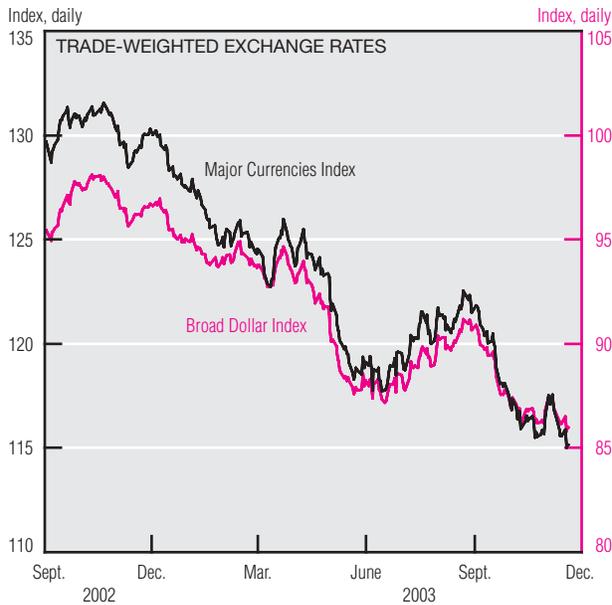
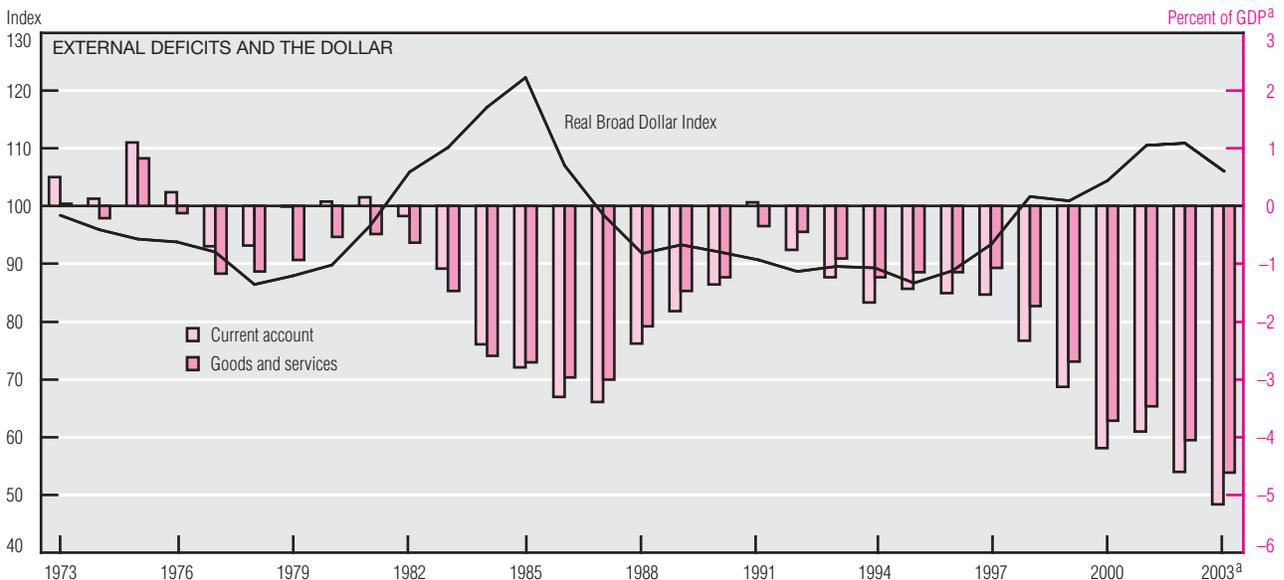


The Deficits Problem



Dollar Exchange Rate Movements

	Percent change from	
	One year ago	Three months ago
Canada	-17.6	-7.2
Euro area	-17.5	-9.2
Japan	-10.4	-6.7
Mexico	12.3	3.8
U.K.	-10.7	-8.8



a. Data through 2003:1IQ.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.10.

The U.S. dollar recently depreciated to its lowest level ever against the euro, in response to fears that foreign financial flows into this country are slowing. Such flows are integrally linked to our current account deficit through a relationship that also encompasses private saving, investment, and the government's budget balance. Will a growing federal budget deficit worsen the situation?

When the U.S. government spends more than it taxes, the Treasury must finance the resulting federal budget

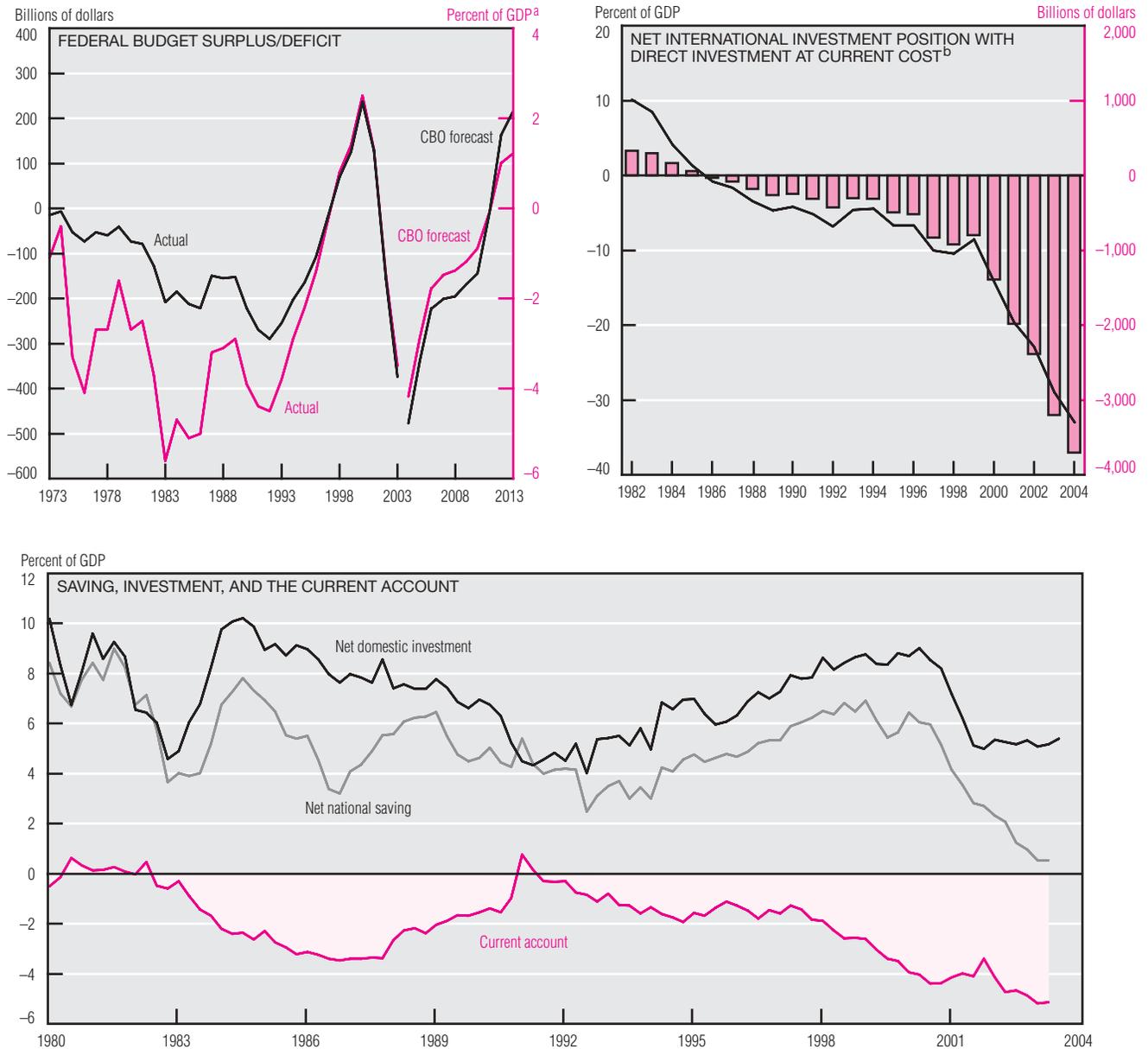
deficit by issuing securities. As Americans buy these Treasury securities, they channel their savings, which otherwise would be available for financing private investment, to the federal government. If all else remained constant, net private investment would necessarily decrease by the full amount of the budget deficit.

Of course, everything else will not remain constant, and to the extent that it does not, the coincidental economic changes will mitigate the budget deficit's adverse impact on domestic investment. For one thing, taxpayers

may decide to save a bit more if the deficit raises real interest rates or if they anticipate higher tax bills to service—and eventually retire—the federal debt. In addition, if the state and local budget situation improves as the federal budget deficit expands, it could cushion the latter's impact on private investment. Finally, foreigners may be willing to buy up a substantial portion of any new Treasury debt issuance. This last possibility ties the federal budget deficit to the current account deficit.

(continued on next page)

The Deficits Problem (cont.)



a.. Actual surplus/deficit is charted as a percent of actual GDP. Forecasted surplus/deficit is charted as a percent of potential GDP.

b. Data for 2003 and 2004 are estimates.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Office of Management and Budget; and Congressional Budget Office.

Since 1982, the U.S. has maintained a current account deficit almost continuously and has financed it by issuing financial claims to the rest of the world. Any country with a deficit in its current account is not saving enough to match its private investment, and its issuance of financial claims to the rest of the world brings in enough foreign savings to make up the difference. Foreigners have been acquiring financial claims on the U.S. and helping to finance investment here for the past 20 years.

By the late 1980s, the rest of the world held more financial claims on the U.S. than the U.S. held against them. Our net international investment position has continued to deteriorate since then. This year, foreigners will probably hold nearly \$3.2 trillion in net claims against the U.S., an amount estimated to equal nearly 30% of this country's GDP. If that ratio continues to grow, foreigners could become increasingly reluctant to acquire additional dollar-denominated financial claims. If this happens, the

dollar will depreciate, real interest rates in the U.S. could rise, and private investment here could slow.

How rapidly this adjustment might occur, and how disruptive its economic consequences might be, is anybody's guess. During the 1980s, fears about the simultaneous growth of current account deficits and federal budget shortfalls proved unfounded. Now, however, our outstanding financial claims are much bigger. A large, growing federal budget deficit surely cannot ease the situation.