

## **The twin deficits of the United States, a comparison of two periods (1981-1988, 2001-2008)**

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The aim of this paper is to analyze the twin deficits in the United States and compared in two periods 1981-1988 and 2001-2008, in order to demonstrate that the twin deficits there is a correlation between the budget deficit and the deficit in the balance current account. The result is that in these periods, we verify this correlation. The budget deficit stems from an increase in defense spending while the deficit of current account stems from an increase in investment and household consumption. The deficit of current account is financed through global savings derived from the surpluses of this scale in countries such as Germany, China and Japan.

**Twin deficits, budget deficit, deficit of current account.**

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## Introduction

Given the transcendence, which carries the budget deficit and the deficit of current account balance for the U.S. economy, both are analyzed in order to study what is known as twin deficits. Where the budget deficit is analyzed when it starts the beginning of the fiscal cycle from September to August each year, in August is when it becomes relevant for its political and economic aspects. The deficit in the current account balance becomes important for competitiveness posed to the U.S. economy relative to other economies.

Both deficits in the periods 1981-1988 and 2001-2008 have been linked simultaneously gaining importance and relevance for their economic implications, being part of the political discourse and initiatives to find a solution to them. Therefore, the hypothesis of this paper is that the twin deficits there are a correlation in the budget deficit and the current account deficit.

The structure of the paper is as follows. Prime to the theoretical framework is established and the first twin deficits period, 1981-1988 is analyzed. After opening and budget surplus, 1993-2000 is studied. The second period of twins, 2001-2008 deficit is then reviewed, and finally the conclusions.

### Theoretical framework and the twin deficits first period, 1981-1988

In recent years discussions on macroeconomic policy has focused on current account deficits experienced by many countries, including the United States with a deficit of 5% of GDP and China with a surplus of almost 3% of GDP.

Policy makers, analysts and academics have focused on the international adjustment process, and discussed the process by which the correction of these imbalances affect the exchange rate, job creation and economic growth (Edwards, 2004) . Hence the importance of analyzing the current deficit account.

In the case of the U.S. economy, it is currently undergoing a deficit in the current account balance plus a budget deficit, which is called twin deficits. But this is not a recent events, dating back to the eighties, when the emerging so-called twin deficits, under President Ronald Reagan.

To establish the theoretical framework of an open economy in which the accounting identity on savings and investment is:

$$Y = C + I + G + XN \quad (1)$$

Where Y=National Income

C= Consume

I= Investment

G=Government spending

XN= Net exports

If consumption and government spending on the right side of equation (1) is passed, it is the following equation:

$$Y - C - G = I + XN \quad (2)$$

$$\text{Where } Y - C - G = S \quad (3)$$

Substituting  $S$  (national savings) in equation 2 we have:

$$S = I + XN \tag{4}$$

Equation 4 indicates that in equilibrium national saving equals investment plus net exports. Rewriting equation (4) gives:

$$S - I = XN \tag{5}$$

This equation indicates that a deficit in the current account balance must be matched by an excess of investment over domestic savings, or insufficient saving relative to investment.

Rewriting the above identity is that:

$$S_{private} + S_{public} - I = XN \tag{6}$$

Donde  $S_{private}$ = Private save

$S_{public}$ = Public Save

This identity clearly indicates how a budget deficit may lead to a deficit in the current account balance. If government saving decreases as a result of a budget deficit, the remaining variables of identity, can behave as follows: private savings should increase to offset public savings, or investment must fall, or the external deficit increases.

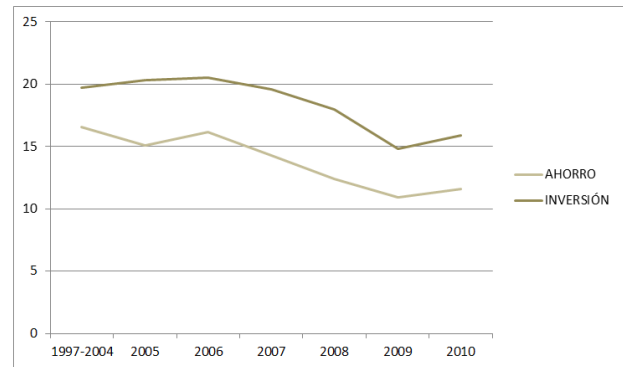
However, the world's imbalances, particularly for the U.S. economy is never satisfied. In the specific case of the U.S. economy investment exceeds savings (see Graphic 1).

Economic theory states that the decline in saving is due to a decline in public savings as a result of an increase in the budget deficit.

They coupled with high budget deficits high interest rates were recorded, which led rigged large volumes of money that caused the appreciation of the dollar (Aguado, 2008: 7).

When saving decreases recorded a higher budget deficit and the result is a decline in investment, or net exports, or both. In the case of the U.S. economy has increased investment and household consumption which has pushed foreign savings decreased and increased external deficit (Dehesa: 2003). Foreign savings has declined. In 1999-2004, was recorded a figure of 16.6% relative to GDP, while in 2010 it was 11.6%. Note that this increased investment is used for productive purposes, which become profitable projects and benefited the economy.

Savings and investments to GDP, the United States, 1997-2010 (percentages)



Graphic 1

Source: Own calculations based on statistics from the IMF, World Economic Outlook, April 2011.

At the time of Ronald Reagan (1981-1988), taxes were lowered, causing tax revenues to GDP spend of 19.6% in 1981 to 18.1% in 1988, while increased spending on defense military at 1.5 million, leading to a budget deficit of just over 3% in that period.

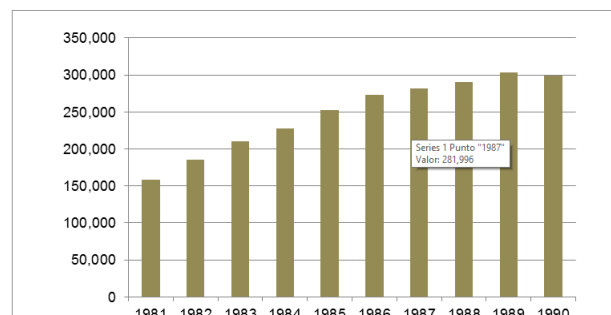
Specifically, defense spending increased by 1.9-fold from 1981 to 1989 of 157.513 to 303,555,000 dollars, respectively. In addition to the increase in defense spending, payment of the services of the public debt increased, moving from 32% in 1980 to 40% by 1984 and 50% in 1988 as a proportion of GDP. This shows that a factor of the increase in debt was military invasions and wars that began in the Reagan era, why defense spending increased. Ie, lower taxes and increased spending produced the largest budget deficits in the post war period (Frankel, 2004).

Note that in such a government, in this type of economy, was called a "voodoo economics" (DeLong, 2004, Krugman, 2003 ) in which the reduction of tax is based on two propositions that little or nulamente have been verified by empirical evidence. These propositions are: a) The Laffer curve in which a reduction in tax rates would end up producing an increase in tax revenues and thus a removal of the fiscal deficit, and b) The Ricardian Equivalence Theory which proposes that the emergence of a deficit would not necessarily imply a decline in national saving in a country, it could be that the private sector will compensate by saving more, so the "crowdingout" effect on investment disappear (Aguado, 2007). As we have seen in the period of the Reagan tax cuts did not lead to an increase in tax revenue, involves the Laffer curve, but they decreased, demonstrating that in this case, do not check the proposition that curve.

Returning to the analysis of the increase in defense spending, it appears that the United States went from being the largest creditor of the world, in 1980 recorded a creditor position of 14% relative to GDP, the largest debtor in 1990 showed a debit position -7% of GDP.

Defense spending in the period 1981-1990, growing at an average annual rate of 38.85%, increasing defense spending from year to year (see Graphic 2).

Defense spending of the United States, 1981-1990  
(millions of dollars)



Graphic 2

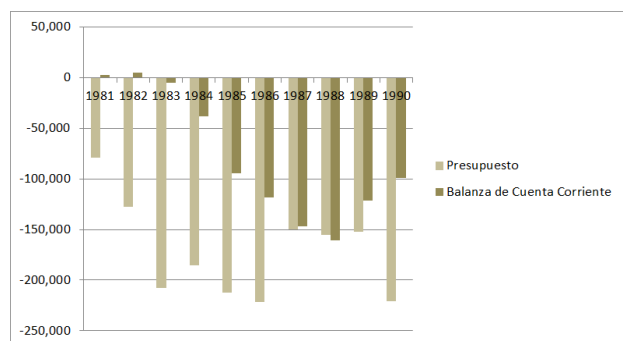
Source: Own calculations based on statistics from the Bureau of Economic

On trade, protectionism intensified because Japanese products were more efficient than the Americans and increased tariffs twice. (Chomsky, 2010: 261-262). Also a restrictive monetary policy imposed at that time by the chairman of the Federal Reserve Paul Volcker was implanted.

The budget deficit and the deficit in the current account balance for the period 1981-1990 show figures ranging from 70.000 to 220.000 million in connection with the budget deficit and 5.000 to 100.000 million dollars from the deficit of current account, which shows that they are correlated. That is, the budget deficit causes a decrease in public saving, to keep the identity (6), private savings should increase or decrease investment.

However, what happened is that the private savings declined, it increased from 10.3% in the period 1981-1984 to 8.6% in the period 1985-1988; and investment increase, moving from 8.2% to 8.6% from one period to another, which led to a deficit in the current account balance (see Graphic 3). Recall that a deficit in the current account balance is counterbalanced by an excess of investment over domestic savings, or insufficient saving relative to investment.

Twin deficits of the United States, 1981-1990 (millions of dollars)



**Graphic 3**

Source: Own calculations based on statistics from the IMF, World Economic Outlook, April 2011.

### Opening and budget surplus, 1993-2000

Due to the budget deficit in 1990 recorded a figure of 3% to GDP budget laws were developed in 1990 and 1993 in the administrations of George HW Bush and Bill Clinton, which consisted of limiting spending and raise taxes on incomes over high (Samuelson, 1999: 636-637). In the presidency of George HW Bush increased taxes on some luxury items (Aguado, 2008: 4). While under President Bill Clinton (1993-2001) increased taxes to higher-income families and defense spending declined.

As a result of this policy, Clinton had taken the economy with a budget deficit of 3.3%, obtained a budget surplus of 1.2% during the last four years of his government, which was transferred to the retirement of pensioners, the generation of so-called 'baby boomers'.

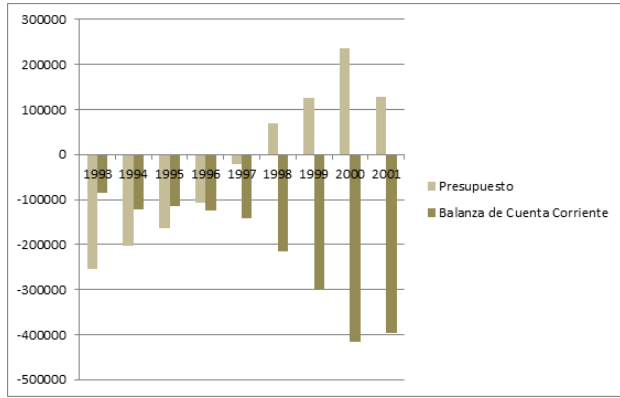
However, in the period 1993-2001, was recorded a deficit on current account, the increase in trade openness, which is derived from the implementation under President Clinton from a firm belief in the benefits of trade liberalization. Hence the Clinton presidency, begin with the signing of the Free Trade Agreement (NAFTA) and China's accession to the World Trade Organization (WTO), events that affected an increase in its rate trade liberalization in 4% and contributed to its economic growth.

It is noteworthy that the external deficit is not due to a budget deficit because in the last four years of the Clinton administration a budget surplus was recorded, while in his entire government deficit of the current account balance is observed. For example in 2000 the budget surplus was 230, 000 million dollars and the external deficit of 405,000 million. (Dehesa: 2003), which shows no correlation between the budget deficit and the deficit in the current account balance for the period 1998-2001 (see chart 4).

It is very important to note that the budget surplus is the result of a decrease in defense spending, because the U.S. did not make, in this period, new military interventions nations of the world.

In addition to the fall of the Berlin Wall and the consequent end of the Cold War helped to reduce defense spending. During the Clinton defense spending increased only 1.04 times, remaining stable from 1995 to 1999 (see Figure 5).

Twin deficits of the United States, 1993-2001 (millions of dollars)



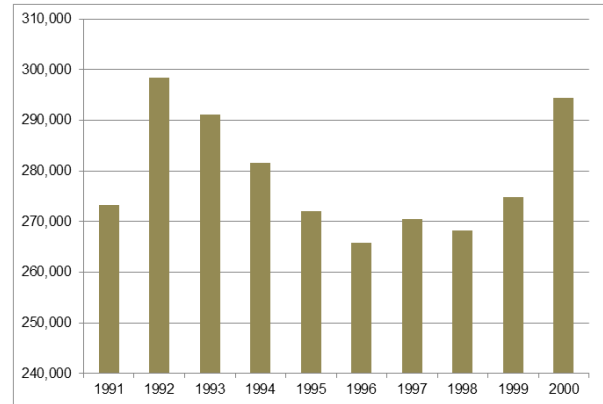
Graphic 4

Source: Own calculations based on statistics from the Bureau of Economic Analysis.

Raising taxes along with reducing defense spending and strong economic growth and the boom in the stock market led to the end of the period of fiscal deficits and the beginning of a brief period of fiscal surpluses, the last four years of the Clinton presidency. Other successes of the Clinton economic management are: a) An increase in employment rose from 109.5 to 131.9 million jobs from 1993 to 2000, as a result of economic growth averaged 4% in that period, b) budget balance transited from -255 to 236 million dollars from 1993 to 2000, c) The rate of investment to GDP rose 4% from 17.5% to 21.5% during this period.

Successes explained by low oil prices until 1999 and the appreciation of the dollar from 1995, which together with the incipient deflation in some key countries, such as Japan made it easier to contain inflation in The United States, as well as the right mix of economic policy consisting of a contractionary fiscal policy associated with an expansionary monetary policy, which was possible due to the low rates of inflation recorded The United States, which were carried out by the Federal Reserve.

Defense spending of the United States, 1991-2000 (millions of dollars)



Graphic 5

Source: Own calculations based on statistics from the Bureau of Economic Analysis.

**The second period of the twin deficits, 2001-2008**

In the era of George W. Bush (2001-2008), a budget deficit, due in part to his campaign promises of lower taxes, for which he signed several laws fiscal reforms to reduce them (Mankiw was recorded, 2009: 592-593);

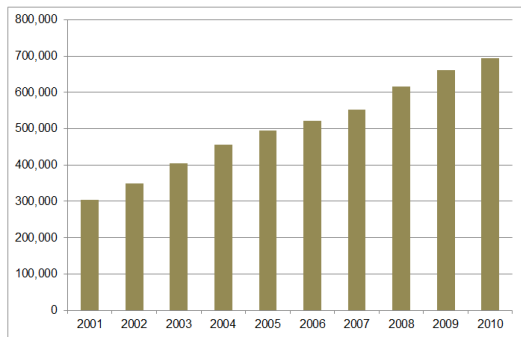
Moreover the fall of the twin towers in September 2001, sparking military invasion of Afghanistan and Iraq and a recession that led to an increase in spending.

It should be noted that the budget deficit in the Bush administration is mainly due to the increased costs of national defense and social security expenses and specific social program called Medicare. Invasions of the United States in both Afghanistan and Iraq led to an increase in spending increases on defense ("national security"), with the consequent return of the economy 'Voodoo'. That is, a key factor is the budget deficit increased yoy in defense spending (see Graphic 6).

This has caused Americans to save less and spend more, which has influenced deficit incurred in the current account balance, which went from 2.9% in 1997-2000 to 4.1% in 2001-2004.

While the United States has saved less, the countries that have saved are the countries of Asia including China (Mankiw: 2009: 726-727).

Defense spending of the United States, 2001-2010 (millions of dollars)

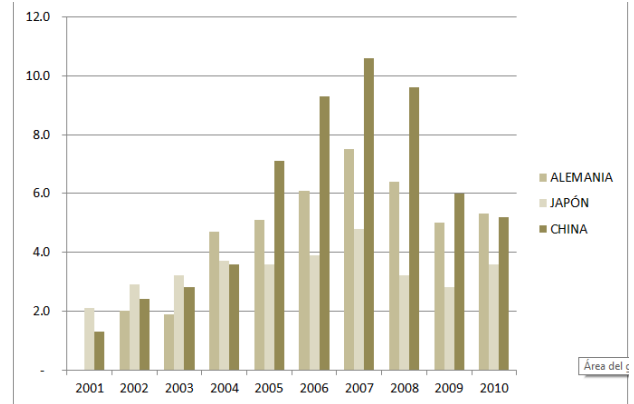


Graphic 6

Source: Own calculations based on statistics from the Bureau of Economic Analysis.

The economic logic is that if a country has a deficit, another nation has to have a surplus, which must be sought in the trading partners of the United States such as China, Japan and Germany as well as in the oil-exporting countries due to high oil prices that occurred in the past decade. In Graph 7 the trade surplus seen Germany, Japan and China in the period 2001-2010 is shown.

Current account balance to GDP, 2001-2010



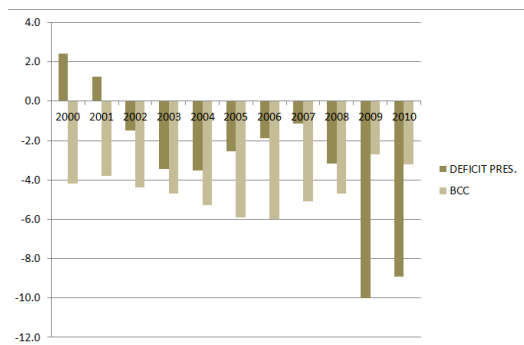
Graphic 7

Source: Own calculations based on statistics to the IMF, World Economic Outlook, April 2011.

Economist Ben Bernanke (Chairman of the Federal Reserve since 2006) uses the term "Global Savings Glut" to refer to global savings has been generated as a result of the surplus in the current account balance in different countries. This saving has financed the current account deficit of the United States, because Asian central banks, especially China, have bought Treasuries United States. However, this willingness of central banks can change the depreciation of the dollar, causing losses to the countries that buy these bonds at low interest rates granted by the United States or to the loss of interest of these countries to maintain fixation system of the Chinese currency to the dollar. Consequently, the United States is in a very vulnerable situation because its deficit of current account went from 3.9% in 2001 to 6% in 2006 and then placed in 5% by 2008. Coupled with the budget deficit recorded a figure of 1.9% in 2001 to 3.5% in 2008, so it shows that both deficits are correlated, ie twins (see Graphic 8).



Twins deficit of the United States relative to GDP, 2000-2010 (percent)



**Graphic 8**

Source: Own calculations based on statistics from the Bureau of Economic Analysis.

## Conclusions

This research examines the twin deficits in the U.S., in order to check the correlation between the budget deficit and the deficit in the current account balance for the period 1981-1988 and 2001-2008.

This is part of a theoretical framework based on the identity  $S_{\text{p\u00fablico}} + S_{\text{privado}} + I = XN$ , from which evidence of twin deficits sample is obtained in those periods a correlation between the budget deficit and the deficit account current, which is explained in terms of which to register a budget deficit, public saving fell, which coupled with a decline in private saving and an increase in investment, led to a deficit in the current account balance. Verifying the fact that a deficit in current account occurs when an investment exceeds domestic savings or a level of national saving is less than investment.

The budget deficit in the periods 1981-1988 and 2001-2008 is explained by an increase in defense spending coupled with tax cuts resulting in a decrease in tax revenue.

This correlation between the budget deficit and the deficit in the current account balance, has an exception that is the last four years of the Clinton administration, 1998-2001, in which a budget surplus and a deficit is observed in the balance of trading account at the same time. The first is explained by a decrease in defense spending, because they did not take out new military invasions and the fall of the Berlin Wall and the end of the Cold War.

The second by an increase in investment and consumption of American families that causes a decline in foreign savings. This despite the fact that during the Clinton administration increased the rate of 4% in opening trade following the signing of NAFTA and China's entry to the WTO.

In all cases the deficit in the current account balance is funded through the global savings derived from surpluses in its balance of countries like Germany, China and Japan, among others, who buy Treasuries United States. Which leads to the U.S. economy as the main problem has scarce savings that comes from excessive consumption of households and the public sector, so it is best policy to decrease public spending, increasing savings public and increase tax revenues to increase private savings and reduce consumption within the country and increase consumption in the world, as some measures to correct the external deficit.



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