

# Revisiting the Twin Deficits Hypothesis: The Effect of Fiscal Consolidation on the Current Account

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# Overall assessment:

- Authors should be praised for all their data and empirical efforts
- Nice and clean analysis
- Clear and robust findings
- Deals with an important and topical issue

# What the paper does

- Revisits twin deficits hypothesis: fiscal contraction leads to improvement in current account
- Question on existence of twin deficits hypothesis and, in particular, size of effect fiscal change on CA is of obvious importance for the U.S.
- U.S. policymakers have often downplayed relation fiscal deficit and CA deficits

# Bernanke (March 10, 2005)

“I disagree with the view, sometimes heard, that balancing the federal budget *by itself* would largely defuse the current account issue. In particular, to the extent that a reduction in the federal budget resulted in lower interest rates, the principal effects might be increased consumption and investment spending at home rather than a lower current account deficit. Indeed, a recent study suggests that a one-dollar reduction in the federal budget deficit would cause the current account deficit to decline less than 20 cents (Erceg, Guerrieri, and Gust, 2005)”

# What the paper does

- Paper compares action-based measure of fiscal change to “traditional” approach of using cyclically-adjusted primary balance (CAPB)
- Use fiscal changes uncorrelated with other factors affecting CA and that are not responses to CA itself
- Also delves into channels for current account improvement (savings, investments, real exchange rate)

# Using CAPB likely biases against twin def. hypothesis

## ➤ Typical regression

$$(1) \quad \Delta CA_t = \alpha + \beta \Delta F_t + \varepsilon_t$$

## ➤ Cyclical adjustment of primary balance may be problematic, for example

- Non-policy factors in  $\Delta F$  that also affect  $\varepsilon_t$  (e.g. third factor causing stock market thus revenues increase *and* increase investments/imports)
- $\Delta F$  may react to factors included in  $\varepsilon_t$  (in particular, economic activity)
- Feedback effects from CA onto  $\Delta F$  (e.g., fiscal tightening in response to rapid imports growth)

# Main findings

- One percent of GDP budgetary contraction improves CA by 0.6%-point of GDP after 2 years
- Improvement is permanent
- Result is robust to:
  - Variations in specification
  - Dropping outliers
  - Result becomes even stronger for countries after euro adoption
  - Large fiscal consolidations

# Main findings

- Improvement in CA takes place both via reduction in investment and roughly equal increase in national saving
- Fiscal consolidation produces substantial depreciation of real effective exchange rate, first through fall in nominal exchange rate, followed by relative decline of domestic price level.
  - Interesting result in itself – contradicts findings by Monacelli & Perotti (2006) and Ravn et al. (2007)
- Effect on CA is even stronger for euro-area after 1999 even though nominal exchange rate is fixed!



# Comment: presentational matters

- Provide more information on precise construction of dataset
- Significance of results seems very strong, provide indication, e.g. show 95% confidence intervals
- Show some graphs of the exogenous fiscal shocks → correspond with familiar episodes?

# General comments on empirical approach

- Anticipation effects should be minor, if not absent, with annual data
  - One might include some forward-looking variables (Yang, 2007; Forni & Gambetti, 2010; Beetsma & Giuliadori, 2011)
- As is also recognised by the authors, it will be hard to avoid a correlation between action-based measure of  $\Delta F$  and factors included in  $\varepsilon_t$ , in particular business cycles
  - Shows us correlation between business cycle variable and your measure of  $\Delta F$

# General comments on empirical approach

- It is unclear to me whether the  $\Delta F$  are fiscal plans, or realisations or a mixture of both? In the first and third cases we may have measurement error.
- Measurement error:  $\Delta F = \text{actual shock} + \text{error}$  ?
- Note that “error” may well be systematically biased
- Further, include controls on RHS of regression equation?

# Comment: shock correlations

- Information on correlations of the fiscal shocks; estimates of effects of  $\Delta F$  may be biased if the  $\Delta F$  of major trading partners changes at same time.
- Suggestion is to control for this by including the average  $\Delta F$  of the main trading partners on the right-hand side of the regression equation.

# Comment: other shocks

- Why only include fiscal policy changes motivated by desire to reduce deficit?
- Would it be possible to include all truly exogenous fiscal policy shocks, such as war expenditures (participation in Afghanistan, etc.)?

# Comment: composition of change fiscal balance

- Literature on fiscal consolidations emphasizes composition of consolidation
- There may be reasons why revenues and spending-based changes have different effects → split estimates into revenues and spending-based changes
- For example, contraction in spending could have a negative effect on unit labor costs (several channels see Ardagna, 2004, and Alesina and Ardagna, 2010), thereby improving competitiveness

# Comment: composition of change fiscal balance

- Also, try to distinguish different types of spending contraction:
  - Government transfers and subsidies
  - Government consumption versus government investment
  - Government wage and non-wage consumption

# Comment: composition of change fiscal balance

- See Lane and Perotti (1998, EER):
  - They link trade balance and its components to the various components of the public budget
  - Composition of fiscal policy change and exchange rate regime matter for effects on external account
  - Higher government wage consumption produces fall in exports and deterioration of trade balance, especially under flexible exchange rates
- See also Lane and Perotti (2003, JPubE).