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Deficits: Twins or Distant Cousins?

Large, persistent federal-budget and foreign-trade deficits have been two of the most prominent features of the U.S. economy in the 1980s. There has been considerable debate concerning the relationship between these deficits and their implications for the "health" of the economy in the long run and standards of living of future generations. From this debate two main opposing views have emerged.

One view is that the federal budget deficit caused the trade deficit to develop, allowing funds to be borrowed from abroad. This "twin deficits" school of thought argues that these foreign funds have supported rapid growth in current consumption and government spending, and that standards of living for future generations in the U.S. will be lower as a result.

The alternative view is that the trade deficit has been the result of improved investment opportunities in the U.S., which have led to increased foreign investment in this country and/or decreased U.S. investment abroad. In this view, then, the trade deficit is evidence of economic strength. The budget deficit is seen as a statistical curiosity of little importance, and only a "distant cousin" of the trade deficit.

This *Letter* presents the arguments that lie behind these two views. Although no consensus has developed concerning which of them is more correct, most economists would agree that the U.S. economy has benefited from the emergence of the trade deficit in the 1980s.

Twins

According to the "twin-deficits" hypothesis, the large federal budget deficit is responsible for the foreign trade deficit both directly and indirectly. Expansionary fiscal policy embodied in the federal budget deficit has led to faster growth in GNP and thereby contributed *directly* to an increased demand for imports in the U.S.

Most analysts have focused on the *indirect* effect of the federal budget deficit. They argue that the budget deficit caused the trade deficit to develop by raising real interest rates and the dollar exchange rate. By raising the federal government's demands on private credit markets, the budget deficit caused real, or inflation-adjusted, interest rates to rise. With higher expected returns available in the U.S. relative to abroad, international and domestic investors bid more aggressively for dollar-denominated assets relative to those denominated in other currencies, causing the dollar to appreciate. Moreover, the expectation that the U.S. government's credit demands would persist far into the future also may have contributed to the dollar's rise.

The higher dollar, in turn, made U.S. goods exported abroad more expensive and foreign goods imported into this country less expensive. The resultant rise in imports and fall in exports led to the U.S. foreign trade deficit.

By definition, the excess of our imports over our exports must be financed by an inflow of foreign funds. Thus, the development of the trade deficit was a mirror image of this net inflow. The availability of these funds mitigated, but did not eliminate, the upward pressure on real (inflation-adjusted) interest rates.

The drop in the private saving rate in the U.S. during the 1980s exacerbated the need for foreign funds. Although the causes of the decline in saving are a matter of debate, it seems clear that lower private saving put additional upward pressure on U.S. real interest rates and thereby contributed to the high dollar, the capital inflow, and the trade deficit.

No rosy future

According to the twin-deficits view, the overall pattern of saving and investment in the U.S. in recent years does not present an optimistic picture of the future. The rise in real interest rates reduced the rate of capital accumulation, although the inflow of foreign funds has kept interest rates from rising by as much as they otherwise would have. As a result, the funds obtained from abroad kept investment from being choked off; however, these funds also indirectly supported higher levels of consumption and government spending. The net effect of higher real interest rates and the inflow of foreign funds is that investment probably has been reduced to some extent, and certainly has not been enhanced.

The lower level of capital formation, in turn, probably has reduced the long-term growth prospects of the U.S. economy. Moreover, the build-up in foreign debt represents a substantial claim on the incomes of future generations. In combination, these developments suggest a decline in future standards of living. In effect, the twin-deficits view suggests that a burden will be placed on future generations of taxpayers, who will be forced to dip into lower incomes to pay for the high level of current spending that the present generation has enjoyed.

Distant cousins

The alternative school of thought sees the budget and trade deficits as two separate issues—or at most "distant cousins," rather than twins. Many economists who make this argument rely on a concept called Ricardian equivalence. Named after the great nineteenth century English economist, David Ricardo, who first described the concept, Ricardian equivalence posits that when the government finances an increase in expenditure through an increase in debt, the public responds by increasing saving enough to cover (the discounted present value of) the implicit future tax liability.

This implies that increased saving by the private sector in response to a budget deficit will prevent real interest rates from rising; the increased demand for funds in credit markets will be met by a higher supply of funds as the public saves more. Thus the link from the budget to the trade deficit is broken: since the budget deficit does not cause real interest rates to rise, it cannot cause either the dollar to appreciate or the trade deficit to develop.

Investment boom

If the budget deficit does not explain high real interest rates and the trade deficit, what does? The distant-cousins view suggests that Reagan fiscal policy provides an answer, but a very different one from that of the twin-deficits view. The cuts in marginal tax rates, and more generally, the free-market, anti-regulation attitudes of the Reagan Administration, it is argued, have reduced tax and regulatory distortions, enabling the U.S. economy to operate more efficiently and generate more output and income.

The greater productivity of resources, in turn, has led to increased demand for financial capital and higher real interest rates in the U.S. These higher returns have made dollar-denominated assets more desirable, raising the world-wide demand for dollars and driving up the dollar exchange rate. The higher dollar has caused the trade deficit to develop, thereby allowing capital to flow in from abroad.

Given that foreign capital is viewed as having flowed into the U.S. to finance investment in plant and equipment, the increase in foreign indebtedness is unlikely to be a burden on future generations. The expansion in our capital stock associated with the inflow of foreign funds is adding to the future rate of growth of the economy, and thus should generate the income necessary to retire the debt, while still allowing for higher living standards in the future.

Thus, although the Reagan tax cuts probably contributed to the federal budget deficit, Ricardian equivalence suggests that the budget deficit has not had an effect on the saving-investment balance, nor on the long-run prospects for the U.S. economy.

Evidence

Clearly, both views can explain the simultaneous rise in the budget and trade deficits, as well as the high levels of real interest rates and dollar exchange rates. Moreover, both views can explain the rapid growth in the economy over the past six years. The twin-deficits view relies on the standard, business-cycle effect of expansionary fiscal policy: increased aggregate demand associated with expansionary fiscal policy stimulated real GNP growth. The alternative view suggests that increased aggregate supply associated with higher capital formation has provided the stimulus to spending that has propelled real GNP.

These two views have different implications for the long-run growth rate of the economy. Under the twin-deficits view, there is no reason to assume that long-run growth has been raised by developments in recent years, since rapid growth represents only a normal cyclical response to demand factors. The alternative view suggests that real GNP permanently may be growing more rapidly. Unfortunately, it is not possible yet to determine statistically whether the rate of real GNP growth has changed permanently.

Another way to determine which view is correct is to analyze the evidence on whether previous government deficits have been associated with high real interest rates, trade deficits, and low private saving rates in the U.S. and in other countries. Unfortunately, despite much research on the subject, evidence can be found to accept or reject the implications of both views, and thus is currently of little help.

Some economists have attempted to discredit the twin-deficits view by pointing out that the federal budget deficit really has not been as large in the 1980s as it appears to have been. Serious measurement errors exist in official budget data. For example, no distinction is made in the federal budget between current and capital expenditures, and the officially stated federal receipts do not include the "inflation tax" that is "raised" when the government is able to pay back its debt in dollars with eroded purchasing power. Proponents of the twin-deficits hypothesis counter that even after the budget is adjusted to account for these factors, the (high-employment) federal budget moved sharply from surplus to deficit in the early 1980s.

Economists also have examined the data on saving and investment in the 1980s for clues as to which view of the budget and trade deficits is correct. Investment in plant and equipment does show rapid growth, as would be predicted by the view that enhanced investment opportunities explain the trade deficit. However, investment normally rises rapidly in economic expansions, and has risen by no more than the average amount registered in post World War II expansions in the U.S. Although this observation would seem to contradict the distant-cousins view, some economists have argued that investment has been quite rapid, given the high real-interest-rate environment. The contrary position is that such an argument depends on the particular investment equation one chooses, and is subject to considerable controversy.

A similar debate exists with respect to the private saving rate. Contrary to the prediction of Ricardian equivalence, the officially measured saving rate actually has declined as the budget deficit has risen. This evidence suggests that the linkage between the budget and trade deficits has not been broken by increased private saving, so the budget deficit may well have been a driving force in the U.S. economy in the 1980s. However, some economists argue that without the budget deficit, the private saving rate would have fallen even more than it did, and that the Ricardian effect was important. Again, however, these assertions are based upon controversial econometric models of saving.

Benefits of the trade deficit

Although the debate among economists about what caused the trade deficit is not resolved, both schools of thought can agree that the emergence of the trade deficit has been beneficial for the U.S. economy in the 1980s. Under the distant-cousins hypothesis, the emergence of the foreign trade deficit permitted an inflow of foreign funds that were used for increased investment in the U.S. In this sense, the trade deficit has been highly beneficial to the U.S. economy.

Under the "twins" hypothesis, the trade deficit also had beneficial effects. In the face of large budget deficits and low personal saving rates, the inflow of foreign capital associated with the rise in the trade deficit kept real interest rates from rising even more than they did. Without this foreign capital, even more business spending on plant and equipment would have been choked off, further dimming the longer-run prospects for growth of the U.S. economy.

These considerations argue forcefully against protectionist trade legislation. Such legislation could seriously restrict the flow of goods and capital internationally, significantly raise interest rates, and reduce prospects for economic growth in the U.S. and around the world.

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