The U.S. dollar continues to decline, particularly against other major currencies. In December, the dollar reached a new low against the euro. Despite this decline, the current account deficit grew for the second straight year in 2003, primarily because of a trade deficit in goods. Many analysts would agree that the current account deficit, as a proportion of GDP, cannot grow indefinitely. Some research has shown that historically, reversal occurs when the current account deficit reaches about 5% of GDP, slightly below where it stands now. In 1986, the deficit reached 3.5% before falling. These may not be good guidelines for the future, however. As Federal Reserve Chairman Greenspan said in a recent speech, “our debt-raising capacity appears to be related to the reduced cost and increasing reach of international financial intermediation.”

Saying that the current account deficit cannot rise indefinitely is equivalent to saying that the capital account surplus cannot rise indefinitely, since they are tautologically equal. The surplus in the first two quarters of 2003 was financed by accumulating foreign-owned assets in the U.S. that exceeded the outflow of U.S.-owned assets abroad. In the third quarter, foreign claims on domestic assets fell, particularly in foreign direct investment and non-Treasury securities. The capital account surplus was virtually unchanged because outflows of U.S. assets owned abroad fell by almost the same amount. In short, foreigners seemed less willing to invest in non-Treasury domestic assets. If this trend continues, either the rate of return on domestic assets must increase, or the capital account surplus must fall. (continued on next page)
The strong economic growth of the U.S. compared to the rest of the world may be one reason the current account deficit has been able to increase as much as it has. According to U.S. Treasury Secretary John Snow, “when our economy is growing faster than Europe or Japan it means we are capable of buying more goods from them than they are buying from us.” Since the middle of 2001, GDP and stock market growth from the euro area and Japan have, in fact, lagged behind ours. However, while the U.S. trade deficit with the euro area has been rising predictably over this period, the trade deficit with Japan has been falling. Furthermore, net purchases of long-term domestic securities from Japan have been rising, whereas those from the euro area have been falling. This illustrates the fact that although the total current account deficit must equal the capital account surplus, the equivalence need not hold on a country-by-country basis.

Although our trade deficit with Japan has fallen—partly because of our increased trade with China—Japan continues to be the largest purchaser of long-term domestic securities, and its purchases of Treasury securities continue to grow relative to the rest of the world. China’s economy and exports have grown more than those of surrounding countries, but the stock indexes of the newly industrialized Asian countries have significantly outperformed China’s stock market this year—and ours as well, for that matter. China itself runs a large trade deficit with these countries and probably will have a small current account surplus in 2003.