

The Antinomies of the Dollar The U.S. Fiscal Deficit And Current Account

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Federal Reserve Board Chairman Greenspan speaks in Washington.

The most recent U.S. recession touched bottom in the third quarter of 2001 when the gross domestic product dropped 1.3 percent. The recovery, begun at the end of that year thanks to prompt tax incentives

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and increased consumption, investment and exports, peaked when GDP growth reached 2.2 percent in 2002 and 3.5 percent in 2003.

The speedy transition from crisis to expansion is the most important macroeconomic effect of George W. Bush's recent anti-cyclical fiscal policy. Nevertheless, by pulling the economy out of

the recession, the government has set its federal budget on what the White House itself recognizes as an "unsustainable path" in the long run. According to the Congressional Budget Office (CBO), the unified public deficit came to U.S.\$375 billion in the fiscal year of 2003,¹ and it will probably increase even more in the next 10 years if unemploy-

ment stays at 5.2 percent and no drastic adjustments are made. In the long run, the increasing fiscal deficit is unsustainable because it represents an explosive public debt. Also, the deficit in the current account as a percentage of GDP has grown continually for more than 10 years. Today, it is at a record high of more than 5 percent of GDP. Just like the government's deficit, the imbalance in the current account is unsustainable because it represents a growing foreign debt and de-stabilizes the exchange rate, prices and the balance of payments.

This article will analyze the fundamental causes and effects of the fiscal deficit and look at the problem of the imbalance in the current account, its relationship to the public deficit and what that means for the stability of the dollar. In conclusion, I will comment on a probable future scenario for the dollar.

THE FISCAL DEFICIT

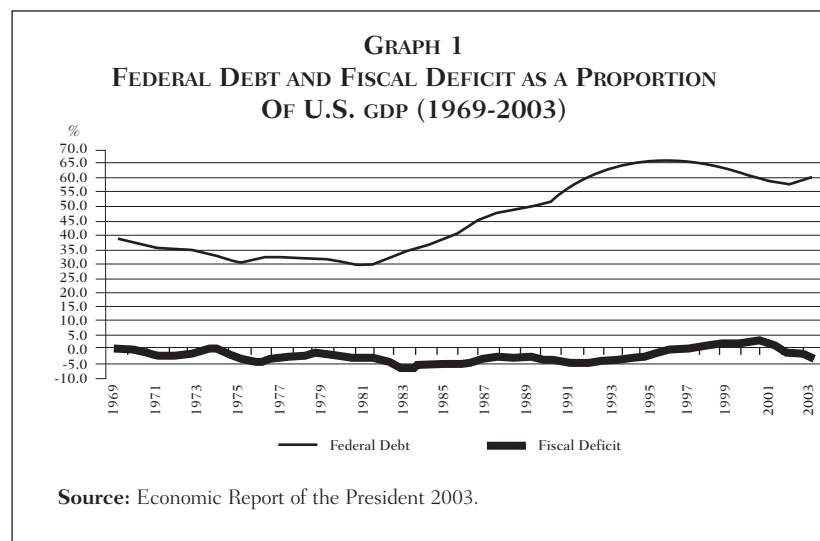
The origin of the current imbalance in U.S. public finances is rooted in the 2001 recession. The swift drop in prices in corporate shares at the end of 2000, the increase in government defense spending, expenditures in several current public programs and the drop in tax rates aimed at stimulating aggregate demand contributed to eliminating the more than 1.5 percent GDP surplus that U.S. government finances reported from 1999 to 2001. The overall result is a unified fiscal deficit of U.S.\$375 billion for the 2003 fiscal year, according to the CBO.² This amount could become explosive in the future, given that the fiscal impetus will continue to support expanding production, while the monetary policy will maintain its ac-

commodating rhythm with practically zero-percent short-term interest rates (see table 1). Two additional reasons to expect future fiscal stimuli to aggregate demand are this year's presidential elections and the Fed's hypothesis that for the moment, the risk of inflation is being held off by the high margins of under-utilization of productive capacity (about 20 percent).

The most recent economic indicators show that, given the impact of the expansive fiscal policy on aggregate demand, the economy has made impressive product and real income gains, even though progress on job creation has been limited.³ According to Alan Greenspan, the economy is now on the path of new sustained expansion. Economic growth *per se* should improve the profile of government accounts. In apparent contradiction, the White House and the Fed have expressed concern about lack of fiscal discipline. Why this concern? Private spending was the driving force behind the 1992-2000 stock market boom and economic expansion; the financial position of the private sector deteriorated 11.5 percent of GDP, reflecting an extraordinary increase in

foreign debt, while public finances improved, going from a higher than 6 percent deficit in 1994 to an almost 2 percent surplus in early 2001. With the 2001 recession, the private deficit dropped and fiscal imbalances reappeared. The importance of this situation is that government debt is one of the fundamental premises on which the Fed designs monetary policy. That is why it is also important to know the exact amount of the fiscal deficit.

The official figure for the fiscal deficit (U.S.\$375 billion in 2003, 3.5 percent of GDP or 16 percent of total spending) was arrived at based on the unified fiscal deficit. It is a figure that underestimates the real size of the problem because it includes spending programs financed by their own sources of revenue. A more precise measurement of the fiscal deficit should exclude the expenditures of federal employee retirement programs, Medicare, social security and unemployment insurance (programs that currently show a surplus).⁴ Thus, the other way of calculating the figure gives us a "core" fiscal deficit that is the part of the budget financed by taxes on individual and cor-



porate income. Therefore, the “core” fiscal deficit for the 2003 fiscal year is approximately U.S.\$600 billion, 5 percent of GDP or 61.3 percent of budgeted spending, not including interest payments or defense spending. This means that to balance the core fiscal deficit, it would be necessary to either reduce government spending by 61.3 percent or increase taxes 56.6 percent with regard to their 2003 levels to prevent the government debt/GDP ratio (δ from now on) from becoming unsustainable. Actually, it is not necessary to balance the government budget. It would suffice to maintain δ constant, which could be achieved—supposing, in accordance with the CBO, that long-term unemployment stays at 5.2 percent—by any of the following three means: 1) an approximately 18 percent tax increase; 2) a core budget cut of 22.1 percent of spending, not including non-interest, non-defense spending; or 3) a combination of 1 and 2. Any of these solutions would make it possible to keep the core fiscal deficit consistent with its historic average over the last 50 years (see graph 1). But, if the govern-

ment does not change its current tax and spending policies, the core fiscal deficit, and therefore, the ratio, will become unsustainable. It should be emphasized that the ratio δ dipped slightly during the boom of the second half of the 1990s, but in the last two years, stopped dropping. This means that the new sustained expansion of economic activity is not guaranteed.

THE DEFICIT IN THE CURRENT ACCOUNT

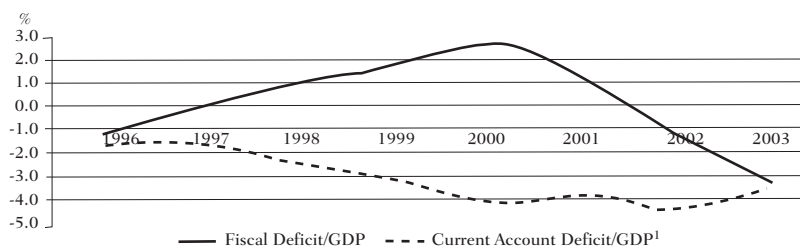
The deterioration of the current account is mainly determined by the negative trade balance. Today’s current account deficit is 5.1 percent of GDP (U.S.\$550 billion) (see graph 2), and it means nothing less than the transfer of U.S. financial assets of equal value abroad. Edward M. Gramlich, of the Federal Reserve System, maintains that there is a link between the fiscal deficit and the imbalance in the current account, but that by no means are they twins, as occurred with the Reagan-era deficits. The impact of the current

account deficit on the fiscal deficit can be illustrated with the following figure: the interest, dividends and capital gains generated by the U.S.\$550 billion associated with the current account deficit do not contribute to tax revenues because basically they are not taxed domestically in the United States. The CBO has overlooked this fact in its fiscal projections when it has not deducted it from the taxable income base that is the premise for the calculation of the fiscal deficit projected from now until 2014. If the deficit in the current account were to stay at today’s 5 percent of GDP, then accumulated untaxed revenue would come to U.S.\$ 302.5 billion. The fiscal deficit, currently at a record high of 5 percent of GDP, would increase 0.5 percent of GDP and, by 2014, government debt would have increased by U.S.\$586.8 billion because of the current account deficit. It is obvious that under these circumstances the ratio δ would be unsustainable and the dollar, the world’s main reserve currency, would become very volatile, feeding a scenario of international financial instability.

In his testimony before the House of Representatives Budget Committee, Alan Greenspan warned of the delicate financial position of the U.S. economy. It is worth quoting him at length:

The dimension of the challenge is enormous. The one certainty is that the resolution of this situation will require difficult choices and that the future performance of the economy will depend on those choices. No changes will be easy, as they all will involve lowering claims on resources or raising financial obligations. It falls on the Congress to determine how best to address the competing claims. In doing so, you will need

GRAPH 2
FISCAL DEFICIT OR SURPLUS AND CURRENT ACCOUNT AS
A PROPORTION OF U.S. GDP (1996-2003)



¹ The figure for 2003 is for the third quarter.

Source: Created by the author with figures from the Economic Report of the President.

to consider not only the distributional effects of policy change, but also the broader economic effects on labor supply, retirement behavior, and private saving. History has shown that, when faced with major challenges, elected officials have risen to the occasion. In particular, over the past 20 years or so, the prospect of large deficits has generally led to actions to narrow them. I trust that the recent deterioration in the budget outlook and the fast-approaching retirement of the baby-boom generation will be met with similar determination and effectiveness. But the ratio of federal debt held by the public to GDP has already stopped falling and has even edged up in the past couple of years—implying a worsening of the starting point from which policy makers will have to address the adverse budgetary implications of an aging population and rising health care costs.⁵

Of course, this would happen if there were no change in current domestic economic policy.

THE DOLLAR, A PROBABLE SCENARIO?

The CBO projected an adjustment in the fiscal deficit between 2004 and 2006, putting it at 1.83 percent of GDP in 2006, based on a 3.5 percent real GDP growth rate and a maximum of 2.1 percent inflation. On the other hand, the dollar has devalued 12 percent vis-à-vis its peak in early 2002 with regard to a broad basket of currencies of its main trade partners (the Federal Reserve “broad” exchange rate). Also, the economy’s three institutional sectors (households, corporations and government) are overwhelmed by their respective debts. Under these conditions, the adjustment of macroeconomic imbalances in the United States has two alternatives: first, a new recession sufficiently deep to absorb the trade deficit and adjust the current account, or, second, a 20-percent or higher devaluation of the dollar to induce a “trade effect” (an increase in net exports) and a “price effect” (an increase in the competitiveness of trade-

able goods, above all vis-à-vis the countries with greater trade surpluses than the United States, that is, Germany, China and Japan). The first method has the disadvantage of increasing the core fiscal deficit and therefore the ratio δ . The second runs the risk of increasing inflation. However, in current conditions, a devaluation of the dollar is the most probable scenario.

IMPLICATIONS FOR THE WORLD AND MEXICO

The Federal Reserve’s Broad Index of the Exchange Rate (BIER) includes the United States’ 36 most important trade partners. The U.S. government argues that the decline of the trade balance is explained because between 1992 and 2003, real GDP has grown more rapidly than the economies included in the BIER calculation. The “growth” effect on the trade deficit is real, but actually the matter is more complex than the official explanation would lead us

TABLE 1
U.S. MACROECONOMIC INDICATORS

	FISCAL DEFICIT/GDP	INFLATION	GDP GROWTH	UNEMPLOYMENT RATE	NET EXPORTS/GDP	NOMINAL INTEREST RATE	REAL INTEREST RATE
1990	-3.9	6.1	1.8	5.6	-1.9	8.1	1.8
1995	-2.2	2.5	2.7	5.6	-2.4	5.9	3.3
1999	1.4	2.7	4.1	4.2	-3.7	5.2	2.4
2000	2.4	3.4	3.7	4.0	-4.6	6.3	2.8
2001	1.3	1.6	0.3	4.8	-4.2	3.6	2.0
2002	-1.5	2.4	2.2	5.8	-1.2	1.7	-0.7
2003	-3.5	2.3	3.5	5.7		1.0	-1.3

Source: Economic Report of the President, 2003.

GRAPH 3
INCOME AND PRICE ELASTICITIES OF U.S. DEMAND
FOR MEXICAN EXPORTS (1981-2002)



to believe. The Fed divides the BIER into two components: “major” and “other important” trading partners. The real GDP of the “major trading partners” has evolved more slowly than that of the United States in the last 10 years. In this case, the “growth effect” is applicable. By contrast, the “other trading partners” have grown more rapidly, but the trade balance with this group has deteriorated similarly to that with the group of “major partners.” In other words, Germany, China and Japan are the main parties responsible for the U.S. trade deficit since the beginning of the 1990s long boom. Germany and Japan, threatened with the imminent risk of deflation, have grown less than the United States, but the dynamism of China’s economy has far surpassed U.S. GDP. In the three cases, the United States has experienced a growing deficit in its bilateral trade balance. This is why a recession would be a bad solution to the new “twin deficits.” A substantial adjustment of the BIER would be more effective than contraction.⁶

How would the correction of U.S. macroeconomic imbalances through a strong devaluation of the BIER affect

the Mexican economy? In recent years, Mexico’s GDP has grown less than the United States’, and yet we have a trade surplus. The devaluation of the dollar would change relative prices in favor of the United States, and, *ceteris paribus*, would decrease our exports and slow down national production even more. The final impact of the adjustment to the BIER on the Mexican economy will depend in part on whether the devaluation is contractive or expansive. In the first case, the contraction of U.S. GDP would lead to a recession in Mexico (the 2001 U.S. recession decreased Mexico’s economic growth rate by a little more than one percentage point). In addition, the U.S. labor market’s reduced ability to absorb excess Mexican labor would have an effect on the remittances emigrants send back to our country (dollar remittances are one of Mexico’s main sources of hard currency and are necessary for financing our current account deficit). On the other hand, if by virtue of the new BIER parity, the U.S. economy expands, the increase in Mexican exports would have a dynamizing effect on our economy. Graph 3 illustrates these effects: since the end of the 1990s boom, income

and price elasticities of our tradeable goods have deteriorated. This means that the adjustment of the BIER would have to be truly expansive for the Mexican economy not to go from stagnation—in the last three years, it has grown less than an average one percent annually—to recession. **NMM**

NOTES

¹ Alan Greenspan, “Economic Outlook and Current Fiscal Issues,” testimony of the chairman before the Committee on the Budget, U.S. House of Representatives, 25 February 2004. <http://www.federalreserve.gov/>

² The unified fiscal deficit is derived from the unified federal budget, which is normally reported in national accounts. However, this budget and, therefore, the unified fiscal deficit, do not reflect the real situation of public finances because they include spending programs financed with their own sources of revenues, like social security, Medicare, federal employee retirement programs and unemployment insurance.

³ Greenspan, *op. cit.* Because renewed economic growth has not decreased unemployment or improved income distribution, the 2002-2003 expansion has been called the “jobless recovery”. See Fred Moseley, “Goldilocks Meets a Bear: How Bad Will the U.S. Recession Be?” *Monthly Review* (New York), April 2002; and Ignacio Perrotini, “Crecimiento con burbujas, deuda y deflación en Estados Unidos y su impacto en México,” José Luis Calva, ed., *La economía mexicana en el 2o. año del gobierno de Fox. Memoria del XVIII Seminario de Economía Mexicana* (Mexico City: UNAM Instituto de Investigaciones Económicas, 2003).

⁴ In fact, these surpluses represent government gross debt because they are invested in government bonds.

⁵ Greenspan, *op. cit.*

⁶ A substantial devaluation of the dollar is not without its consequences. For example, most of the private debt has gone through the stock market. This represents a potential for disrupting the financial system and dollar stability that the Fed must surely have taken into account. The effects of a devaluation on inflation, the distribution of wealth and public finances should also not be underestimated.