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Economic Research:

Twin Deficits: Mind The Gap(s)

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As the Trump administration looks to implement increasingly protectionist policies in an effort to fight a widening trade deficit, the president may find the culprit a little closer to home.

The combination of tax cuts associated with the 2017 tax reform and higher spending in 2018 and 2019 following the 2018 bipartisan budget agreement will likely widen the U.S. fiscal deficit to $991 billion by 2020. The federal deficit would be more than double the $439 billion of 2015--its recent low. (It was a beastly $666 billion last year.) As a percentage of GDP, the federal budget deficit could widen to 4.5% in 2020, from 3.5% in 2017.

Overview

- Based on S&P Global Economists' analysis of tax cuts and increase in government expenditures in the pipeline, the U.S. fiscal deficit will likely expand to $991 billion by 2020. According to our review, the current account deficit, a broader measure of trade, will be $700 billion by 2020.
- Free trade isn't necessarily to blame for this--and protectionist policies may not be the answer.
- Helping fuel the twin deficits is low domestic productivity, which propels the purchase of cheap foreign products.
- Since the U.S. consistently spend more than it saves, Uncle Sam will likely become more reliant on foreign capital inflows to fund its deficit.
- While deficits aren't necessarily bad, the debt necessary to finance the deficit may create large and persistent imbalances, increasing risks of reaching unsustainable levels.

What stands out this time around compared with past business cycles is that the trajectory of fiscal deficit has reversed from its path of reduction, even as the current unemployment rate would seem to indicate that the economy is near full employment. Despite rapid improvement, the deficit was still larger as a percent of GDP for fiscal years 2016 (2.6%) and 2017 (3.5%) than it was at the end of any other expansion.

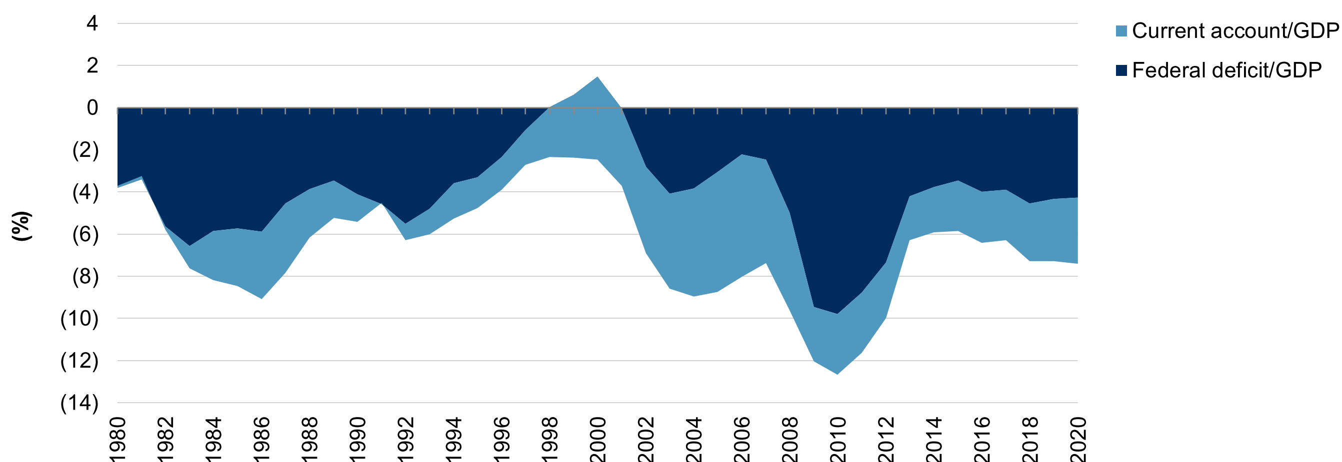
Tax cuts will likely give the U.S. households and businesses a near-term incentive to consume. S&P Global economists don't expect the tax cuts and increased government spending to

appreciably boost the economy's potential growth rate by triggering an acceleration in the labor force or total factor productivity growth above our long-term baseline projections--this likely means a lift to consumption and investment with only modest productivity gains. The stronger economy also mean higher imports, meaning more money could end up overseas, purchasing relatively cheaper products than in the U.S., thus widening the trade deficit.

The widening fiscal deficit contributes to a wider current account deficit, a broader measure of trade, to around $700 billion by 2020, from just $465 billion last year. Data since 1980 shows that the current account deficit doesn't necessarily have to widen with fiscal deficit if household savings go up or private investment goes down, or some combination of the two. We do not expect private investment to go down in the coming years, nor do we expect household savings to go up. As a result, we expect the second twin--the current account deficit--to reach about 3.3% of GDP by the end of 2020. This represents a higher deficit than recent lows, but still 3 percentage points below what was back in 2005-2006. Given the low savings rates in the U.S., the deficits will make the economy more reliant on inflows of capital from abroad.

Chart 1

The Twin Deficits Look To Grow Again In The Coming Years



Sources: Oxford Economics and S&P Global Economics estimates.

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This is just what President Trump has repeatedly railed against in his goal to lower the trade and current account deficits with higher tariffs. But he shouldn't be surprised. Something similar happened after the 1981 and 1983 cut taxes under President Ronald Reagan, and the 2001 and 2003 cuts under President George W. Bush.

The good news is that, in contrast to what is often said (and assumed by the Administration), trade deficits don't necessarily spell trouble for the U.S. economy. A larger deficit is in part explained by a strong economy, which gives American consumers and companies more money to spend, at home and abroad. A strengthening economy generally means higher interest rates, which attract foreign investment, in turn equalizing the current and capital accounts. And since the dollar is still the world's premier reserve currency--and the primary one for global transactions--other countries rely on holding U.S. Treasuries. The enormous demand for U.S. financial assets means that the U.S. is able to finance its high consumption with foreign borrowing at low rates.

On the other hand, the current tax stimulus and fiscal spending comes at a time when the economy is at or near full employment and the output gap now positive. Already, we expect some of that increased domestic demand will translate into purchases of products from abroad, leading to a wider trade deficit. (To be sure, import intensity, or the responsiveness of U.S. imports with respect to domestic activity, has diminished compared with the past, but it still exceeds the responsiveness of U.S. exports with respect to foreign activity for now.) Since we expect U.S. real GDP growth of 2.9% this year and 2.6% in 2019--which are above the growth rate potential--the output gap will only become more positive, meaning that the fiscal multipliers that measure the short-term effects of fiscal spending on growth will likely be smaller than any other stage in the business cycle. A combination of the economy's stretched capacity and the subsequent higher inflation expectations will make the Federal Reserve more likely to raise interest rates to counter the expected inflationary pressures.

Borrowing From Peter To Pay Paul

We recognize that growing fiscal imbalances--if left unchecked--imply deterioration in the U.S. fiscal profile. Moreover, the large inflows of foreign capital that accompany trade deficits can lead to financial bubbles, with some research indicating that foreign inflows may have contributed to the U.S. housing bubble that led to the Great Recession. Others have argued that a large deficit could drain demand from the domestic economy and slow growth when the economy is performing under its potential.

At any rate, Uncle Sam's generosity comes at a time when the federal debt trajectory was already expected to rise in the years to come. This leaves him little choice but to write an I.O.U. in order to cover his increased spending, especially when the tax cuts are expected to take a bite out of revenues. Meanwhile, U.S. households and businesses are low on savings and so won't be able to pick up the tab (unless they change their behavior, which we don't expect in our base case). Lower gross national savings relative to investment/consumption spending means a portion of the federal budget deficit is already financed by foreign capital. Widening fiscal deficits will be effectively financed by money from abroad.

In March 2018, foreign investors (private and government) held $6.3 trillion of U.S. federal government debt, more than twice as much as in 2008, according to the Department of Treasury. The share of debt owned by foreigners fell in that time period, to 44% from 56%, primarily because the Federal Reserve was buying so much itself through its quantitative easing program. China is the largest holder of Treasuries at the moment ($1.2 trillion, followed by Japan with $1 trillion), and between them they account for more than $2 trillion of U.S. securities (Ireland is a distant third with $318 billion). Mainland China's holdings peaked in 2013 at more than $1.3 trillion. They fell by a record 15% in 2016 but have since jumped again to just under $1.2 trillion as of March 2018. Japan's holdings have declined nearly $200 billion from their peak in late 2014, likely because of the increased cost of hedging the currency exposure as U.S. interest rates rise.

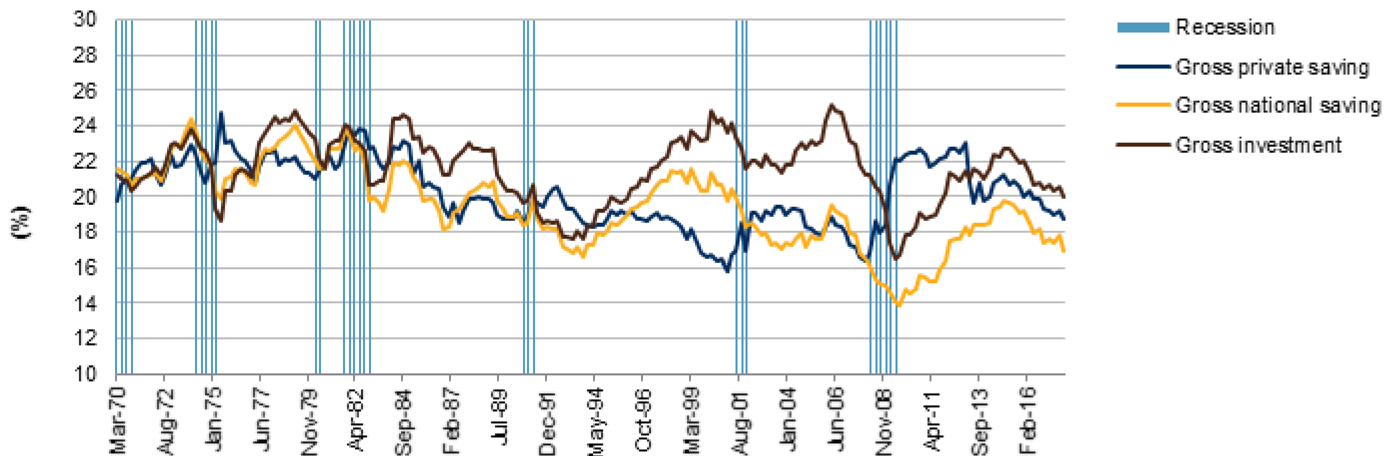
The capital account, also known as the financials account, is the side of the balance sheet where external borrowing resides. The balance of payments dictates that the current account must match the capital account.

The U.S.'s persistent trade deficit, or, the broader concept of the current account deficit, comes down to the simple fact that the U.S. consistently spends more than it saves. That extra spending is financed by borrowing from abroad in the form of debt or equity (foreign direct investment) as reflected in the capital account surplus. Since the current and capital accounts must match, as the current account deficit widens, so does the capital account surplus, and vice versa. This puts the president's suggestion to world leaders at the World Economic Forum at Davos in January that

"America is open for business" and "now is the perfect time to bring your business, your jobs and your investments to the U.S." at odds with his arguments against free trade and globalization. Since the current account must equal the capital account, one account can't go up (or down) without the other.

Chart 2

The U.S. Borrows From Abroad To Offset Weak Savings



Source: St. Louis Fred and S&P Global economist calculations for gross investment (= national saving - net exports)

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If one listens to some U.S. lawmakers, protectionist policies will narrow the trade deficit--and it's true that targeted tariffs can shrink a bilateral imbalance. But that won't necessarily fix a broader trade deficit. The economic impact from any trade measure usually depends on how it affects capital, since the current and capital accounts must be equal. So, when America's capital inflows rise--for example, because increased economic uncertainty resulting from trade sanctions causes more money flows into safe-haven U.S. assets (reflects strength of the U.S.)--so must its overall trade deficit, with the higher inflows causing adjustments to the economy or the value of the U.S. dollar.

It's important to recognize that the trade imbalances in the U.S. in recent years mainly reflect the fact that other countries access U.S. capital markets to invest their earnings from selling goods and services. Capital markets in the U.S. are deep, flexible, and completely open, making it easy for countries that run trade surpluses to park their excess savings in U.S. assets, thereby expanding the capital account. And as long as the U.S. remains a relatively good place to invest with wealth of investment opportunities, foreigners are going to invest in the U.S. more, on net, thus increasing Americans' producing and consuming capacity beyond what domestic savings allow.

The inherent strengths of the U.S. economy and status as the world's premier reserve currency enable the U.S. to absorb a large amount of excess savings abroad. With so much money pouring in from overseas, the U.S. capital account is forced into surplus. And given the capital account and current account must equal, the U.S. inevitably run a trade deficit.

But increased trade tensions could throw a wrench in these works. Could protectionist policies

upset Uncle Sam's relations with key partners just when the U.S. economy needs even more foreign capital to fund its spending spree? While not our forecast, if demand from abroad for U.S. Treasuries weakens just as the twin deficits widen, the U.S. could see long-term interest rates jump and a tightening credit conditions, thus slowing down the growth rate, or worse, cutting the U.S. expansion short.

A Sample Of Recent Protectionist Measures

	Inception date	Announcement date
Withdraw from Trans-Pacific partnership	30-Jan-17	
Softwood lumber tariffs	7-Dec-17	25-Nov-16
NAFTA renegotiations	17-Jul-17	
Section 201 “safeguard” tariffs on washing machines and solar cells	7-Feb-18	22-Jan-18
Section 232 “national security” tariffs 25% on steel imports and 10% on aluminum imports	23-Mar-18	20-Apr-17
Section 301 “discriminatory practice and burden or restrict US trade”	22-Mar-18	
· $50 bil. in goods imports from China threat		
· $50 bil. in goods imports from U.S. threat		
· $150 bil. (cumulative) in goods imports from China threat		
Revamped version of KORUS	28-Mar-18	
Presidential order blocking proposed takeover of Qualcomm by Broadcom	12-Mar-18	12-Mar-18
Chinese firm Ant Financial to withdraw effort to acquire U.S. money-transfer firm MoneyGram International	2-Jan-18	2-Jan-18
Presidential order blocking the acquisition of Lattice Semiconductor Corporation by China Venture Capital Fund Corporation Ltd.	13-Sep-17	13-Sep-17
Buy American and other provisions in Fiscal Year 2017 continuing resolution	5-May-17	5-May-17
In the pipeline:		
Restrictions on investment from China (from 301 section IP investigation)	N/A	14-Aug-17
Trump administration reportedly considers stiffer regulation on auto imports	N/A	N/A

N/A--Not applicable. Sources: Office of the U.S. Trade Representative, Global Trade Alert, and the Wall Street Journal, 4/6/2018

We expect interest rates to rise gradually this year and next, making U.S. assets even more attractive and encouraging capital flows. Increased uncertainty from the trade dispute could mean even more money flows into the haven of U.S. assets, pushing long-term rates even lower--all while the Fed is raising rates at the short end. Could Fed policy, combined with trade tensions, cause a yield curve inversion? In the past, an inverted yield curve has led to a recession within six to 24 months. (Although the same outcome has not been observed with consistency in other advanced countries and thus is only an empirical observation in the U.S.) Or would the Fed be forced to slow its normalization of monetary policy?

Already, one of our U.S. Business Cycle Barometer Report's leading economic indicators, the term spread (or the slope of the yield curve) is fairly flat, signaling a neutral reading. If the Fed continues to raise rates at the same time as money floods into safe-haven dollar assets, that reading could easily tip into the red.

A trade confrontation adds economic uncertainty for our U.S. growth forecast. Most recognize that a trade war is disruptive, and this uncertainty may create a slower growth outlook for the U.S. In

our analysis, the direct impact from an escalation of trade tensions with China, for example, could cut 0.2%-0.6% from GDP growth in 2018 and 2019 (see "Global Trade At A Crossroads: Will The U.S.-China Trade Tempest Make Landfall Or Blow Out To Sea?" published May 4, 2018). And this doesn't take into account the secondary effects from trade tensions, which only makes it worse. After all that uncertainty in global trade and investment environment, will the dispute yield better arrangements in the future? That remains to be seen.

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