



Fiscal deficits and current account deficits[☆]



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ARTICLE INFO

Article history:

Received 18 July 2012
Accepted 23 January 2013
Available online 9 May 2013

JEL classification:

E62
F41
F42
H30
H63

Keywords:

Non-Ricardian households
Government deficits
Government debt
Global current account imbalances

ABSTRACT

Recent fiscal stimulus packages depend for their effectiveness on the assumption of non-Ricardian savings behavior. We show that, under the same assumption, higher fiscal deficits can have problematic implications if they turn out to be permanent. First, if they occur in large countries they significantly raise the world real interest rate. Second, they cause a short run current account deterioration equal to around 50% of the fiscal deficit deterioration. Third, the longer run current account deterioration equals almost 75% for a large economy such as the United States, and almost 100% for a small open economy.

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“As the global economy recovers and trade volumes rebound, however, global imbalances may reassert themselves. As national leaders have emphasized in recent meetings of the G-20, policymakers around the world must guard against such an outcome. We understand, at least in principle, how to do this. The United States must increase its national saving rate. Although we should deploy, as best we can, tools to increase private saving, the most effective way to accomplish this goal is by establishing a sustainable fiscal trajectory, anchored by a clear commitment to substantially reduce federal deficits over time.” (Ben Bernanke, 19 October 2009, Federal Reserve Bank of San Francisco's Conference on Asia and the Global Financial Crisis, Santa Barbara, California).

1. Introduction

In response to the 2008 financial crisis many governments announced sizeable expansionary fiscal stimulus packages. As documented in Freedman et al. (2009), the sizes and compositions of these packages differed greatly across countries, but almost all of them were large as a share of GDP. The initial policy debate mainly concentrated on their short-run efficacy in stimulating output and preventing the tax base from collapsing, with much less attention devoted to long-run fiscal sustainability issues. But it is becoming increasingly clear that sustainability will be a real concern in many countries. Specifically, a significant share of the initially envisaged increases in government deficits may represent not just a temporary spike to cope with the crisis, but rather a permanent drifting up to what are perceived to be unsustainable levels. The consequences of these permanent deficit changes are the main concern of this paper.

[☆] The views expressed in this paper are those of the authors and do not necessarily represent those of the IMF or IMF policy.

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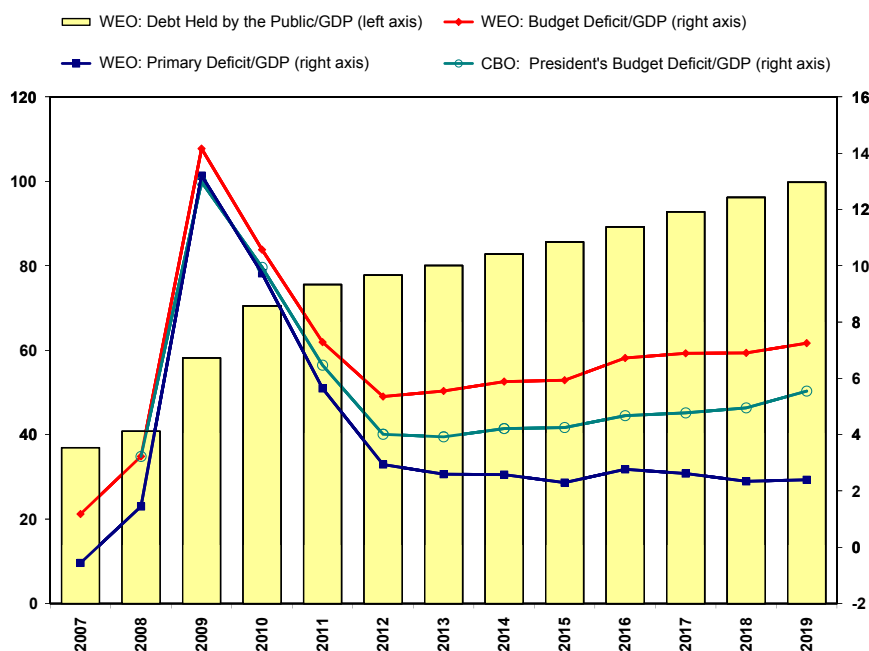


Fig. 1. 2009 IMF WEO and CBO baseline projections for U.S. deficit and debt.

A prominent example is the United States, whose fiscal outlook just after the outbreak of the crisis is examined in detail in Auerbach and Gale (2009). One of their main concerns is that the baseline fiscal projection in Congressional Budget Office (2009) may be far too optimistic because it assumes that the provisions of the stimulus package are allowed to expire. The authors emphasize that a drift towards making higher deficits permanent would not be at all unprecedented, in that the major share of the current decade's deficit deterioration relative to the very favorable 2001 CBO baseline projection can be attributed to the extension of Bush tax cuts that were originally billed as temporary. Auerbach and Gale (2009) find that the combined effects of further extending the Bush tax cuts and of accounting for the stimulus package would result in deficits that by 2019 would be worse than the official CBO baseline deficit projection (2% of GDP) by almost 5% of GDP, and that even this may be too optimistic. This view is more pessimistic than the baseline projection in the IMF's 2009 World Economic Outlook (4.9% deficit by 2019) and with the CBO projection of the President's 2010 budget proposal (5.5% deficit by 2019), which are both shown in Fig. 1. That figure also shows that according to the IMF WEO projection the U.S. debt-to-GDP ratio is expected to reach 100% over the next decade.

All of the more recent problems are of course in addition to longer-run concerns such as demographics and medical costs that have been emphasized for years, and which meant that the United States faced the prospect of large and persistent future deficits even before the onset of the crisis. Fig. 2 shows longer term CBO projections of deficit and debt dynamics until 2080. They are highly unstable, with debt reaching between 300% and 700% of GDP depending on assumptions.² Finally, it should be emphasized that since the onset of the crisis debt projections have also become subject to another serious risk, increased uncertainty about the long-run sustainable growth rate of potential output.

In an age of increasing macroeconomic interdependence across countries, the interest in the longer-run consequences of fiscal deficits is no longer exclusively motivated by the study of individual economies, but also by spillovers between multiple economies, specifically by global current account imbalances. The concern with U.S. twin (fiscal and external) deficits has probably been the most pressing example until recently, but there are now numerous other examples of smaller open economies implementing very sizeable increases in fiscal deficits. The question we ask in this paper is whether such deteriorations in fiscal deficits can be a major contributing factor to deteriorations in their current account deficits. Or conversely, would an eventual fiscal consolidation among major deficit spenders make a sizeable contribution to the resolution of global current account imbalances?

The empirical literature has mostly concluded that the link between fiscal deficits and current account deficits is weak or non-existent.³ However, this literature faces at least two difficult problems. First, while fiscal deficits may have some immediate impact on the current account, the full effect of permanent deficit shocks may take years or even decades to arrive, making it difficult to correctly capture and distinguish it from other shocks in reduced-form empirical work. The main response to this problem has been the use of multi-year averages or filters to cyclically adjust fiscal data. However, this

² Government Accountability Office (2009) and Auerbach and Gale (2009) contain similar projections.

³ See Bernheim (1987), Roubini (1988), Chinn (2005), Chinn and Ito (2007), Chinn and Lee (2009), Chinn and Steil (2006), Kopcke et al. (2006), Bussière et al. (2010), and Gagnon (2011).

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