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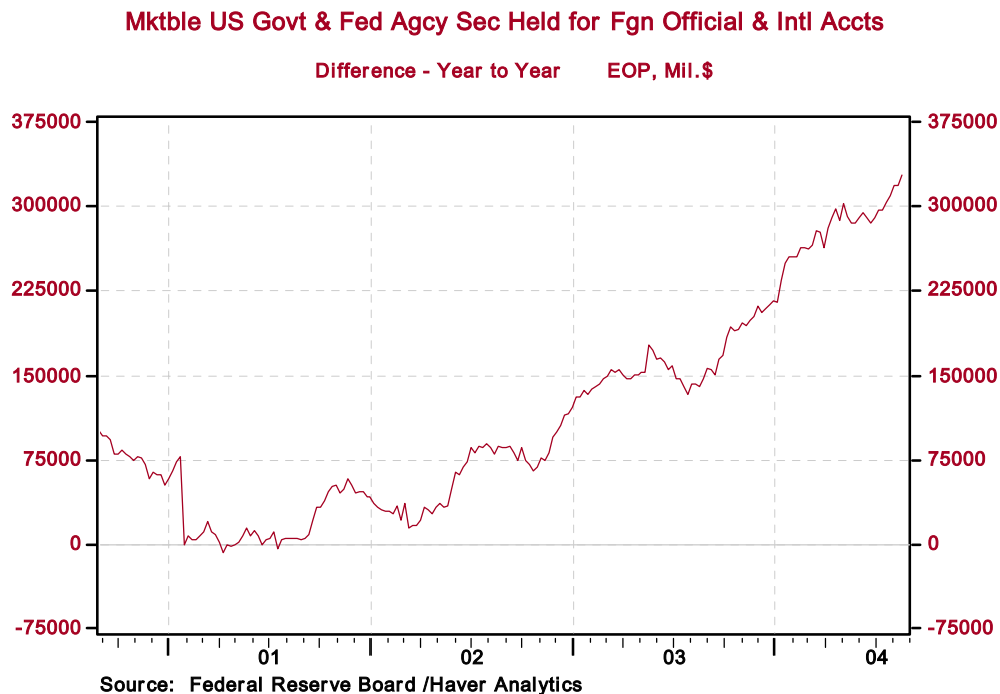
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August 23, 2004

How Long Will Foreign Central Banks Keep Financing Our Treasury Deficit?

In the three weeks ended August 18, holdings of U.S. government and agency securities by foreign official accounts (mostly foreign central banks) in custody accounts at the New York Fed increased by \$34.7 billion. In the 52 weeks ended August 18, these custody holdings increased \$328.3 billion (see Chart 1). Primarily, Asian central banks have been the buyers of these securities. Why have these Asian foreign central banks gone out of their way to mightily help finance our federal and current account deficits? Is it a vote of confidence in the management of the U.S. economy? Hardly. These Asian central banks have become the marginal buyers, or *de facto* buyers of last resort, of excess U.S. dollar balances in the global economy. If these Asian foreign central banks had not purchased these greenbacks and recycled them into U.S. government and agency securities, the dollar would be lower in value vs. their currencies and U.S. interest rates would be higher. The reason Asian central banks have been willing to help us out is that they have perceived that their economies would suffer if the dollar were to sink too rapidly in that their exports would be adversely affected.

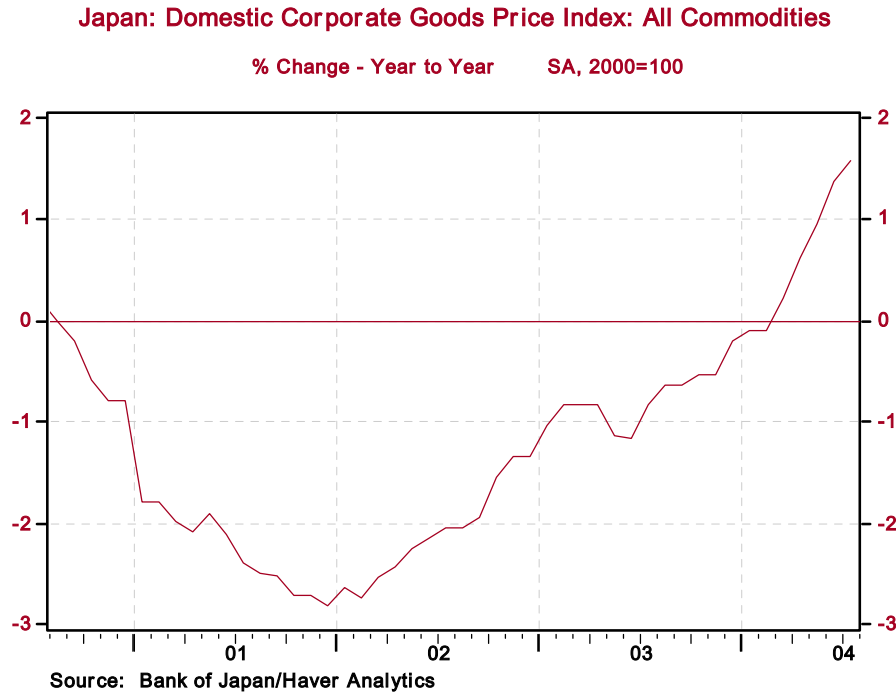
Chart 1



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Is there something that could diminish the willingness of foreign central banks to keep supporting the dollar and our government bond market? You bet – inflation. As shown in Chart 2, after several years of declining wholesale prices, those prices are now advancing at a 1.6% annual rate in Japan. Although Japanese consumer prices still are falling, the rate of decline has slowed. It is only a question of time before rising Japanese wholesale prices morph into rising Japanese consumer prices. A rising yen against the dollar would temper the rise in Japanese wholesale prices, especially rising crude oil prices in yen terms. My bet is that by midyear 2005, the Bank of Japan will have lost its appetite for dollar and U.S. government securities. At that point, the dollar is likely to take a dive and so, too, will U.S. Treasury prices.

Chart 2



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