The current account balance measures the combined balance on international trade, net foreign investment income, and net unilateral transfers to foreigners. Largely because of persistent trade deficits, the current account balance has fallen considerably over the last seven years, reaching 5.6% of GDP in the third quarter of this year. A current account deficit must be exactly offset by the combined surplus in the capital account and the financial account. (The financial account is the difference between the net inflow of foreign-owned assets in the U.S. and the net outflow of U.S.-owned assets abroad.) Since the capital account is small, relatively speaking, a current account deficit will very nearly equal a financial account surplus, except for measurement error.

The financial account feeds directly into the net international investment position (NIIP), the difference between U.S.-owned assets abroad and foreign-owned assets in the U.S. As foreign- and U.S.-owned assets have grown over time, changes in the valuation of these asset positions have come to play a larger role in year-to-year changes in the NIIP. For example, in 2003 the financial account showed a $546 billion surplus, but the NIIP declined only $198 billion. Since roughly half of U.S. assets abroad are held in foreign currencies, and most foreign-owned assets are dollar denominated, the direct effect of the 2003 dollar depreciation was an increase in the NIIP that offset nearly half of the negative contribution from the financial account.

The NIIP has nevertheless continued to fall relative to GDP. In recent

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years, the rate of return on domestically owned assets abroad has exceeded the rate of return on foreign-owned assets in the U.S. to such an extent that income receipts on the former have exceeded income payments on the latter. As the NIIP continues to fall, some analysts expect that the balance on income receipts and payments will soon become negative. The growth in this financing cost of accumulating net foreign debt, as measured by the NIIP, precludes an indefinite deterioration of the current account balance.

Current account reversals have often been preceded by currency depreciation. Dollar depreciation should put upward pressure on import prices and downward pressure on export prices (although changes often are not one for one and can occur with a lag). In 1985, the dollar began declining against major currencies; after peaking at more than 3% of GDP in 1988, the current account deficit fell and it was eliminated altogether by 1991. Since 1980, other industrialized countries have typically experienced currency depreciation before and during current account reversals. These reversals have tended to occur when the deficit reached about 5% of GDP and have often been accompanied by slower growth. Such a slowdown in the U.S. could have negative consequences for the world economy.