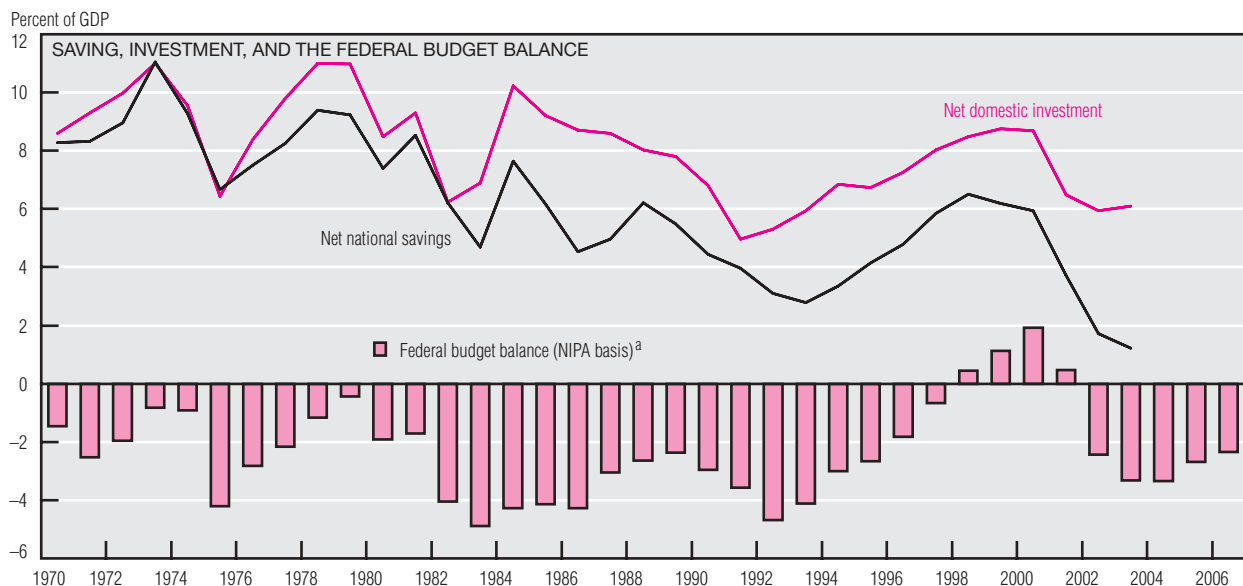
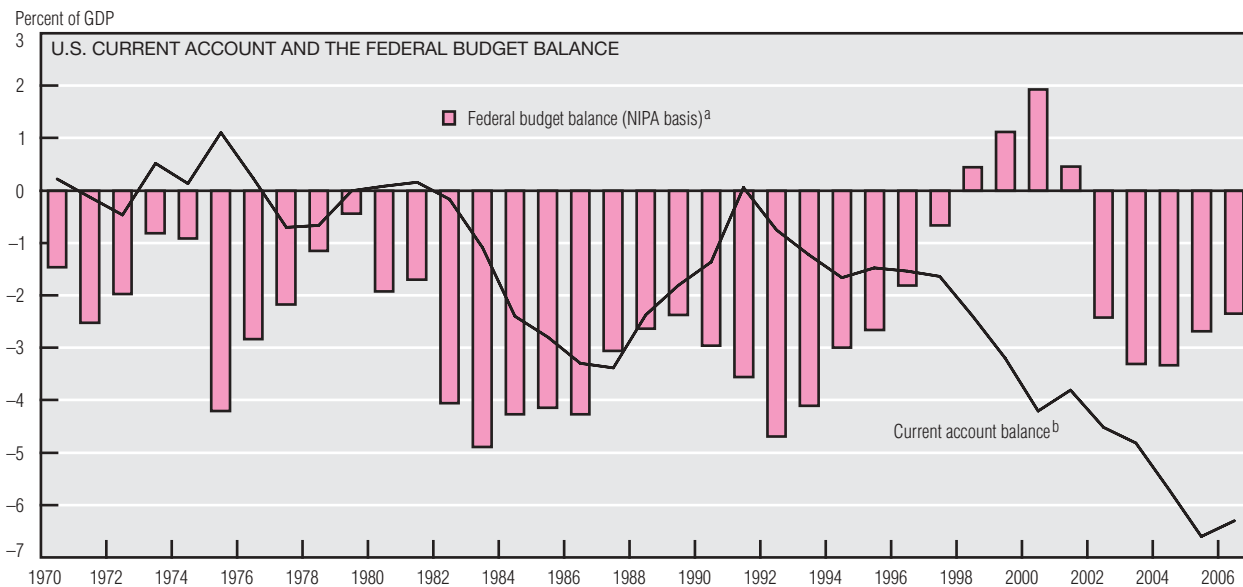


The Twin Deficit Problem



a. Congressional Budget Office forecasts for 2004–06. NIPA refers to U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts*.

b. Author's forecasts for 2004–06.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Congressional Budget Office.

The U.S. finances its current account deficits by issuing financial claims—stocks, bonds, Treasury issues, bank accounts, etc.—to the rest of the world. When foreigners hold net financial claims on the U.S., Americans tap these funds to finance investments and consumption. Any country that runs a current account deficit like ours and experiences an inflow of foreign savings will find that its domestic investment exceeds its domestic savings by exactly that amount, assuming no measurement error.

Because the federal government finances its budget shortfalls by issuing

debt instruments to savers, budget deficits (all else constant) reduce the amount of private savings available for financing private investment here—and raise interest rates in the bargain. Attracted by the prospect of higher yields, foreigners channel their savings into the U.S. and fill the growing wedge between domestic investment and savings. In the process, aggregate demand also expands, widening the current account deficit. Many economists refer to this connection as the “twin deficit problem”: A wider government budget deficit leads to a wider current account deficit (all else constant).

All else, however, rarely stays constant. Although this connection is logically straightforward, economists have not mustered much empirical support for it because widening U.S. budget deficits set off all sorts of economic reactions. For example, if budget deficits result in higher interest rates, private investment might fall and private savings might rise with constant or even smaller current account deficits. It seems that the federal and current account deficits are more like distant cousins than twins.