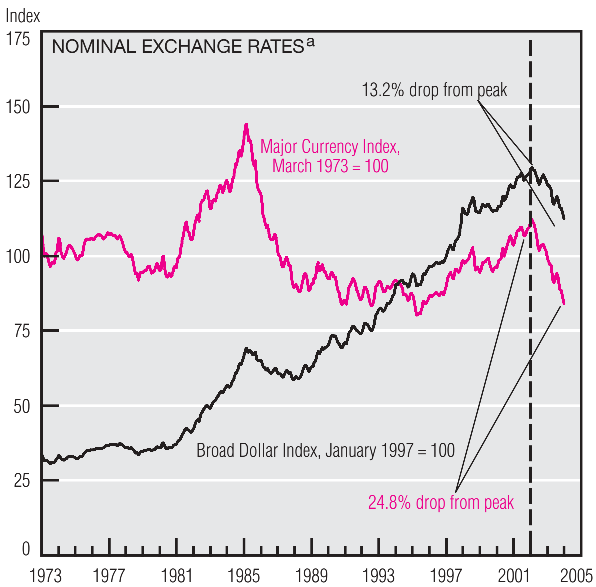
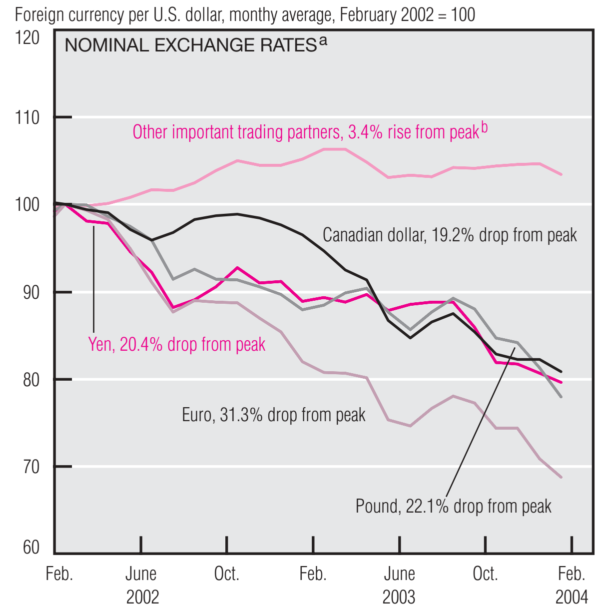
The Current Account and the Dollar





Balance of Payments (billions of dollars)

	Current account balance	Total net financial flows	Official financial flows	Private financial flows	Other items	Statistical discrepancy
2002:IQ	–426.9	446.3	26.5	419.8	–1.1	–18.3
2002:IIQ	–491.3	370.7	183.0	187.7	–1.1	121.8
2002:IIIQ	–490.9	684.8	30.2	654.6	–1.5	–192.4
2002:IVQ	–514.3	610.2	124.9	485.3	–1.4	–94.4
2003:IQ	–554.8	562.7	164.0	398.7	–1.6	–6.3
2003:IIQ	–557.6	600.0	229.0	371.0	–6.2	–36.2
2003:IIIQ	–540.2	493.2	175.3	318.0	–3.2	50.1
Change						
2002:IQ–2003:IIQ	–130.7	153.7	202.5	–48.9	–5.1	–17.9
2003:IIQ–2003:IIIQ	17.4	–106.8	–53.8	–53.0	3.0	86.3

a. Data through January 27.
b. Weighted average of a subset of Broad Dollar Index currencies that do not circulate widely outside the country of use.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases,* H.10.

The current account deficit narrowed in 2003:IIIQ, the first significant drop since the dollar began its recent decline. This pattern—smaller deficit, depreciating dollar—suggests that investors' diversification out of dollar-denominated assets has become a key underlying market development. When investors diversify out of dollar assets, the supply of dollars in foreign exchange markets outpaces the demand, and the dollar depreciates. This depreciation makes U.S. goods more competitive in world markets and narrows the current account deficit. All else equal, diversification could put upward pressure on real interest rates and make investment in the U.S. harder to finance. Although it will tend to raise the prices of traded goods, a dollar depreciation fueled by investor diversification need not signal an accelerating inflation rate.

Prior to last year's third quarter—between 2002:IQ and 2003:IIQ—the dollar depreciated, and the U.S. current account deficit widened as business activity in this country outpaced economic growth abroad. All else equal, when the U.S. grows faster than the rest of the world, our imports increase relative to our exports, and the current account deficit expands. As we buy more abroad than we sell there, the supply of dollars in the foreign exchange market outpaces the demand for them, and the dollar depreciates. Should it reappear and persist, this pattern of events would have few negative implications for real interest rates and investment but could be a harbinger of future inflation pressures.