

Is the Dollar Sustainable?

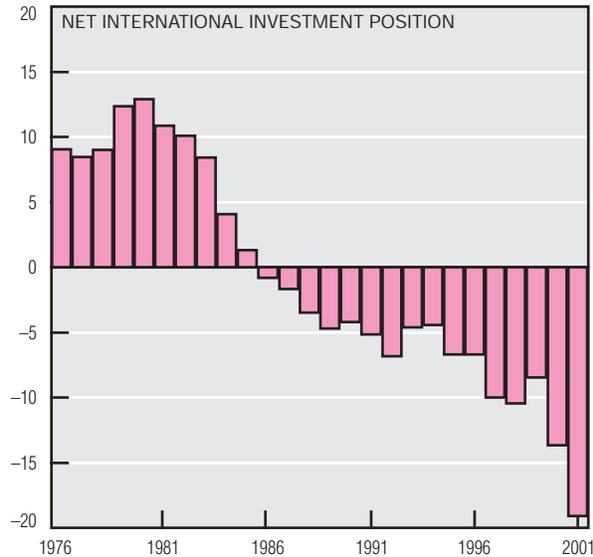
Major Currencies Index, March 1973 = 100^a



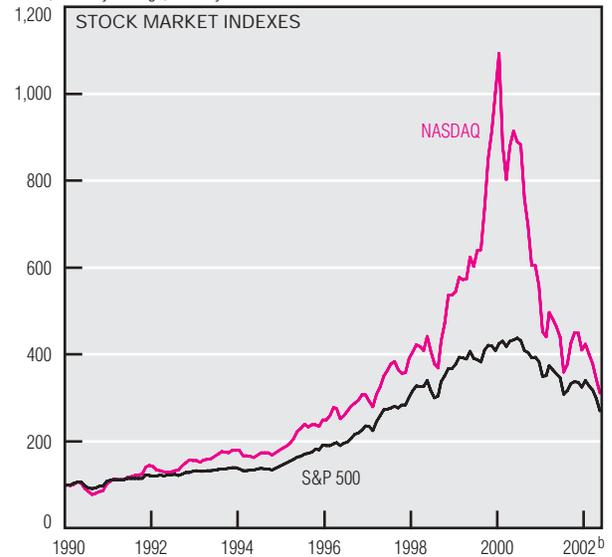
Percent of GDP



Percent of GDP



Index, monthly average, January 1990 = 100



a. Includes the currencies of Canada, the euro area, Japan, U.K., Switzerland, Australia, and Sweden.

b. Data through July 23.

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

Shaken by disclosures in U.S. equity markets, the dollar has slid about 7% against the currencies of our major trading partners since April. Some economists worry that a more fundamental adjustment may be in the offing.

The U.S. has run a current account deficit almost continuously since 1982, primarily because we import more than we export. This year, the current account deficit will approach \$500 billion, or 5% of GDP, and most analysts expect that it will continue to expand over the next year.

We finance this deficit by issuing financial instruments—stocks, bonds, bank accounts—to foreigners, giving them a claim to our future output. Currently, international investors' net financial claims against the U.S. are equal to approximately 19% of our GDP. (The Commerce Department records this as a negative net international investment position.) Although 19% is high, it is not unprecedented, and we have no metric by which to judge it excessive or unsustainable.

Nevertheless, some analysts fear that international investors will

become increasingly reluctant to hold additional dollar-denominated assets in their portfolios. In that case, U.S. interest rates would rise, and the dollar would depreciate in foreign exchange markets to trim the trade deficit and to coax additional financial inflows.

Whether the U.S. is on the cusp of such a development is anyone's guess, but the accounting scandals rocking U.S. equity markets cannot but make international investors more skittish about holding U.S. securities.