First Trust
Monday Morning OUTLOOK

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630-517-7756 • www.ftportfolios.com July 6, 2021

"Twin Deficits" Won't Tank the Dollar

Many analysts have been thinking and writing about the "twin deficits" and whether the record-breaking size of those two deficits, combined, mean the US dollar is about to plummet versus other currencies.

Before we get into the weeds, a little background is necessary. When people talk about the twin deficits they are talking about the budget deficit plus the trade deficit. Combined, these two deficits were 22.8% of GDP in the year ending in the first quarter, easily the highest on record. Before the pandemic, the record high was 12.8% of GDP back in 2009. Before the Financial Crisis, previous peaks included 8.7% in 2004-05 and 8.0% back in 1985-86.

The reason they are called the "twin" deficits is that superficial Keynesian theory suggest they *should* go together. The idea is that if a country runs a larger budget deficit, it should have higher interest rates, which should drive up the value of the dollar. In turn, a higher dollar means more imports (we can buy more stuff!) and lower exports (foreigners buy less because it costs them more to get dollars).

This theory seemed to work in the 1980s. Budget deficits grew under President Reagan, mostly because of more defense spending, and so did the trade deficit.

However, the theory fell apart in the 1990s, when the budget deficit fell (and even turned into surpluses). If the theory held, you'd expect the trade deficit to shrink, too. But that didn't happen. In fact, the current account deficit, which is the most comprehensive measure of the trade deficit, hit a new peak at 3.9% of GDP in 2000, even higher than the peak of 3.3% in the late 1980s.

What this showed was that the old Keynesian theory behind the twin deficits was too superficial and the two deficits don't have to move in tandem. What really matters isn't whether the government runs a larger or smaller budget deficit; what matters is the set of policies the government is implementing.

In the 1980s, the Reagan Administration cut tax rates, deregulated, and got inflation under control. All of these policies made the US a better place to invest. Those policies attracted capital from the rest of the world, which pushed up the dollar and also increased the trade deficit.

In the 1990s, a large combination of factors helped the economy and also reduced the budget deficit. These include lower inflation (which reduced the effective capital gains tax rate), the "peace dividend" (which allowed for less military spending), President Clinton holding to the federal spending caps inherited from President Bush, the failure of Clinton-care, enacting welfare reform and Medicare reform, free trade pacts, and the natural aging of Baby Boomers into their peak earning years.

All of these helped reduce the budget deficit, but they also made the US a better place to invest. And being a better place to invest meant a higher dollar and an increase in the trade deficit. So, in the 1990s, the twin deficits were not twins at all: the budget deficit went down and the trade deficit went up.

Right now, the combined twin deficit is at a record high. But notice that almost all the increase is due to the budget deficit. The trade deficit is larger than it was a year ago, but is roughly the average it's been for the past twenty years.

Now, ask yourself, since the onset of COVID, since when the budget deficit has soared, has the US adopted policies to improve its long-term growth potential? Have we cut tax rates? Have we deregulated? Have we reigned-in or reformed government spending programs or made them more actuarially sound? No, we have not, unfortunately. What we have done is spent future taxpayers' money like there is no tomorrow to generate some extra economic growth in the short-term.

The pandemic-related policy set in the US is not as dollar-friendly or investment-friendly as what we did in the 1980s or 1990s. However, because every other country has done similar things, the US is a relative safe-haven for economic activity versus others.

Considering all this, we do not expect a massive increase in the trade deficit to match the surge in the budget deficit. The lack of a massive trade deficit to match the budget deficit is important for forecasting the dollar because a massive trade deficit could put political pressure on the Federal Reserve to reduce the exchange value of the dollar by postponing rate hikes. Again, we don't see that happening.

But at least it brings us back to what really matters for predicting future changes in the value of the dollar: monetary policy. Forecasting changes in the dollar is probably the toughest part of managing assets. And, right now, we are not forecasting the dollar to either plunge or soar in the next year.

The one thing we do know is that if the dollar does make a big move in either direction, it won't be because of what we already know about the twin deficits.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-6 / 9:00 am	ISM Non Mfg Index – Jun	63.5	**63.7**	60.1	64.0
7-8 / 7:30 am	Initial Claims – July 3	350K	**381K**		364K
2:00 pm	Consumer Credit– May	$18.3 Bil	**$18.0 Bil**		$18.6 Bil

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.