The Twin Deficits

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1. The trend in the US current account deficit is not sustainable

2. The increase in the deficit since 2000 is due to a fall in US National Saving (Fig. 1), which is in turn due to rising federal budget deficits. This level of deficits will continue, despite promises to the contrary.

3. In other words, we are faced with a repeat of the Twin Deficits of the 1980s. The parallels are extensive. In both cases, the administration launched permanent tax cuts, with little simultaneous discipline on the rate of growth of government spending (including – but not limited to -- spending that goes under the name “national security,” some of which is pork). In both cases the result was record budget deficits. (Fig. 2.)

4. The parallels include the shifting rationales for the tax cuts: at first Lafferite (i.e., the claim that there would be no increase in deficits), and then when large deficits materialize, a shift to the Starve the Beast rationale (i.e., the claim that budget deficits put downward pressure on government spending, more effectively than the alternative regime in place during the 1990s). One can see from Figure 3 that the Starve the Beast claim does not describe actual spending behavior. Spending as a share of GDP is cut under a budgetary discipline regime of “shared sacrifice” that simultaneously raises tax revenue; spending is not cut under a Starve the Beast regime that cuts taxes.

5. Use of the term “twin deficits” does not mean that current account deficits and budget deficits always move together. Nobody pretends otherwise, except to set up a straw man in order to be able to knock it down. Not all siblings are twins. Obviously the current account deficit and budget deficit don’t together if there is a big increase in investment, as there was in the US in the 1990s. But this does not describe the current decade, when the budget deficit has indeed led the current account deficit (nor the 1980s).

6. In some ways, the current bout of fiscal irresponsibility is worse than the 1980s:
   a. The retirement of the baby boom generation is that much closer.
   b. We now have other fiscal time bombs as well, such as phony sunsetting of tax cuts, the need to fix the AMT, and the proposed privatization of social security.
   c. The current administration seems to lack the ability (which the Reagan Administration and elder Bush did have) to perceive when reality diverges
from the speechwriters’ script and to respond by making a mid-course correction. To the contrary, the White House is proposing still more tax cuts.

d. Meanwhile, the US has lost the popular sympathy and political support of much of the rest of the world. In the past, deficits from imperial overstretch have been manageable because others have paid the bills for our troops overseas: Germany and Japan during the Cold War, Kuwait and Saudi Arabia in 1991. Now the hegemon has lost its claim to legitimacy in the eyes of many. Next time the US asks other central banks to bail out the dollar, will they be as willing to do so as Europe was in the 1960s, or as Japan was in the late 1980s after the Louvre Agreement?

e. A more speculative thought. Why has the increase in the US trade deficit this time (i.e., 2001-04) taken the form of lost exports, rather than rapidly rising imports as during 1981-2000? Are foreign consumers perhaps turning against US brand names?

7. Admittedly, the US has had to pay little or no price for its profligacy, so far. The dollar has depreciated a lot (2002-04); but, as of yet, that hasn’t pushed up inflation or interest rates.

8. By means of what policy prescriptions should current account adjustment be accomplished? The “dollar depreciation” vs. “budget cutting” choice is a sterile debate. Both policy shifts can affect the trade balance. As in the late 1980s, the desirable approach is a credible long-run path of deficit reduction together with depreciation. But the currently proclaimed path of deficit reduction (i.e., in half by 2009) is not in fact credible.

9. What about the question of the “second best” policy? If we take the budget deficit as given, perhaps some dollar depreciation is desirable -- e.g. what has already happened over the last two years, which will eventually show up in the trade balance (with a two-year lag, not a one-year lag). But the benefits are limited. Interest rates will rise. (Perhaps through higher inflation; but the pass-through coefficient has fallen, so the effect will more likely come through higher real interest rates.) Budget deficits mean that some sector of the economy must be crowded out to make room. Higher interest rates will transfer some of the crowding out from dollar-sensitive sectors (net exports) to interest-rate-sensitive sectors (domestic demand). Perhaps this is an improvement, in order for others to share more evenly the burden of crowding out that is now being borne exclusively by exporters, but only up to a point. In any case it is a second-order question.

10. The conference management asks, “Is there any role for policy coordination to help manage the adjustment process?” None of the coordination precedents fits particularly well. The European quid pro quo that is familiar from the Bonn Summit of 1978 and other occasions -- fiscal expansion – would not be appropriate this time around. Furthermore, the Plaza Agreement of 1985 is a less promising precedent than many seem to think, because the dollar is not now stronger than can be justified by fundamentals. A potential package today would include Asian central banks
together agreeing to let their currencies appreciate (each one being reluctant to do so on their own), and perhaps also the Europeans agreeing to stand by to rescue the dollar in case it goes into freefall, as under the Louvre Agreement. But the US is unlikely in any case to exercise the requisite leadership, and particularly unlikely to cut its budget deficit. Without the relevant “quo,” why bother discussing the “quid”?

11. The starting point of the diagnosis by Dooley, Folkerts-Landau, and Garber -- that today’s global monetary system is a new Bretton Woods, with East Asia playing the role that Europe played in the 1960s -- is right. But I think the diagnosis then goes wrong. I don’t agree with them that this can go on for a long time. It may be a Bretton Woods system, but we are closer to 1971 (the date of the collapse) than to 1944 (the date of the agreement) or 1958 (when convertibility was first restored). Here is why:
   a. Capital mobility is much higher now than in the 1960s.
   b. The US can no longer necessarily rely on the support of foreign central banks.
   c. There exists a credible rival for lead international reserve currency, the euro. It has many of the desirable characteristics of an international currency. This was not true in the late 1970s and early 1990s when the press feverishly speculated that the dollar might be overtaken by the yen or mark. If the UK and some other countries were to join EMU, the euro could eventually overtake the dollar.
   d. It is true that each Asian central bank stands to lose a lot, in the value of its current holdings, if dollar sales precipitate a dollar crash. But I agree with Barry Eichengreen that each individual participant will realize that it stands to lose more if it holds pat than if it joins the run, when it comes to that.

12. When will the dollar complete its descent? I don’t know. We could see a temporary reversal in the trend, a la Mundell-Fleming, when US interest rates rise.

13. I am more confident in predicting that the US bond market will suffer an abrupt decline before long. Until now it has been buoyed by three factors, all of which will come to an end:
   a. Easy monetary policy, i.e., Fed purchases of US securities
   b. The same thing from Asia: central bank purchases of US securities
   c. Investors may still be putting some weight on official government projections of declining future deficits. They have yet to internalize fully the dismal outlook in more objective forecasts.

When these factors come to an end, long term interest rates should rise to 6% or more (= 2% inflation + 2 ½% real short-term + 1 % normal term premium + 1% for an expected path of rising debt/GDP). That is not even counting the dumping of huge new quantities of US treasury bonds on the market to fund a transition to privatized social security accounts. Nor does it count possible unforeseen factors such as new instability coming from the Mideast or new oil price increases. It seems to me that a future crash is more likely to come in the bond market, because it is so clearly out of line today, than in the currency, equity or commodity markets, emerging markets, or even real estate markets. But all are vulnerable.
Figure 1:
National Saving, Investment, and Current Account, as Shares of GDP
Apparently when a Republican president comes in, the budget balance plummets.

**Figure 2: US Federal Budget Balance as Share of GDP**

Is the deficit pattern due to Democratic tax increases & Republican tax cuts? Not entirely. Spending is at least as important.

**Fig. 3: US Federal Spending as % of GDP, by Presidential Term**