The U.S. current-account deficit widened from $96.2 billion in 1999:IVQ to $102.3 billion in 2000:IQ. This movement reflects a decrease in the surplus on the services balance combined with an increase in the goods deficit. This rapidly increasing goods deficit, resulting primarily from imports to the U.S., almost completely accounts for the sharp increase in the current-account deficit since 1997. Imports have been boosted by rising incomes and by a strong dollar that makes imports to the U.S. cheaper and exports more expensive.

The sustainability of the U.S. current-account deficit concerns many analysts. The counterpart of this deficit is a strong capital inflow, which can be seen as financing consumption of imports in excess of exports. One can also view capital inflows as a vote of confidence in the U.S. economy that might, in turn, explain the strength of the dollar. This latter view implies that the trade deficit is less worrisome so long as the dollar remains strong.

The dollar’s international value is also related to differences in interest rates between countries. A major concept in international finance is uncovered interest rate parity—the notion that interest rate differentials must be balanced by expected changes in currency exchange rates. This concept implies, for example,

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International Developments (cont.)

that if U.S. interest rates are higher
than Japanese, market participants
must expect the yen/dollar exchange
rate to decline. According to this
view, recent increased differentials
between U.S. interest rates and those
of Germany and Japan suggest that
the dollar is expected to depreciate
more than before.

Researchers have found little evi-
dence of a link between short-term
interest rate differentials and ex-
change rate movements. However,
there is stronger evidence of a link
between longer-term interest rates
and longer-term movements in cur-
rency values. Thus the recent, re-
latively abrupt increase in the dif-
ference between 10-year interest
rates in the U.S. and those in Ger-
many and Japan might indicate ex-
pectations of a longer-term decline
in the dollar.

Petroleum products form a major
component of the recent decline in
the U.S. goods balance. The volume
of petroleum imports has risen
sharply since 1999, with prices in-
creasing at a faster rate than other
import prices or even overall con-
sumer prices.

The importance of petroleum
price increases depends largely on
whether they are expected to be
temporary. The positive correlation
between the Import Price Index for
petroleum and the 10-year U.S.
Treasury bond yield is consistent
with an increase in expected infla-
tion imbedded in the bond yield. On
the other hand, interest rates may
have risen partly in anticipation of
increased inflation.

SOURCES: U.S. Department of Commerce, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Deutsche Bundesbank; Japan
Securities Dealers Association; and Association of Call and Discount Companies/Nihon Keizai Shinbun (Nikkei).