DWS

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A Viewpoint from Joshua N. Feinman

The Twin Deficit and the Government Shutdown

On the budget deficit and the government finances: They have deteriorated in the past few years, which is quite unusual for this stage of a cycle as the deficit is usually low and decreasing when growth is solid and unemployment is low. The deterioration is partly due to the recent tax and spending initiatives, but also due to the longer-term trends related to entitlement spending[1]. There is little indication that this is causing problems now as financial markets seem not to care much, and the United States has substantial fiscal latitude, reflecting among other things that it issues debt denominated solely in its own currency – the global reserve currency no less, with no credible rival on the horizon – backed by an independent monetary policy, with a long history of honoring its debt obligations, deep and well-functioning capital markets, stable government, rule of law, and a still-vibrant, innovative economy. So we expect no near-term fiscal cliff for the United States. But that does not mean its fiscal latitude is unlimited. Allowing debt to march ever higher will eventually raise debt-servicing costs – they are already starting to edge up, though still below where they were in earlier decades as a percentage of gross domestic product (GDP) because of lower interest rates – and since about 40% of all publicly-held U.S. Treasuries are held abroad, this will result in a net loss of national income. Also, high debt levels reduce the room for fiscal maneuver to combat future recessions or build infrastructure. Most importantly, the more resources commanded by government redistribution or entitlement spending and the borrowing it entails, will leave fewer resources available for other, potentially more productive endeavors, reducing the economy's growth potential. This is the real – albeit largely hidden, counterfactual – cost of the fiscal trajectory the United States is on.

As for the current account deficit: it is moderate by historical standards, around 2.5% of GDP, down from more than 6% prior to the financial crisis. There is no trouble for the United States in financing as this becomes evident from the previous elaboration. In fact, though the U.S. net international investment position[2] has grown to more than 40% of U.S. GDP reflecting persistent current account deficits, the U.S. primary income balance[3] remains positive, reflecting the higher rates of return U.S. investors earn overseas than foreigners earn in the United States as they disproportionately own low-yielding Treasuries.

On the shutdown: its direct drag on U.S. GDP is relatively minor – the rough rule of thumb is about 0.1% for every 10 days this shutdown lasts – but that is just the direct effect in the form of delayed pay to federal workers and the like. The indirect effects could be larger – disruption to travel, business contracts with the government, etc. – are harder to calibrate, and will presumably

In a nutshell

- The budget deterioration is partly due to the recent tax and spending initiatives, but also due to the longer-term trends related to entitlement spending.
- There is no trouble for the United States in financing either its budget deficit or the current account deficits.
- Most of the effects of the government shutdown will be small, temporary, and recoverable but some impacts will grow the longer the shutdown lasts, and small amount of activity may be permanently lost.

[1] Entitlement spending is a subset of mandatory spending that can be spent without congressional approval, such as Social Security payments
[2] Foreign assets held by U.S. residents less U.S. assets held by foreigners
[3] Income earned by U.S. investors on their foreign assets less income earned by foreigners on their U.S. assets

grow the longer the shutdown lasts. Most of these effects will be temporary and recoverable – federal workers will eventually get their back-pay when the government reopens, etc. – but some small amount of activity may be permanently lost. Finally, the situation has no clear resolution in sight, which is troubling, not least because it speaks to a political dysfunction that could carry over into other things such as for example the need to raise the debt ceiling[4] later this year or pass the renegotiated North American Free Trade Agreement (NAFTA).

[4] It is the legislative limit on the level of national debt that can be incurred by the U.S. Treasury

Glossary

Current account

The **current account** includes trade in goods and services, a net-factor-income balance (e.g. earnings on foreign investments and cash transfers from individuals working abroad) and transfers (e.g. foreign aid). It is a part of the balance of payments.

Financial crisis

The **financial crisis** refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

Fiscal policy

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Monetary policy

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

North American Free Trade Agreement (NAFTA)

The **North American Free Trade Agreement (NAFTA)** is a trade agreement signed by Canada, Mexico and the United States, creating a trilateral trade bloc in North America, which came into force on January 1st, 1994.

Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Reserve currency

A **reserve currency** is a foreign currency held in significant quantities by central banks and international financial institutions. Foreign currency reserves allow a country to pay off its international debt obligations or boost its currency’s value.

Treasuries

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes

(2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

Yield

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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