Current Account Deficits and Welfare in a Time of Fiscal Profligacy

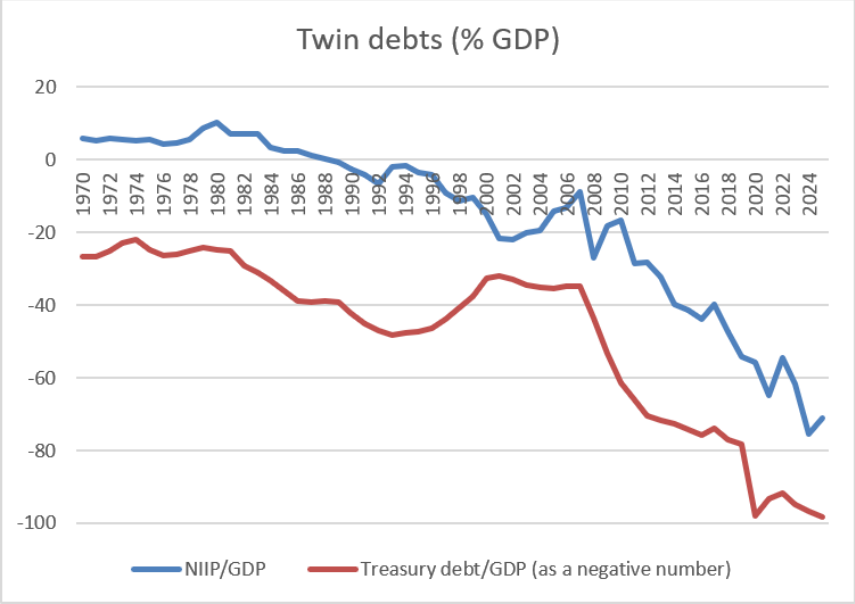
Kimberly A. Clausing and Maurice Obstfeld

Note on Plans for Completion: *This project is underway, and we've made progress on sections II and III. We plan to work on this throughout the Fall, finishing a preliminary draft by December. The paper should be finished well before your May conference date.*

I. Introduction and Motivation

In recent years, US policymakers throughout the political spectrum have shown little concern about fiscal deficits, enacting spending increases and tax cuts, even as fiscal imbalances average about 6 percent of GDP, and US debt to GDP ratios surpass 100 percent. On the other hand, in some quarters, current account balances are taken as a rationale for trade protection and even upending the global trade system, supposedly to the US advantage.

These two imbalances are related. Indeed, when large fiscal and CA deficits emerged in the early 1980s, many referred to causally linked "twin deficits": fiscal expansion was held to drive up US real interest rates, appreciating the dollar and creating an expanded trade deficit. The correlation between the twins is not always readily apparent; for example, the CA deficit remained high in the 1990s despite the restoration of federal budget balance by President Clinton. Still, in recent years, the IMF (and others) have identified the US budget deficit as an important driver of wider global current account imbalances, along with structural characteristics and policies in other countries. Over the long term, federal debt and the US NIIP have trended strongly together, with shorter-run divergence.



Economists often worry that large fiscal deficits crowd out domestic investment, a worry supported by empirical observations – including Feldstein and Horioka (1980) – that showed correlations between domestic savings and investment, as well as higher interest rates in the wake of borrowing. However, borrowing from abroad dampens crowding out and lowers the welfare costs of fiscal deficits. This contrasts with a common narrative about the US debt, which holds that US debt is not a worry if "we owe it to ourselves". As it turns out, owing debts to others improves welfare.

This is partly due to the simple gains from intertemporal trade. Countries with a tendency to borrow (or a preference for consuming now) are better off if they can access international capital markets. The country's capital stock will be higher, and the domestic interest rate will be lower, with international capital mobility. In that sense, international imbalances are not the cause of deindustrialization, which would be larger absent international capital mobility, since the US capital stock would be lower. International capital mobility increases welfare, lowering the costs of intergenerational transfers for younger generations.

Beyond the fiscal deficit, other factors affect international imbalances, and not every country/time will experience the "twin" debt relationship shown above. There are also important factors that determine financial stability and debt sustainability that deserve attention from policymakers. In the end, fiscal deficits present consequential problems. However, international imbalances make these problems better, not worse.

Outline for the Remainder of the Paper.

II. Data Patterns

a. Feldstein Horioka showed strong correlations between savings and investment; to some extent, those patterns have broken down.
b. The United States shows times of "twin deficits" and times of divergence.
c. Deficits are flows; the US stock picture shows some evidence of twin debt.
d. Other major countries have a diversity of patterns.

III. Borrowing Abroad and the Welfare Implications of Debt: A Simple Model

a. Diamond (1965) showed that debt has important welfare consequences in OLG models due to its negative impact on capital accumulation, which tend to reduce steady state welfare. However, Diamond also considered the case where the government can borrow abroad, which lowers the welfare costs of debt (in comparison to a closed economy case).
b. Persson (1985) extends this OLG model to the case where the private sector can borrow and lend internationally. This leads to an even larger deterioration in the NIIP in the wake of government borrowing, but a smaller impact on welfare.

c. We generate a simple OLG model that shows that, in a closed economy, debt has three costs for a representative consumer: (1) Disposable income for the younger generation is lower because of the taxes needed to service the extra debt, directly reducing welfare; (2) lower income in the younger generation reduces saving and thereby, the capital stock, with adverse effects on wages; and (3) young savers acquire more debt and less capital with their diminished saving, leading to a further adverse movement in wages. If the government can borrow abroad, that avoids factor (3). With private and public capital mobility, that avoids both factors (2) and (3), making debt issuance in that context the least costly alternative of all.

IV. Context and Extensions

a. Is there a convenience yield for government debt? How would that affect the story?
b. Does it matter if the borrower/lender is a big country (like US/China)? How does that affect the terms of trade from inter-temporal trade?
c. What are the implications of risk premia/regimes? If US debt becomes a more risky asset due to higher risk of default, higher inflation risk, or other institutional decay, how does that change the twin deficits problem? What are the implications for welfare?

V. What are the risks associated with borrowing abroad?

a. At present, goods markets are becoming more fragmented. If international financial markets also become more fragmented, how does this affect the costs of foreign borrowing in the future?
b. What are the consequences of diminished US "exorbitant privilege" due to excess US debt? Holding either too little or too much debt could harm one's role as a dominant currency.
c. How do foreign holders of debt affect the functioning of the Treasury market and interactions between monetary and fiscal policy? Is there increased sensitivity to shocks?
    - For example, US Treasury is currently worried about large Japanese sales of Treasuries.
    - How do such concerns affect central bank independence and concerns about fiscal dominance?

VI. What are the policy implications?

a. What are the implications of this analysis for the effectiveness and welfare implications of capital import taxes and tariffs?
b. What are the lessons for fiscal policy in terms of the implications of deficit/debt trajectories?