The Washington Times
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Sound dollar dynamics

By Richard W. Rahn
Published July 23, 2007

Does it strike you as a bit odd that non-Americans continue to invest their savings in the United States when the conventional wisdom is that the dollar will continue falling? Why would rational people invest in a declining asset? Do they understand something the politicians and commentators don't?

Last month the U.S. government released another report that the value of foreign-owned assets in the U.S. exceeds the value of U.S.-owned foreign assets (by $2.5 trillion), and the dollar has dropped to record lows against the euro. Some politicians and media folk treated these news events as a national disaster. In fact, foreign investment in the U.S. is not a problem and does not mean the dollar will fall or rise in relation to any other currency.

The following will explain all. The reason individuals, businesses or governments "save," that is, spend less at a moment in time than they receive, is to allow for a higher rate of spending in the future. Individuals typically save money during their high earning years before retirement so they can spend more during retirement.

Now assume a wealthy Norwegian (or if you wish, substitute German, Japanese, or Chinese) wants also to save for his retirement. Norway, being a small oil-rich country, does not have that many domestic investment opportunities. So the Norwegian wants to diversify his risk by investing in other countries. The U.S. is appealing to him because it has the world's strongest economy, the rule of law, strong protections for private property and does not tax foreign investors on their portfolio interest, dividends, and capital gains.

Furthermore, he can also legally and properly defer any immediate Norwegian tax liability by making his investment through an offshore entity, such as the Channel Islands, Bermuda, or Cayman (because Norway, like most countries and unlike the U.S., has a territorial tax system).

The Norwegian investor must first obtain U.S. dollars before making his investment, so he goes to the bank and buys dollars with his Norwegian krone. The bank may have obtained its dollars from a Norwegian oil company that sold oil to the U.S. Assume our Norwegian buys U.S. government bonds, U.S. corporate stocks and a condo in Miami Beach with his dollars. When the U.S.

government pays interest on the bonds, it pays in dollars, as do U.S. companies when they pay dividends; and it matters not who received the dollars.

Literally, millions of other foreign investors (including individuals, companies, and governments) make similar decisions every year. Each investor has a different local situation, different desires and needs and different time preferences; hence, they won't all sell their U.S. assets at once. (Despite global warming, the January weather in Miami Beach is going to continue to be better than that in Oslo for the next few centuries.)

When foreign investors do sell their assets, they receive dollars. The only thing they (or whoever buys their dollars) can do with the dollars is buy U.S. goods and services or invest back into the U.S.; either way, it is a net gain for the U.S.

Currency fluctuations are caused by changes in interest rates, inflation rates, rates of return, tax and spending policies, and perceived changes in risk between countries. As the dollar rises against the euro, Europeans will find it more desirable to invest in U.S. real estate and will increasingly buy U.S. goods and services, while finding it more difficult to sell their own goods in the U.S., which at some point will cause the euro to fall relative to the dollar.

New Yorkers have invested more in Florida than Floridians have been investing in New York for a century, and this has been to Florida's benefit. Europeans have invested in America in many more of the last 400 years than vice versa, and this is to America's benefit.

Over the long run, the U.S. is likely to have higher growth rates than Europe because of more favorable demographics, and somewhat smaller tax and regulatory drags. The U.S. is also likely to continue to be more politically stable and do a better job in protecting the rule of law and property rights than most other countries in the world. In some years, the U.S. will make policy mistakes — such as increasing government spending too much or letting the Bush tax cuts expire. But over the long run, the U.S. is the safer bet.

Finally, the U.S., unlike many other countries, has most of its assets and liabilities in its own currency. Countries get themselves in trouble when they have their assets in their own currency and many of their liabilities in another currency (like dollars). Hence, it makes little difference whether a New Yorker or a Brit owns a Miami condo, or a Texan or German owns stock in a Virginia high-tech company — because it is all in dollars.

The U.S. "deficit" does not have to "correct" itself anymore than does the Florida "deficit" with New York — it can go on for centuries. And by the way, my bet is the dollar will be higher against the euro a year from now.

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