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

John C. Bluedorn[1] Daniel Leigh[1]

[1]Research Department
International Monetary Fund

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Twin Deficits Hypothesis

- No clear consensus on effect of fiscal balance on CA.
  - Textbook view: budget deficit $\downarrow \Rightarrow$ CA deficit $\downarrow$.
  - Previous studies: Many find *weak* link (0.1-0.2), with a few larger (0.5-0.8). Kim and Roubini (2008) find opposite.
- Problem: standard empirical approach may *under*play twin-deficits link.
- Solution: new evidence from action-based fiscal consolidations $\Rightarrow$ *strong* link in baseline (0.6).
- Also: adjustment mechanisms (S&I, q), euro adoption

Standard Approach

Minimal empirical specification:

$$\Delta CA_t = \alpha + \beta \Delta F_t + \varepsilon_t$$

- Want ΔF to be uncorrelated with ε_t (both respond to cycle).
- Standard approach: cyclical adjustment ($\Delta CAPB$).
- Problems with standard approach:
  - Nonpolicy factors remain. Stock price boom.
  - Countercyclical policy response to DD (Finland, 2000).
  - Response to CA (France, 1983).

Examples

- Finland, 2000: Asset price boom and rapid DD growth, so government cut spending to reduce risk of overheating. Authorities cited lack of independent monetary policy in justifying budget cuts (Finland Ministry of Finance, press release, March 2000).
- France, 1983: "In response to the widening current account deficit since late 1981, the authorities announced a package of measures on March 25, 1983 aimed at reducing domestic demand . . . The package consisted of public spending cuts, tax increases, and measures to increase private saving" (IMF Recent Economic Developments, 1983).

Identification

We use Devries et al. (2011)'s new dataset on action-based fiscal consolidations.

- They identify the motivations and budgetary impact of fiscal consolidations from the historical record for 17 OECD members from 1978-2009.
  - Documents include Budget Speeches, Budgets, OECD Economic Surveys, and IMF Staff Reports.
- Highlight policy changes primarily motivated by desire to reduce budget deficit, *not* restraint of DD or CA deficit.
- 173 cases of such changes in dataset, mean of 1% of GDP, ranges from -0.8% to 4.7% of GDP.
- These are the key inputs in our empirical analysis.

Examples

- United States, 1993: Omnibus Budget Reconciliation Act raised taxes and cut spending – "a little more in deficit reduction today, so that we can all enjoy better jobs and higher incomes tomorrow" (The President's Radio Address, 15 May 1993, p. 1).
- Austria, 1996: Authorities cut spending and raised taxes to conform to the Maastricht Treaty criteria – "With first-round participation in EMU the top economic priority since EU membership in 1995, the federal government agreed with the social partners and the lower levels of government on a phased two-year consolidation package to reduce the structural deficit" (1997 IMF Staff Report, p. 4).

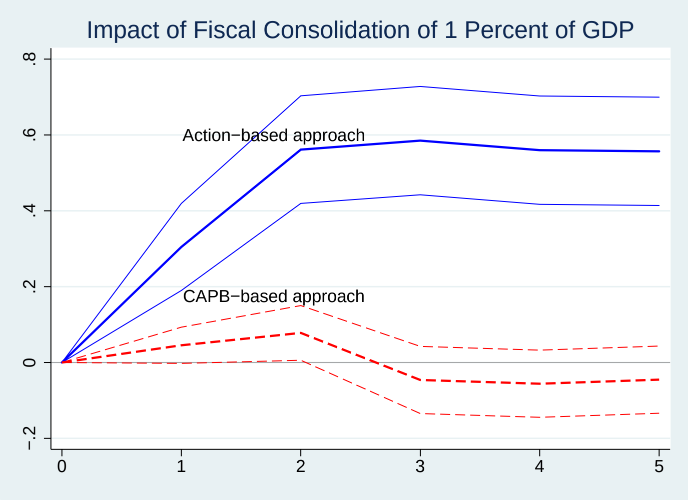
Econometric Methods

Baseline Specification:

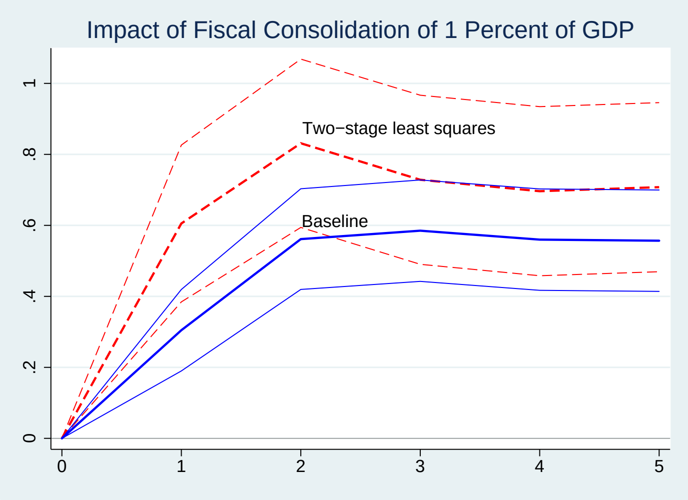
$$\Delta CA_{i,t} = \mu_i + \lambda_t + \sum_{j=1}^{2} \beta_j \Delta CA_{i,t-j} + \sum_{s=0}^{2} \gamma_s \Delta F_{i,t-s} + \upsilon_{i,t}$$

- ΔF is the change in fiscal policy measure (either action-based or CAPB-based).
- Use differences due to non-stationarities. Cumulate impulse responses to get level effect.

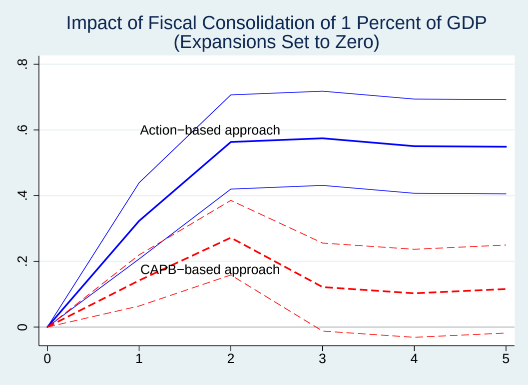
Baseline Current Account Response



Robustness

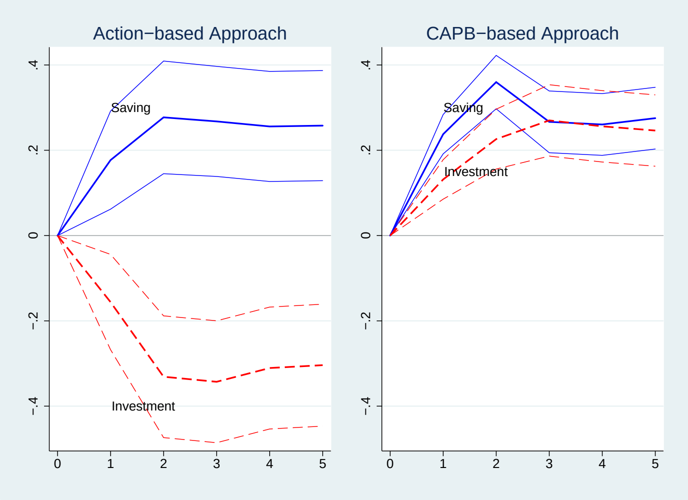

Impact of Fiscal Consolidation of 1 Percent of GDP
Two−stage least squares
Baseline
0
.2
.4
.6
.8
1
0
1
2
3
4
5

Robustness

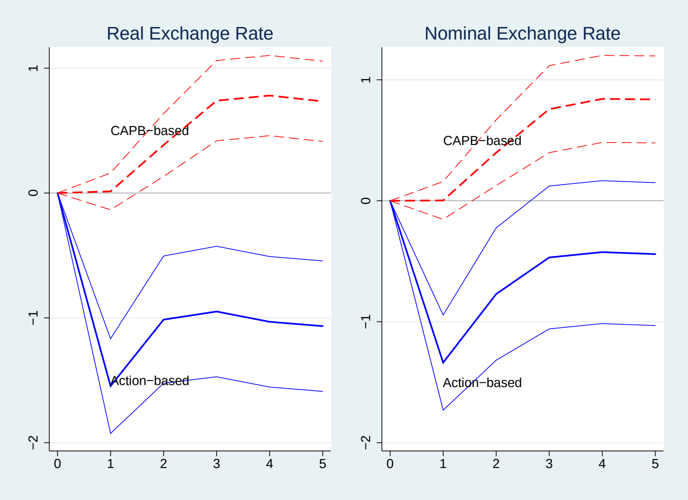


- Also robust to static specification, longer lags, and dropping outliers (extreme values or Cook's distance).

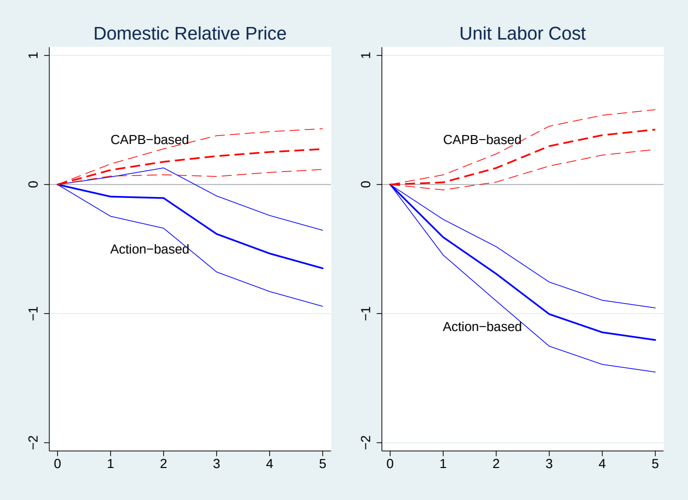
Saving and Investment



Real and Nominal Exchange Rates



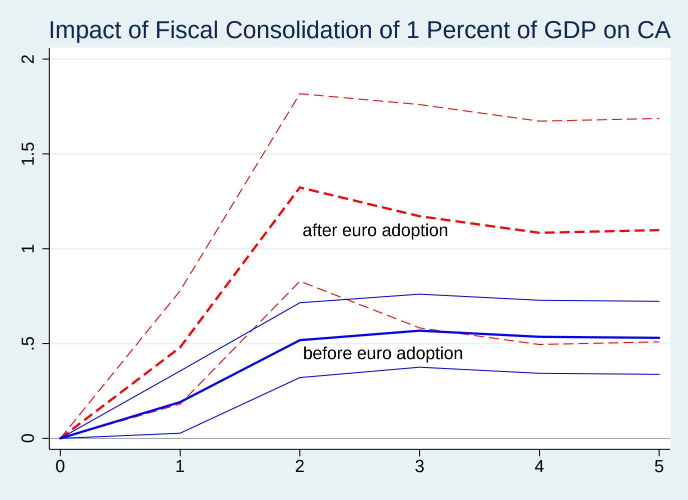
Price Differentials and Unit Labor Costs



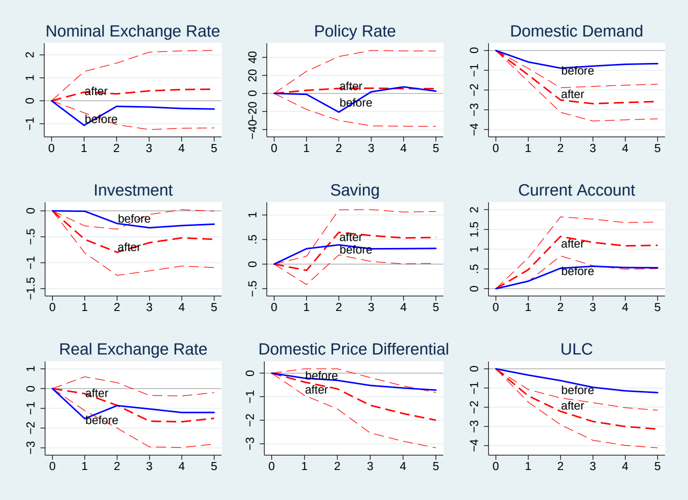
Twin Deficits and the Euro

- Real exchange rate appears key, usually via nominal exchange rate adjustment.
- If no independent monetary policy, adjustment must rely on other channels – quantities or domestic prices.
- Examine experience of euro adopters, before and after.

Twin Deficits and the Euro



Adjustment under the Euro



Conclusion

- Action-based estimates of fiscal policy effect on CA is strong and long-lasting in baseline (0.6 within two years).
- Key channels: I $\downarrow$ and real depreciation.
- Stark contrast with CAPB-based estimates.
- Euro adoption does not appear to have weakened twin-deficits link. Evidence of "internal devaluation."