Flash Economics

N° 44
November 21st, 2024

Patrick Artus

Senior Economic Advisor

patrick.artus-ext@ossiam.com
@PatrickArtus

Should we be worried about a public deficit, a current account deficit or low long-term capital inflows?

We often worry about countries with large budget deficits (currently the United States, France, Italy and Japan, for example). But if a country has a large budget deficit and a current account surplus (e.g. Italy and Japan), it covers the public deficit with domestic savings, and its situation is much less worrying.

If the country has a budget deficit and a current account deficit, but receives large inflows of long-term capital, its budgetary situation is not very worrying, since it covers the budget deficit with domestic savings and imported long-term savings (this is the case in the United States, for example).

The most worrying case is that of a country with a public deficit, a current account deficit and low long-term capital inflows, since it depends on short-term capital inflows to finance its public deficit and does not cover its public deficit with domestic savings or long-term savings borrowed from the Rest of the World.

The situation of a country with a large public deficit but also a current account surplus is not very worrying.

There is often concern about the situation of **countries that have chronically large budget deficits**, but which also have a high rate of public surplus. This is the case, for example, in the **United States, France, Italy and Japan (Charts 1/2).**

Chart 1
Fiscal deficit (as % of nominal GDP)

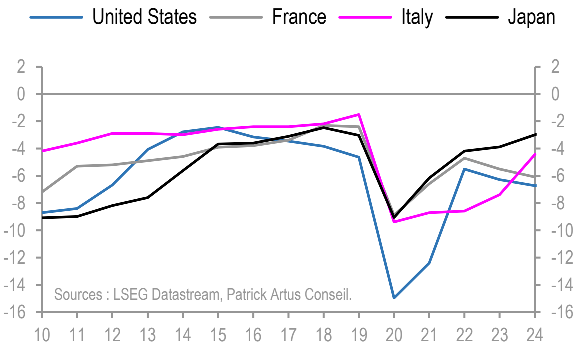
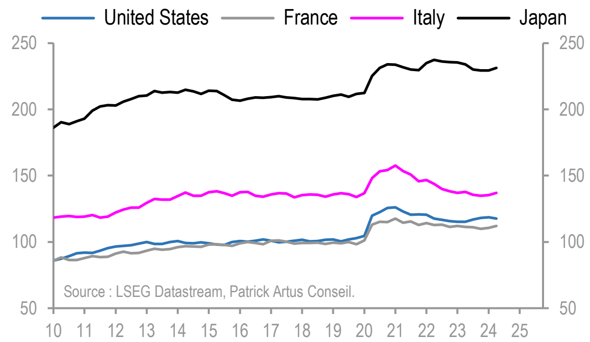
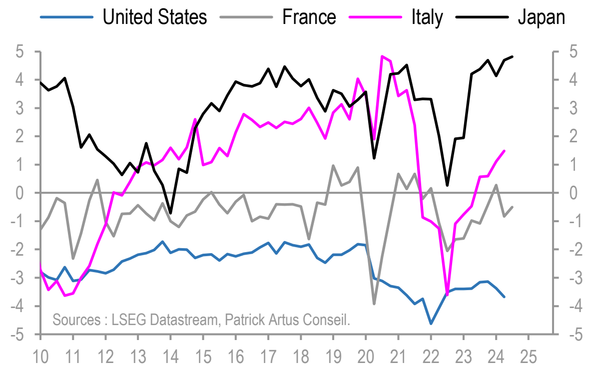


Chart 2
Public debt (as % of nominal GDP)



But, in reality, **the situation of countries that have a budget deficit but also a current account surplus** (such as Japan and Italy, **Chart 3**) is not very worrying.

Chart 3
Current account balance (as % of nominal GDP)

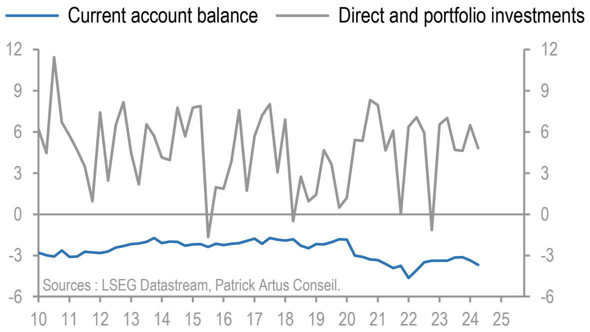


These countries cover their public deficit with their domestic savings and do not have to borrow from the Rest of the World to finance their public deficit.

Countries with a budget deficit and a current account deficit but which have long-term capital inflows that cover the current account deficit are not in a very worrying situation either.

If a country has a large budget deficit and a current account deficit but benefits from long-term capital inflows that cover its current account deficit, it is not in a very worrying situation either. Indeed, this country has the capacity to offset the current account deficit with long-term capital inflows, **which means that it has no difficulty covering its public deficit with domestic savings and long-term savings borrowed from the Rest of the World. Chart 4 shows that this is currently the case in the United States**.

Chart 4
United States: Current account balance, direct and portfolio investment inflows* (as % of nominal GDP)

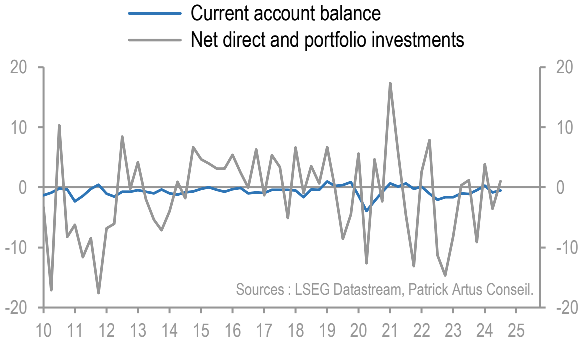


(*) Direct and portfolio investment inflows are capital inflows leading to an increase in liabilities (in this case for the United States) and therefore have a positive sign.

The most dangerous case: countries with a budget deficit, a current account deficit and no long-term capital inflows

If a country has a public deficit, a current account deficit and low long-term capital inflows, **it must finance part of its public deficit with short-term capital inflows**, which renders the financing of the public deficit precarious and exposes the country to the risk of a public debt crisis. **This is the case in France, for example (Chart 5).**

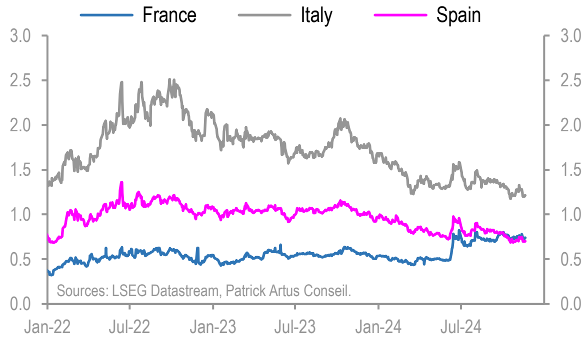
Chart 5
France: Current account balance, net direct and portfolio investments (as % of nominal GDP)



Summary: As long as domestic savings or long-term savings borrowed from the Rest of the World cover the budget deficit, the risk of a public finance crisis is low.

If the public deficit is covered either by domestic savings (the country has a current account surplus) or by long-term savings borrowed from the Rest of the World (the country has long-term capital inflows that cover its current account deficit), the risk of a public debt crisis, and of an induced sharp rise in long-term interest rates, is low. The dangerous situation is therefore that of countries with a large budget deficit, a current account deficit and low capital inflows (e.g. France), since they use short-term capital inflows to finance part of their public deficit. The risk is therefore that France's long-term interest rate spread vis-à-vis Germany will eventually exceed the level of Italy's spread (Chart 6).

Chart 6
Yield spread on country's 10-year government bonds against Germany (as % point)



Disclaimer