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A tale of two deficits

The richest country in the world is living beyond its means, says **Joseph Stiglitz**. The question is not when, but how hard, the landing will be

America has been borrowing abroad at the rate of $2 billion a day to pay for its huge trade deficit, with its imports vastly exceeding its exports. The richest country in the world is living beyond its means. Even the most powerful country in the world, however, cannot escape the simple arithmetic of debt: money will have to be sent abroad to pay the interest and, eventually, repay the loans. As it does so, America will be poorer.

If we are to fix the problem, we must understand what caused it. Trade deficits are always equal to the difference between national (domestic) savings and investment. Trade deficits are, therefore, the result either of increased investment or reduced savings. If national savings go down – as when the government runs a huge fiscal deficit – then, unless investment goes down in tandem, the trade deficit must rise. That is why we speak of the twin deficit problem: fiscal deficits normally lead to trade deficits. We had this problem in the Ronald Reagan years, and we are having it again now.

What caused the deficit?

If the trade deficit is the result of the fiscal deficit, we need to push the analysis back one step further. What caused the fiscal deficit? Four years ago, the George Bush administration could blame the deficit on the economic downturn or problems inherited from the past. This is no longer the case. Economic growth has resumed and unemployment has fallen, and it is clear that America has a very large structural deficit. The turnaround from a surplus of 2% of gross domestic product (or national income) inherited from the Clinton administration to the 4% deficit is dramatic and largely due to the Bush tax cuts for upper-income Americans.

Of course, the war in Iraq has contributed, but so too have the enormous increases in corporate welfare and the subsidies for agriculture. The effective tax amnesty – inducing American corporations to bring their money back to America in return for paying a tax that is a sixth of their normal tax – has made this year's revenues look better than they otherwise would, and the deficit smaller than it otherwise would. Make no mistake, however: there is an enormous structural deficit in the American economy thanks to increased public spending and tax breaks for business and the wealthy. And structural deficits do not just go away by themselves.

Good and bad borrowing

Fiscal and trade deficits are not always a problem. It depends on what gives rise to them. For instance, in the Clinton years, the fiscal deficit was brought under control but investment boomed, and America had to turn abroad for finance. There is a difference, however, between borrowing to finance investment – it provides the basis for future growth, enabling the country to repay the debt – and borrowing to finance a consumption binge.

Unlike the trade deficits of the 1990s, America's borrowing today is not the result of an investment boom. Nor is the government's deficit caused by a sudden commitment to repair its ageing highways and bridges, to modernize its airports or to strengthen the levees that protect the country against floods. On the contrary, the disaster in New Orleans showed that there had even been cutbacks in essential investments. It will be years before we see the full consequences of other cutbacks in long-term investments, such as in university-based basic research.

Today's trade deficits are caused by low savings rather than high investment. With personal savings close to a record low of zero, and the government running huge deficits thanks to the tax cut for rich Americans, the term "consumption binge" is the best description for what is going on. Whatever the rhetoric, the Bush tax cuts have not led to more investment.

It is because the Bush trade-cum-fiscal deficits are a consequence of this consumption binge that they pose such high costs and risks for the future. They have also brought few current benefits. What is remarkable about the fiscal deficit is how little stimulus it has provided the economy. Normally, a 6% fiscal turnaround (from 2% surplus to 4% deficit) would have led to a true boom.

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Little public spending to save New Orleans

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This is important, because it has forced the Federal Reserve to have extraordinarily low interest rates. Ordinarily, low interest rates lead to more borrowing and also more investment, so while indebtedness increases, this is balanced by an increase in assets. In this case, lower interest rates have helped the American economy mainly by inducing households to refinance their mortgages, and this refinancing has caused some households to spend some of the money freed up. The housing bubble has meant that balance sheets still look good. It is hard to see, however, how this engine for the economy can continue in the face of rising interest rates and oil prices. Furthermore, if the bubble does burst, household balance sheets will really be in trouble. The problems in government and household balance sheets make responding to the inevitable crises – such as that posed by Katrina – all the more difficult.

Who is to blame?

The administration has been looking for someone to blame – weak growth in Europe or the undervaluation of the Chinese currency. A revaluation of the renminbi may narrow the bilateral trade deficit between China and America, but does anyone really believe that it will have a substantial effect either on American savings or investment? If not, it will have no effect on the trade deficit either. At most, it shifts the deficit from China to others. China seems willing to lend to America, a kind of vendor finance to support its sales. Others may be less willing.

Faster European growth would be good for Europe and the world. Once exchange rates and interest rates adjust, however, the trade deficit will be largely unchanged. If American investment increases (as it may, as American exporters invest more to meet the needs of Europe), the trade deficit may even increase.

Other changes in the global economy also have modest effects on the trade deficit.

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Increased interest rates may improve the trade deficit because they slow investment, but this is hardly good news either for America or the world. By contrast, a return to the boom of the 1990s, with its heady investment, does not appear on the horizon. If it should, the trade deficit would soar even more.

Spend, spend, spend

There is only one reasonably reliable way of bringing down the trade deficit, and that is by reducing the fiscal deficit. The Bush administration has talked about taming the deficit, but the expenditure increases already built in will make this difficult and their proposals belie their words. First, in another example of misleading information, the cost of Bush's Medicare drug benefit (which remarkably proscribed the federal government from bargaining down prices) appears to be far higher than originally claimed, and will add $2.5 to $3 trillion to the deficit over the next 20 years.

Then there is Iraq. Bush's White House economist Larry Lindsey left soon after he suggested the war might cost $200 billion, twice the official number. It turns out, however, that his estimate was a low one. The cost of the war is approaching a quarter of a trillion dollars, and increasing at the rate of $5 billion a month. Moreover, the costs of the lifetime disability and healthcare benefits – and the increased costs of recruiting to maintain the strength of the armed forces – will be in the billions.

Making tax cuts permanent would add $1.8 trillion to the fiscal deficit in the next 10 years. Social security privatization (which now looks dead) would have added $1.5 trillion in the next 10 years and $6 trillion in 20. To paraphrase one of America's great senators, Everett Dirksen, a trillion here, a trillion there, and soon you're talking real money. Fortunately, some responsible Republican senators are likely to rein in the spending/tax cut spree, but prospects for real deficit reduction look dim.

The administration's tax-and-spend high deficit policies represent a high-risk macroeconomic strategy – but a risk with little upside potential. It was a risk that was unnecessary. There were alternative strategies that would have almost surely produced more growth with smaller trade and fiscal deficits. We have already seen some of the consequences, such as global imbalances leading to high levels of exchange-rate volatility. This may, however, be only the beginning.

That which is not sustainable will not be sustained. If America were not the economic powerhouse that it is, the day of reckoning would already have come. The only questions that the world faces today are how long it will persist, how it will be tamed and how much damage – to America and the world – will be done in the interim. How hard will the landing be? GA

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