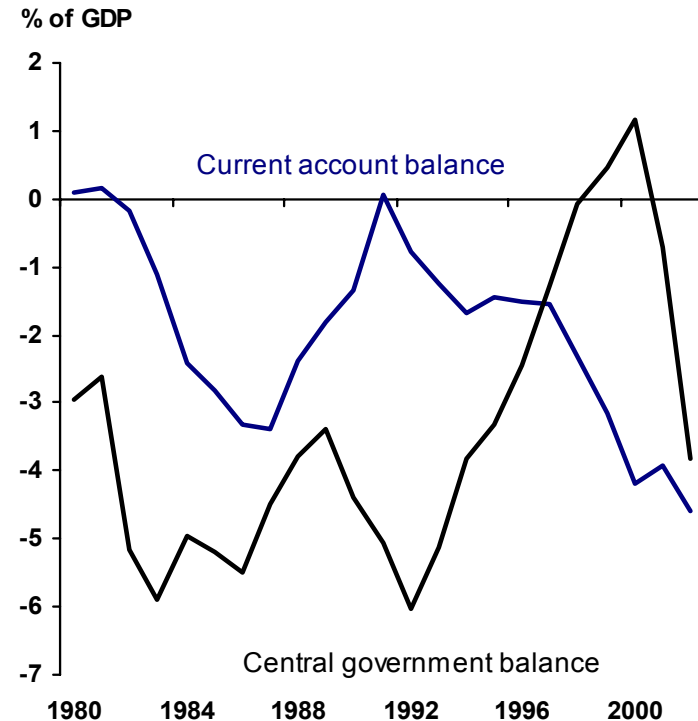


THE RETURN OF THE US TWIN DEFICITS

- Within the past three years the US budget has moved sharply from surplus to deficit, leading to a return of the so-called “twin deficits” phenomenon that played a central role in macroeconomic debate during much of the 1980s. Then, the emergence of the twin deficits was associated with a combination of fiscal loosening and monetary policy tightening that saw the current account deficit peak at about 3.5% of GDP in 1986.
- By early this year the US current account deficit had reached a record high of 5% of GDP. This is roughly the level at which some rules of thumb suggest developed economies become wary of pressures for external adjustment. At present, funding the US external shortfall requires an inflow of approximately US\$2b per working day. This huge financing requirement has been contributing to downward pressure on the US dollar since early 2002.
- The pressure for external adjustment is complicated by the growing fiscal imbalance. According to the Congressional Budget Office, if current fiscal policies remain in place, the US will continue to post budget deficits for the remainder of this decade. All else equal, this would place *upward* pressure on US interest rates and hence the greenback.



Source: IMF World Economic Outlook September 2003