YANNI PARTNERS

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Twin Deficits

IN THIS ISSUE

Positioning portfolios in a time of growing twin deficits.

Yanni Partners monitors key economic, political, and social trends to ascertain the investment implications, and we advise clients how to respond to major trends in the capital markets. One major trend that warrants close scrutiny is the growth of the twin deficits.

Since 2002, the U.S. dollar has declined 50% relative to the Euro and 35% versus the Canadian dollar.[1] Two possible contributors to the drop of the dollar are the increasing current account deficit coupled with a budget deficit in the United States. Collectively, these shortfalls are known as the twin deficits. As of fiscal year end 2004, the budget deficit was 3.6%[2] of Gross Domestic Product (GDP), and the current account deficit was approximately 6%[3] of GDP. In this issue of *Measuring Up,* Yanni Partners will discuss the origins of the deficits and their relationships, the potential problems of running twin deficits, and possible solutions proposed by policy makers. We also discuss how Yanni Partners can position clients' portfolios appropriately.

Origins of the Budget and Current Account Deficits

A budget deficit arises when the Federal Government spends more during the year than it collects in receipts (i.e., taxes). The United States incurred a $413 billion budget deficit as of fiscal year end 2004 (9/30/04) (*see Figure One*).[4] The main contributors to the deficit have been lower tax revenue from the past recession combined with a weak economic recovery, and higher government spending on homeland security programs coupled with the war in Iraq.[5] Budget deficits result in reduced national savings (the sum of private savings and the current budget deficit). Since 2000, personal savings have declined, while the budget deficit has widened, thus leading to a decrease in national savings.[6] As national savings drops so does future income, and Americans' ability to accumulate real and financial assets decreases. A smaller pool of monies will be available for investment, leading to higher interest rates and slower economic growth.[7]

The other component of the twin deficits is the current account deficit. It is composed of three factors: international trade in goods and services (the largest piece), followed by net investment income and net unilateral transfers, which have a

[1] Cooper, PhD., Sherry, "Dollar Doldrums-Tacit Approval by Washington," *ViewPoint,* November 2004.

[2] Baum, Carolyn, "U.S. Economy Either Sails or Limps into 2005," *Bloomberg.com,* December 17, 2004.

[3] Coy, Peter, "That Trade Deficit is no Debacle," *BusinessWeek,* January 31, 2005.

[4] Baum, Carolyn, "U.S. Economy Either Sails or Limps into 2005."

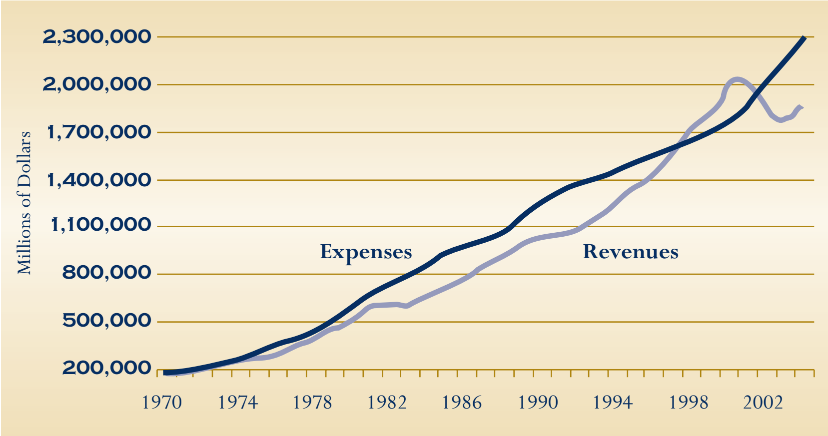
[5] Crawford, PhD., Peggy, and Terry Young, PhD., "The Twin Deficits: A Looming Crisis?," Pepperdine University, *Graziadio Business Report,* Volume 7, Number 2, 2004.

[6] Hung, Juann H. and Kim J. Kowalewski, "The Decline in the U.S. Current-Account Balance since 1991," Congressional Budget Office, *Economic and Budget Issue Brief,* August 6, 2004.

[7] Gale, William and Peter Orszag, "The U.S. Budget Deficit: On an Unsustainable Path" The Brookings Institution, *New Economy,* December 2004.

FIGURE ONE

Federal Government Budget Revenues vs. Expenses



Source: Office of Management and Budget

much smaller effect on the overall balance of the current account.[8] The trade imbalance represents the difference between what the U.S. exports and what it imports. Based on the strong U.S. economy relative to the rest of the world, imports have exceeded exports, leading to a deficit (*see Figure Two*). In fact, if U.S. economic growth were to equal world growth (if the U.S. growth rate fell to the lower world growth rate), the U.S. would still import more than it exports to the rest of the world.[9] When the United States imports goods, dollars flow to the foreign exporting company, which can then either use those dollars to buy American exports or financial assets, or sell the dollars to another investor, who has the same options.

How the Deficits are Related

When the U.S. Government runs a budget deficit, it raises money by issuing Treasury securities, such as three-month, six-month, and ten-year issues. There are several potential buyers of U.S. Treasury securities, including domestic and foreign investors. When Treasury securities are purchased, the Government uses this money to finance the deficit. However, economic growth may suffer if American investors purchase Treasury securities, thereby reducing domestic savings and leaving less capital available for productive investments, such as new plant and equipment or new companies.[10] Another domestic alternative is for the Federal Reserve to finance the deficit by buying U.S. Treasury securities. The Federal Reserve increases the nation's money supply by purchasing these securities. The increased money supply will result in rising inflation, as the surplus dollars bid up the prices of goods and services. Rising inflation can then lead to slower economic growth and eventually a recession. On an international level, rising inflation will result in a wider trade deficit since imports will be relatively cheaper than their domestic counterparts, while exports will slow as higher input costs raise prices.[11]

From an international perspective, when foreign countries lend to the Federal Government by buying U.S. Treasury securities with monies received from exporting goods to the U.S., they are funding the budget deficit. However, by buying U.S. Treasury securities instead of American goods, foreign countries increase the trade gap, thereby widening the current account deficit.[12] In fact, foreigners own 50% of outstanding U.S. Treasuries, 12% of U.S. Agency securities, and 25% of U.S. corporate bonds.[13] Currently, Japanese and

FIGURE TWO

Current Account Deficit Relative to GDP

Year	1999	2000	2001	2002	2003	2004*
Current Account Deficit (millions)	$263,252	$378,344	$362,692	$421,735	$496,508	$693,168
% of GDP	2.9%	3.9%	3.6%	4.1%	4.6%	6.0%

**Estimated*

Source: U.S. Census Bureau

[8] Hung, Juann H. and Kim J. Kowalewski, "The Decline in the U.S. Current-Account Balance since 1991."

[9] Cooper, James C. and Kathleen Madigan, "U.S.: Time to Cope with Co-Dependency," *BusinessWeek,* February 28, 2005.

[10] Gramlich, Governor Edward M., "Speech: Reducing Budget Deficits," The Federal Reserve Board, June 24, 2004.

[11] Corrigan, Sean, "The Twin Deficits: Myths and Truths," Mises Institute, September 2, 2004.

[12] Corrigan, Sean, "The Twin Deficits: Myths and Truths."

Chinese central banks have been financing much of the trade deficit by purchasing U.S. Treasury securities, in an effort to keep their currencies from appreciating against the dollar. From the American point of view, these Treasury purchases are keeping interest rates low and the Dollar/Yen relationship less volatile.[14] Since the "Asian crisis" in 1997, the Asian central banks have relied on the stability of the U.S. Government and financial market to stimulate domestic growth and keep employment high. Over the years, Asian central banks have purchased nearly $1 trillion of U.S. Government securities with a roughly zero real rate of return, presumably to support the dollar in order to maintain the competitiveness of their export industries.[15]

Potential Problems

From 1985 to 1987, the U.S. was running twin deficits. By 1987, the budget and current account deficits were approximately 3% and 3.5% respectively of GDP.[16] During that time, interest rates rose in order to attract foreign funds to finance the deficit and raise capital. In October 1987, this imbalance corrected and led to a collapse in the values of the dollar and stock market, which eventually led to a recession.[17] Based on this past experience and a current budget deficit running 3.6% and current account deficit of 6% of GDP, some speculate that this imbalance will lead to the same result as the 1987 correction.

As the dollar continues to decline (*see Figure Three*), foreign investors may demand higher interest rates to compensate for the foreign currency exchange loss, which could increase domestic borrowing rates, or foreign investors may sell their U.S. holdings outright. The sell-off could lead to a collapse in the financial markets and dollar; import prices would then rise, potentially leading to higher inflation. Inflation would likely prompt higher interest rates. However, with a dearth of current attractive investment opportunities around the world, the likelihood of a severe run on the dollar appears quite low.[18]

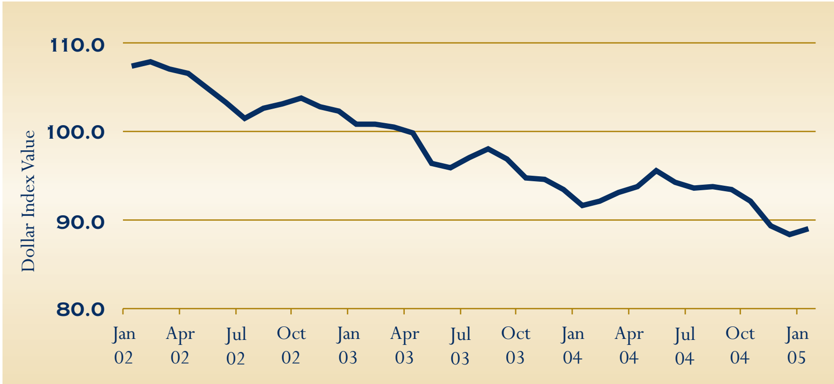
Solutions

Economists have proposed various solutions to correct the twin deficits, however each solution poses drawbacks. The most commonly cited solution is to balance the federal budget by establishing yearly budget targets that will eventually eliminate the deficit.[19] Eliminating the budget deficit will promote sustainable economic growth through stable interest rates, while continuing to attract foreign investment. However, to eliminate the deficit, a combination of spending cuts and tax hikes may be necessary. For example, in the proposed budget for 2006, more than 150 reductions and eliminations in non-defense discretionary programs have been proposed, which will save about $20 billion in 2006, as well as an additional set of reforms in mandatory programs, saving about $137 billion over the next ten years.[20] Reduced spending such as the examples provided, as well as higher taxes, might however lead to a slowdown in economic growth. Despite this possibility, the spending cuts will help slash the deficit by half from its originally estimated 2004 peak to just 1.5% of GDP by the year 2009.[21]

A second possible solution would be to allow the dollar to depreciate further against major trading partners' currencies and/or force China to remove its currency peg.[22] This currency realignment would force domestic interest rates up, as foreign investors

FIGURE THREE

Depreciating Value of the Dollar



Source: Morgan Stanley

[13] Cooper, PhD., Sherry, "Dollar Doldrums-Tacit Approval by Washington."

[14] Eichengreen, Barry, "America's Twin Deficits: The End is Near (But Not that Near)," University of California, Berkeley, October 7, 2004.

[15] Cato Daily Dispatch, "Dollar Slides as Asian Banks Drops Greenbacks," Cato Institute, February 23, 2005.

[16] Baum, Carolyn, "U.S. Economy Either Sails or Limps into 2005."

[17] Ratajczak, PhD, Donald, "Monthly Summary for December: Do the Twin Deficits Matter Anymore?," Morgan Keegan Fixed Income Research, January 12, 2005.

[18] Gongloff, Mark, "The Twin Deficits Loom," CNNMoney, March 11, 2003.

[19] Gramlich, Governor Edward M., "Speech: Reducing Budget Deficits."

[20] Office of Management and Budget, "Overview of the President's 2006 Budget," Office of Management and Budget, 2005.

[21] Office of Management and Budget, "Overview of the President's 2006 Budget."

[22] Cooper, PhD., Sherry, "Dollar Doldrums-Tacit Approval by Washington."

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would demand a higher return to compensate for the lower dollar. The lower dollar could benefit U.S. exporters, which could then sell more due to cheaper U.S. goods overseas.

Another option is to simply do nothing. The U.S. is growing faster than the rest of the world; therefore it is logical that we are running a trade deficit, as higher personal income leads to increased demand for imports, while lower growth abroad curbs demand for American exports.[23] Strong economic growth and demand for imports are signs of economic prosperity, and this growth will attract foreign investment. Even if U.S. growth cools in the near future, foreign investors will probably continue to invest in the U.S. due to a lack of attractive investment opportunities abroad.[24] Also, because of the political and economic stability of the United States, foreign governments may value the liquidity of the dollar in these uncertain times.[25] As discussed earlier, however, if the deficits continue and the dollar depreciates, foreign investors will eventually demand higher interest rates, which could slow domestic economic growth.

How Yanni Partners Can Help

Yanni Partners closely monitors global economic issues and will continue to educate clients on these issues and their effects. We will closely monitor developments with the twin deficits and ascertain the investment implications. Persuasive evidence of risks of higher interest rates will prompt Yanni Partners to recommend more defensive fixed income portfolios for clients, such as shortening the duration of their fixed income portfolios to limit risk exposure to rising rates. If Yanni Partners foresees the risks of increases in inflation, appropriate responses would be recommended, such as potentially higher allocations to investments with explicit inflation protection such as TIPS and possible exposure to real estate and/or other "real return" assets.

[23] Coy, Peter, "That Trade Deficit is no Debacle."
[24] Gongloff, Mark, "The Twin Deficits Loom."
[25] Ratajczak, PhD, Donald, "Monthly Summary for December: Do the Twin Deficits Matter Anymore?."

Calendar of Events

June 6, 2005

Yanni Partners Corporate Golf Outing

Sewickley Heights Golf Club
Pittsburgh, PA

Attendance by invitation only.

Yanni Partners provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

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