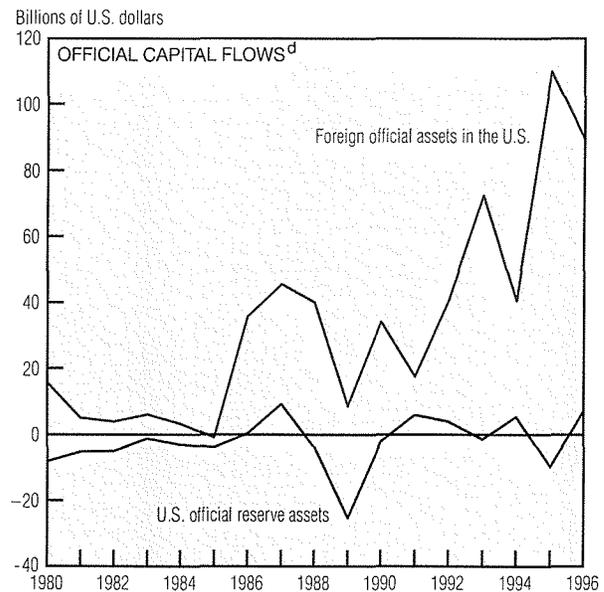
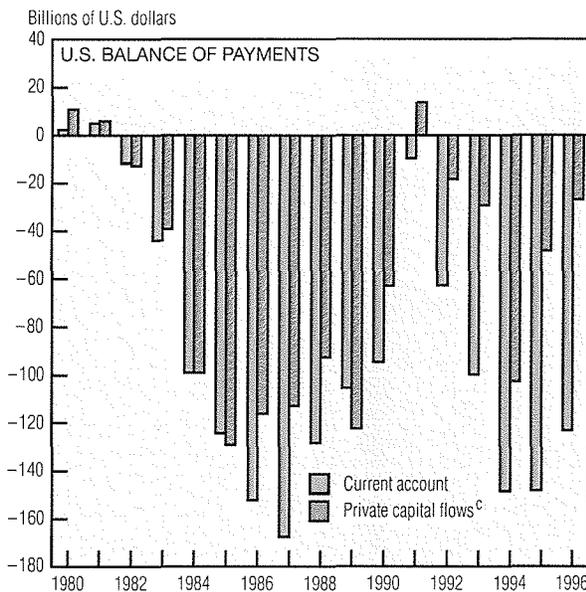
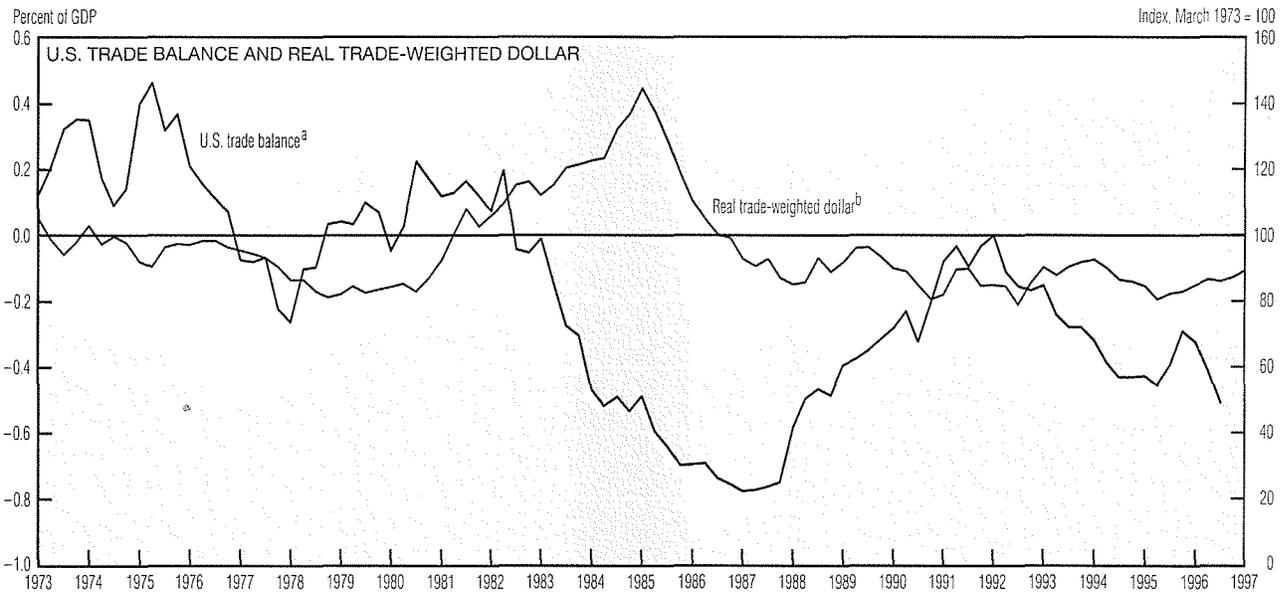


The Current Account and the U.S. Dollar



a. Trade in goods and services.
 b. Quarterly average of monthly data.
 c. Private capital flows have signs reversed and include the statistical discrepancy as unrecorded capital flows. Positive values represent a capital outflow.
 d. Positive values represent a capital inflow.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

Observations that the dollar is overvalued imply that its current level is unsustainable and that its recent path is inconsistent with a growing U.S. current account (trade) deficit. Since mid-1995, the real (inflation-adjusted) dollar has appreciated 10%, while the trade deficit has widened by \$6 billion. Much of this appreciation reflects dollar movements against the Japanese yen. Unfortunately, the relationship between the dollar and the trade deficit is neither as clear nor as un-

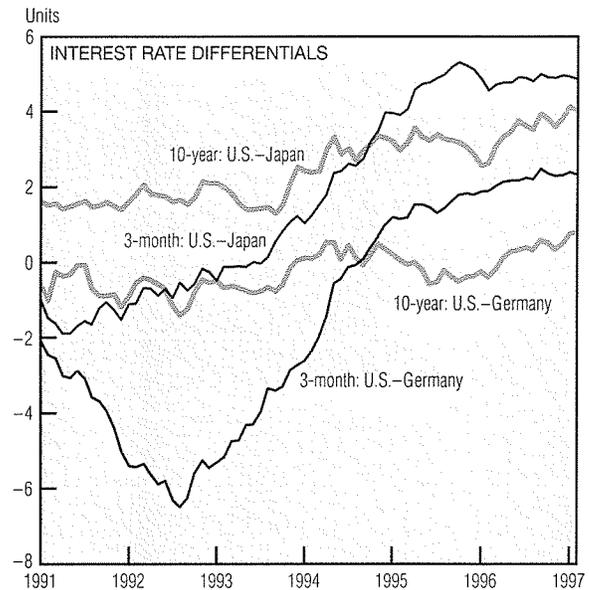
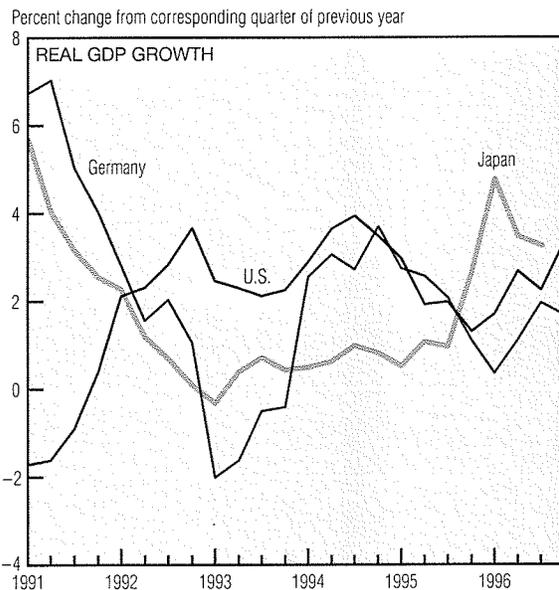
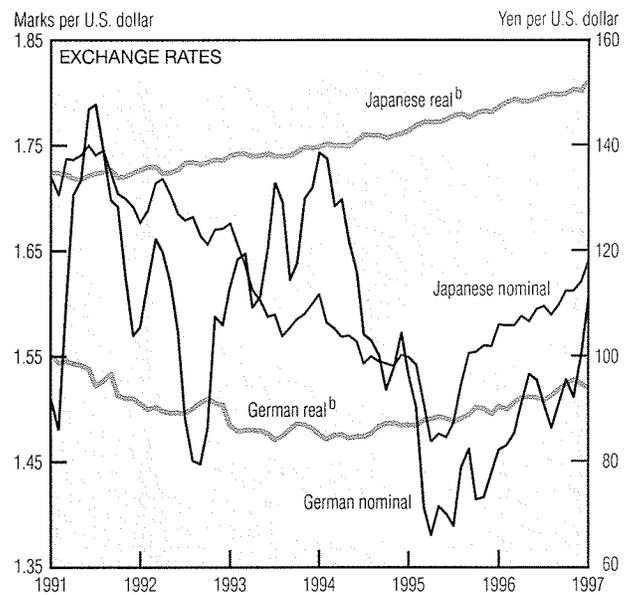
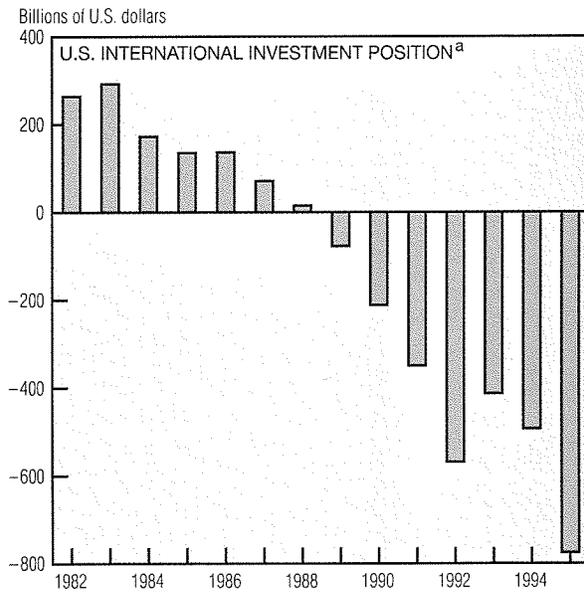
ambiguous as many pundits would have us believe.

A country running a trade deficit is absorbing—through its consumption and investment—more of the world's resources than it is producing. Such a country is also spending beyond its current income and must borrow from abroad to finance that expenditure. This economic fact of life guarantees that a net inflow of foreign capital will always exactly match a current account deficit in a nation's balance of payments.

A country may incur a current account deficit through various routes, each with different implications for its exchange rate. If, for example, domestic demand initially increases, imports will expand, the domestic currency will depreciate, and the trade deficit will grow. Domestic interest rates may also rise to attract the counterbalancing inflow of foreign capital. This standard view holds that the dollar depreciates when the U.S. trade deficit widens.

(continued on next page)

The Current Account and the U.S. Dollar (cont.)



a. Direct investment recorded at market value.

b. The real exchange rate is calculated using consumer prices for Germany, Japan, and the U.S. The base period is November 1991.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor; Bank of Japan; Statistics Bureau of the Japanese Prime Minister's Office; Statistisches Bundesamt; Deutsche Bundesbank; and Board of Governors of the Federal Reserve System.

Alternatively, suppose that improved investment opportunities attract an inflow of foreign capital. The domestic currency may appreciate, making domestic goods more expensive relative to foreign goods and striking the balance between increased capital inflows and a larger trade deficit. This second case connects a dollar appreciation to a U.S. trade deficit.

Which scenario best describes the U.S. position is unclear, but over the recent business expansion, real economic growth and interest rate dif-

ferentials have favored an inflow of foreign capital. Nevertheless, an expanding inflow of foreign official capital—not private capital—has financed our current account deficits since 1994. Conceivably, without this influx, we might have observed some alternative configurations of higher interest rates and lower dollar exchange rates.

In any case, as a current account deficit persists, the world accumulates claims on the future output of the deficit country. Eventually, as happened to the U.S. in the late

1980s, that country becomes a debtor. If debts pile up, creditors may hesitate to acquire additional debt unless the risk premium also increases. At this point, either higher interest rates, currency depreciation, or some combination of the two will become necessary to attract additional foreign savings. The dollar's exchange rate may depend more on our accumulated stock of international debts than on our current trade deficits, but the point at which our debts become problematic is difficult to predict.