage while suffering a paucity of domestic outlets that offer a combination of good returns, safety, and convenience.

The fact that global savers accommodate U.S. consumers by keeping U.S. interest rates lower than they otherwise would be and the dollar stronger than it otherwise would be is simply a manifestation of America's comparative advantage at supplying wealth storage facilities.

In the new global economy, America offers prime wealth storage facilities on par with the Lexus as a source of automotive services. The former generates a demand for dollars while the latter generates a demand for yen. The real source of global strength is no longer exclusively the purview of suppliers of superior tradable goods. Now, suppliers of global services like wealth storage enjoy a new prominence that may, as in the case of the United States over the past decade, be manifest as a rising current account deficit accompanied by a stronger currency.

A rising current account deficit is no longer a sign of weakness in this context. The fact that global savers accommodate U.S. consumers by keeping U.S. interest rates lower than they otherwise would be and the dollar stronger than it otherwise would be is simply a manifestation of America's comparative advantage at supplying wealth storage facilities.

Wealth Storage and Market Adjustments

As with any market-driven process, there are limits to the arrangement whereby the U.S. exports wealth storage services in exchange for net imports of goods. Understanding those limits is as important—perhaps more so—for determining the future path of the dollar and U.S.-global interest rates as simply watching the path of the U.S. current-account deficit.

Among the most basic constraints on sales of U.S. assets abroad is the fundamental notion of diversification. The level of gross foreign claims on U.S. assets is approaching $14 trillion, about 25 percent of U.S. wealth and perhaps 10 percent of global wealth. Eventually, foreign investors would become reluctant to own, say, the bulk of U.S. assets or to have the majority of their wealth holdings invested in one country. However, we are far from such limits for two reasons.

First, while foreign claims on U.S. assets are now at $13.5 trillion, U.S. claims on foreign assets are about $11 trillion. Net foreign claims on U.S. assets of $2.5 trillion are about 20 percent of just one year's U.S. income (GDP).

Meanwhile, thanks to rapid appreciation of the dollar value of U.S. foreign assets since 2002, the net international investment position of the United States has actually improved slightly as a share of GDP over the past few years, from minus 23.4 percent of GDP in 2002 to minus 20.4 percent of GDP in 2005. As a recent JPMorgan report aptly observes, "The dollar value of the stock of U.S.-owned foreign assets has increased rapidly enough to offset most of the large financial inflows into the U.S."

A second reason to suggest the sustainability of U.S. current account deficits is to recognize that the rising U.S. current account deficit is an observable counterpart of the stable rise in global financial intermediation by the United States. The rise in the dollar value of U.S. investments abroad underscores the important role the United States is playing as a financial intermediary in a world of rapidly globalizing financial markets. Foreign investments

in the United States—international U.S. borrowing—is concentrated in liquid, low-risk government securities and other short-term financial assets. Meanwhile, U.S. investments abroad—international U.S. lending—tends to be in riskier, longer-term investments whose value has grown along with the rapid rise in global wealth over the past half decade. The U.S. global balance sheet therefore looks like that of a financial intermediary that earns its profits by borrowing short and lending long. It earns its profits by issuing liquid deposit facilities for savers while simultaneously accumulating investments in the form of longer-term, higher earning assets.

Of course there are risks in the heretofore profitable role of the U.S. as a global financial intermediary. There could be a run on dollars precipitating rapid withdrawals (or more likely, less rapid deposit growth) of U.S. liquid liabilities while less-liquid foreign assets held by Americans could not be liquidated easily to meet such withdrawals. There is no global lender of last resort.

Stability of the New System

That said, the system is likely to be stable for two compelling reasons. First, the global economy has a stake in the smooth functioning of the new, highly integrated global financial system. Global stability makes it work and thereby bestows benefits on all the participants. Exporting nations, including oil exporters that sell to the United States while storing wealth there, have no interest in a dollar collapse, which would simultaneously collapse their exports. Similarly, a U.S. financial collapse would destroy part of the wealth that global exporters have stored in the United States.

Second, and even more fundamentally, the global financial system is self-equilibrating. Over the past year, as U.S. interest rates have risen, more accommodating inflows have come to the United States. Simultaneously, the projected U.S. budget deficit for fiscal year 2006 has dropped by about $130 billion from the original estimate of $420 billion to about $290 billion, thanks to sharply higher U.S. tax revenues. The tax revenues were boosted by lower taxes on capital gains that enhanced U.S. investment opportunities and boosted growth. That bullish combination probably enhanced foreign capital inflows. A lower budget deficit has contributed to a reduction of the U.S. current account deficit during the first quarter of 2006 as GDP has risen. As the U.S. economy slows going forward (given Fed tightening and the drag of higher energy prices), U.S. spending will fall relative to income, thereby lowering the current account deficit further.

Higher oil revenues may actually enhance U.S. capital inflows as oil exporters seek increased wealth storage facilities in a liquid market where the central bank—the Federal Reserve—is demonstrating its commitment to stability by continuing to raise interest rates even as the economy may be slowing.

Over the longer run, the path of the dollar will be affected by the pace of development of wealth storage facilities globally and by the emergence of global investment opportunities. In the extreme, if Japan, Europe, or even China moves rapidly to develop wealth storage facilities on par with those in the United States, fewer funds would flow to the United States and, given the current level of U.S. dissaving, the dollar would weaken and U.S. interest rates would rise. But therein lies the path to a new equilibrium that entails less U.S. dissaving and more net spending on U.S. goods.

Balance, Not Imbalances

The reality remains that currently observed global financial flows, as large as they may seem when viewed piecemeal as the U.S. current account deficit, are actually manifestations of balances of opposing flows. They are not "imbalances" as they are often characterized. "Imbalances" are unsustainable and would long ago have been eliminated by adjustment of endogenous variables like interest rates, incomes, prices, and of course exchange rates. But for now, the flows represent balances, and it is far more enlightening—not to mention more accurate—to view them as such.