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## Ely's Fed Fax

### *Bert Ely's Irregular and Highly Irreverent Commentary on the Fed*

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6 pages

## There Ain't No Free Lunch

Articles about the alarming \$15.5 billion U.S. trade deficit in November for goods and services and the rise in the trade deficit for 1998 did not focus sufficient attention on the serious, long-term consequence of America's trade deficits -- the United States has become the world's largest debtor nation. This dubious status is the cumulative effect of the United States' annual trade deficits since 1983. The solid line on the accompanying chart illustrates how the U.S. net debtor position has grown as a percentage of U.S. GDP, reaching 16.4% at the end of last year.

If there is any solace in the solid line, it is that the net debtor picture at the end of 1997 probably was not as bad as it initially looks. This is the case because future adjustments to this annual estimate of the net debtor position probably will reduce it as a percentage of GDP. As you will note from the accompanying figure, the year-end 1997 estimate for past years, as a percentage of GDP, was less than estimates made at the end of 1993 and 1995 (the dashed lines). These revisions reflect the fact that these balance sheet figures represent what often are very rough estimates. Nonetheless, unless changes in the foreign exchange value of the U.S. dollar have a powerful offsetting effect, the U.S. net debtor position, as a percent of GDP, probably worsened last year. The year-end 1998 estimates will not be available until this summer.

In case you are not familiar with the government's calculation of the United States' net debtor position (called the International Investment Position of the United States), the accompanying table shows this calculation. It appeared on page 32 of the July 1998 issue of the Survey of Current Business, which is published by the Department of Commerce. The data on the chart reflect direct investments at market value (lines 18 and 36) rather than at book value. As you will note from the table, U.S. assets abroad (at market values) were about \$5 trillion while foreign-owned assets in the United States (in effect, the estimated market value of claims the rest of the world has on the United States and its citizens) were approximately \$6.3 trillion. In effect, the U.S. net debtor position was slightly more than one-fourth of U.S. claims on the rest of the world and slightly more than one-fifth the rest of the world's claims on the United States. It is only a matter of coincidence that the amount of U.S. Treasury securities owned abroad (line 28 plus line 37), at \$1.25 trillion, almost equaled the U.S. net debtor position. As big as that number is, it equals just 20% of gross foreign claims on the United States.

How high can the net debtor percentage go -- it is anyone's guess, but at some point in time, it must begin to reverse through a sharply lower trade deficit and/or a weaker dollar. As our friend, Al Greenspan, observed on Wednesday during his testimony to the House Ways & Means Committee, "the continued increase in our net external debt and its growing servicing costs clearly are not sustainable indefinitely." This statement highlights an especially troubling aspect of the net debtor situation -- in 1997, net U.S. international income (income on U.S. assets abroad minus income on foreign assets in the United States) shifted from positive to negative. After decades of positive net income (reaching 1.1% of GDP in 1981), which helped to offset trade deficits, the United States, due to its growing net debtor position, now has negative investment income which worsens its net debtor position.

At some point, America will start paying an even higher price for this net debtor position as foreigners demand higher interest rates and returns on equity capital for having taken such a large investment and foreign exchange risk in the United States. The relatively free lunch we have enjoyed because of the willingness of foreigners to extend credit to us may soon end. How soon depends on that willingness. Many economists argue that we have such a high net debtor position because foreigners want to invest in the United States. In other words, we are forced to have a trade deficit because foreigners are flooding the United States with investment dollars. That's nonsense. Foreigners accept financial claims on the United States because they want to sell their goods and services here. In effect, the United States has a big accounts payable with the rest of the world, some portion of which has since been converted into direct investment and stock market investments. Nonetheless, it is an accounts payable. As it continues to grow, the risk of collecting on it could grow, which would drive up interest rates. What may be postponing higher rates is the fact that numerous other countries, particularly in East Asia and South America, are (1) economically troubled and (2) more than willing to sell us as much as we want to buy, and will take our IOUs in exchange, for now.

The growth in the U.S. net debtor position helps to explain another recent phenomenon -- the continuing drop in the U.S. inflation rate even as the savings rate declines. In effect, we (or at least those with equity investments) are having our cake and eating it, too, as people cash in their gains from the Greenspan stock market bubble (see EEF #77, December 10, 1998) to spend on current consumption. In other words, in a variant of having both guns and butter, the willingness of foreigners to become even bigger creditors of the United States lets us enjoy both a high level of consumption as well as sufficient domestic investment, particularly in housing.

When this goldilocks world will end, and what will happen in its aftermath, is the multi-trillion dollar question with a multi-part answer. Here are some speculations. One, the trade deficit eventually will decline as a percent of GDP. Two, eventually the net debtor position, as a percentage of GDP, will begin to decline. Three, real interest rates will climb as we bid higher to hang onto the world's savings that have been invested in the United States. Four, the dollar will not weaken materially because higher real interest rates will hold sufficient funds in the United States. Five, higher interest rates will knock some air, and maybe a lot of air, out of the Greenspan stock market bubble. Six, a lower trade deficit will mean a higher portion of goods consumed in the United States will be produced in the United States. Seven, a combination of lower stock prices and a lower trade deficit implies that there will be a higher savings rate, which suggests less domestic consumption and a higher unemployment rate.

However, eight, increased domestic manufacturing, due to import substitution, will cushion the unemployment effects of lower consumption. In other words, the job impact of reduced U.S. consumption will be felt to some extent outside the United States -- just what troubled economies need. Nine, foreigners will steadily convert their claims on the United States into direct investments, which means more physical assets in the United States will be foreign-owned while corporate globalization will see the ownership of many U.S. businesses shift to other countries. Witness DaimlerChrysler. Ten, the United States may not travel a smooth path after its net debtor position starts to shrink.

In sum, the U.S. may survive the bottoming out of the U.S. net debtor position, as a percentage of GDP, better than some might expect, but at a not insubstantial cost -- the world's leading nation will be a significant debtor to the rest of the world for many years to come.

## Short Takes

### **I was wrong about the Euro**

In EFF #44 (June 30, 1997), I boldly predicted that the Euro would not launch at the first of this year. I was wrong because I underestimated the desire of Europe's bureaucrats, and particularly its central bankers, to make Euroland a reality. But now that the Euro is a reality, how will Europe fare and will it fare well enough for the Euro to survive? Mechanically, it can survive, as evidenced by the Euro's extremely smooth launch and recent talk about advancing the date for putting Euro coins and currency into circulation. The Euro's real test will be the ability of an economically diverse Euroland to live with a uniform short-term interest rate as some countries start to overheat (Ireland, for example) while others cool economically (Germany, for example). It will be interesting to see how appealing the Euro looks a year from now.

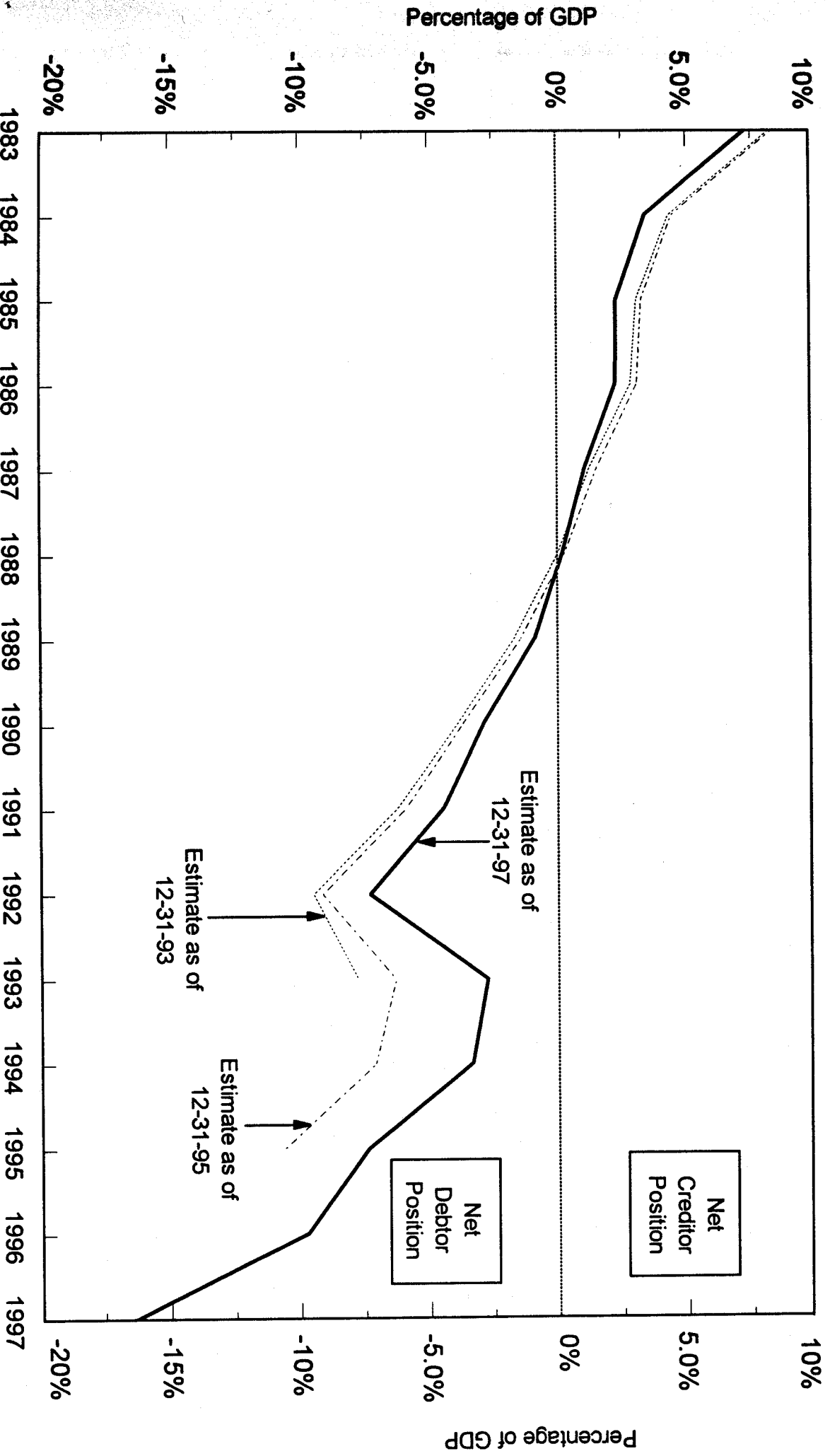
### **More bad news about Japan**

Accompanying this issue of EFF is a recent Wall Street Journal op-ed of mine, headlined "Is Creditor Better Than Debtor?" While it is not great to be a debtor nation, creditor status is not a panacea if your domestic economy is going to hell, as Japan's is.

### **Giving the devil his due**

As intrepid readers of EFF know, I am not a big Greenspan fan because of his success in strengthening the harmful myth that Fed monetary policy is good for America and the world. But I must give Al credit, in his Ways & Means testimony Wednesday, for strongly attacking the Clinton proposal to invest a portion of the Social Security trust fund in the stock market. As David Wessel reported in yesterday's Wall Street Journal, "the Fed chairman was explicit" in his criticism of the Clinton proposal, which raises this question: Why can't Al be equally explicit when pontificating about monetary policy? If he were, of course, it would be difficult for him to avoid undermining the myths about monetary policy which have laid the foundation for his forthcoming sainthood. Now the big question: Did Al's comments on Social Security hurt his reappointment chances?

# The Net International Investment Position of the United States is Continuing to Deteriorate, in Part because of the Continuing U. S. Trade Deficit



**Table 1.—International Investment Position of the United States at Yearend, 1996 and 1997**

[Millions of dollars]

Line	Type of investment	Position 1996 <sup>r</sup>	Changes in position in 1997 (decrease (-))					Position 1997 <sup>p</sup>
			Attributable to:				Total (a+b+c+d)	
			Capital flows <sup>r</sup> (a)	Valuation adjustments				
				Price changes <sup>s</sup> (b)	Exchange rate changes <sup>1</sup> <sup>s</sup> (c)	Other changes <sup>2</sup> <sup>s</sup> (d)		
1	Net international investment position of the United States:	-767,076	-254,939	-51,669	-127,725	-22,159	-456,492	-1,223,568
2	With direct investment positions at current cost (line 3 less line 24)	-743,656	-254,939	-116,094	-197,805	-9,961	-578,799	-1,322,455
3	With direct investment positions at market value (line 4 less line 25)							
	U.S. assets abroad:							
3	With direct investment positions at current cost (lines 5+10+15) ...	3,767,018	478,502	175,135	-155,352	-27,992	470,293	4,237,311
4	With direct investment positions at market value (lines 5+10+16) ...	4,347,148	478,502	416,045	-224,102	-10,474	659,971	5,007,119
5	U.S. official reserve assets .....	160,739	1,010	-20,762	-6,144	-7	-25,903	134,836
6	Gold .....	96,698		<sup>3</sup> -20,762		<sup>4</sup> -7	-20,769	75,929
7	Special drawing rights .....	10,312	350		-635		-285	10,027
8	Reserve position in the International Monetary Fund .....	15,435	3,575		-939		2,636	18,071
9	Foreign currencies .....	38,294	-2,915		-4,570		-7,485	30,809
10	U.S. Government assets, other than official reserve assets .....	81,677	-174		-17	-3	-194	81,483
11	U.S. credits and other long-term assets <sup>5</sup> .....	79,786	-202		-8	-3	-213	79,573
12	Repayable in dollars .....	79,114	-168			-4	-172	78,942
13	Other <sup>6</sup> .....	672	-34		-8	1	-41	631
14	U.S. foreign currency holdings and U.S. short-term assets .....	1,891	28		-9		19	1,910
15	U.S. private assets:							
15	With direct investment at current cost (lines 17+19+22+23) .....	3,524,602	477,666	195,897	-149,191	-27,982	496,390	4,020,992
16	With direct investment at market value (lines 18+19+22+23) .....	4,104,732	477,666	436,807	-217,941	-10,464	686,068	4,790,800
17	Direct investment abroad:							
17	At current cost .....	936,954	121,843	9,325	-28,998	-15,252	86,918	1,023,872
18	At market value .....	1,517,084	121,843	250,235	-97,748	2,266	276,596	1,793,680
19	Foreign securities .....	1,280,159	87,981	186,572	-108,411		166,142	1,446,301
20	Bonds .....	403,373	46,723	8,671	-13,718		41,676	445,049
21	Corporate stocks .....	876,786	41,258	177,901	-94,693		124,466	1,001,252
22	U.S. claims on unaffiliated foreigners reported by U.S. nonbanking concerns .....	449,978	120,403		-7,724	-261	112,418	562,396
23	U.S. claims reported by U.S. banks, not included elsewhere .....	857,511	147,439		-4,058	-12,469	130,912	988,423
24	Foreign assets in the United States:							
24	With direct investment at current cost (lines 26+33) .....	4,534,094	733,441	226,804	-27,627	-5,833	926,785	5,460,879
25	With direct investment at market value (lines 26+34) .....	5,090,804	733,441	532,139	-26,297	-513	1,238,770	6,329,574
26	Foreign official assets in the United States .....	801,062	15,817	16,968		54	32,839	833,901
27	U.S. Government securities .....	612,656	-2,936	4,615		55	1,734	614,390
28	U.S. Treasury securities .....	592,891	-7,270	4,174		55	-3,041	589,850
29	Other .....	19,765	4,334	441			4,775	24,540
30	Other U.S. Government liabilities <sup>7</sup> .....	23,099	-2,521			-1	-2,522	20,577
31	U.S. liabilities reported by U.S. banks, not included elsewhere .....	113,098	21,928				21,928	135,026
32	Other foreign official assets .....	52,209	-654	12,353			11,699	63,908
33	Other foreign assets:							
33	With direct investment at current cost (lines 35+37+38+39+42+43) ...	3,733,032	717,624	209,836	-27,627	-5,887	893,946	4,626,978
34	With direct investment at market value (lines 36+37+38+39+42+43) ...	4,289,742	717,624	515,171	-26,297	-567	1,205,931	5,495,673
35	Direct investment in the United States:							
35	At current cost .....	666,962	93,449	-2,680	-1,330	-4,556	84,883	751,845
36	At market value .....	1,223,672	93,449	302,655		764	396,868	1,620,540
37	U.S. Treasury securities .....	504,792	146,710	10,459			157,169	661,961
38	U.S. currency .....	186,843	24,782				24,782	211,625
39	U.S. securities other than U.S. Treasury securities .....	1,199,460	196,845	202,057	-20,378		378,524	1,577,984
40	Corporate and other bonds .....	588,043	130,879	19,532	-20,378		130,033	718,076
41	Corporate stocks .....	611,417	65,966	182,525			248,491	859,908
42	U.S. liabilities to unaffiliated foreigners reported by U.S. nonbanking concerns .....	346,727	107,779		380	-1,331	106,828	453,555
43	U.S. liabilities reported by U.S. banks, not included elsewhere .....	828,248	148,059		-6,299		141,760	970,008

<sup>p</sup> Preliminary.

<sup>r</sup> Revised.

<sup>1</sup> Represents gains or losses on foreign-currency-denominated assets due to their revaluation at current exchange rates.

<sup>2</sup> Includes changes in coverage, statistical discrepancies, and other adjustments to the value of assets.

<sup>3</sup> Reflects changes in the value of the official gold stock due to fluctuations in the market price of gold.

<sup>4</sup> Reflects changes in gold stock from U.S. Treasury sales of gold medallions and commemorative and bullion coins; also reflects replenishment through open market purchases. These de-

monetizations/monetizations are not included in international transactions capital flows.

<sup>5</sup> Also includes paid-in capital subscriptions to international financial institutions and outstanding amounts of miscellaneous claims that have been settled through international agreements to be payable to the U.S. Government over periods in excess of 1 year. Excludes World War I debts that are not being serviced.

<sup>6</sup> Includes indebtedness that the borrower may contractually, or at its option, repay with its currency, with a third country's currency, or by delivery of materials or transfer of services.

<sup>7</sup> Primarily U.S. Government liabilities associated with military sales contracts and other transactions arranged with or through foreign official agencies.

# Is Creditor Better Than Debtor?

By BERT ELY

Japan's position as the world's largest creditor nation is often cited by the Japanese and others, as an argument that its internal financial disarray is manageable. After all, Japan has, through its mercantilist trade policies, accumulated huge trade surpluses with the result that it is owed, on balance, \$1 trillion by the rest of the world. With such a huge nest egg, how can it be in serious financial trouble?

That is a valid question, but the answer is by no means as simple, or as encouraging, as it might at first sound. The truth is that this huge positive balance, including central-bank official reserves and other claims on foreign governments or private borrowers, is independent of the country's domestic accounts. It cannot neutralize Japan's substantial domestic debt problems as huge government budget deficits push the ratio of national debt to gross domestic product toward untenable levels. This domestic financial deterioration recently caused two major rating agencies, Moody's and Fitch ICB, to strip the Japanese government of its triple-A debt rating.

## Financial Japan Inc.

There are two reasons why Japan's status as the world's largest creditor nation is not a source of economic strength. First, its net balance is smaller than reported. Second, its creditor-nation status gives its politicians yet another excuse for delay in resolving its debt problems and unleashing the massive economic restructuring the country so badly needs.

## RECKONING



The net creditor position is the difference between the financial claims the Japanese have on the rest of the world and those the rest of the world has on the Japanese. The country's total external holdings, including direct investments in factories and office buildings outside Japan, amount to about \$3 trillion. The total claims of the rest of the world on Japan — also including direct investment — amount to about \$2 trillion, which produces the net figure of \$1 trillion mentioned above. This data excludes the relatively modest foreign assets owned by Japanese citizens because these assets mostly lie

outside the control of Financial Japan Inc. (the Japanese government and financial institutions) and therefore cannot easily be tapped to solve Japan's economic problems.

But there are problems as well with the investments that are included in that \$1 trillion net balance. It breaks down as follows: About 50% is net financial claims of private entities; 25% is net direct investment; also private; 20% are the government's official reserves held by the central bank, the Bank of Japan. The official re-

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serves are mostly U.S. Treasury securities.

Much has been made of the huge Japanese holdings of the U.S. national debt in its roughly \$200 billion of official reserves of foreign cash and securities. But less noticed is the fact that the Japanese government, because of its recent deficit-financing binge, also has a large external debt. In fact, its foreign borrowings are approximately equal to its official reserves.

It is further often ignored that because Japan's total foreign holdings are so huge, its net creditor position could be quickly eroded by serious losses on those holdings. For example, a one-sixth decline in the value of Japan's \$3 trillion in gross claims would cut in half Japan's \$1 trillion in net claims on the rest of the world.

This scenario is by no means far-fetched. Japan's gross claims should be discounted for three reasons, starting with its direct investment in plant and equipment elsewhere in the world, which is 10 times foreign direct investment in Japan. A substantial amount of this foreign direct investment consists of factories elsewhere in East Asia, which have lost value due to a glut of manufacturing capacity in that region. At the same time, foreign direct investments in Japan made decades ago are worth more today, which further undercuts Japan's net creditor position.

Japan's financial institutions also face substantial losses on their foreign loans, especially on loans to foreign affiliates of Japanese companies. Many of these affiliates, located elsewhere in East Asia, suffer the problems of those countries. Worse, many loans to affiliates have not been

legally guaranteed by their Japanese parents, which raises the loss exposure of Japanese lenders. Given that Japan's gross foreign loans and other debt claims outside Japan approach \$2 trillion, even a 10% loss on these claims would substantially diminish Japan's net creditor position.

Finally, like many other countries, Japan possibly has overstated its official reserves. In particular, the reported reserves may not fully reflect offsetting liabilities arising out of swaps and futures transactions. Also, insufficient disclosure of the specific assets constituting these reserves and where they are held within the government casts doubt on their amount.

These doubts are heightened by the fact that most of Japan's official reserves are not recorded on the Bank of Japan's books. Doubts about the amount of Japan's net claims on the rest of the world will soon increase, for two reasons: the growing funding problems of Japan's banks and a flight from the yen itself by Japanese citizens.

Because of their deteriorating financial condition, Japanese banks increasingly have difficulty borrowing dollars and other currencies to fund their non-yen assets; that is, the loans and investments they have made outside of Japan. Due in part to collectibility problems, these banks cannot shrink their non-yen assets as fast as their non-yen liabilities (debts) are maturing. The so-called Japanese premium — the additional rate of interest Japanese banks now pay, due to their weak condition, on borrowings from foreign banks — has risen so high that some Japanese banks instead are selling yen to foreign banks. The foreign banks then invest that yen in Japanese government debt, which has driven interest rates to absurdly low and at times even negative levels. The Japanese government may even be lending some of its dollar reserves to illiquid banks to ease their funding strain.

A far greater threat to Japan's status as the world's largest creditor nation would be a flight from the yen by Japanese citizens. Japan's household sector has approximately \$10 trillion of financial assets,

largely in currency, bank deposits, insurance reserves, and deposits in the government's Postal Savings System. These assets are 10 times Japan's net claims on the rest of the world and almost 50 times Japan's official reserves. Japanese savers now earn record low returns on their savings — in some cases less than 1% — and face a loss in international purchasing power if the yen again slips in value, as many predict it will.

Not surprisingly, Japanese citizens increasingly are seeking higher returns and protection against a falling yen by investing in non-yen financial assets, including deposits in foreign banks and U.S. Treasury bills as well as foreign stocks and mutual funds. In effect, these individuals are pulling yen out of Japanese financial institutions and then selling those yen to buy non-yen assets. As of Dec. 1, Japanese banks began selling foreign mutual funds, making capital flight even easier. To protect the value of the yen, the Japanese government is forced to sell dollar assets to soak up the yen sold by its citizens.

## Highly Risk-Averse

Although the Japanese are highly risk-averse, an increasing proportion of the Japanese populace will flee the yen as Japan's debt ratings continue to slide toward junk bond status. Given their highly liquid savings, Japanese citizens could quickly strip Financial Japan Inc. of its most liquid foreign assets. Worse, from the government's perspective, foreign assets owned by its citizens will be largely beyond its control or even awareness.

Hence, despite Japan's continuing trade surpluses, one can reasonably expect the growth in Japan's net claims on the rest of the world to slow or even start shrinking as losses in the value of Japan's foreign claims become more evident and as Japanese citizens increasingly flee the yen. Japanese officials will then find it even harder to rationalize their delay in addressing Japan's domestic debt problems and the growing structural weaknesses of its economy. Japan's overdue restructuring, when it finally occurs, will deepen its recession, but that has become unavoidable given the degree to which the government's delays in addressing the country's economic problems have greatly compounded those problems.

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