The U.S. Budget Deficit and Foreign Exchange

How the hefty U.S. government budget deficit has an impact on foreign exchange rates and your business.

*By Charles Slack*

As the U.S. budget deficit and spiraling debt capture the attention of politicians, the media, and the public alike, much of the focus has been on domestic issues such as government spending, public pensions, and taxes. Less publicized, but equally important, is the impact these forces can have when the value of the dollar falls, driving up costs for U.S. businesses and organizations that must exchange currency to buy goods or hire workers overseas.

Even more ominous than the current budget deficit of about $1.3 trillion is the large and growing U.S. debt—money that the government has borrowed by issuing U.S. Treasuries, and which it will have to repay. Since 2002, the national debt has more than doubled, from $6 trillion to more than $14 trillion—or, nearly the same size as the entire U.S. GDP.

In 2010, the financial ratings agency Moody’s Investors Service warned that U.S. Treasury bonds, traditionally considered one of the safest investments in the world, could be downgraded if the U.S. government fails to correct its debt problems. Earlier this year, New York University economist Nouriel Roubini echoed those sentiments, warning of a fiscal “train wreck” unless the United States effectively manages its deficit and debt.

“Everybody focuses on the deficit. But the real impact is from the debt,” says Kimberly Amadeo, an Arizona-based consultant and head of WorldMoneyWatch.com, which advises companies on how global economic trends impact their businesses.

**Reserve status in question?**

Since the end of World War II, the dollar has been the world’s unrivalled reserve currency—the currency that other countries purchase in order to diversify and stabilize their own economies. That
status gives the dollar inherent strength through good times and bad—an important consideration for U.S. organizations that routinely exchange dollars into other currencies.

While countries globally still hold more than 60 percent of their foreign reserves in dollars, countries such as China are increasingly expressing alarm at the growing size of the U.S. debt.

“When the debt is the same size as our GDP, they start to wonder about our ability to pay it all back,” Amadeo says. If those doubts grow, countries could scale back Treasury purchases. China, France, and other countries have even raised the possibility of elevating the Chinese yuan or a new currency to replace the dollar as the world’s reserve.

“So far, it’s mainly saber-rattling,” Amadeo says. For years, China has kept the yuan deliberately low to boost its own export-driven economy. And despite the great economic strides China has taken in recent years, great logistical hurdles remain before the yuan could become a global reserve currency.

Still, the mere fact that world leaders are discussing such a shift reflects a more tenuous position for the dollar. Indeed, since 2002, the dollar has declined more than 50 percent to the euro, Amadeo says.

Further declines are possible as the country grapples with ways of reducing the debt and the deficit. Politicians and the public alike will have to address the need for serious reforms in areas such as Social Security, Medicare, and defense, Amadeo says.

Meanwhile, individual business or organization managers are starting to consider taking certain steps to prepare themselves in case the dollar declines. For those that are preparing, Amadeo suggests:

**Lock in good rates.** Airlines and other businesses buy contracts for future fuel purchases in order to protect themselves from price volatility. In the same way, if foreign exchange is a regular part of your business, consider locking in exchange rates that you consider attractive, in advance. Of course, there are risks. Over the short term, volatility in the markets could cause the dollar to increase,
meaning you could miss out on a favorable exchange rate. Over time, though, if the dollar steadily
declines, locking in rates could add protection. And, knowing your costs in advance can help you plan
ahead, Amadeo says. Due to the complexities of foreign exchange, she adds, it’s always best to get
guidance and help when engaging in foreign exchange.

**Ramp up your exports.** A weak dollar may make it costlier to buy things or pay employees
overseas, but it provides a competitive advantage when selling. Look for ways to export your goods
and expertise in order to offset the rising costs of the things you must import.

**Source locally.** For years, inexpensive labor in the Far East has encouraged U.S. businesses to hire
out production and services to other countries. While outsourcing may still be a bargain, the prospect
of rising wages in developing countries, and the possibility of a falling dollar, make this a good time to
think about developing local sources for some of the things you need.

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