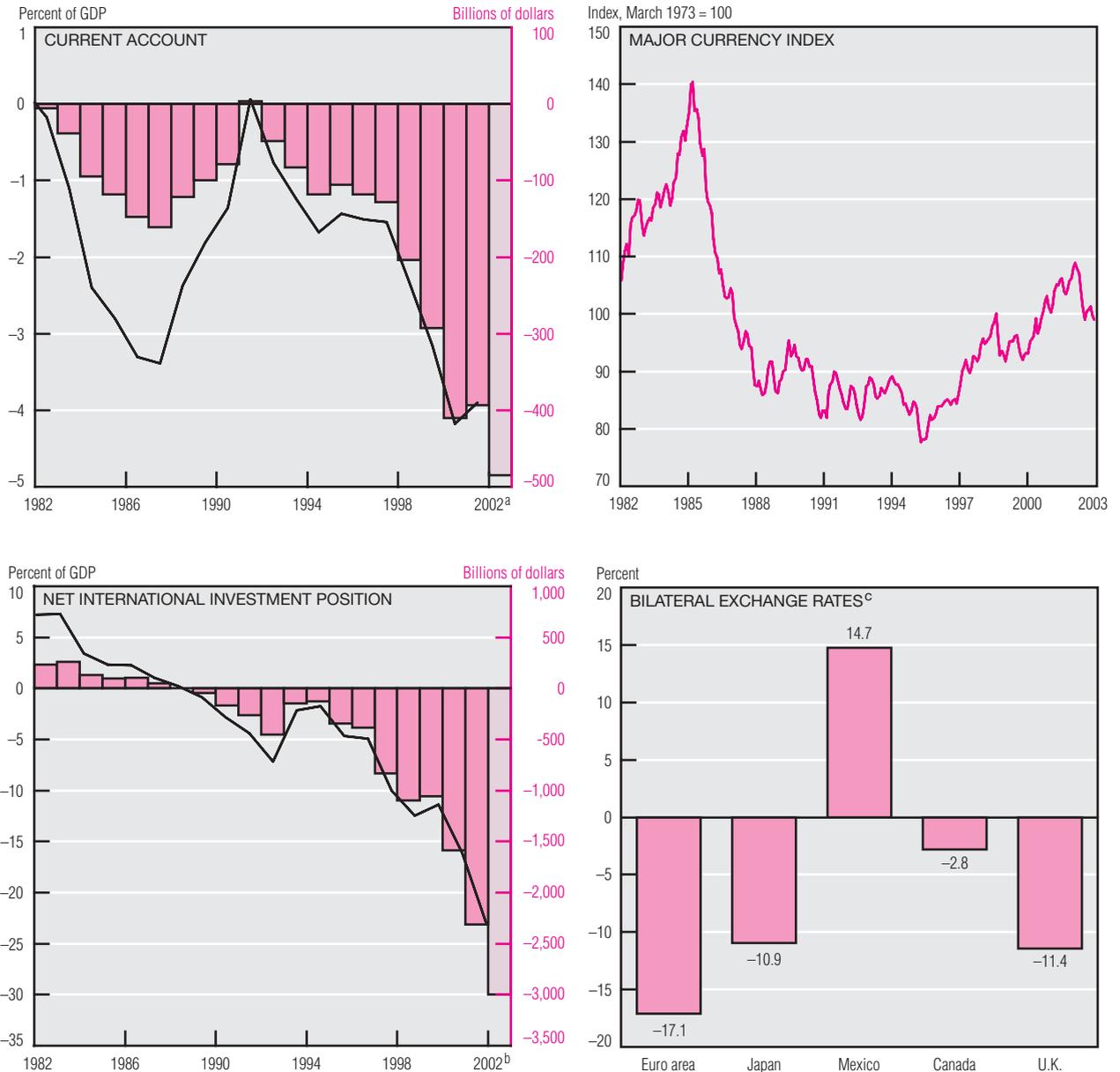


# Dollar Depreciation and the Current Account



a. Annualized average of the first two quarters.

b. Author's estimate.

c. Percent change in bilateral exchange rates since February 2002 peak.

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

Since its most recent peak in February 2002, the U.S. dollar has depreciated nearly 11% on a trade-weighted-average basis against the currencies of the major industrial countries. Although the dollar's recent movements may reflect a number of factors, many observers have long claimed that persistent U.S. current account deficits must eventually exert a downward pressure on the dollar.

For 20 of the past 21 years, the U.S. has posted a current account deficit, primarily because we import more goods and services than we export.

In the first half of 2002, the current account shortfall equaled \$485 billion (annual rate), roughly 4.7% of GDP.

To finance these deficits, we have given foreigners various financial claims against future U.S. output and have reduced our claims on output abroad. This process creates financial inflows that, abstracting from measurement error, exactly equal the current account deficit. Since the late 1980s, the stock of foreign claims against the U.S. has exceeded the stock of U.S. claims on other countries; last year, the market value of

the nation's negative net international investment position equaled nearly \$3 trillion or 29% of GDP.

Our net international investment position cannot continue to decline relative to GDP indefinitely. At some point, international investors will become reluctant to hold additional claims against the U.S. Then, real interest rates will rise and the exchange value of the dollar will fall to attract additional financing. We cannot claim to have reached that point, but it's a point worth considering.