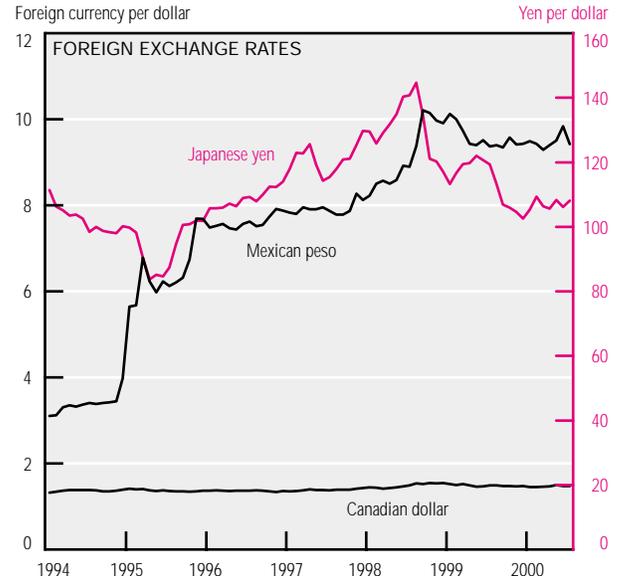
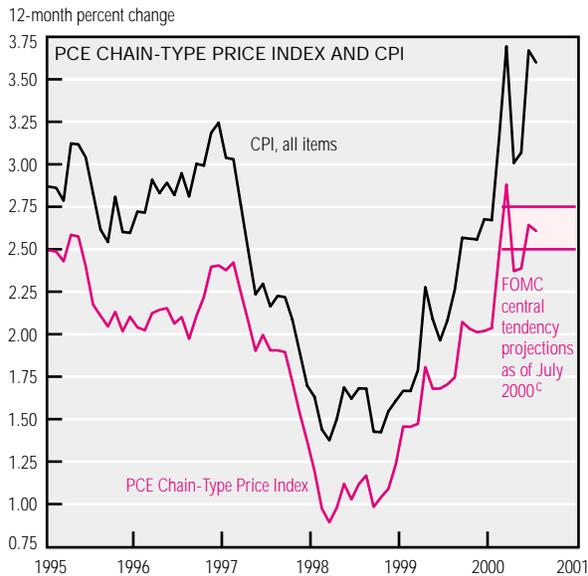
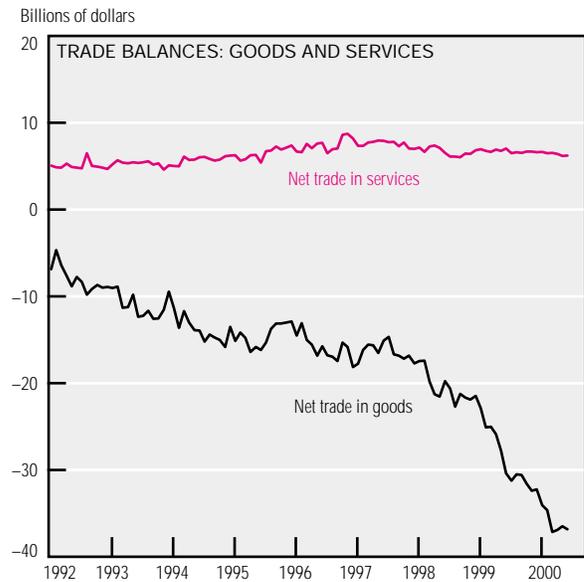
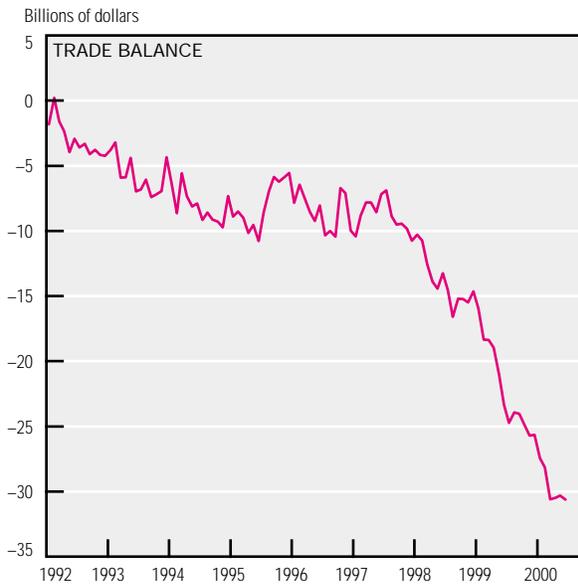


The U.S. Trade Deficit



SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

The monthly U.S. trade deficit has been essentially unchanged since March, with a slight decline in the services surplus offset by a slight decline in the goods deficit. This June's deficit of \$30.6 billion was about 25% larger than last June's. If monthly deficits for the rest of 2000 were somehow to remain at this level, the annual deficit would be only 36% greater than in 1999. Last year's deficit exceeded 1998's by 59%.

The deficit with Canada, our largest trading partner, was \$4.3 billion, 50% more than a year ago. The exchange rate with Canada, however, has remained relatively

stable. With Mexico, our second-largest trading partner, the deficit was \$2.3 billion, 9% more than a year ago. The exchange rate with Mexico also changed little from a year ago but is somewhat volatile. The June deficit with Japan was \$6.3 billion, slightly less than a year ago; the exchange rate, while stable in recent months, has depreciated somewhat in the past year.

A country that runs a trade deficit is absorbing—through consumption and investment—more of the world's resources than it is producing. Such a country also is spending beyond its current income and must borrow

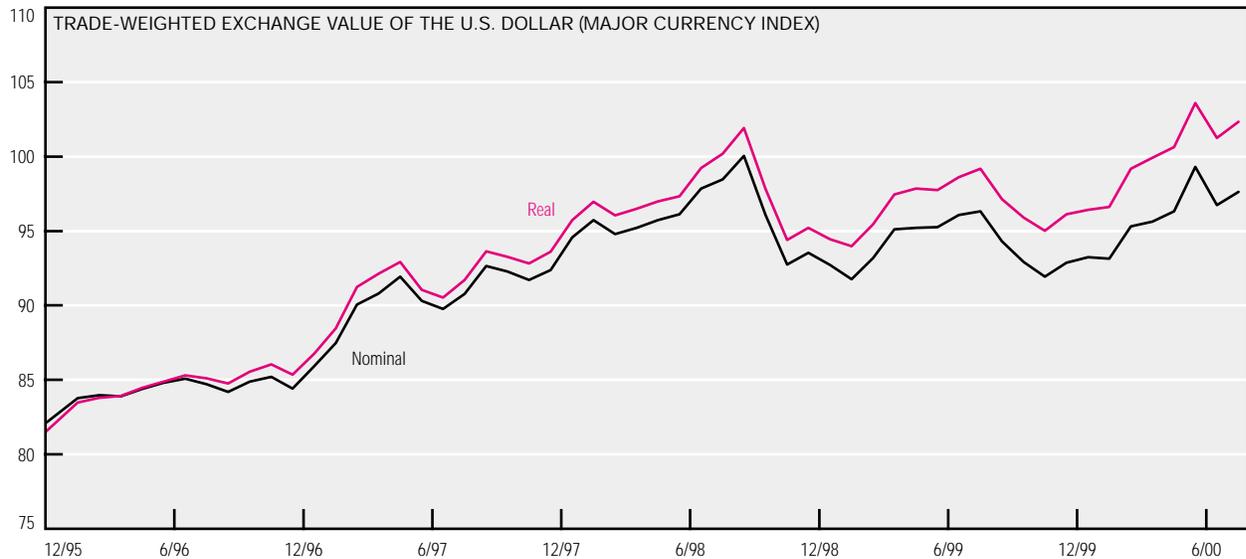
from abroad to finance its expenditures. This economic fact of life guarantees that a nation's net inflow of foreign capital will always exactly match its current-account deficit.

To understand the competitiveness of U.S. goods and services in foreign markets, it is important to gauge movements in the dollar's value. Because the dollar often appreciates against some currencies and depreciates against others, economists construct weighted-average indexes of exchange rates to gain an overall perspective. Usually, the weights reflect trade shares between countries. The Major Currency Index (MCI), for

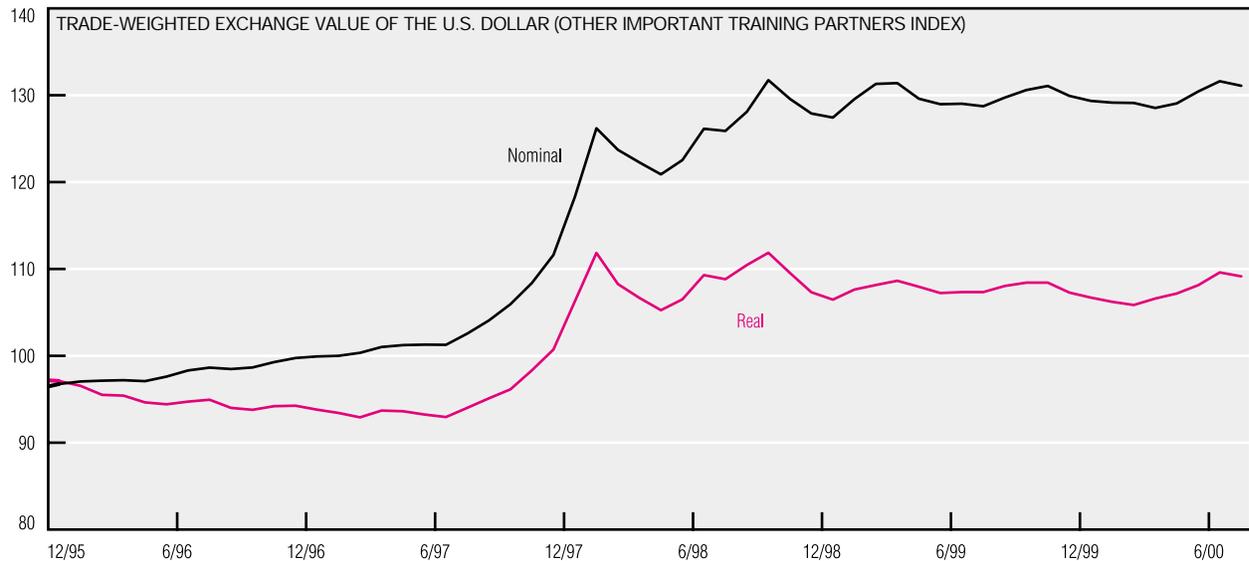
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The U.S. Trade Deficit (cont.)

Index, March 1973 = 100



Index, March 1973 = 100



SOURCE: Board of Governors of the Federal Reserve System.

example, includes currencies heavily traded in financial markets like those of the G-10, the euro area, and Australia. The Other Important Trading Partners (OITP) Index reflects movements of the dollar against currencies of U.S. trading partners in Asia, Latin America, Eastern Europe, and the Middle East. Adjusting for inflation differentials between the U.S. and its trading partners provides indexes of the dollar's average real value in foreign trade.

A country may incur a trade deficit in various ways, each with different implications for its exchange rate.

If ebullient domestic demand alone were responsible for widening the deficit, the dollar would depreciate as the deficit widened. But while the U.S. trade deficit has been growing steadily since 1997, the value of the dollar has not declined in currency markets. That is, despite the increasing net flow of dollars to be exchanged with foreign currencies in trade, the foreign currency price of dollars has not generally declined.

Both the MCI and the OITP indexes of the dollar's value have appreciated slightly this year and significantly since 1997. This real

appreciation suggests that, despite the growing deficit, U.S. goods and services are becoming less price-competitive abroad, while foreign goods grow more price-competitive in the U.S. This is not all bad, if demand in the U.S. essentially exceeds our economy's productive capacity.

Dollar appreciation suggests that investment opportunities in the U.S. have attracted an increasing inflow of foreign capital. This demand for dollars brings appreciation that makes foreign goods less expensive than domestic ones.