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To answer this question recall that the trade deficit means that the United States is buying more goods and services than it sells abroad (imports exceed exports). Just like an individual or a firm needs credit to spend more than its income, the trade deficit requires financing by foreigners. Foreigners finance the trade deficit by lending to Americans or by investing in the United States (buying property or businesses). However, at some future date, the trade deficit must turn into surplus, so that the foreigners get paid back.

For the trade deficit to turn into a surplus, imports must fall and exports must rise. One way this adjustment can take place is if the dollar depreciates, making imports more expensive for Americans and exports cheaper for foreigners. If trade deficits are sufficiently large and unsustainable, economists believe that they will be associated with a weakening dollar at some future date.

The U.S. economy has been doing very well for many years now, making it an attractive place for foreigners to invest in. As a result, they have been willing to finance growing U.S. trade deficits in the 1990s (**Chart 1**). While the deficits have reached unprecedented levels, the dollar has shown no consistent signs of weakening over this decade (**Chart 2**). Thus, trade deficits can be sustainable for a very long time, making the short run relationship between trade deficits and the dollar very tenuous.

To conclude, in the long run, trade deficits may be expected to contribute to a weaker dollar, as the economy adjusts to create the surpluses needed to repay foreign investors. However, in the short run, the relationship between the trade deficit and the dollar is weak, and the value of the dollar is determined largely by investor preferences for U.S. dollar assets.

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