MONTHLY ECONOMIC MEMORANDUM

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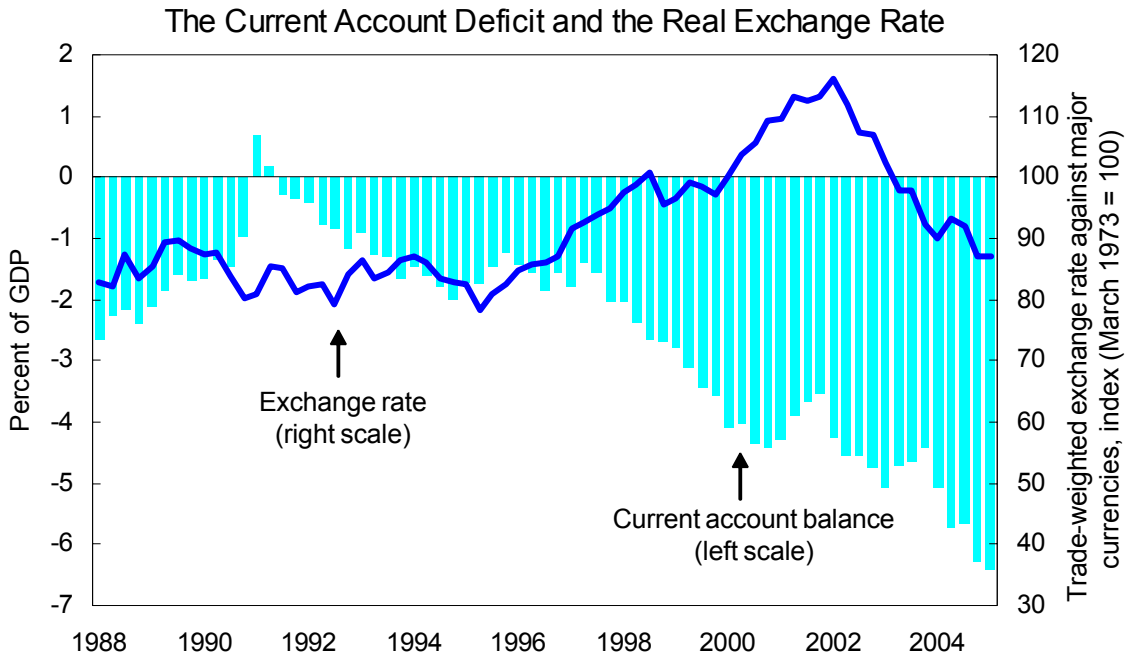
JOINT ECONOMIC COMMITTEE – DEMOCRATIC STAFF

SENATOR JACK REED (D-RI) – RANKING DEMOCRAT

DEFICITS AND THE DOLLAR



Source: Bureau of the Census, U.S. Department of Commerce and Federal Reserve Board.

The current account deficit has continued to widen in the past two years, even as the dollar has declined.

The United States has been running an ever widening trade imbalance with the rest of the world for more than a decade (**Chart 1**). During that period, the foreign exchange value of the dollar was at first relatively stable as the economy began to recover from the 1990-91 recession. The dollar then rose during the economic boom of the late 1990s, which was also a time when the federal budget was moving from deficit to surplus. In the past few years, however, as the federal budget has moved into deficit again, the still widening trade imbalance has been accompanied by a falling dollar.

Clearly there is no simple relationship between the dollar and the trade deficit, or between the federal budget deficit and the trade deficit. There are, however, some general economic principles that show how these economic variables are linked together and the possible ways the current trade imbalance can be resolved.

The Trade Deficit and the Current Account

The *trade deficit in goods and services* is the difference between the value of goods and services purchased by U.S. residents from the rest of the world (U.S. imports) and the value of goods and services sold by U.S. residents to the rest of the world (U.S. exports). In 2004, the United States had a record trade deficit in goods and services of $617.6 billion composed of a deficit in goods of $665.4 billion and a surplus in services of $47.8 billion.

The *current account deficit* is a broader measure that includes not only trade in goods and services, but also income flows and net unilateral transfers. Income earned by U.S. owners of foreign assets and the compensation paid to U.S. residents working abroad enter the current account as credits along with exports. Income paid to foreign owners of U.S. assets and the compensation paid to foreign residents working in the United States enter as debits along with imports. Unilateral transfers are items such as U.S. government grants to foreigners, remittances, and gifts.

The current account deficit was a record $668.1 billion (5.7 percent of GDP) in 2004 and has exceeded 6 percent of GDP in the past two quarters. The current account deficit is sustainable only to the extent that it can be financed by selling U.S. assets or borrowing from the rest of the world.

The Exchange Rate

The exchange rate is the price at which dollars can be exchanged for foreign currency. The demand for dollars (supply of foreign currency) comes from foreigners who want to purchase U.S. goods, services, and assets priced in dollars or from U.S. exporters who have been paid in foreign currency they want to convert to dollars. The supply of dollars (demand for foreign currency) comes from U.S. residents who want to buy foreign goods, services, and assets (or from foreign sellers who have been paid in dollars but want to convert them to their own currency).

The exchange rate shown in Chart 1 is a multilateral exchange rate—a weighted average of the dollar's exchange rate against a market basket of major currencies, where the weights reflect the relative importance of each country's trade with the United States. It is also a real exchange rate, meaning that it is adjusted for differences in inflation rates between the United States and its trading partners. Changes in this measure of the exchange rate show whether U.S. goods and services generally are becoming more or less expensive than those of our trading partners.

The Exchange Rate and the Trade Deficit

When the demand for dollars is relatively strong the dollar appreciates. A stronger dollar makes U.S. exports more expensive abroad and U.S. imports cheaper at home, which can worsen the trade deficit. That is what happened in the second half of the 1990s, when the U.S. economy was strong and the appreciation of the dollar was driven by a demand by foreigners to invest in the United States. In a sense, U.S. financial assets became an important U.S. export, filling the gap between U.S. imports and traditional exports of goods and services.

The dollar peaked in early 2002 and has depreciated by about 25 percent since then. A fall in the dollar can improve the trade deficit by encouraging exports and discouraging imports. However, changes to imports and exports resulting from changes in the exchange rate can take some time to play out, and the trade deficit may initially worsen when the dollar depreciates (because the price of imports has gone up but the quantity purchased has not yet gone down).

Moreover, the central banks of some Asian economies that view exports as an important source of economic growth have been resisting the appreciation of their currency (which would hurt their exports) by buying dollars. China, for example, maintains a fixed exchange rate with the dollar and has been intervening heavily in the foreign exchange market by purchasing U.S. Treasury securities and other dollar-denominated assets. In effect, governments that intervene to support their currency are helping to finance the U.S. trade deficit and limiting adjustment through the exchange rate.

Box: The Arithmetic of Trade and Budget Deficits

The national income and product accounts (NIPAs) provide a framework for understanding the relationship between the trade deficit, national income, and national spending. They also provide a framework for understanding how changes in the federal budget deficit can affect the trade balance.

The trade deficit and the gap between income and spending. The arithmetic of the NIPAs shows that a trade deficit can only occur when national spending exceeds national income, necessitating borrowing from abroad to make up the difference.

U.S. national product is the value of goods and services produced by U.S. labor and U.S.-owned capital and other resources; U.S. national income is the income earned in that production. Apart from measurement error in the data, they are two sides of the same coin. U.S. national spending differs from U.S. national product (and hence from U.S. national income) because it includes imports (which are not a part of national product) and excludes exports (which are). Thus, *national spending = national income + imports – exports*, or

(1) national spending = national income + the trade deficit

In this formulation, the trade deficit is conceptually the same as the current account deficit, and hence a measure of increased international indebtedness.

The trade deficit and the gap between saving and investment. The arithmetic of the NIPAs shows that a gap between national spending and national income is equivalent to a gap between national investment and national saving.

National saving is the sum of private and public saving. Private saving is the part of national income that is not spent on consumption or paid in taxes. Public saving is the difference between taxes and government spending, or equivalently the combined budget surpluses of the federal government and state and local governments. Government budget deficits are negative public saving. Using these definitions and the fact that national product is composed of consumption, national investment, government purchases and net exports, (1) can be transformed into:[1]

(2) national investment – (private saving + public saving) = the trade deficit

The trade deficit and the budget deficit. It follows from (2) that an increase in the federal budget deficit (which reduces national saving) will increase the trade deficit to the extent that it is not completely offset by a reduction in investment or an increase in private saving.

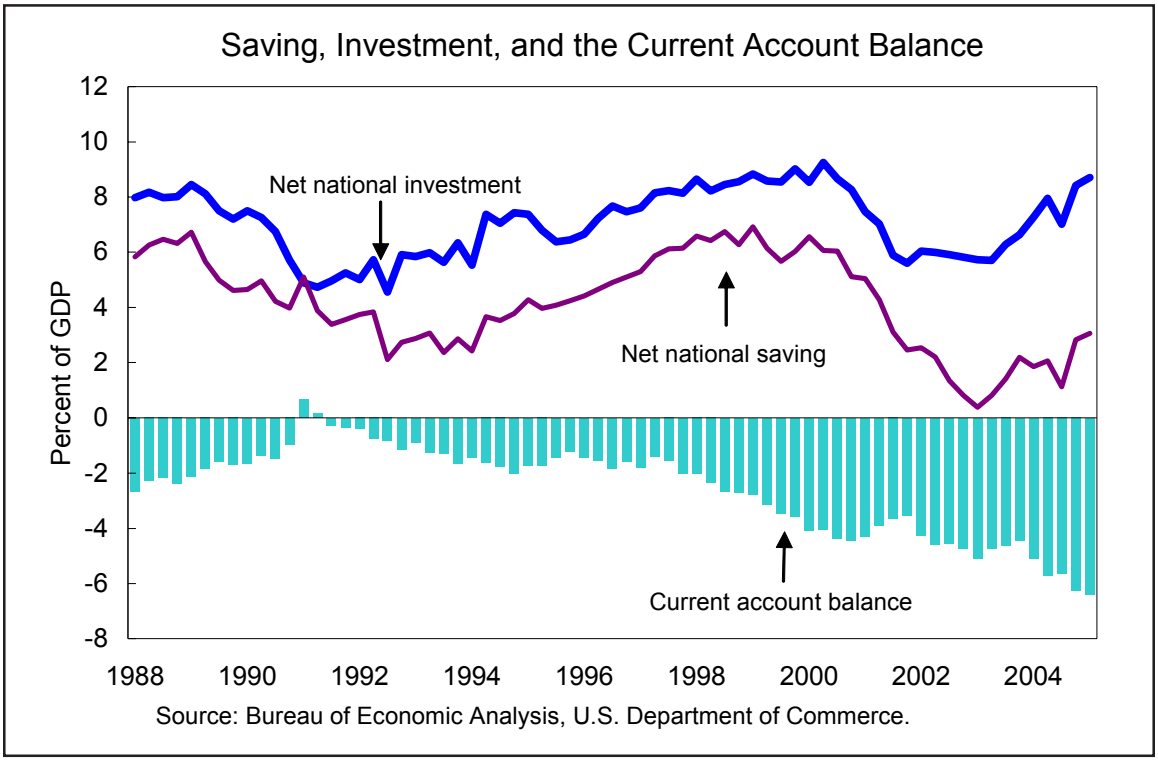
[1] From the NIPAs, *national spending = consumption + national investment + government purchases*, and *national income = consumption + taxes + private saving*. Substituting in (1) and rearranging gives *national investment - private saving - (taxes – government purchases) = the trade deficit*. Substituting *public saving* for *(taxes – government purchases)* yields (2).

The Budget Deficit and the Trade Deficit

Central bank intervention, foreign trade practices, and the relative strengths of the U.S. and foreign economies can affect the trade balance with particular countries and regions. From a macroeconomic perspective, however, a trade deficit reflects excessive domestic spending and an imbalance between national investment and national saving (**Box**).

Large federal budget deficits were associated with a sharp drop in national saving after 2000. That decline in national saving has not translated into a similar decline in national investment, but only because the United States has run a large current account deficit (**Chart 2**). Without the substantial purchases of U.S. Treasury securities by foreign central banks and others that have helped finance that deficit, U.S. interest rates would almost certainly be much higher than they are now and national investment would be much lower.

Maintaining investment through foreign borrowing contributes to higher productivity growth in the United States. However, the income from investment financed



by foreign borrowing accrues mostly to the foreign lenders. A high fraction of U.S. national investment is being financed by foreign borrowing, and future U.S. national income will be reduced by the costs of financing and repaying those loans.

The United States also experienced a gap between national investment and national saving in the 1990s. At that time, however, the federal budget deficit was shrinking and national saving was rising—just not fast enough to keep pace with the boom in investment. The result was also a widening current account deficit, but in that episode an increasing fraction of U.S. national investment was being financed by U.S. national saving.

Risks and Policies to Restore Balance

Despite the depreciation of the dollar that has taken place so far, the current account deficit remains large. Many analysts believe that a substantial further depreciation of the dollar will be necessary to restore balance. However, relying on depreciation alone to restore balance is a risky and unwise policy. It is also important for the United States to increase its national saving.

Thus far, the depreciation of the dollar has been relatively orderly and there has not been a flight from the dollar among foreign holders. However, a depreciating dollar causes dollar-denominated assets to lose value, and private investors and foreign governments may suddenly decide that the benefits of holding dollars no longer justify the risks. A widespread dumping of the dollar could precipitate an international financial crisis. But even an orderly further depreciation of the dollar and reduction in foreign capital inflows is likely to be accompanied by inflationary pressures from rising import prices and a further tightening of monetary policy by the Fed.

Without an increase in national saving, any reduction in the current account deficit would be accompanied by reduced national investment that would harm future growth. Private saving might spontaneously rise some from its current low level, but it would be imprudent to count on that. As many experts, including Federal Reserve Chairman Greenspan, have said, the best way to increase national saving is to reduce the federal budget deficit. That is also a good way to reduce the trade deficit and to promote U.S. national investment and a rising standard of living.