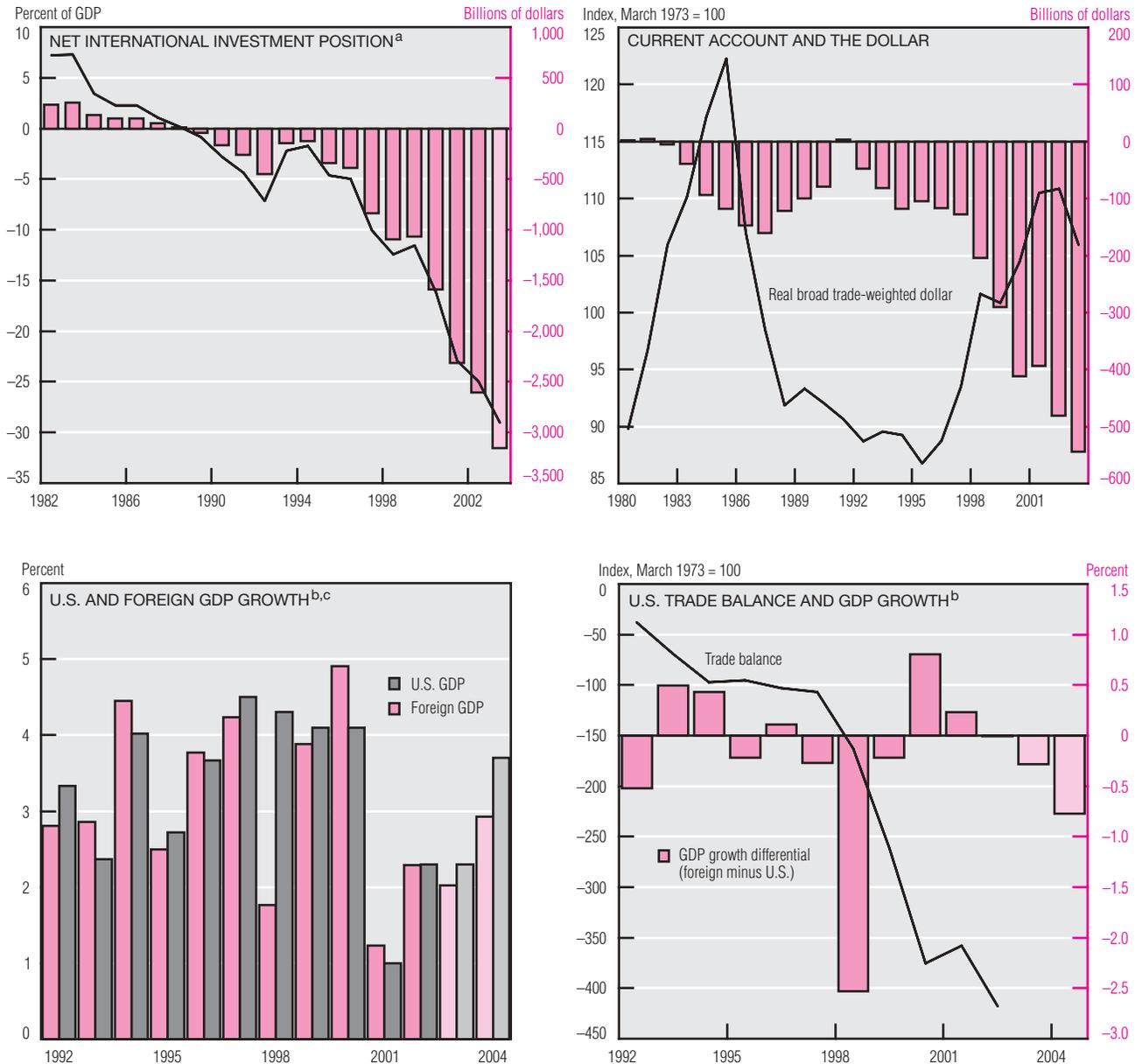


What's Driving the Dollar?



a. Data for 2003 are the author's estimates.

b. Data for 2003 and 2004 are forecasts from *Blue Chip Economic Indicators*.

c. Top 15 lending partners.

SOURCES: Board of Governors of the Federal Reserve System; U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, July 10, 2003.

Market reports often suggest that nervous international investors are driving down the dollar's foreign exchange value. A closer look at the data, however, does not seem to support this story.

Because of our persistent current account deficits, foreigners now hold net financial claims against the U.S. equal to nearly 30% of our GDP—a percentage that has more than doubled in just five years. Many economists fear that if this pattern continues, foreign investors will become progressively more reluctant to add

dollar-denominated claims to their portfolios and will quickly diversify in the face of uncertainty. As this happens, the dollar will depreciate and real interest rates in the U.S. could rise, narrowing the current account deficit.

The dollar's overall depreciation since February 2001, however, which has not been associated with a smaller current account deficit, is not consistent with the scenario just described. A more likely story begins with the goods market, not the financial market. Because U.S. economic growth exceeds that of our major

trading partners, our demand for imports has exceeded world demand for our exports by a widening margin. Our demand for goods from abroad has provided a supply of dollars to the foreign exchange market that has outpaced foreign demand for dollars, producing a dollar depreciation.

Although premature, concerns about foreign investors' diversification out of dollar assets are not unfounded. Net foreign claims cannot rise indefinitely relative to GDP.