Should We Worry About the Deficit(s)? An MMT-Minsky Perspective

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How will Trumponomics Deal with the Twin (Budget and Trade) Deficits?

- What will Trump do about the “twin deficits”?
  - On budget: promised to extend tax cuts while reducing wasteful spending
  - On trade deficit: we are losing because everyone treats us like suckers by sending us their output!
    - We send them $ and they send us boatloads of stuff.
    - We …. *lose*?
- **Tariffs**! Kill 2 birds with 1 stone.
  - A lot is riding on those tariffs!

Downgrading the Exorbitant Privilege

- Barry Eichengreen: US $ is special--trade deficits do not devalue the currency and financing US excesses doesn't raise interest rates
- But that is coming to an end! Credit raters on the attack!
  - Standard & Poor's downgrade was first in 2011
  - Fitch waited until 2023
  - Moody's struck in May 2025
- The consensus is unanimous: the dollar's days are numbered; borrowing costs will rise; we must get the fiscal house in order!
- It is the Twin Deficits Debate of 1980s--*Deja Vu all over again!*

How Should Sovereign Debt Be Rated?

- After they downgraded **Japan in 2002** I looked for justifications:
  - John Bohn, president of Moody’s: “Our rating measures the ***probability that the issuer will default*** …. without regard to "a borrower's country, industry, or type of fixed-income obligation".
  - Mizuho Securities: "Moody's and others have used ***historical default ratings*** for corporate entities….On the other hand, regarding sovereigns (particularly highly rated OECD countries) there is a lack of data…”
- So, they measure “risk of default”, but no “highly rated OECD” country ***has ever defaulted on its debt***.
- It is hard to put probabilities on something that ***never happens***.

2011 S&P Downgrade of US

- The NYT invited eight of us to contribute editorials
  - **Barry Eichengreen**: "As I note in my book, *Exorbitant Privilege*, the political gridlock and uncertainty could be the catalyst for mass flight away from U.S. treasury bonds… the dollar would crash. Interest rates would spike. This could make the last financial crisis look like a walk in the park." **Worse than GFC**!
  - **Yves Smith** chastised the raters: "The United States is simply not at risk of default. **Default is impossible** for a sovereign currency issuer. The Standard & Poor's rating firm should be embarrassed."
  - **Barry Ritholz**: "I have stopped paying any attention to anything that S.&P. says or does. Its performance over the past decade has revealed it to be incompetent and corrupt – it sold its AAA ratings to the highest bidder. It is the broker who lost all your money, the girlfriend who cheated on you, the partner who stole from you…."

My response (2011):

- Attempting to influence the **political** debate in Washington the raters who blessed every toxic waste subprime security with AAA ratings now see problems with sovereign government debt.
- A decade ago Moody's downgraded Japan so I wrote to them pointing out that a **sovereign currency issuer cannot be forced into default**.
- They back-tracked and said they were not rating ability to pay, but rather the ***prospects for inflation and currency depreciation***.
- After 10 more years of running deficits, Japan's debt ratio is ***200 percent***, it borrows at ***zero interest rates***, it makes every payment that comes due, its ***yen remains strong*** and ***deflation*** reigns.
- ***Make that almost 25 years now!***

What is the nature of the credit risk?

- Sovereign government debt is different: there is ***no risk of involuntary default***, so “credit” rating is not applicable.
- In the US there is a possibility of ***voluntary*** default because of the ***debt limit***. So, there is a ***political risk*** that Congress might ***choose*** to default rather than raise it.
- Perhaps this should be assessed—but **not** by credit raters.
- To borrow from Keynes, even ***considering*** a voluntary default should “be recognized for what it is, a somewhat disgusting morbidity, one of those semi-criminal, semi-pathological propensities which one hands over with a shudder to the ***specialists in mental disease***.”

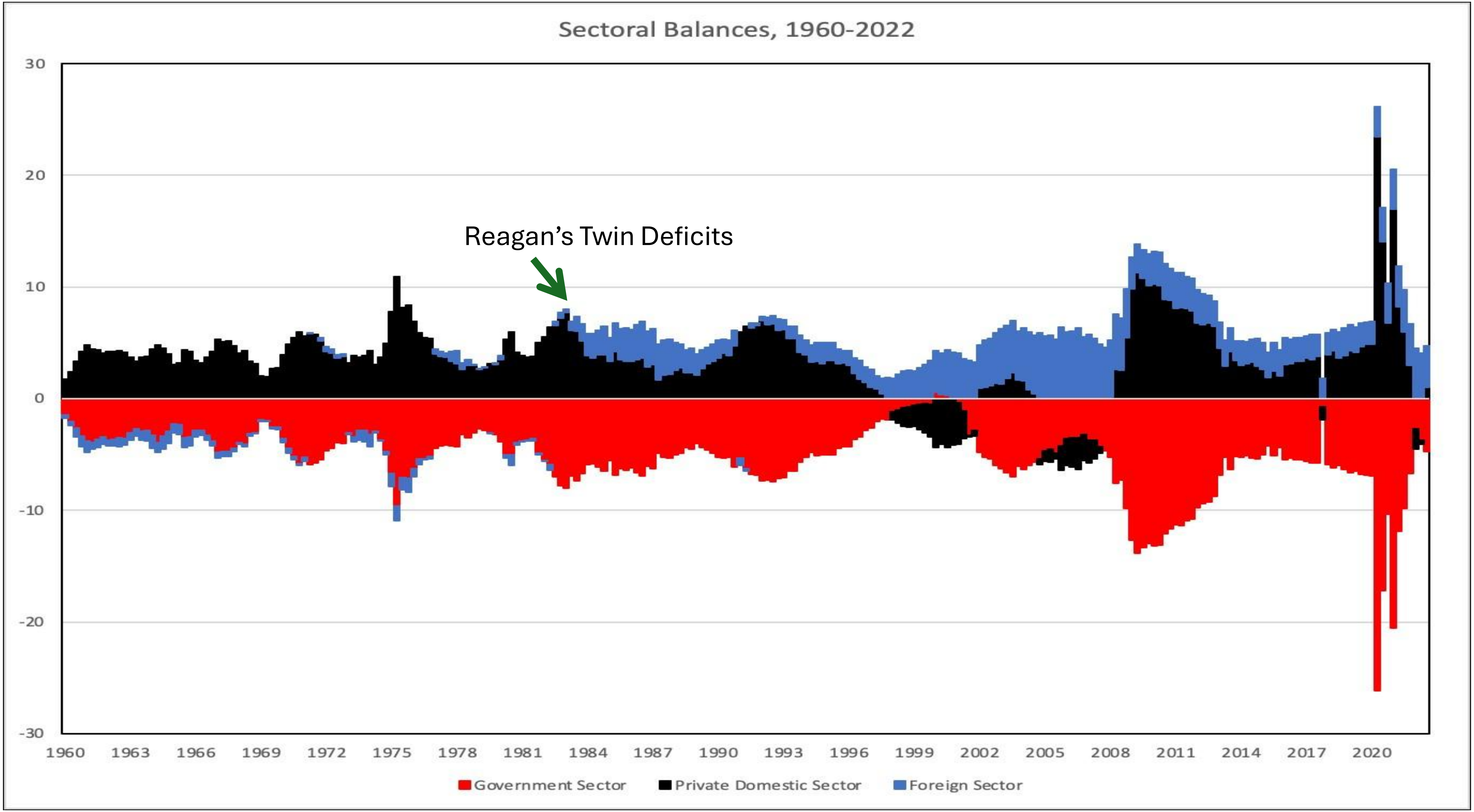
How Does Sovereign Government Spend, Tax, and “Borrow”

- ***Treasury spending***: Central bank ***credits*** a bank’s reserves, and the bank credits the account of the recipient.
- ***Taxing***: Central bank ***debits*** a bank’s reserves, and the bank debits the account of the payer
- ***Deficit*** = ***net credit*** of reserves; normally ***drained*** through a bond sale
  - Credit-rating bonds makes no more sense than rating central bank reserves; CB makes all payments for Treasury with reserve credits
  - The Fed now pays interest on reserves—there is no longer any difference between reserves and bonds.
  - The Fed incurred losses of \$231B by May, and has about \$1T in mark-to-market losses on its bond portfolio
  - ***Downgrade the Fed***?

The 1980s Twin Deficits Debate Revisited

- **Claim**: Big ***budget deficit*** of Reagan years increased government ***borrowing***, crowding out ***investment***, driving up ***interest rates***, ***strengthened*** $, created ***trade deficit***
- **Reality**: Volcker's high interest rates increased value of $, driving up trade deficit
- **Longer-term effects**: loss of competitive advantage to Japan; rise of Yen and Mark as rivals to Dollar
- **Longer-term policy response**: Neoliberalism, Trade Agreements, Promises of Fiscal Austerity through "pay-fors" and other budget agreements
- How did that work out? More ***Twin Deficits***:

  (***Please Lord, make me chaste; but not just yet!***)



Sectoral Balances, 1960-2022
Reagan's Twin Deficits
30
20
10
0
-10
-20
-30
1960
1963
1966
1969
1972
1975
1978
1981
1984
1987
1990
1993
1996
1999
2002
2005
2008
2011
2014
2017
2020
Government Sector
Private Domestic Sector
Foreign Sector

The Upside of Exorbitant Privilege

- As Mathew Klein reports:
  - 60% of the world's **foreign exchange reserves** are held in U.S. dollars
  - 80% of all trade (outside Europe) is **invoiced** in U.S. dollars
  - 60% of international and foreign currency **banking assets and liabilities** are denominated in U.S. dollars
  - 70% of foreign currency **debt issued by companies** is denominated in U.S. dollars.
  - For perspective, U.S. economy is about **25%** of the world economy.

Minsky's approach to the Dollar (Reagan Years)

- It is the responsibility of world's reserve currency issuer to keep it strong.
  - Likened to a bank's responsibility for its own money: holders need assurance that bank money will hold its value.
  - Most important consideration for $: will it hold value against main currencies?
- A two-edged sword—strong dollar keeps imports **cheap** for Americans and US exports **expensive** for foreigners.
  - Cheap imports are **disinflationary**: they absorb wages, leaving less to spend on domestic output
  - However, as a net importer, the US is exposed to imported inflation— ***oil and food*** are typically the most important sources of inflation pressure.
    - along with shelter—which is irrelevant for this discussion
  - But international oil trade is denominated in $--ROW needs more $ to buy oil—so we get inflation pressure but not much pressure on $ from OPEC price hike

How to keep the dollar strong

- Two choices***: Tariffs*** or ***high interest rates?***
- ***Tariffs***: Minsky favored targeted tariffs but preferred VAT to raise price of imports, rebated to exporters
- Are ***high Interest rates*** necessary to preserve value of $?
  - exorbitant privilege lets US enjoy low interest rate
  - US interest rate sets a hurdle that other central banks must beat
    - Why? Dollar assets are safer—no default by government, and govt is seen as backing up many privately-issued dollar debts
    - Even though the US is the biggest debtor country in the world, it’s total interest spending on its dollar debts is less than its earnings on foreign assets held by Americans

Goals of Trumponomics I

- Trump: a country should only earn dollars to purchase US goods.
  - Essentially sees the $ only as a **medium of exchange**—a simplistic Monetarist view of money. And it conflicts with the role the dollar plays as the **international reserve currency.**
- Countries that accumulate dollars for other purposes are punished with tariffs.
  - This creates an incentive to **abandon the dollar** in international trade and challenge to the supposed exorbitant privilege.
- Trump wants a **weaker currency** to promote exports--conflicting with maintaining the dollar's position in the currency hierarchy.
  - **Contrast** with Minsky: maintain **strong** $
- Furthermore, Trump has used performance of the stock market as a barometer of economic performance.
  - A weaker dollar is not likely to benefit that, putting additional pressure on the privilege.

Trumponomics Goals II

- Trump railed against “Biden’s inflation”. But a **weaker dollar plus tariffs** could spur inflation—generating **Fed rate hikes**.
- Trump—along with most politicians—wants to **reduce the budget deficit**. At the same time he wants to extend **tax cuts**, so deficit reduction falls on **tariffs** and **spending cuts**.
- I won’t address the failure of DOGE to find savings. Instead I argue that the government’s balance will be in **deficit**—regardless of savings or tariff revenue.
- The necessity that **sectoral balances will balance** ensures this
- Blaming Congress for its inability to balance the budget makes no sense without a plan for eliminating **saving of dollars by American households, firms and foreigners**.

Exorbitant Privilege and Budget Deficits

- The US domestic sector almost always runs a surplus—with the exception of the bubblicious late 90s that collapsed into the Global Financial Crisis.
  - Consumers want to save—for college, for retirement—and while they might spend more than their income for a while, they eventually cut back on spending.
  - They also face credit constraints—at some point lenders will curtail lending.
- Firms can (sometimes do) spend more than their income to invest in capacity that will increase income later.
  - Those deficits can offset household saving so that the private sector runs a deficit—that is sustainable at least for a while as firms build up capacity
- This is what we saw in Japan during its golden age: firms spent more than their income from 1980 until near the end of the 1990s, fueling growth

What can we learn from Japan?

- Eventually, the business sector flipped to a surplus, and with less investment and slower growth, household saving collapsed.
- Later, the Japanese current account surplus also fell due to the GFC and competition from lower-cost Asian competitors.
- All this created a chronic and growing budget deficit.
- It is simple math, not fiscal imprudence.

Exorbitant Privilege and Budget Deficits

- While developing Asian countries can achieve high rates of investment—up to a third or more of GDP—this is unlikely for a “**consumer-led**” economy like the US.
- So business sector deficits won’t offset consumer savings for long. Our **domestic private sector runs surpluses**.
- As the international reserve currency issuer, the US is not likely to run **sustained current account surpluses**—in spite of high tariffs and trade barriers.

Trump’s Tariff Folly

- Trump originally linked each country’s tariff to its **bilateral trade surplus**—so the tariff falls to zero only with ***balanced trade***. This is fundamentally inconsistent with the role of the dollar.

- Budget deficits are “baked in” by ***Exorbitant Privilege***—if the private sector saves 3% and the ROW saves 3% the **math** says Uncle Sam is at a deficit of 6%.

- The twin deficits are sustainable and will be sustained. Until the math changes.