

Budget and External Deficits:  
Not Twins but the Same Family

Edwin M. Truman\*  
Senior Fellow  
Institute for International Economics  
Prepared for  
The Macroeconomics of Fiscal Policy  
Federal Reserve Bank of Boston  
Annual Research Conference  
June 14-16, 2004

**Introduction**

The United States has had a current account deficit for most of the past thirty years.<sup>1</sup> Since 1969 the deficit has averaged 1.5 percent of GDP -- 2.9 percent over the past 10 years -- and it is generally projected to be about 5 percent of GDP in 2004. As a result, the US net asset/liability position or net international investment position (NIIP) turned negative after the mid-1980s, and has been heading south ever since, reaching about minus 25 percent of GDP at the end of 2002.<sup>2</sup> What is new is the reemergence of substantial US fiscal deficits for the first time since the mid-1990s. Does this mark the return of the external deficit's twin?

In this paper, I first argue that the two deficits are linked through the saving-investment identity in the national income accounts, but they are not analytical or behavioral twins. That is, when the supply of government saving declines (the fiscal deficit increases), the net inflow of foreign saving (the external or current account deficit) does not necessarily change either dollar for dollar or with the opposite sign. Both deficits are part of the same family in the sense that they are both US problems although they are also problems for the rest of the world.

---

\* Thanks go to Frabrizio Iacobellis and Gunilla Pettersson for research assistance on this paper. I have also benefited from comments by Martin Baily, Ralph Bryant, Joseph Gagnon, Morris Goldstein, and Catherine Mann. Errors of fact and interpretation remain my own.

<sup>1</sup> The current account, as now computed, was in surplus in 1970. It returned to surplus in 1973-76 induced by the dollar's devaluation and a US recession, and again in 1980-81, induced by the same two influences, and most recently in 1991, because of a large net inflow of Gulf-War-related transfer receipts.

<sup>2</sup> It is hazardous to forecast the NIIP estimate for the end of 2003, which will be released at the end of June 2004. Estimates are sensitive to the behavior of equity markets, but also to dollar depreciation, which boosts the net dollar value of investments abroad.

Second, at their present rates, neither deficit is sustainable. However, this observation provides little insight into how long they can or will continue.

Third, with respect to economic implications, failure to correct the fiscal deficit would have adverse effects on growth and on the standard of living in the medium and longer term in the form of higher real interest rates, lower investment, and lower potential output.

Fourth, failure of the external deficit to narrow is likely to have milder negative effects over the same timeframe; the gap between GDP and GNP (GDP less net income payments abroad) will widen, but GNP would continue to expand. Because of the costs and uncertainties associated with shifting resources from the non-traded to the traded goods and services sector, correction of the external deficit via exogenous exchange rate adjustment, in the absence of a change in fiscal or other policies, would likely involve negative effects on growth and the US standard of living.<sup>3</sup> By assumption, net inflows of foreign saving to the United States would decline, real interest rates would be higher, and investment and potential output lower. Even as the gap between GDP and GNP narrowed, the growth rate of GNP would probably slow.<sup>4</sup>

Fifth, prompt correction of the fiscal balance in the short run would entail slower growth, but it would be positive for growth and the standard of living over the longer run compared with delayed adjustment. Prompt correction of the external deficit via exchange rate adjustment, even if it occurs smoothly, is likely to be associated with lower near-term growth. A delayed correction of the external deficit may involve larger macroeconomic costs of transition to a sustainable position.

Finally, with respect to policy implications, smooth, low-cost correction of the US current account deficit would be facilitated by prompt correction of the fiscal deficit. An optimal strategy would be to seek delay in external adjustment until the fiscal adjustment is well in hand. However, while current account adjustment is inevitable, it is also endogenous, and we may not have the luxury of time to achieve optimal sequencing.

---

<sup>3</sup> At full employment, if the narrowing of the external deficit occurred as the result of acceleration in growth abroad, these effects might be somewhat ameliorated.

<sup>4</sup> If the increase in the negative NIIP had produced a large risk premium on US liabilities on average as well as on the margin that subsequently was substantially reduced, this might not be the case.

## Are the deficits related?

Dudley and McKelvey (2004, 7) recently articulated the twin-deficits view:

[T]he budget and trade deficits are intertwined. Chronic budget deficits create a shortfall of domestic saving. This leads to higher interest rates, a stronger dollar, and foreign capital inflows. In this way, the initial budget deficit becomes transformed into twin budget and trade deficits.

Figure 1 depicts in the top panel gross government saving and the net inflow of saving from abroad (the external or current account deficit) and in the bottom panel gross investment and gross private saving. The data are from the national income and product accounts (NIPA).<sup>5</sup> Gross government saving is federal saving plus state and local saving.<sup>6</sup> The net inflow of foreign saving from abroad (foreign saving for short) is the NIPA translation of the current account balance with the sign reversed. Thus, the figure summarizes the key components of the saving-investment identity.<sup>7</sup>

Visual inspection of figure 1 reveals that government and foreign saving do not generally move in the opposite direction. In fact, their annual levels and changes as a percent of GDP are positively correlated at 0.04 and 0.22 respectively, but not significantly.<sup>8</sup>

Consider three episodes of large changes in government saving over the past 25 years:<sup>9</sup>

- From 1979 to 1983, government saving declined by 4.4 percent of GDP; from its low in 1980 to 1987, the net inflow of foreign saving rose by 3.6 percent of GDP. This was the heyday of the twin-deficits

---

<sup>5</sup> Some might prefer to use net saving and investment concepts, but this distorts the overall picture because no corresponding adjustment is made to inflow of saving from abroad. Others might prefer stock concepts, for example, changes in wealth, but the accounting framework and statistical base for such analyses are not well developed for open economies.

<sup>6</sup> Most of the action in gross government saving comes from the federal sector.

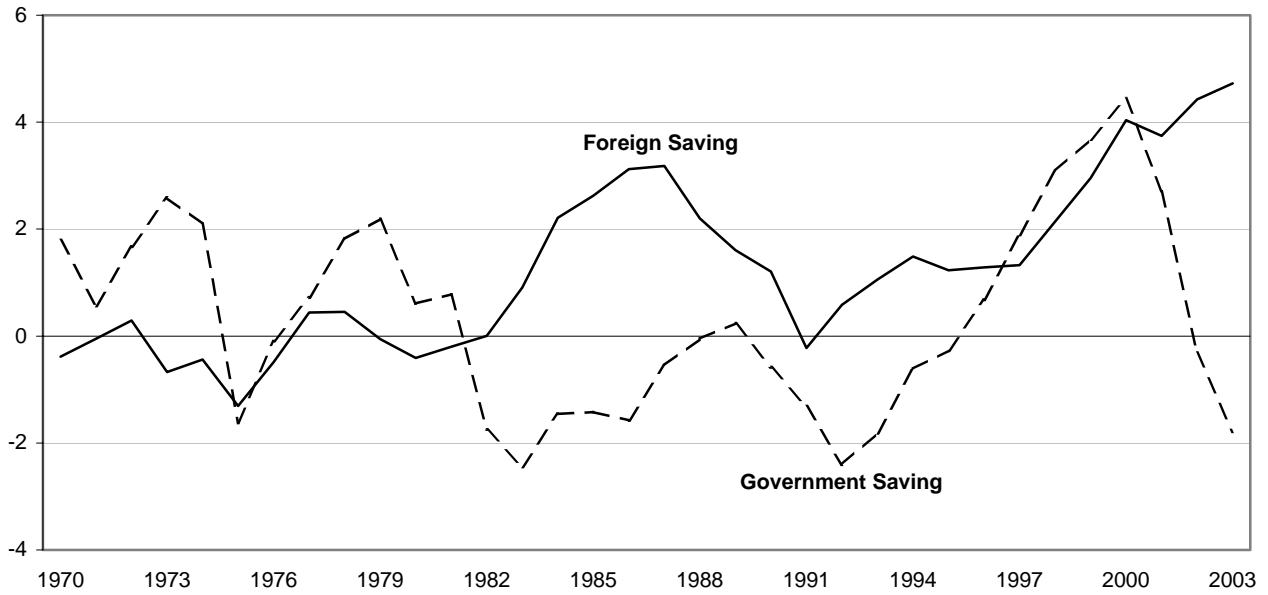
<sup>7</sup> Private saving is presented alone and minus the statistical discrepancy; combining the statistical discrepancy with private saving does the least visual damage.

<sup>8</sup> In dollar terms, the correlations are also positive at 0.32 and 0.04 for levels and changes respectively; only the first is significant.

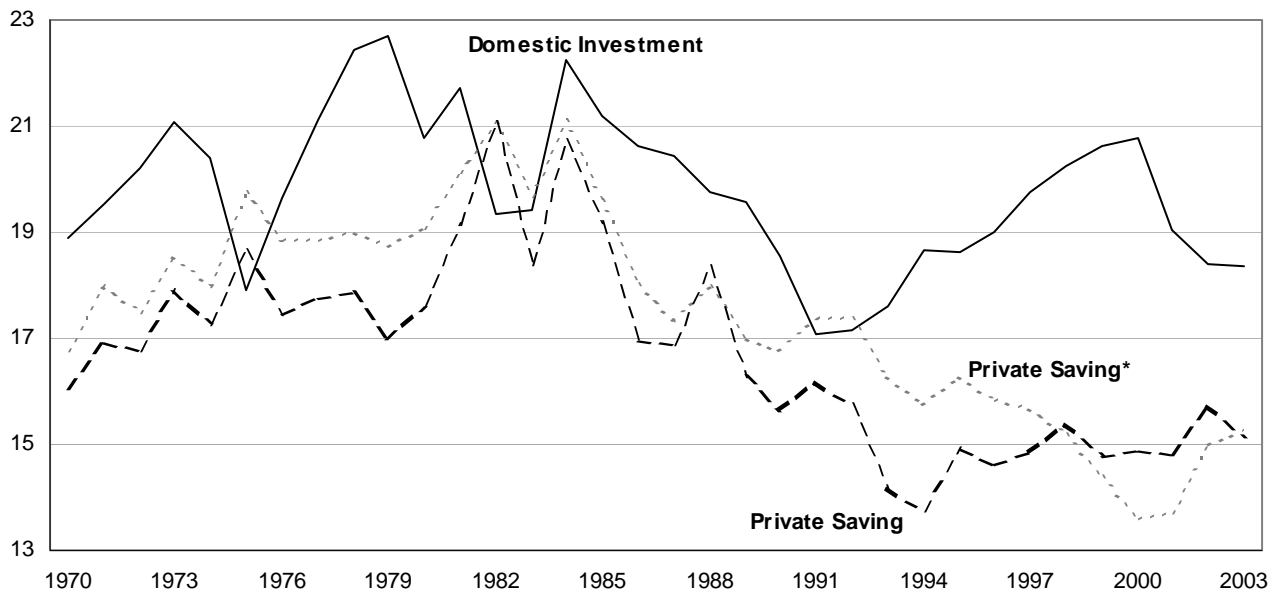
<sup>9</sup> Of course, during each of these episodes more than fiscal policy was affecting government saving and net inflows of foreign saving. For example, business cycles affect government saving as well as the current account. According to the IMF's WEO database, the US general government structural deficit widened by 3.8 percent of GDP from 1981 through 1986, tightening the twin-deficits pattern. However, the improvement from 1992 to 2000 was 5.3 percent of GDP, and the deterioration from 2000 to 2003 was 4.5 percent of GDP, providing little support for the twin-deficits hypothesis.

**Figure 1: U.S. Gross Saving and Investment 1970-2003**  
(percent of GDP)

**A. Foreign Saving and Government Saving**



**B. Investment and Private Saving**



\*Private saving minus the statistical discrepancy.

Source: Bureau of Economic Analysis, National Income and Product Accounts

story, but the story is somewhat undercut by the fact that from 1983 to 1987 government saving actually rose by 1.9 percent of GDP.

- From 1992 until 2000, government saving increased by 6.8 percent of GDP while foreign saving also increased by 4.6 percent of GDP, suggesting that something other than the twin-deficits phenomenon was occurring.
- From 2000 to 2003, government saving declined by 6.3 percent of GDP while foreign saving increased by only 0.7 percent of GDP, which also is not fully consistent with the simple twin-deficits story.

During these three episodes not only was fiscal policy changing in the United States but also policies were changing in the rest of the world, and other developments were affecting the global economy. Consider a few examples to illustrate the basic point that there is no necessary systematic relationship between the behaviors of the two deficits. Figure 2 presents a two-by-two matrix. On the side are increases or decreases in government saving (toward fiscal surplus or deficit). Across the top are increases or decreases in foreign saving (toward external, or current account, deficit or surplus).

**Figure 2: Analysis of Twin Deficits**

<b>Government Saving</b>	<b>Net Inflow of Foreign Saving</b>	
	<b>Increase</b>	<b>Decrease</b>
<b>Increase</b>	Toward Fiscal Surplus & External Deficit	Toward Fiscal Surplus & External Surplus
<b>Decrease</b>	Toward Fiscal Deficit & External Deficit	Toward Fiscal Deficit & External Surplus

The twin-deficits case involves an increase in discretionary US government spending with no monetary accommodation.<sup>10</sup> Government saving decreases because of the expenditure expansion, and the net inflow of foreign saving increases (current account deficit widens) because the boost to income sucks in more imports; see the lower left-hand box. In addition, the interest rate rises, which tends to appreciate the dollar; net imports increase more and some of the potential increase in the interest rate is ameliorated by an even larger inflow of foreign saving in the form of a transfer to the rest of the world of claims on the United States. How all this works out in a general equilibrium context in the short, intermediate and longer term depends on assumptions about various lags, sticky prices or wages, expectations formation, and balance sheet constraints that may or may not be satisfied over particular time horizons.

Sticking with the short-term, consider impacts on the rest of the world. Treating the rest of the world as a single country with unchanged policies, it moves toward external surplus (a decrease in the use of foreign saving) and government saving increases; see the upper right hand box. Because the United States is a large country, the initial fiscal expansion tends to push up both US and foreign interest rates with adverse effects on investment and potential GDP in both countries.<sup>11</sup>

Consider a second case: a positive productivity shock in the United States. This stimulates investment but also raises the real interest rate. Government saving increases (the fiscal deficit shrinks) and the net inflow of foreign saving increases (the external deficit widens); see the upper left hand box. In the rest of the world, the net inflow of foreign saving is reduced (the external deficit narrows), but government saving increases as well; see the upper right hand box. Again, interest rates rise in both countries, but the rise is associated with an increase in investment and potential GDP in the United States, but the opposite in the rest of the world.<sup>12</sup>

Thus, the two deficits need not move systematically together. On the other hand, the United States has both.

---

<sup>10</sup> The liability side of the central bank's balance sheet is unchanged.

<sup>11</sup> The situations would be reversed if the fiscal expenditure expansion were abroad.

<sup>12</sup> Again, the situations would be reversed if the positive productivity shock were abroad. Moreover, if there were a negative productivity shock abroad, the rest of the world would move toward fiscal deficit and external surplus. In the United States, government saving also would decrease and the net inflow of foreign saving would increase, placing the United States in the twin-deficits box in the lower left hand corner via another route.

## **Are the Deficits Sustainable?**

Neither the US budget deficit nor the US current account deficit is likely to be sustainable at their current rates of roughly 5 percent of GDP. Herb Stein's famous remark is regularly quoted to reassure us that what is unsustainable will not continue indefinitely. What is more difficult to assess is how long either type of deficit can continue on a substantial scale and whether there are differences with respect to their sustainability.

### ***The External Deficit***

On the external side, dating back to before I left the Federal Reserve in 1998, when the current account deficit was only 2.3 percent of GDP, it was accepted that our external deficit was not indefinitely sustainable at that rate. Freund (2000) and Mann (1999) concluded from their studies of the experiences of other industrial countries that pressure for correction often arises when external deficits are in the range of 4 to 5 percent of GDP.

In recent remarks, Greenspan (2003 and 2004b) has emphasized three points. First, one cannot predict with any precision how long external deficits and a growing negative net international investment position (NIIP) can be sustained. Second, the adjustment process most likely will be triggered by the reluctance of foreign country investors to continue to accumulate net claims on the United States. Third, the increased openness of the global financial system has contributed to a reduction in home bias.<sup>13</sup> This trend implies that deficits and surpluses could pile up for a longer period than in the past before a process of adjustment or correction begins. Greenspan (2004a, 4) also argues, "We may not be able to usefully determine at what point foreign accumulation of net claims on the United States will slow or even reverse, but it is evident that the greater the degree of international flexibility, the less the risk of crisis."

There is no consensus about the size of any US external adjustment once it gets underway. Truman (2004) describes a number of views, which range from moving the US current account position into surplus and paying down some of the net external debt that has already accumulated to merely reducing the deficit to less than 4 percent of GDP.

---

<sup>13</sup> Greenspan (2004b, 5) reports a decline in the GDP-weighted correlation of saving and investment rates among OECD countries from 0.97 in 1970, and 0.96 as recently as 1992, to 0.80 in 2002.

Several considerations are relevant. One can ask what it would take to stabilize the ratio of the NIIP to GDP at the level of minus 25 percent that prevailed at the end of 2002. If the normal or trend nominal growth rate of the US economy is 6 percent, then the ratio could be stabilized at a current account deficit of 1.5 percent of GDP.<sup>14</sup> With net transfer payments of 0.5 percent of GDP and negligible net income payment or receipts, this would mean that the United States could still have an annual trade deficit of 1 percent of GDP and stabilize the NIIP ratio.

However, the US NIIP consists disproportionately of interest bearing dollar-denominated liabilities. The total was about \$2.5 trillion at the end of 2002, and probably rose by at least another \$300 billion in 2003. These net liabilities are predominantly short-term. At the abnormally low nominal dollar interest rates of recent years, the financial cost of those liabilities has been understated. At a normal nominal short-term interest rate 300 basis points higher than it is today, closer to 4 percent than 1 percent, the interest cost of \$2.8 trillion in net interest-bearing liabilities would be \$84 billion higher or about 0.7 percent of GDP.<sup>15</sup>

Even if the US external adjustment process eventually stabilizes the NIIP ratio, the process will not be instantaneous. In the meantime the ratio would rise along with the interest-bearing component. On the other hand, the adjustment process almost certainly would involve a substantial depreciation of the dollar well in excess of the 12 percent that has occurred since February 2002 on the Federal Reserve Board staff's broad index, and this would tend to boost the dollar value of US foreign assets relative to US liabilities to foreigners.<sup>16</sup> If the NIIP ratio stabilized at minus 35 percent of GDP, a trend growth rate of US nominal GDP of 6 percent implies a sustainable current account deficit of 2.1 percent of GDP. The associated trade deficit might be 0.5 percent of GDP, implying the need for reduction in the US trade deficit of about 4 percentage points of GDP from the current 4.5 percent.

---

<sup>14</sup> Analyses of debt sustainability are often couched in terms of real or nominal growth rates, interest rates, and primary surpluses or deficits, as well as debt levels. However, given the complexities of statistics on the US NIIP, it is simpler to use the relationship that for the NIIP to stabilize, the annual addition to it (the current account deficit) must equal the nominal growth rate of the economy times the net stock of debt.

<sup>15</sup> O'Neill and Hatzius (2004) estimate that if US government bond yields rise to 6 percent, the average level of the 1990s, this would add 1.2 percentage points to the US current account deficit relative to GDP.

<sup>16</sup> The IMF (2004b, 16) has estimated that a 25 percent depreciation of the dollar reduces the US NIIP ratio by 7 percent of GDP.



The view that the eventual adjustment of the US external position can and will be smaller rests on the proposition that the United States is and will remain an attractive place for residents of other countries (individuals, money managers, corporations) to invest. For example, the current account deficit may only have to narrow to 3 percent of GDP.<sup>17</sup> At a 6 percent nominal trend growth rate, a US current account deficit of 3 percent implies that the NIIP ratio would stabilize at minus 50 percent of GDP. Moreover, it could be some years before that level was reached.<sup>18</sup>

Alternatively, Mann (2003) suggests normalizing the US current account position on the margin to what would be consistent with the US share of global GDP (about 33 percent) or with the US share of non-US global wealth measured by market capitalization (about 55 percent). In her calculations, based on data as of mid-2002, produce US current account deficits of 2.4 and 3.6 percent of GDP respectively in 2005.

Freund (2000) and Mann (1999), in their studies of industrial countries that have experienced substantial external adjustments, find that normally in these periods external debt ratios stabilized but did not reverse. On the other hand, positing a partial adjustment of the US current account in the next several years, say, to 2-1/2 or 3 percent of GDP would not achieve stabilization. One might also think that if the US NIIP ratio were headed for minus 50 percent of GDP, there might at that point be some correction or overshooting in the form of trade or current account surpluses to pay down some of the debt. In addition, if 50 percent were a de facto market-induced limit, then there would be limited scope for deficits larger than 3 percent of GDP going forward. In effect, they would have to average around that figure and the dollar's medium-term volatility, say, over the course of a year or two, might increase even as the amplitude of its swings decreased.

It is difficult to prove anything in this area, but based upon these considerations, my view is that once the US current account adjustment gets seriously under way, with the deficit narrowing to significantly less than 5 percent of GDP for a period of years, the low point will be closer to 1 percent than 4 percent. In other words, at a minimum the correction will be 2-1/2 percentage points.

---

<sup>17</sup> O'Neill and Hatzius (2004) argue that deficits at this rate may well be sustainable "for a time."

<sup>18</sup> If one thought that the US current account deficit of 5 percent of GDP were sustainable, that would imply an eventual NIIP ratio of 83 percent.

### *The Fiscal Deficit*

Turning to the sustainability of the US fiscal deficit, many of the same points arise. My sampling of the newer literature on the issue suggests substantial consensus that US federal deficits of 5 percent of GDP should not and will not go on forever.<sup>19</sup> Perhaps, there is a greater consensus on this point than there is on the sustainability of the US external deficit of the same size.

As Gramlich (2004) argues, fiscal deficits are less sensitive to market forces of self-correction than external deficits. In the limit, of course, the US government might be unable to float its debt, and the resulting crisis fiscal adjustments might be described as market driven. Long before that point is reached, we expect economic conditions to interact with political forces to bring change. One potential economic channel is through slower economic growth associated with higher interest rates and lower investment, which tends to worsen the budget deficit and comes to be seen as the source of slow growth and malaise. It took more than a decade from 1981 to 1992 for these forces to come into play politically. Arguably political forces this time have advanced the process more rapidly.

Finally, with respect to the fiscal deficit, as in the case of the external deficit, views differ about how large an adjustment is desirable and over what time horizon. However, for the longer run, again, there may be a greater consensus than in the case of external deficits that the appropriate objective for the fiscal deficit should be zero, or a small positive figure, more than enough to stabilize the debt to GDP ratio. That weak consensus rests on three considerations: maintaining room to maneuver fiscal policy either through discretionary action or the use of automatic stabilizers; increasing the overall rate of saving in the economy; and preparing for the demographic future. Different analysts emphasize different points, but they often reach similar conclusions.

Thus, it is generally agreed that neither the US fiscal deficit nor the US current account deficit is indefinitely sustainable at its current rate. However, the reasons and the associated logic are somewhat different. One explanation for this difference is that the

---

<sup>19</sup> The treatments in Gale and Orszag (2003), Gramlich (2004), IMF (2004a and 2004b), Laubach (2003), Mühleisen and Towe (2004), Rivlin and Sawhill (2004), Rubin, Orszag, and Sinai (2004), and Summers (2004), for example, tend to focus on the federal deficit rather than the general government deficit or surplus. However, most of the variability is at the federal level.

economic and financial implications of the continuation of the two deficits are not entirely the same.

### **Economic Implications of the Deficits?**

The economic implications of US fiscal and current account deficits for the US and global economy are in some respects similar. Both deficits appear in the saving-investment identity. However, the US fiscal deficit over the longer term reduces US and global saving, and the US current account deficit merely redistributes saving from the rest of the world to the United States, and presumptively redistributes wealth in the other direction.

With respect to the fiscal deficit, in the short run such deficits normally stimulate economic activity; policy actions to reduce the deficit dampen economic activity. Over the medium and longer term, if fiscal deficits are not corrected, the stimulative effects wear off. In a closed economy, the reduced level of national saving pushes up interest rates as the economy returns to full employment. This dampens investment, labor productivity, and potential output.

In an open economy, part of the impact on US interest rates and investment may be muted because saving can be sucked in from the rest of the world. However, foreign economies also share in the adverse effects of higher US government debt; their interest rates are higher, investment is lower, labor productivity is lower, and potential output is lower.<sup>20</sup> They are partially compensated, of course, by higher returns on US assets.

Most analytical and empirical studies agree with the basic thrust of these arguments although there are differences in empirical magnitudes at each step of the process. Supply side effects from tax reductions and, in principle, from more efficient government spending are a relevant qualification. However, my reading of the literature is that these effects may reduce the size of the negative longer-run effects, but they generally do not reverse their signs. Over the longer run, the enlarged stock of government debt dominates. In models with binding long-run balance-sheet conditions, this dominance of government debt has the additional implication that unless the debt stock is restored to its original level -- fiscal surpluses of equal size follow deficits -- the

---

<sup>20</sup> Simulations reported in IMF (2004b) suggest that by 2010 the current US fiscal expansion will reduce the level of US potential GDP by  $\frac{3}{4}$  to 1-1/4 percent, and the level of potential GDP in the aggregate of the rest of the world by 1 to 2 percent.

adverse effects on the US and global economies persist except to the extent that there is an offset from supply-side effects.

Analysis of the economic implications of current account deficits is complicated by the fact that those implications in size, and occasionally in sign, depend upon the causes of the deficits and the condition of the US and global economy. The effects can be viewed as either positive or negative in both the short and longer runs.

For example, in the short run, a widening of the current deficit associated with slower growth abroad is associated with downward pressure on US economic activity and employment, which may or may not be welcome depending on the condition of the domestic economy. At full employment, the external deficit allows domestic demand to exceed supply, permitting an increase in domestic consumption and/or investment. To the extent that the dollar appreciates as part of the process, the positive terms of trade effect also boosts welfare in the form of the real value of consumption.

In the medium or longer run, the appropriate conditioning assumption is that the economy is at full employment. In this context, current account deficits again have both positive and negative effects, depending in part on the nature of the comparison. On the positive side, domestic demand exceeds supply; the country is permitted to live beyond its means. In addition, it is likely that the dollar is appreciated relative to where it would be without the deficit, which provides a positive terms-of-trade effect. On the negative side, the country is borrowing from abroad, which presumptively depresses the standard of living. Even if the current account deficit permits a higher level of investment, the direct returns on that investment flow abroad. The level and growth rate of GNP are lower compared with a situation in which the same rate of domestic investment occurred without the current account deficit.

In popular and political discussions, correction of the US external deficit is associated with a boost to US employment and output. What this view ignores is that normally the economy should be operating at full employment.<sup>21</sup> Thus, a reduction in the external deficit, with production (GDP) is unchanged, means gross domestic purchases (absorption, GDP less net exports) must be reduced. For example, if the US

---

<sup>21</sup> Of course, deficits are likely to affect the distribution of employment and capacity utilization across sectors with possible economic and obvious political implications.

trade and current account deficits have to be reduced by 2-1/2 percent of GDP, that implies a reduction of \$1,000 per capita in gross domestic purchases at an unchanged level of real GDP. During the 1987-90 period of US external adjustment, GDP per capita grew at an annual rate of 1.5 percent, compared with 3.0 percent during the previous four years. However, gross domestic purchases expanded only 0.9 percent per year, compared with 4.6 percent over the previous period. Consumption advanced at only 1.2 percent, less than a third of the average rate of the previous four years. “It was the economy, stupid,” in 1992, but the source of the economic malaise was poorly understood; growth in standards of living had stagnated.

Because of these ambiguities, it is conventional to try to distinguish between current account deficits that are a larger or smaller source of concern; see for example Summers (2004). Is the economy with the current account deficit at full employment? Does it appear that the deficit is financing consumption or investment? Is the investment in the traded or non-traded sectors of goods and services? Is the deficit otherwise leading to distortions in the economy between those two sectors? Is the deficit financed by private or official capital inflows? If the flows are private, are they long term or short term. These are good questions, but rarely are they susceptible to definitive answers even in a specific case, which limits their usefulness to guide policy.<sup>22</sup> Moreover, most of the questions implicitly relate not to the current account deficit per se but to what happens when an unsustainable deficit begins to narrow.

A continuation of unsustainable US current account deficits points to other potential global problems. One is the risk of a rise in protection, which imposes long-run costs on both the US and the global economy. Geopolitical implications are also relevant; Summers (2004) refers to the “balance of financial terror” associated with large concentrated official holdings of short-term dollar denominated claims on the United States. More generally, countries that are large international debtors find it more of a challenge to exert leadership in political as well as economic spheres. This challenge is complicated, on balance, though some say ameliorated, by the fact that the dollar is an

---

<sup>22</sup> The composition of the fiscal deficit also matters to some analysts. Are widening deficits associated with increases in investment or consumption? Should the focus be on the unified budget deficit or some other concept? What time horizon should be used in analyzing the issue? As is normally the case in such matters, answers to these questions often depend on the issue under examination and sometimes depend on who is doing the analysis. As a result, there is a lack of consensus.

international currency in the sense that it is widely used by countries as a unit of account, means of payment and store of value in circumstances in which the US residents are not involved.<sup>23</sup>

Again, many of these concerns and considerations do not relate to the US current account deficit per se, but to the process of correction once it is underway. Under these circumstances, the existence of an external and a fiscal deficit in the family, even if they are not twins, increases the risks. Gramlich (2004) introduces the concept of a “credibility range” applying to each of the deficits, ranges in which neither type of deficit has large effects on asset prices – interest rates or exchange rates. Extending his concept, when either deficit is large or has been expanding, the credibility ranges narrow for both deficits. Confidence in US financial policy is undermined (Truman 2001), and the risk of crisis rises. Rubin et al. (2004) vividly describe a number of adverse scenarios, implicitly disagreeing with Greenspan (2004a), quoted above, who sees greater flexibility reducing the risk of crisis. Freund (2000) in her study of experiences of industrial countries with large current account adjustments brings out a key point: external financial crises are much more common after the process of adjustment is underway than as a trigger to the adjustment process.<sup>24</sup>

### **Implications for Economic Policies?**

With two unsustainable US deficits, policymakers should embrace policies to maximize the probability of a smooth adjustment. Policies should aim at adjustment sooner rather than later, in effect reducing the probability of a crisis and preserving some room for maneuver, in order to minimize the damage to the US and global economies if things do not go just right. They might also hope for cooperative policies in the rest of the world to boost growth and for a large dose of good luck. However, none of the effective strategies is risk free or costless.

The core issue is the low US saving rate. As stated by Summers (2004, 2), “I am reluctantly convinced that the most serious problem we have faced in the last 50 years is

---

<sup>23</sup> This aspect of the dollar’s role is much more relevant and complicating to the exercise of US monetary policy than the dollar’s limited reserve role because of the high degree of inertia in official reserve holdings; see Truman (2004).

<sup>24</sup> Of the 25 episodes Freund reviews, 17 involved external financial crises, using the a modified Frankel and Rose (1996) index approach, but only four occurred before the current account deficit reached its widest point.

that of low national saving, resulting dependence on foreign capital, and fiscal sustainability, which has far-reaching implications for the US and the global economy.” Some economists think that the answer is to attract more saving from abroad, but that offers only a short-run fix. Some economists believe that tax gimmicks, normally reductions but also removal of the tax deductibility of mortgage interest payments, can lift the private saving rate. My impression is that there are fewer economists with these views than there once were. Most economists agree that the most reliable, but less than foolproof, method of increasing national saving is to reduce the fiscal deficit and raise government saving, whether by expenditure reductions or tax increases. The short-run impact on the economy will be to slow growth, but the long-run impact will be to raise growth and living standards. Reducing the budget deficit should contribute to lower interest rates and may be associated with a weaker currency, which would tend to narrow the current account deficit and offset some of the short-term drag of fiscal policy.

Should the United States deliberately seek to weaken the dollar? No. We should have learned in the late 1970s that the United States could not devalue its way to prosperity even if we could successfully manipulate exchange rates, which we could not. It is a different question whether we should discourage other countries from manipulating or pegging their exchange rates when doing so impedes the global adjustment process. The actions of the Chinese authorities in purchasing large quantities of dollars and of the Japanese authorities doing the same thing, to the extent that the latter actions are effective, distort the global adjustment process. As Greenspan (2004b) observed with unusual candor, the Chinese authorities are delaying the adjustment process. The consequences of that delay may be a more disorderly adjustment process down the road.

If the distortions to the adjustment process that are associated with de facto or de jure dollar pegs were reduced or removed, presumably the yen would appreciate a bit further, the Renminbi would be re-pegged at an appreciated rate, and the currencies of India and of other East Asian countries would adjust or be adjusted upward. It is possible that the dollar might be unchanged on average because the euro, Canadian dollar, and other currencies that have had large appreciations against the dollar over the past two-plus years would depreciate, which would reallocate some of the US external adjustment. A more likely result would be a smaller overall appreciation of those currencies over the

longer run as the global adjustment process runs its course. If the US external deficit has to contract by a minimum of 2-1/2 percentage points of GDP, about \$300 billion, and if we accept the rule of thumb that a real depreciation of 1 percent on the Federal Reserve Board staff's broad index will be associated with \$10 billion in current account adjustment, then the dollar's eventual adjustment will have to be at least 30 percent; we are at most a third of the way there.<sup>25</sup>

What about US monetary policy? To the extent that the US fiscal deficit is decisively narrowing, US monetary policy can be easier. Let me be clear, full employment and price stability would be associated with a lower federal funds rate in real and nominal terms than otherwise would be the case absent a spontaneous surge in investment. At the same time, if the dollar were depreciating and the current account deficit were narrowing, monetary policy has a role to play in restraining the growth of aggregate demand relative to aggregate supply, facilitating a faster expansion of output than of domestic demand. If the dollar were depreciating with little prospect of lower fiscal deficits, then monetary policy should be even tighter.

One question on which economists do not agree is whether exchange rate adjustment can do it alone in narrowing a current account deficit or whether in addition growth should be deliberately slowed. Experience, reviewed by Freund (2000), suggests that growth does slow in most countries undergoing external adjustment and exchange rate depreciation. However, these experiences reflected a range of policies interacting with a range of economic and financial conditions.<sup>26</sup> It is also another matter deliberately

---

<sup>25</sup> These rules of thumb assume the dollar's adjustment is exogenous which does not fully capture exchange market developments since early 2002. Moreover, different models yield different results, and the results depend on assumptions about accompanying policies and objectives. Baily (2003) reports simulations of the effects of exogenous dollar depreciation in the Macroeconomic Advisors model; the results can be interpreted as implying a rule of thumb of about \$20 billion per percentage point of dollar adjustment; US real GDP also declines relative to baseline. On the other hand, in FRB/Global (Levin, Rogers and Tryon 1997), an exogenous dollar depreciation produces about \$6 billion per percentage point when monetary policies in the US and abroad follow Taylor rules; here US real GDP rises relative to baseline. If US and foreign real GDP were unchanged, the FRB/Global result would be closer to \$10 billion per percentage point.

<sup>26</sup> In the simulations reported by Baily (2003), an exogenous change in the dollar is associated with real GDP 4.8 percent lower after 10 years and a reduction of the current account deficit of 2.5 percent of GDP.



and permanently to lower the level of US real GDP 6-7 percent in order to reduce imports of goods and services by, say, 2 percent of GDP.<sup>27</sup>

On the other hand, adjustments in monetary and fiscal policies at home and abroad for countries undergoing an exchange-rate-induced external adjustment do play a significant role in determining how large the adjustment will be or how much exchange rate change is need to achieve an external adjustment of a given size.<sup>28</sup> More broadly, the IMF staff (2004a) has advocated a cooperative strategy to facilitate the orderly resolution of global imbalances: US fiscal contraction, European structural adjustment, Japanese banking and structural adjustment, and increased exchange rate flexibility and structural adjustment in Asia. To this package, I would add easier monetary policy in Europe to sustain European growth and to take some of the appreciation pressure off the euro. I would also add policies in Asia to stimulate consumption and discourage domestic saving. With increasing saving in the United States, this would keep global saving and investment in balance and reinforce the effects of exchange rate changes on adjustment.

### **Summary**

1. The US fiscal and external deficits are linked through the saving-investment identity, but they are not analytical or behavioral twins.
2. Both deficits are unsustainable although there is little consensus, especially for the external deficit, about what would be sustainable.
3. The economic implications for the US economy of continuation or correction of each deficit are complex and differ somewhat. The adverse effects of continuation of the fiscal deficit are likely to be more pronounced than those associated with continuation of the external deficit. Correction of the external deficit could well be more problematic precisely because its evolution is essentially endogenous.
4. The fiscal deficit is more debilitating, and policy can do something about it. The exogenous external deficit is a source of risk and instability to the US and global economies.

---

<sup>27</sup> This calculation is based upon US nominal GDP of \$11,600 billion, imports of goods and services of \$1,700 billion, and an income elasticity of 2.0.

<sup>28</sup> A permanent boost of 3 percent in the level of foreign GDP (US export weighted) would raise exports of goods and services by \$36 billion (0.3 percent of GDP) on a base of \$1,200 billion and an income elasticity of 1.0.

5. It is difficult to imagine how the United States could achieve a substantial correction of the external deficit and still maintain a large fiscal deficit because of the size of the implied drop in the rate of domestic investment that would be involved.
6. It is more critical to reduce the fiscal deficit where policy has more of a role and the beneficial economic effects are more obvious.

## References

- Baily, Martin. 2003. Persistent Dollar Swings and the US Economy. In C. Fred Bergsten and John Williamson eds. *Dollar Overvaluation and the World Economy*. Washington: Institute for International Economics.
- Dudley, William C. and Edward F. McKelvey. 2004. The US Budget Outlook: A Surplus of Deficits. *Global Economic Paper* 106 (March 31). New York: Goldman Sachs.
- Frankel, Jeffrey and Andy Rose. 1996. Currency Crashes in Emerging Markets: An Empirical Treatment. *Journal of International Economics* 41: 351-66.
- Freund, Caroline. 2000. Current Account Adjustment in Industrialized Countries. *International Finance Discussion Papers* 692. Washington: Board of Governors of the Federal Reserve System.
- Gale, William G. and Peter R. Orszag. 2003. The Economic Effects of Long-Term Fiscal Discipline. *Urban-Brookings Tax Policy Center Discussion Paper* 8. Washington: Urban Institute.
- Gramlich, Edward M. 2004. Budget and Trade Deficits: Linked, Both Worrying in the Long Run, but not Twins. Remarks at the Los Angeles Chapter of the National Association of Business Economists. Photocopy (March 31).
- Greenspan, Alan. 2003. Remarks on the Current Account at the Cato Institute. Washington: Board of Governors of the Federal Reserve System. Photocopy (November 20).
- Greenspan, Alan. 2004a. Globalization and Innovation. Washington: Board of Governors of the Federal Reserve System. Photocopy (May 6).
- Greenspan, Alan. 2004b. Remarks on the Current Account before the Economic Club of New York. Washington: Board of Governors of the Federal Reserve System. Photocopy (March 2).
- IMF (International Monetary Fund). 2004a. Economic Prospects and Policy Issues. *World Economic Outlook*. Washington: International Monetary Fund.
- IMF (International Monetary Fund). 2004b. How Will the US Budget Deficit Affect the Rest of the World? *World Economic Outlook*. Washington: International Monetary Fund.
- Laubach, Thomas. 2003. New Evidence on the Interest Rate Effects of Budget Deficits and Debt. *Finance and Economics Discussion Paper Series* 2003-12. Washington: Board of Governors of the Federal Reserve System.
- Levin, Andrew T., John H. Rogers, and Ralph W. Tryon. 1997. A Guide to FRB/Global. *International Finance Discussion Papers* 588. Washington: Board of Governors of the Federal Reserve System.
- Mann, Catherine L. 1999. *Is the US Trade Deficit Sustainable?* Washington: Institute for International Economics.
- Mann, Catherine L. 2003. How Long the Strong Dollar? In C. Fred Bergsten and John Williamson eds. *Dollar Overvaluation and the World Economy*. Washington: Institute for International Economics.
- Mühleisen, Martin and Christopher Towe eds. 2004. *US Fiscal Policies and Priorities for Long-Run Sustainability*. Washington: International Monetary Fund.
- O'Neill, Jim and Jan Hatzius. 2004. US Balance of Payments, Unsustainable, But . . . *Global Economics Paper* 104. New York: Goldman Sachs.

- Rivlin, Alice M. and Isabel Sawhill. 2004. *Restoring Fiscal Sanity: How to Balance the Budget*. Washington: The Brookings Institution.
- Rubin, Robert E., Peter R. Orszag, and Allen Sinai. 2004. Sustained Budget Deficits: Longer-Run US Economic Performance and the Risk of Financial and Fiscal Disarray. Paper presented at the AEA-NAEFA Joint Session, Allied Social Sciences Associations Annual Meetings. Photocopy (January 4).
- Summers, Lawrence H. 2004. The United States and the Global Adjustment Process. Washington: Institute for International Economics. Photocopy (March 23).
- Truman, Edwin M. 2001. The International Implications of Paying down the Debt. *International Economics Policy Briefs* PB01-7. Washington: Institute for International Economics.
- Truman, Edwin M. 2004. The Euro and Prospects for Policy Coordination. In Adam Posen ed. *The Euro at Five*. Washington: Institute for International Economics (forthcoming).