

International Economic Trends

August 2003



Is the Current Account Deficit Weighing on the Dollar?

The United States has run current account deficits since the early 1990s. But only in the last couple of years have these deficits assumed extraordinary proportions. From the second quarter of 2002 through the first quarter of 2003, the U.S. current account deficit has been 4.8 percent of GDP.

A country with a *current account* deficit has more imports of goods and services than exports and net receipts of transfers from abroad. Any current account deficit must be matched by a *financial and capital account* surplus. In other words, a country with a current account deficit surrenders claims on future income—such as physical assets, stocks, and bonds—to foreigners. The ongoing U.S. current account deficit of 4.8 percent of GDP translates into an average of \$1.6 billion in net capital imports per business day. That is, foreign investors have been accumulating U.S. assets at an unusually high rate.

Foreign investors might become wary of holding increasingly larger portions of their wealth in U.S. assets. In order to promote continued investment in the United States, U.S. assets would then have to become more attractive. One way of attracting foreign investment is to lower the price of the asset in foreign currency terms. A decline in the foreign exchange value of the dollar would do just that. Therefore, a large current account deficit might be expected to depress the value of the dollar over time. But what about the current account deficit?

Caroline Freund studied 25 episodes of current account reversals of industrialized countries during the period 1980-97.¹ The study covers only cases in which a current account deficit that peaks at 2 percent of GDP or more subsequently reverses direction by at least 2 percent of GDP within three years. The author finds that, when a current account deficit approaches 5 percent of GDP, that country's real exchange rate—the exchange rate weighted by trading partners and adjusted for differences in the rates of inflation between that country and its trading

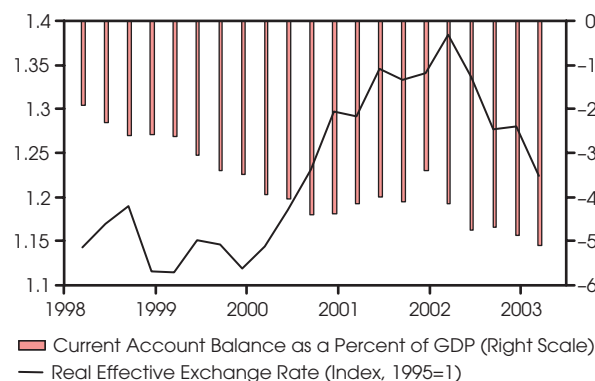
partners—starts depreciating. Typically, the current account starts to reverse toward balance one year after the onset of the currency depreciation. Three years after the peak deficit, most of the countries show a nearly complete reversal to a balanced current account.

The chart shows the real effective U.S. dollar exchange rate and the U.S. current account balance as a percentage of GDP for the period 1998:Q1 through 2003:Q1. In spite of a current account deficit in the neighborhood of 4 percent of GDP, the real effective value of the U.S. dollar appreciated considerably from 2000 to early 2002; subsequently, the dollar started declining amidst further widening of the current account deficit (to about 5 percent of GDP). If the United States follows the typical pattern of current account reversals, then we can expect that during the next three years the real effective exchange rate will keep depreciating and the current account deficit will swing back to balance.

—Frank A. Schmid

¹ Freund, Caroline L. "Current Account Adjustment in Industrialized Countries." International Finance Discussion Paper No. 692, Board of Governors of the Federal Reserve System, December 2000. www.federalreserve.gov/pubs/ifdp/2000/692/ifdp692.pdf.

Current Account Balance and Exchange Rate



NOTE: Quarterly observations: first observation, 1998:Q1; last observation, 2003:Q1.

SOURCE: Bureau of Economic Analysis (Current Account Balance and GDP), International Monetary Fund (Real Effective Exchange Rate).