In 2005, the U.S. current account deficit will reach an estimated $783 billion or about 6.3% of GDP. Globally, current account balances must sum to zero. Less obviously, at the national level, the current account must equal the financial flows account because a country that runs a current account deficit must finance it by a financial inflow. There are two possible causes for the large U.S. deficit: Either the U.S. has a high demand for current consumption, which it must finance by borrowing from the rest of the world, or the rest of the world desires to invest in U.S. assets, which implies that we must run a current account deficit.

Which scenario is more likely? If the U.S. is demanding higher levels of consumption, then the dollar’s value might decrease when our residents must purchase foreign currency with dollars in order to buy foreign goods. On the other hand, foreigners’ desire to invest in U.S. assets could have the contrary effect—causing the dollar to appreciate—because the demand for dollars would be stronger. A quick look at the data cannot distinguish one story from the other. During the three-year period beginning in February 2002, the dollar depreciated substantially, which suggests that the dominant force behind the growing current account deficit was high U.S. consumption. Since February 2005, however, the dollar has stabilized and appreciated somewhat, which implies that strong foreign demand for U.S. investments is the dominant force behind the increase in the U.S. current account.