The Glorious Evils Of The Twin Deficits

Psycholinguistics has nothing to do with Alfred Hitchcock's 1960 cinematic classic, but rather the way words and sounds trigger impulses in the brain. Apparently we all are prisoners of these subconscious and subliminal reactions.

This can lead to some unfortunate associations with common economic descriptors such as "surplus" vs. "deficit," or "strengthen" vs. "weaken." The connotations of these word sets are such that we instinctively are attracted to strength and surplus and seek to avoid the opposite states of weakness and deficit. The words themselves attract politicians desirous of either solving the problems perceived to be associated therewith or at least being seen as trying to do so, and that in itself can preclude reasoned study and serious debate.

Take the case of the "twin deficits," a phrase that arose during the 1980s to describe the simultaneous deficiencies in the federal budget and in the merchandise trade balances. Thoughtful observers such as Pete Peterson, now of the Blackstone Group, sounded warnings based on accounting identities prior to the 1987 stock market crash that someday we would have to pay the price of our profligacy. Ross Perot carried the torch for this cause in his 1992 campaign, and the eminent Robert Rubin championed the cause of budgetary discipline during the Clinton administration.

And The Problem Is?

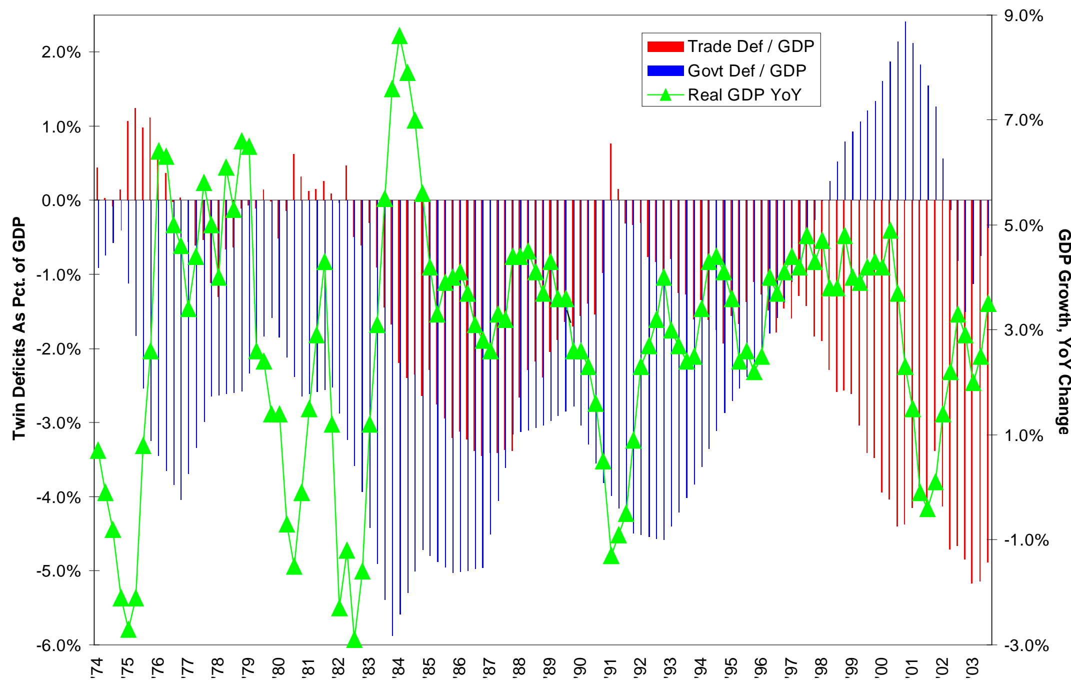
We now sit at 45-year lows in nominal interest rates with a recovering stock market and an economy that at least recently has shown some spark. Let us examine whether our psycholinguistic impulses, our fears of "deficit," "debt" and a "weak" dollar have been justified by the economic data or whether they best are consigned to the dark closets of our childhood nightmares.

In each of the cases below, please remember there are no controlled experiments in economics, and so we have no idea what the outcome would have been under a different combination of deficits. In addition, the trade deficit used is the current account deficit reported quarterly by the Commerce Department; this measure includes the flow of services as well as the more familiar merchandise trade deficit that is goods-only. The government deficit is exclusive of state and local balances. Both deficits are displayed as percentages of current dollar GDP.

For reference, we have been going through the deepest trade deficits in our history; these deficits exploded after the Asian crisis of 1997-1998 as export demand slowed and huge capital inflows from Asia to the United States necessitated a counterbalancing current account deficit. A trade deficit can be restated as a capital surplus, and vice-versa. The federal deficit, while quite large in absolute terms, is rather tame as a percentage of GDP. Its size is exaggerated by the recent period of federal surpluses during the late Clinton years.

Growth

Do the deficits affect GDP growth? Under the Keynesian model of the economy, a trade deficit lowers GDP and government borrowing may raise GDP to the extent it does not exceed foregone investment.

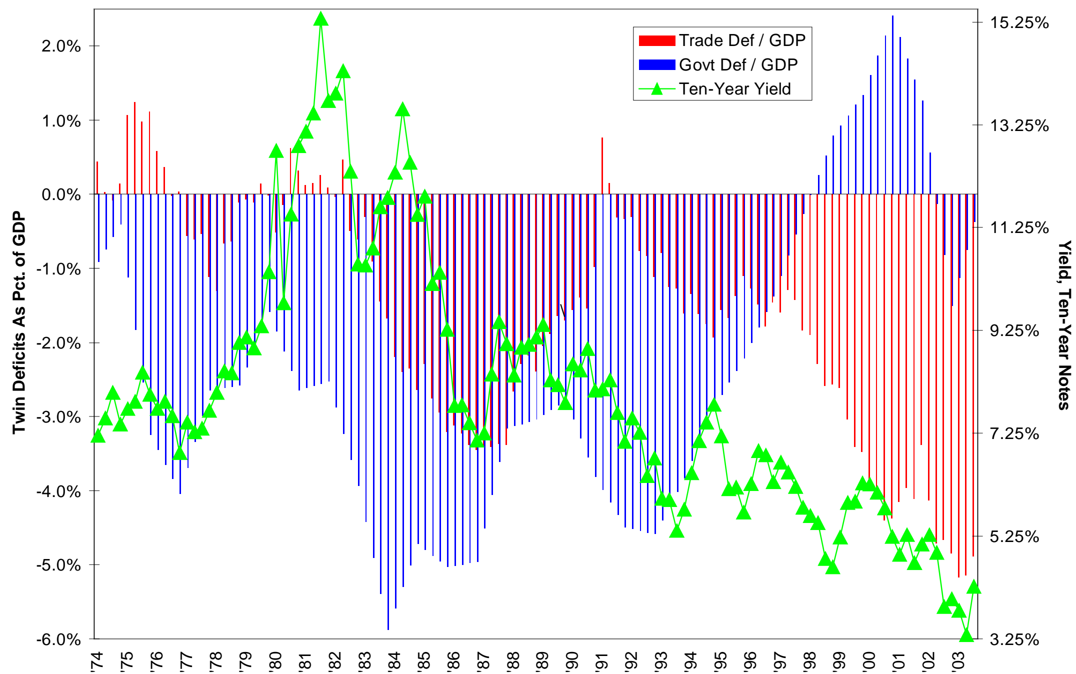


The periods of recession coincide with near-balance or surplus in the current account deficit; this is to be expected as import demands fall during recessions. The periods of deep federal deficits, concentrated in the Reagan and early Clinton years, correspond to periods of solid GDP growth. The federal surpluses and massive trade deficits seen in the late Clinton and early Bush-43 years correspond to the post-bubble recession; the present combination of twin deficits is associate with solid GDP growth. On balance, the twin deficits have not slowed the economy.

Interest Rates

If you borrow money, you have to pay it back, and that would suggest that deficits might push up interest rates. Nominal ten-year note yields peaked at a time of near-balance or surplus in the current account deficit, and well before the deepest federal deficits. Note yields have fallen continually since then, and reached their lows at a time of large twin deficits. Federal borrowing is only one component of total credit demand, and those big trade deficits really are capital surpluses. Statistically, the twin deficits do not appear to have any ability to push note yields higher.

Do Deficits Cause Higher Interest Rates?



What About Inflation?

The note yields depicted above are nominal, not adjusted for inflation. Surely our massive debts give us an incentive to inflate the money supply and pay our creditors back with worthless paper, right? Wrong: The start of the disinflation of the 1980s was preceded by an expansion of the federal deficit and accompanied by an expansion of the trade deficit. The GDP deflator actually rose after the budget surpluses of the Clinton years and then fell again as the deficits rose.

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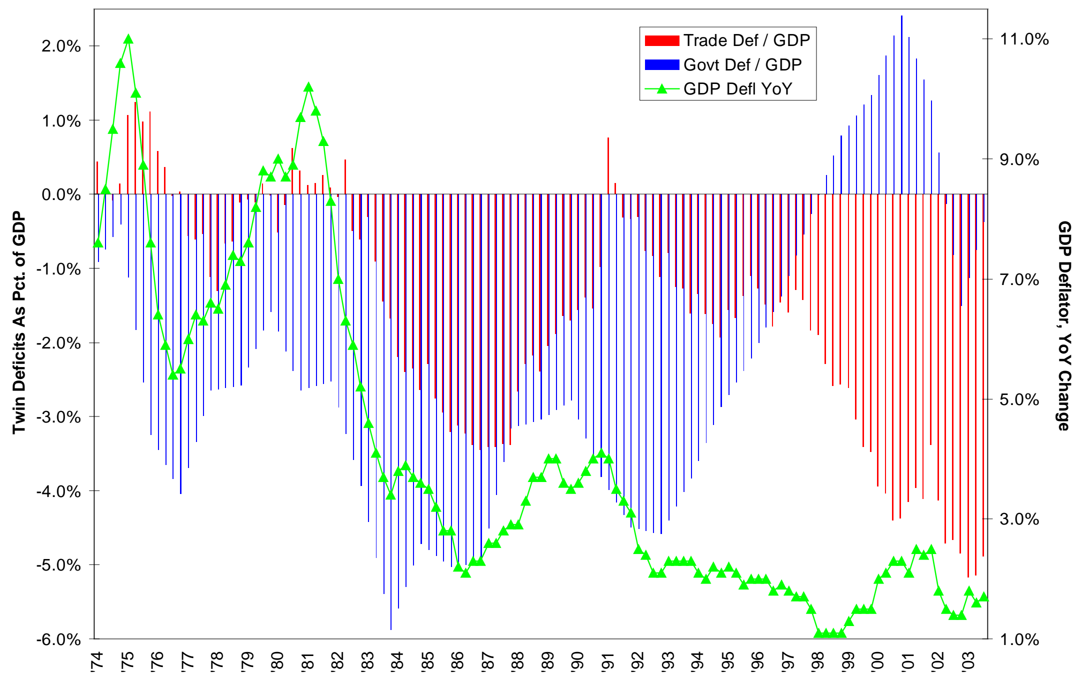
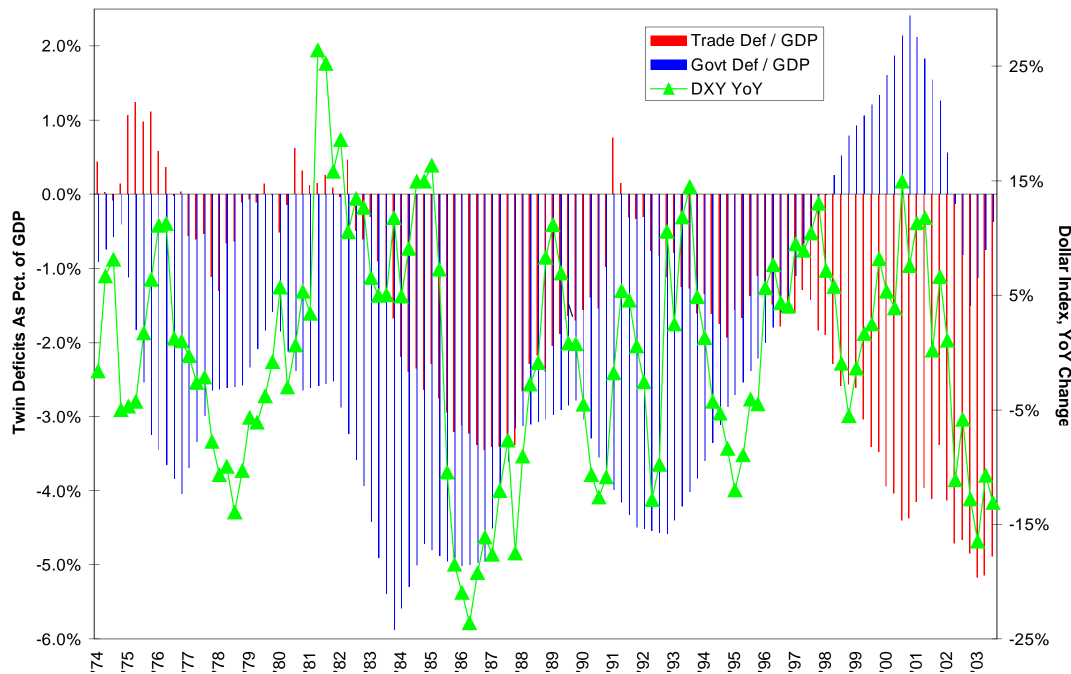


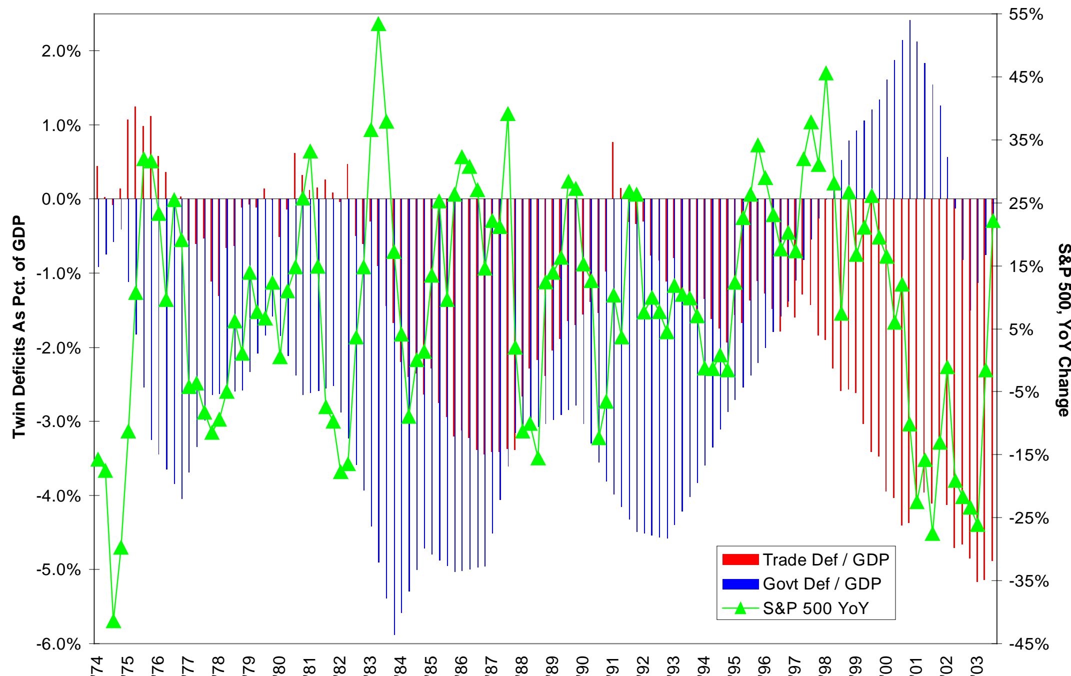
The Impact On The Dollar

The dollar had its period of greatest strength, as predicted by Nobel laureate Robert Mundell, during periods of fiscal stimulus and tight money. It did not rally as the current account deficit closed in the late 1980s and early 1990s, nor did it rally as the federal budget moved back into balance in the early Clinton years. It remained firm after the Asian crisis as the Federal Reserve's rate hikes of 1999-2000 provided support. Its present weakness correlates far more closely to the federal funds rate of 1% than to any measure of the deficit.



Stocks And The Deficits

Stocks strengthened in the face of the expanding twin deficits in the early 1980s as both inflation and interest rates fell. The great boom of the late 1990s coincided with the closure of the federal deficit, but in the face of an expanding current account deficit - remember those capital inflows. The stock recovery of 2003 has occurred despite an obvious lack of fiscal discipline in Washington and an out-of-control current account deficit.



The Bottom Line

Given all of the caveats above about the limitation of analysis done without a controlled experiment and with quarterly economic data, it is striking that only one indicator and only at one time, stocks during the move toward federal budget balance in the late 1990s, had the "good" outcome in association with narrower deficits. In all other cases, GDP, inflation, interest rates, the dollar and stocks all either shrugged off wider deficits or rose in the teeth thereof.

This is not to defend a lack of discipline or economic balances, and it certainly is not to promote the Orwellian "less is more" conclusion. It is, however, to suggest or even insist that we all abandon our knee-jerk reactions to the latest economic datum and instead look at how it modifies the larger picture. That will produce fewer panics and fewer headlines, and in this case, fewer are better.