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TWIN DEFICITS AND SUSTAINABILITY

L. RANDALL WRAY

In the mid to late 1980s, the U.S. economy simultaneously produced—for the first time in the postwar period—huge federal budget deficits as well as large current account deficits, together known as the "twin deficits" (Blecker 1992; Rock 1991). This generated much debate and hand-wringing, most of which focused on supposed "crowding-out" effects (Wray 1989). Many claimed that the budget deficit was soaking up private saving, leaving too little for domestic investment, and that the "twin" current account deficit was soaking up foreign saving. The result would be higher interest rates and thus lower economic growth, as domestic spending—especially on business investment and real estate construction—was depressed. Further, the government debt and foreign debt would burden future generations of Americans, who would have to make interest payments and eventually retire the debt. The promulgated solution was to promote domestic saving by cutting federal government spending and private consumption (Rock 1991; Council of Economic Advisers 2006). Many pointed to Japan's high personal saving rates as a model of the proper way to run an economy.

The twin deficits have returned with a vengeance. After running surpluses at the end of the Clinton boom, the federal government balance turned sharply toward deficit, decreasing by nearly

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Senior Scholar L. RANDALL WRAY is professor of economics at the University of Missouri–Kansas City and director of research at the Center for Full Employment and Price Stability. The author thanks Wynne Godley for discussion that led to this Policy Note, and for providing the data used to produce the figure.

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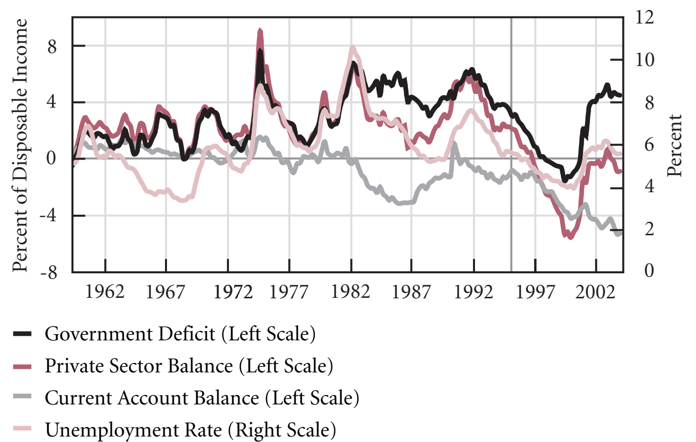
7 percent of disposable income (DI). By the same token, the current account deficit, which had shrunk by more than half during the Clinton years, exploded. (The current account deficit is defined as the nation's excess of imports and other current payments over exports and other current receipts.) It is now twice as large, relative to DI, as it had been at its previous peak during the 1980s. This time around, discussion nears a hysterical level, with dire predictions concerning not only intolerable burdens for future Americans, but even the possible bankruptcy of the federal government and the nation as a whole (Altman 2006). Further, Americans' insatiable appetite for the world's saving not only endangers their own well-being, but also depresses growth in developing nations. The Council of Economic Advisers recommends that the "United States should raise its domestic saving rate" to reduce its current account deficit and reduce reliance on foreign saving (2006, p. 127). There is widespread agreement that both deficits are unsustainable.

In this Policy Note, I argue that the twin deficits are, indeed, "unsustainable," but for reasons that are completely absent from public discourse. I first briefly review the framework being adopted for this analysis. I next review the recent historical record, then turn to an examination of whether the twin deficits are sustainable.

The Three Balances and the Unemployment Rate



Sources: U.S. Bureau of Labor Statistics and Bureau of Economic Analysis

A Framework for Analysis

The figure provides a plot of empirical data, including the overall government balance and current account balance, with both variables presented as a percent of DI. It is important to note that the sign of the government's balance is reversed (a deficit is positive)—for reasons to be made clear in a moment. There are two additional variables shown: the private sector balance and the unemployment rate.

For many years, the Levy Institute has been using the "three balances" approach developed by Wynne Godley (1996, 1999) to provide insight into the relations among the three sectors of the economy: private, government, and foreign. Previous work has rigorously demonstrated that the balances are inexorably linked through an identity, and, more importantly, that analysis of the balances can yield information about cause and effect. I do not repeat a detailed argument here, but briefly describe this analysis before turning to the twin deficits.

If one of the three sectors spends more than its income, at least one of the others must spend less than its income, because for the economy as a whole, total spending must equal total receipts or income. While there is no reason why any one sector has to run a balanced budget, the system as a whole must. In basic textbooks, this is summarized as "injections equal leakages" at the aggregate level. In practice, the private sector traditionally runs a surplus—spending less than its income. This is how it accumulates net financial wealth. For the United States, the private sector surplus has averaged about 2 to 3 percent of DI, but it does vary considerably over the cycle, reaching as high as plus 9 percent and falling below zero in recent years (see figure). Private sector saving (or surplus) is a leakage that must be matched by an injection. Before Reagan, the United States essentially had a balanced foreign sector; the current account balance swung between small deficits and surpluses. Over the course of the Reagan-Bush years, the current account deficit grew to 3.2 percent of DI, and fell to less than 2 percent at the end of the 1990s, before growing to more than 6 percent of GDP today. That is another leakage that drains domestic demand.

In the United States, the government sector, taken as a whole, almost always runs a budget deficit, reaching to well above 5 percent of DI under Reagan and both Bushes. For the United States, the budget deficit has been the injection that offsets the "normal" private sector and occasional foreign sector leakages. With a traditional private sector surplus of 2 to 3 percent of DI and a more or less balanced current account, the "normal" budget deficit needed to be about 2 to 3 percent of DI during the early Reagan years. Until the Clinton expansion, the private sector never ran a deficit. However, since 1996, the private sector has been in deficit every year except one (during

the depths of the last recession), and that deficit climbed to more than 5 percent of DI at the peak of the boom. A private sector deficit acts as an injection, raising domestic demand and encouraging production. As production and employment rise, tax revenues grow faster than government spending, reducing the budget deficit. This chain of events actually drove the federal budget into surplus—as high as 2.5 percent of GDP—at the peak of the Clinton boom. At the same time, the growing economy caused imports to rise faster than exports, generating a current account deficit. Almost all economists and policymakers thought the Clinton budget surplus was a great achievement and projected the surplus to continue for 15 years or more. However, most never realized that, by definition, the large surpluses meant that the private sector had to spend more than its income on a hitherto unknown scale, as long as the current account deficit remained constant. Therefore, rather than accumulating financial wealth, the private sector was running up debt (Wray 1999). The budget surplus was short lived, because it drove the economy into recession, causing tax revenues to fall below government expenditures, as jobs were lost and income stopped growing.

As mentioned, the trade deficit represents a leakage of demand from the U.S. economy to foreign production. There is nothing necessarily bad about this, so long as we have another source of demand for U.S. output, such as a federal budget that is biased to run an equal and offsetting deficit. Private sector net saving (that is, running a surplus) is also a leakage. If we add the current account deficit that we have today (about 6 percent of DI), to the normal private sector surplus of 2 to 3 percent of DI, that gives us a total "normal" leakage, out of aggregate demand, of 8 or 9 percent of DI. This leakage would have to be made up by an injection from the government sector; the only way to sustain such a large leakage is for all levels of government together to run a deficit of that size. Since state and local governments are required by constitutions and markets to balance their budgets, and, on average, actually run surpluses, it is up to the federal government to run deficits on the necessary scale.

The federal budget deficit is largely nondiscretionary over the span of a business cycle; and at least over the shorter run, we can take the current account as also largely outside the scope of policy—with imports a function of domestic demand, but exports depending on demand from the rest of the world. A driving force of the cycle, then, is the private sector leakages. (However, this is not to be interpreted as an endorsement of the view that leakages "cause" or "finance" injections, which has it backwards.) When the private sector has a strong desire to save, it tries to reduce its spending below its income. Domestic firms cut production, and imports might fall too. The economy cycles downward into a recession as demand falls and unemployment rises. Tax revenues fall and some kinds of social spending (such as unemployment compensation) rise. The budget deficit increases more or less automatically. On the other hand, when the private sector has a high desire to spend, as it has had on an unprecedented scale for nearly a decade, it can accumulate debt, driving the current account balance into deficit and reducing (or even eliminating) the budget deficit.

The Twin Deficits in Historical Perspective

From this perspective, the 1980s experience is not too difficult to explain. As the economy began to recover from the Reagan recession of the early 1980s, the private sector balance fell from a very high surplus—above 6.3 percent of DI—to just over 1 percent by 1989. Unemployment gradually declined, from almost 11 percent to a trough below 5.5 percent by the late 1980s. The budget deficit also declined, although with a lag, by 3 percent of DI, as income growth increased tax revenue. The increased demand by the private sector was not completely offset by the adjustment of the government's balance; the remainder "leaked" to the foreign sector, as the current account moved from a balance to a deficit above 3 percent of DI. Near the end of the 1980s, private sector spending failed to keep pace with income, as a large and growing surplus (saving) reappeared, again reaching close to 6 percent of DI at the beginning of 1992. The resulting recession drove the budget deficit back above 6 percent as unemployment rose, and lower demand for foreign output closed the current account deficit.

Recall, from the beginning of this Policy Note, that discussion during the 1980s focused on the necessity of reducing the budget deficit and increasing private saving in order to increase the supply of loanable funds for investment and encourage economic growth. Actually, as the private sector reduced spending and increased its surplus, the economy stagnated. Rather than generating better economic performance, the higher level of private sector saving was associated with higher government deficits, higher unemployment (reaching nearly 8 percent), a recession, and a lower current account deficit.

However, after a long but weak recovery in the early 1990s—associated with continued but falling private sector surpluses—the economy finally started to grow at a robust rate in the middle of the decade. By the end of 1995, the private sector balance had returned to a more normal surplus of about 2 percent of DI; faster growth also reduced the budget deficit—to about 3.5 percent—while the current account deficit grew to 1.5 percent. Over the remainder of the 1990s, as discussed above, the private sector surplus continued to deteriorate and turned negative in 1997. Unemployment fell to its lowest levels since the 1960s. Strong economic growth drove the overall government budget to historically large surpluses, and the current account to record deficits. It is important to recall that the budget surplus was projected at the time to continue for at least 15 years, and retirement of federal government debt was supposed to be adding to the nation's net wealth. In fact, the sum of the current account deficit and the government surplus equaled the private sector deficit; given the current account, each additional dollar of government surplus, by identity, meant another dollar of private sector deficit. Indeed, retirement of federal government debt equals a net reduction of private sector wealth. The leakage of private sector income and wealth to budget surpluses and current account deficits eventually contributed to recessionary forces that brought the boom to an end by 2000.

The recession under the younger Bush saw a sharp turnaround of the private sector and government balances. The government surplus morphed into a deficit of more than 5 percent of DI, a swing of 6.7 percent of DI—the largest turnaround since the 1974–75 recession. Similarly, the private sector balance moved, by about 6 percent of DI, to a small surplus. While there was initially a small reduction of the current account deficit, recovery quickly turned the trend downward. Finally, the unemployment rate rose quickly in the recession, but has only very slowly fallen in recovery—at a pace that is even slower than that experienced in the "jobless" 1990s recovery.

Note how closely the unemployment rate tracks trends of the private sector balance in the figure—rising when saving rises and falling when saving falls. The period after 1995, to the right of the heavy vertical line, stands out because the private sector surplus fell much more quickly than did the unemployment rate. This more rapid fall in the private sector balance is a result of the current account balance behaving differently after 1995: as the current account deficit opened up, the demand injection created by a lower private sector balance was dissipated through imports. A larger increase of private sector spending, relative to income, was thus required to drive the unemployment rate lower. The required boost depends on the government's fiscal stance. If the budget is biased to run surpluses when growth is robust—as was the case in the late 1990s—then larger private sector deficits are needed to fuel growth.

Given how large the external leakage has become, even at current moderate rates of growth, the private sector cannot achieve balance between income and spending unless the budget deficit is above 6 percent of DI. The problem is that it appears unlikely that there is much political will to deliberately allow the budget deficit to rise to, say, 8 percent or 9 percent of DI, should the private sector finally decide to return to a normal surplus balance of 2 or 3 percent of DI. Rather, the adjustment would almost certainly have to come through growth rates that are slow enough to permit some combination of a reduced current account deficit and a budget deficit far beyond that which is thought desirable.

Sustainability of the Twin Deficits

This brings us back to the issue of sustainability. Let us first look at the sustainability of the fiscal deficit.

Recall that one of the main arguments about the twin deficits of the 1980s revolved around the supposed "crowding-out" effect. While the mainstream recognizes that interest rates are still low—even after concerted efforts by the Fed to raise them—mainstream economists still hold out the possibility that budget deficits, in the context of low private sector savings, will eventually push up rates. "Mark Zandi, an economist at the analysts' website Economy.com, said the low level of savings would become a problem only if interest rates continued to climb" (Thornton 2006). Insufficient domestic saving would then force the United States to turn to foreign savers—but these are already tapped out, lending to finance the current account deficit. Hence, investment will falter, and long-run growth will be hindered.

According to conventional wisdom, if domestic saving rates cannot be improved, then the budget deficit must be reduced. Indeed, in its latest projections, the White House claims the budget deficit is on course to fall to 2.6 percent of GDP for 2007, and to less than 1 percent of GDP by the end of the decade (Daniel and Balls 2006). Federal tax revenues grew by 15 percent in fiscal year 2005, and are expected to rise by 7.3 percent in

2006—obviously this is much in excess of private sector income growth (*Financial Times* 2006). If this tightening can continue, conventional wisdom maintains it will reduce the absorption of private sector saving (both domestic and foreign) and thereby leave more saving for private investment. At the same time, the tightening will have some impact on the projected trillions of dollars of fiscal deficits—said to burden future generations and even to threaten the solvency of the U.S. government.

Such mainstream analyses fail to understand the connections among the sectors. Tightening the fiscal stance will not *substitute* for low private sector saving, but rather will *reduce* private sector saving (all else being equal). Continued growth of tax revenue beyond the rate of private sector income growth is likely to reduce net income and lower the rate of growth of private sector wealth. It is improbable that this environment will encourage investment or long-term U.S. growth. Indeed, there is already evidence that U.S. growth is being hindered by the tightening fiscal stance. The GDP grew at only 1.1 percent in the fourth quarter of 2005; disposable income grew by only 1.4 percent in 2005 (Bajaj 2006). It appears the real estate bubble might finally burst, as new home sales fell by 10.5 percent in February (Reuters 2006). As discussed, any reversion of private sector balances toward a "normal" surplus of 2 to 3 percent of DI would have a devastating effect on domestic demand and employment. In the current politically charged environment (with both Republicans and Democrats vying to reduce the budget deficit), policymakers probably would be unwilling to relax the fiscal stance toward a budget deficit that would allow, without a substantial slowing (or elimination) of growth, a private sector surplus. In the past, a swing of the private sector balance of, say, 5 percent of DI has been associated with a rise of the unemployment rate by 3 percentage points or more.

It is likely that the trade imbalance is "unsustainable"—but not for the reasons usually cited (U.S. solvency; external demand for the dollar). Rather, because economic growth currently requires that U.S. consumers continue to run up deficits and accumulate debt, growth probably will come to an end when consumers eventually cut back spending. This will reduce imports, albeit by an unknown amount. Similarly, the U.S. budget deficit is also "unsustainable"—in the sense that it will surely change—but again, not for the usual reasons. The budget deficit will rise if the U.S. private sector reduces its net spending; it will fall if the pace of private spending increases. It is misguided to speak of the U.S. federal government, or the nation as a whole, facing financial constraints in a regime of sovereign currency and floating exchange rates. The next U.S. recession—and global slowdown—will not be due to the insolvency of the United States, but rather will result from a slowdown of the rate of growth of spending by U.S. consumers.

While household debt ratios, as well as debt-service ratios, have trended upward, an end to the current sluggish expansion is not likely to be initiated by a sudden wave of defaults and bankruptcies. Instead, it will come when household borrowers and banking sector lenders decide it is time to retrench—to slow the growth of borrowing by, and lending to, the personal sector. Conceivably, this slowdown could trigger a snowball of defaults. The question is whether policymakers will react to a deceleration quickly enough to prevent a major and prolonged recession, or, worse, a debt deflation of the sort feared by Hyman Minsky.

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