COMMENTARY ROI: Reuters Open Interest

Who is funding America's widening debt with the rest of the world?

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A street sign for Wall Street is seen outside the New York Stock Exchange (NYSE) in New York City, New York, U.S., July 19, 2021. REUTERS/Andrew Kelly/File Photo Purchase Licensing Rights

ORLANDO, Florida, July 24 (Reuters) - Foreign capital is flooding into Wall Street courtesy of the AI revolution. Paradoxically, however, this is intensifying the spotlight on America's chronic external deficit. How long can this massive imbalance last?

Investors around the world have poured trillions into the U.S. stock market in recent years, lured by the juicy returns promised by the artificial intelligence boom, which has spurred the biggest capex spending spree in history. This flow of overseas money into U.S. equities is now the key funding source for the U.S. current account deficit, which has widened beyond pre-pandemic levels.

America's current account deficit represents the difference between the value of all the goods, services, interest, dividends, and income the U.S. imports and what it exports. The U.S. has been in deficit for decades. To fill that gap, foreigners must "lend" money to Uncle Sam by purchasing U.S. assets.

The Trump administration is striving to reduce that gap, especially the goods and services trade deficit, through a range of policies around immigration, domestic investment, and, of course, tariffs. It remains to be seen how successful those efforts will be. The trade gap has been hovering around 3% of GDP for the last few years, and the current account deficit is closer to 4% of GDP.

These are big shortfalls in a $31 trillion economy. Attracting foreign capital to fill them is necessary to prevent the dollar from tumbling or bond yields from spiking.

In theory, it doesn't matter how the gaps are covered, just as long as they are. But some sources of capital may be preferable to others.

Over the past 20 years, the composition of this funding mix has shifted – from the yield-insensitive "official" sector to return-hungry private investors – and that has arguably made America's massive foreign liabilities look a lot more worrisome.

GREENSPAN'S FAMOUS 'CONUNDRUM'

In February 2005, then-Fed Chair Alan Greenspan noted a "conundrum": U.S. bond yields remained low despite a series of interest rate hikes. What could explain this?

A month later, then-Fed Governor Ben Bernanke offered a potential answer. In a now famous speech, "The Global Savings Glut and the U.S. Current Account Deficit," Bernanke noted that emerging economies had, in a turnaround from previous decades, become a source of capital lending rather than borrowing. It was this flood of capital coming into the U.S., especially into the government bond market, that was suppressing interest rates.

He had a point. In the decade leading up to the Global Financial Crisis, the U.S. current account deficit was large, hitting a record 6% of GDP in 2006. This yawning deficit was financed by various sources of foreign wealth, whether from oil ("petrodollar" Gulf countries), trade surpluses (China, and much of Asia) or high levels of national savings (Japan).

What all of these funding sources had in common was a thirst for U.S. government debt, or Treasuries. Central banks were hoovering up Treasuries to keep their exchange rates competitive and build their foreign exchange buffers.

Bernanke argued that this foreign demand for U.S. debt delayed the reckoning that the widening global imbalances – the large U.S. deficits and corresponding surpluses elsewhere – portended.

While the day of reckoning may have appeared to come in 2007-08 in the form of the U.S. subprime housing crisis, global credit crunch and Global Financial Crisis, these global imbalances are back. Now, though, the nature of U.S. deficit financing has changed dramatically.

FLIGHTY VS STICKY FLOWS

The increasing integration of global financial markets in recent decades and loosening of capital controls in many emerging and developing economies have helped boost capital accumulation in the private sectors of these countries. These funds, in turn, have often found their way back into U.S. financial assets as overseas investors have sought large, liquid markets and the prospect of high returns. As a result, private foreign capital has gradually replaced central bank capital as the primary funding source for the U.S. current account deficit.

Consider that in 2004, Japan's official holdings of U.S. Treasuries accounted for 18% of all outstanding U.S. debt held by the public, and in 2010, China's equivalent share represented 14%. These holdings have evaporated to less than 4% and just 2% today, respectively.

Of course, overseas investors continue to buy Treasuries. Their total holdings stand at a record $9.4 trillion, more than half of which is now held by the private sector. But overall, foreigners now hold only 30% of all outstanding, publicly held U.S. federal debt, compared to 50% in 2012. Foreign governments have gradually reduced exposure to U.S. bonds for various reasons, including geopolitical, financial, and domestic economic considerations.

Equities now hold more allure. In 2010, foreign investors held a third of their U.S. financial assets in equities, and 22% in Treasuries. In the first quarter of this year, those shares stood at 61% and 14%, respectively. Foreign ownership of U.S. stocks now stands at a record 18%, nearly double what it was in the mid-2000s.

This shift could be a cause for concern. "Central banks tend to be 'buy and hold' investors to a large extent. Central banks typically care about safety, liquidity, then yield. In that order," says Eswar Prasad, professor of economics at Cornell University. "For private investors, to some extent the order is flipped for them - they care about yield, liquidity and a little less about safety."

This isn't an issue when Wall Street is booming. But it's not difficult to imagine that dynamic suddenly turning, if Wall Street hits the skids or other markets suddenly look more attractive. Private capital flows could then slow, or worse, reverse, making America's current account financing much more perilous.

chart

NIIP IT IN THE BUD

On the other hand, foreign investors may simply be onto something.

It sounds counterintuitive, but by some measures, today's U.S. tech behemoths are just as "safe" an investment as Treasuries. Apple and Microsoft have a triple-A credit rating, unlike the U.S. government, and the two-year yield on some corporate debt, like Microsoft bonds, is sometimes lower than the two-year Treasury yield.

Moreover, some of the Big Tech firms are now so important to the U.S. government from an economic, strategic and national security standpoint that it's almost unthinkable that they would be allowed to fail.

It's not just private overseas sector capital that has been lured into Wall Street in recent years. Many central banks and sovereign wealth funds have increased exposures to trillion-dollar U.S. megacaps like Apple, Microsoft and Nvidia. In essence, they've swapped the safety and liquidity of Treasuries for what many now consider the safety, if not the liquidity, of Big Tech.

According to analysts at Deutsche Bank, the gap between increasing net flows into U.S. stocks and slowing flows into U.S. debt has never been wider.

"The U.S. fiscal position is weakening, while U.S. corporate profitability is going from strength to strength," they write, adding: "AI could accelerate these dynamics as companies get richer and the redistributive pressures on governments grow."

In fact, one unwelcome byproduct of the AI buildout may be a wider U.S. current account deficit. A Fed paper this month found that investment-specific technology shocks are associated with a "persistent current account deterioration of roughly 10% relative to its historical average." That is usually because imports surge as tech investment booms.

This phenomenon threatens to be even more pronounced in the current AI investment frenzy because around 90% of the relevant equipment is imported from East Asia, the authors note.

Fears about the U.S. current account are nothing new, of course. If a crisis does eventually materialize, it won't be out of the blue. It will come slowly over the horizon.

It's also good to remember that despite decades of warnings from deficit hawks about the imminent collapse of the U.S. under its debt burdens, America is still the place to be for investors, and the dollar is still the undisputed global reserve currency.

But the size of the imbalance is getting hard to ignore. Another way to look at the flood of capital coming into America is the country's net international investment position (NIIP). This is essentially all U.S. assets held by foreigners less all foreign assets held by Americans. This figure currently stands around $21 trillion, according to the Bureau of Economic Analysis, or around 70% of U.S. GDP. Twenty years ago, that was closer to 10% of U.S. GDP.

Big numbers, big flows, and maybe one day, a big problem.

chart

(The opinions expressed here are those of the author, a columnist for Reuters)

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