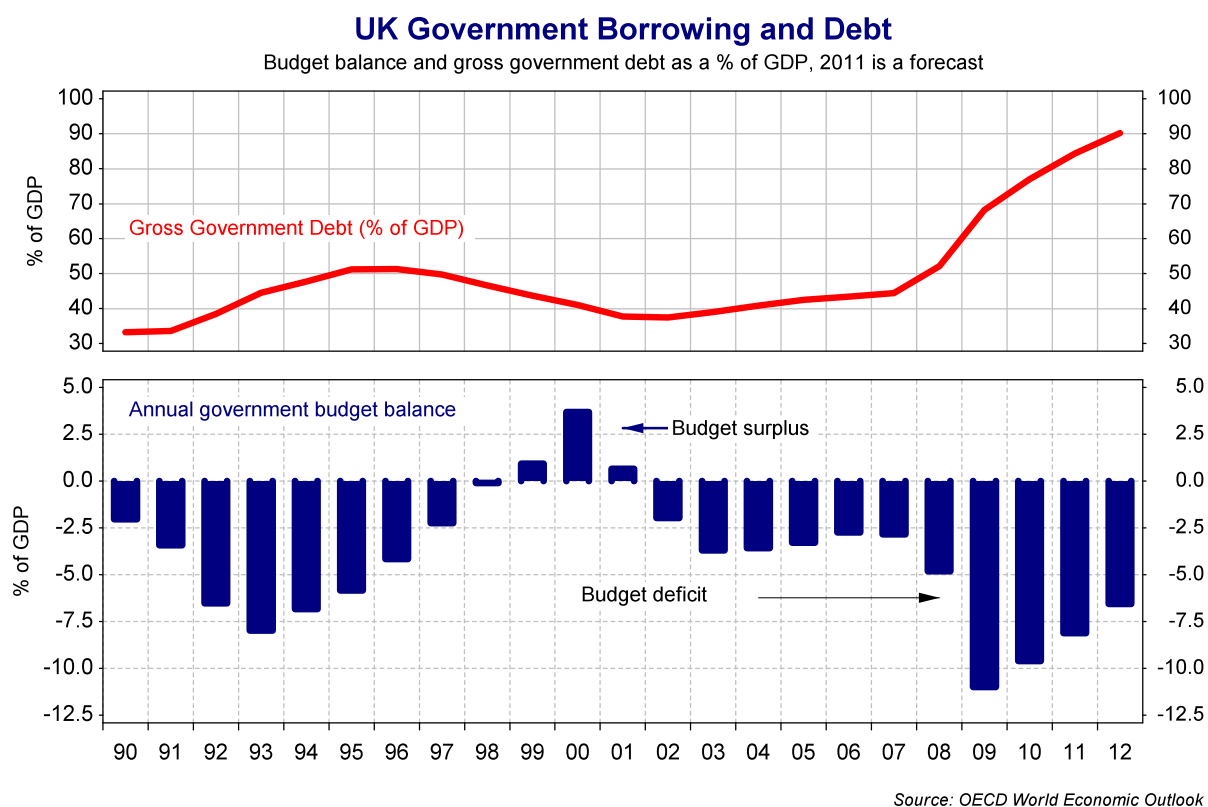


## A2 Macro Revision: The Economics of Twin Deficits

**Twin deficits** refer to a situation where an economy is running both a fiscal deficit and also a deficit on the current account of the balance of payments (BoP).

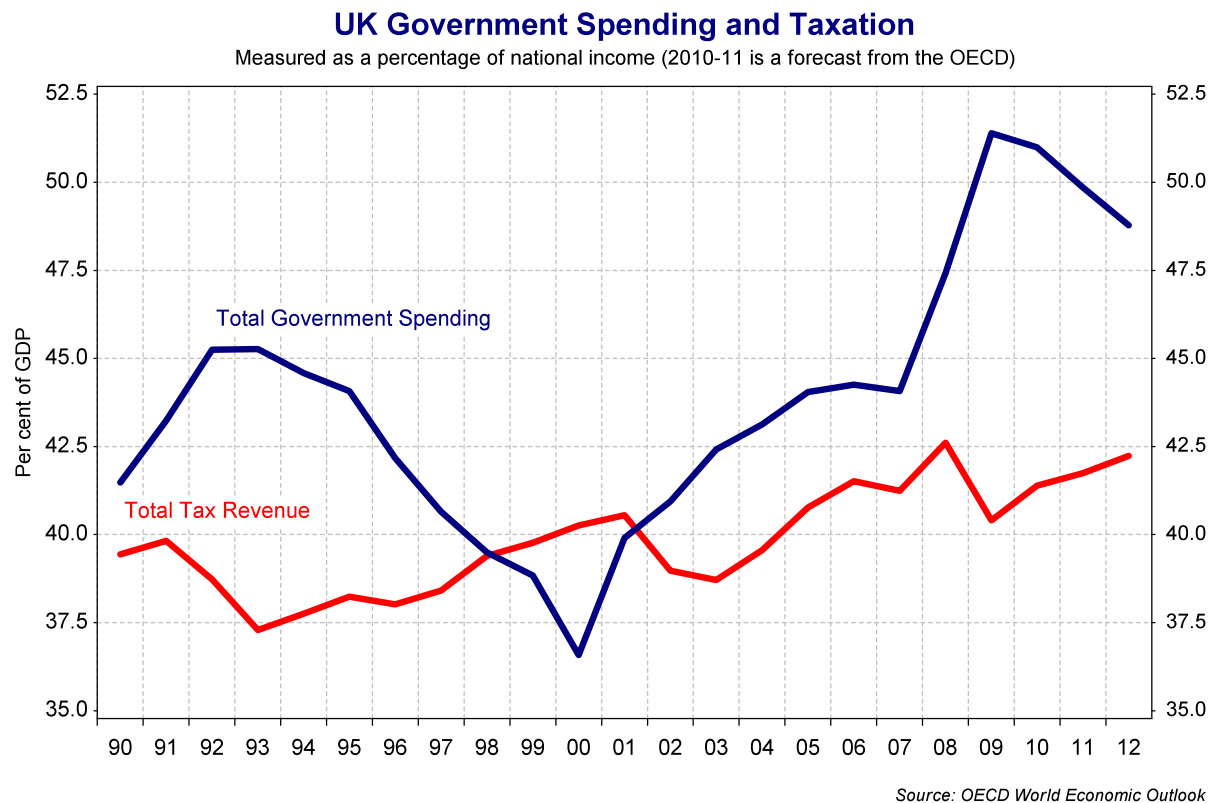
### Fiscal deficit

- **Fiscal deficit** - the annual amount by which government spending exceeds income from taxation. Also known as the **budget deficit**, when a country is running a fiscal deficit it must finance this by borrowing through the issue (sale) of new debt.
- A government will normally borrow money by issuing bonds or other securities and the **interest rate** on this debt will depend on the willingness of lenders to offer credit, the expected rate of inflation and the risk of whole or partial default.
- The government of a country with low or worsening **credit ratings** may need to negotiate loans from institutions such as the World Bank, the International Monetary Fund, sovereign wealth funds or other governments / overseas banks.



The huge size and scale of the fiscal deficits being run by many countries in the wake of the Global Financial Crisis and the subsequent recession has made government borrowing one of the most important issues in economic policy at the moment. There is a fierce debate between those who believe that governments must take drastic steps to consolidate (reduce) their borrowing through **fiscal austerity** measures and those who oppose fiscal tightening believing that it might bring about another recession and a possible depression.

The **UK Coalition Government** (elected in May 2010) has opted to accelerate the timetable for fiscal deficit reduction. They have decided that the main burden of deficit reduction will be from reduced spending rather than increased taxes – see the chart below which includes 2011-12 forecasts.



The case for reducing the fiscal deficit in the UK

1. High levels of government debt threatens financial stability and the UK's AAA credit rating
2. Higher debt and future taxes might crowd-out the private sector's ability to expand i.e. higher taxes and higher interest rates will curb demand and ability to fund investment
3. It is inequitable to leave future generations with excessive levels of debt to repay – better to make a sizeable reduction in the deficit now rather than burden succeeding generations
4. There are doubts about the value of the fiscal multiplier and effectiveness of fiscal stimulus policies. Monetary policy (low interest rates and a lower exchange rate) can continue to support the growth of demand even if fiscal policy is being tightened.
5. A debt reduction policy will enhance the UK's macroeconomic policy credibility, improve confidence and provide support to an economic recovery

Arguments against deficit reduction

1. UK Government bond yields (interest rates) are low – it is sensible for the government to borrow now especially to fund important infrastructure investment as a boost to AD
2. Deep cuts in spending will derail a fragile economic recovery / bring about a double dip – and another recession will make the fiscal deficit worse in 2012-15
3. Let monetary policy do the job of controlling inflation – don't slash and burn public spending
4. Doubts about resilience of the private sector – will businesses and industries grow sufficiently strongly to absorb the thousands of jobs that will be lost in the public sector?

- The idea of an “expansionary fiscal contraction” is an oxymoron and makes no economic sense. Cutting government spending will reduce demand and bring about negative multiplier and accelerator effects on the UK economy

Most critics of deficit reduction are **Keynesian economists**

The Keynesian school argues that fiscal policy can have powerful effects on AD, output and employment when an economy is operating well below full capacity national output. Without a fiscal stimulus, an economy may be stuck in a semi-permanent recession and there is the risk of being stuck in a Liquidity Trap (monetary policy becomes ineffective).

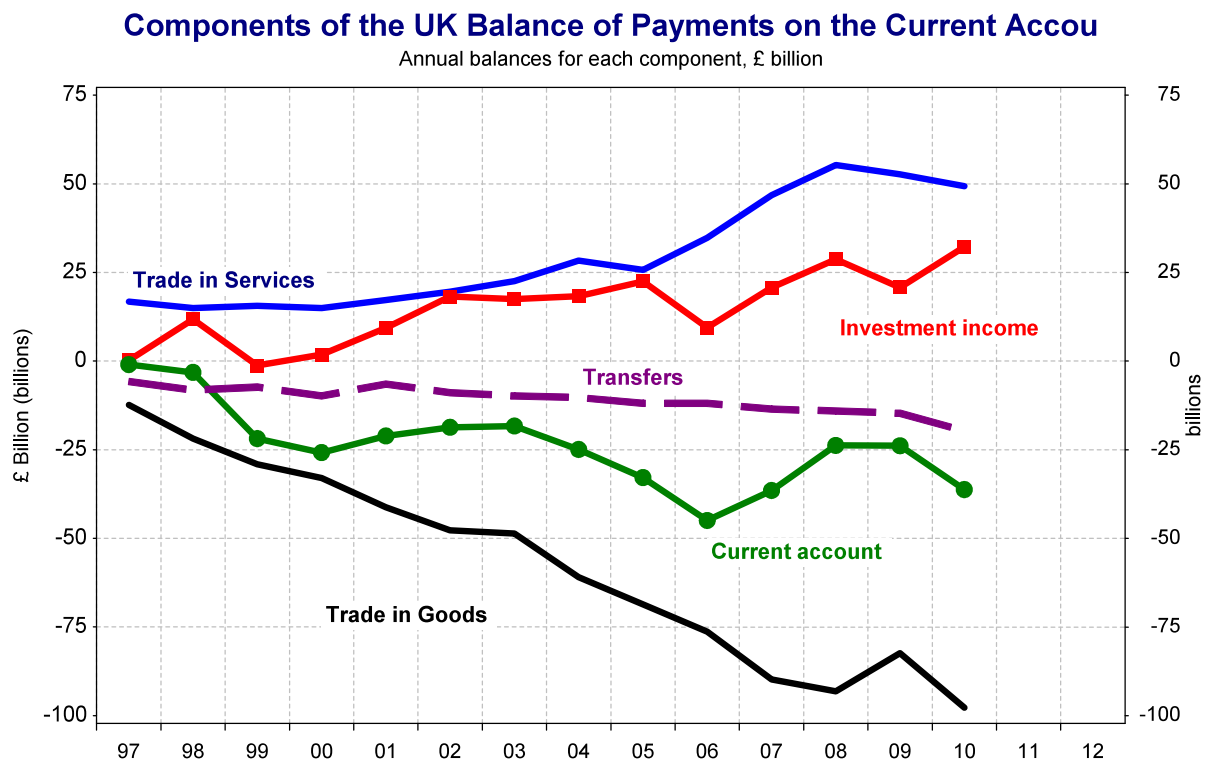
## Current Account Deficits

This relates to a situation in a country’s overseas balance of payments where the amount by which money relating to trade, investment etc going out of a country is more than the amount coming in. This leads to a net outflow of money from a country’s circular flow.

The current account balance is made up of four separate balances:

- Balance of trade in goods
- Balance of trade in services
- Net investment income from external assets
- Transfers

If inflows i.e. exports are greater than outflows i.e. imports, the UK is running a current account surplus. If outflows exceed inflows – the UK is running a deficit.



Source: Reuters EcoWin

Many students confuse a fiscal deficit with a current account deficit – they are different. The former relates only to government finances whereas the current account reflects the international trade and investment income performance of an economy as a whole.

In the case of a current account deficit, a nation needs to operate an off-setting surplus on the capital account of their balance of payments and this can be done in several ways including

- Attracting inflows of direct and portfolio investment from overseas
- Attracting short term banking flows into their economy (so called hot money)
- Attracting other flows including some remittances from migrant workers located overseas
- Short term borrowing / financial assistance from the World Bank and IMF

A current account deficit can have many causes – both demand and supply-side and whether or not a deficit matters depends in part on why it is happening. The UK economy for example has been running a current account deficit for many years in a row. Much of the deficit has been the result of a growing trade deficit in goods (approaching £100bn a year) only partially offset by surpluses in trade in services and a net inflow of investment income.

When considering the causes of a current account deficit it is important to distinguish between:

- (i) **Cyclical causes** – the downturn in world trade in 2009 causing a fall in the value of exports
- (ii) **Structural causes** – e.g. the effects of globalisation and the supply-side performance of the UK's manufacturing export businesses including relatively low productivity and research
- (iii) **External shocks** – e.g. volatility in commodity prices such as for food and oil/gas – the UK is a net importer of both and the balance of payments suffers when global prices are rising.

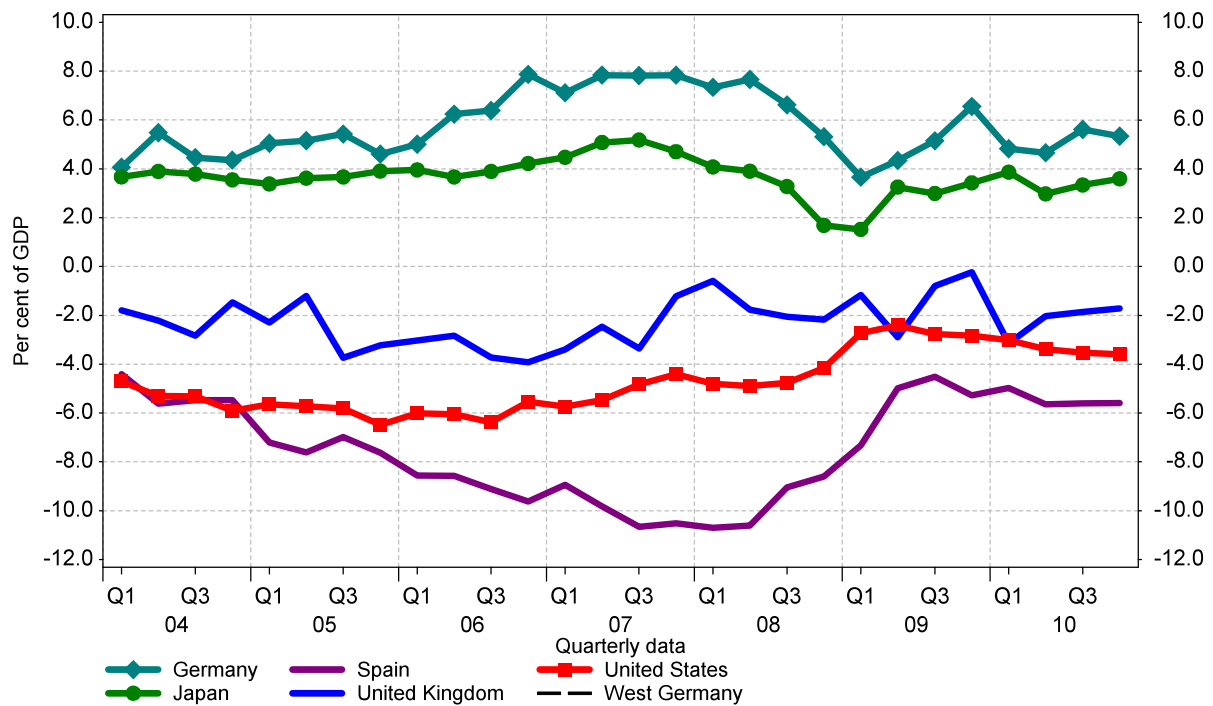
### **Does a current account deficit matter?**

The main arguments for being relaxed about a current account deficit are as follows:

- (i) **Partial auto-correction:** If some of the deficit is due to strong consumer demand, the deficit will partially correct when the cycle turns and there is a slowdown in spending or a recession.
- (ii) **Investment and the supply-side:** Some of deficit may be due to increased imports of new capital and technology that will improve productivity and competitiveness of producers.
- (iii) **Capital inflows balance the books:** Providing a country has a stable economy and credible policies, it should be possible for the current account deficit to be financed by inflows of capital without the need for a sharp jump in interest rates.

## Current Account Deficits and Surpluses

Current account balance as a percentage of GDP



### Counter views

- (i) **Structural weaknesses:** The deficit may be a symptom of a wider structural problem i.e. a loss of competitiveness, insufficient investment or a shift in comparative advantage
- (ii) **An unbalanced economy:** A large trade gap can reflect an 'un-balanced economy' typically the consequences of a high level of consumer demand contrasted with a weaker industrial sector. Eventually these "trade imbalances" have to be addressed.
- (iii) **Loss of output and jobs:** A widening trade deficit may result in lower output and employment because it represents a leakage from the circular flow of income and spending. Workers who lose their jobs in export industries, or whose jobs are lost because of a rise in import penetration, may find it difficult to find new employment.
- (iv) **Potential problems in financing a current account deficit:** Countries cannot always rely on inflows of capital to finance a current account deficit. Foreign investors may eventually take fright, lose confidence and take their money out.
- (v) **Downward pressure on the exchange rate:** A large deficit in trade can lead to a fall in the exchange rate. This would then cause imported inflation and might lead to a rise in interest rates from the central bank. A declining currency would help stimulate exports but the rise in inflation and interest rates would hit demand, output and employment