Liquid Insight

Do twin deficits matter for rates & FX?

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Rates and Currencies Research
Global

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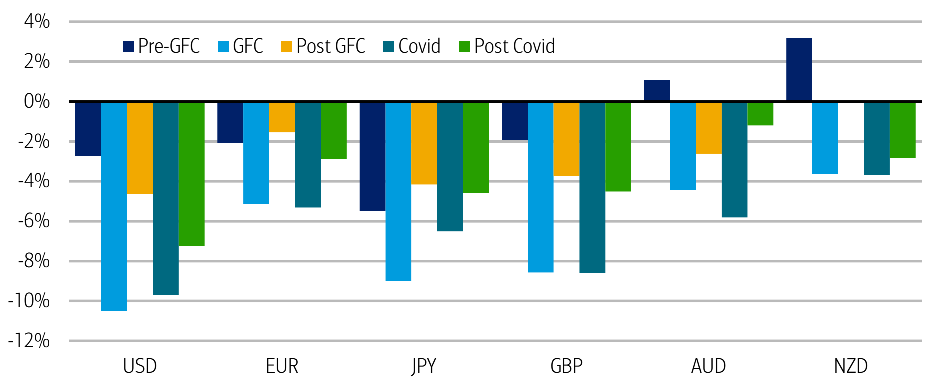
Key takeaways

- Twin deficits = not made equal: FX impact depends on ability to attract inflows & stagflation. Fiscal rules are a red flag
- GBP & EUR suffer due to fiscal rules; no such anchor for USD & protected by reserve status; vol adj x-border flows hurt NZD
- Wider real/nominal rate spreads due to the twins. Reagonomics provides the template on how +ve turns into a -ve for G10.

By Kamal Sharma & Mark Capleton

Exhibit 1: Selected G10 budget balances % GDP
Worse fiscal situations than at the start of the millennium.



Source: BofA Global Research, loomberg, IMF

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Should we be concerned?

In short, yes. We have placed great store in voicing our concerns on the impact of twin deficits on rates and FX. Our priors argue higher r* and weaker FX on widening deficits to attract cross-border capitals to finance the "twins". However, evidence of broad based G10 FX/rates volatility has been absent over the last 20-years. Context matters and FX misalignment is perhaps more pertinent to adjustment in a freely floating FX environment. Notional anchors (fixed exchange rates; fiscal rules) provide markets with a target to aim at. The main rates market call that falls out from this is the view that the US's huge and growing dependency on foreign capital, especially when compared with the Eurozone will require a wider US-Euro nominal and real yield difference. This aligns with our views on relative growth prospects and relative neutral real policy rates, which point the same way.

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Should we be concerned by twin deficits?

In short, yes but all currencies will not be treated equally and the conditions for a "crisis" are relatively narrow. Lessons from the past 30 years suggest that markets are likely to pinpoint idiosyncratic stories/anchos and discriminate against currencies where valuation/market reputation make the case clear.

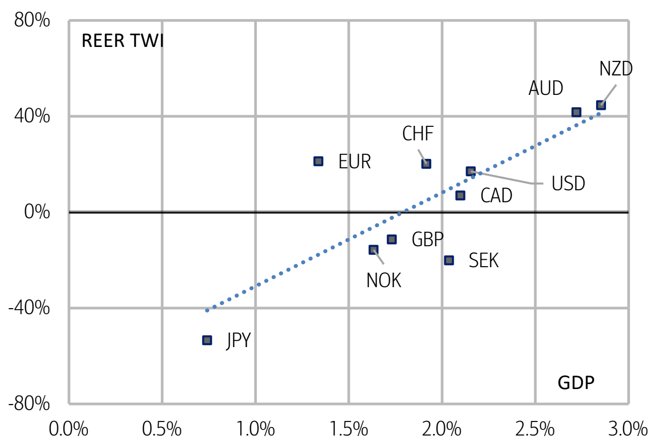
However, the UK experience is telling in that it represents an insight into what a perfect storm of large twin deficits and concerns about growth could look like for FX performance. The key ingredient to the recent tumult in UK markets has been concerns that widening deficits come at the same time as stagflation. This is the scenario that we are most concerned about for the global economy: stretched fiscal positions against the backdrop of rising stagflation concerns.

It is therefore worth looking at the current G10 position: dual balances versus a measure of stagflation. For the latter, we look at the Misery Indices compiled by Bloomberg which incorporate inflation and unemployment to gauge stagflation pressures.

Normalising the indices for G10 using 1yr rolling Z-scores shown in Exhibit 3, shows that most G10 currencies are not experiencing concurrent rises in inflation and the unemployment rate. Japan has been the outlier. US, Canada and UK are exhibiting some signs of stagflation but the rest of G10 are not. Exhibit 3 perhaps best explains why the UK has been in focus at the start of the year, with the Misery Index close to flipping into positive territory. Even then, we do not think the urgency with which the market latched onto the fiscal distress theme was warranted, as subsequent data has shown.

Exhibit 2: G10 GDP vs REER TWI, average 2000-2024

Stronger growth – stronger inflation.



Source: BofA Global Research, Bloomberg

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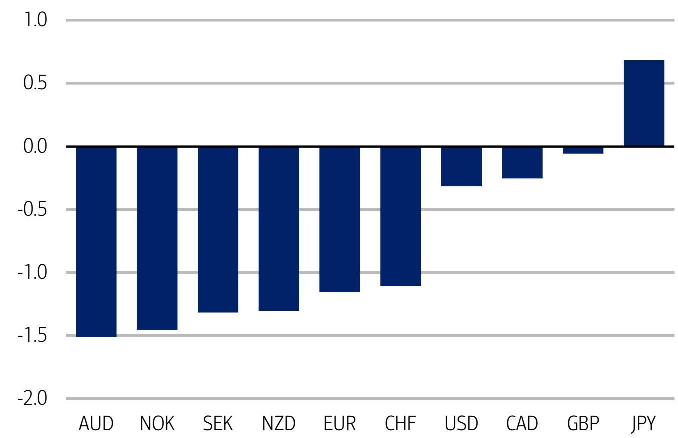
Exhibit 3: 1yr rolling z-score Bloomberg Misery Index*

Minimal stagflation concerns in G10.



Source: BofA Global Research, Bloomberg. *+ve z-score = rising stagflation risks and vice versa

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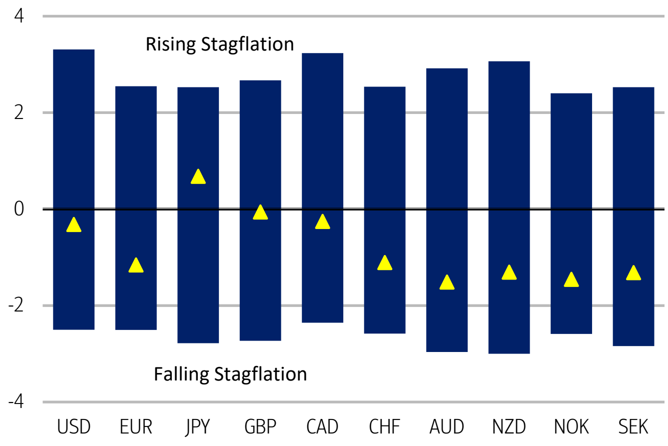
This point is reinforced in Exhibit 4. We look at the min/max z-scores for the Misery Index versus current values. For now, our analysis suggests that global imbalances are unlikely to be an imminent issue for G10 FX. In Exhibit 5, we use a scatter plot to look at those currencies that are potentially more vulnerable.

The direction of travel is as follows – a wider twin deficit combined with rising stagflation risks (top left quadrant) should be potential warning signs. None of the G10 currencies is currently populating this quadrant but GBP, USD and to a lesser extent CAD are close.

On the flip side, NOK, SEK and CHF fall comfortably into the bottom right quadrant – no risks of fiscal concerns for strong surpluses and low stagflation risks. EUR is interesting in that the aggregate masks significant divergence amongst the Eurozone with France and Italy the most exposed to relatively high dual deficits.

Exhibit 4: Z-Score Bloomberg Misery Index – Range & Current Reading
Little sign of stagflation in G10 = dual deficits not under imminent threat



Source: BofA Global Research, Bloomberg

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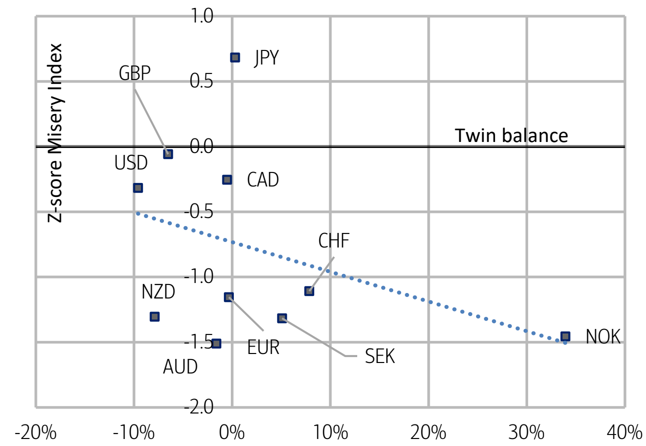
Exhibit 5: G10 Twin balances (2025F) vs z-score Misery Index
GBP, USD twin deficits vulnerable to rise in stagflation



Source: BofA Global Research, Bloomberg, IMF WEO

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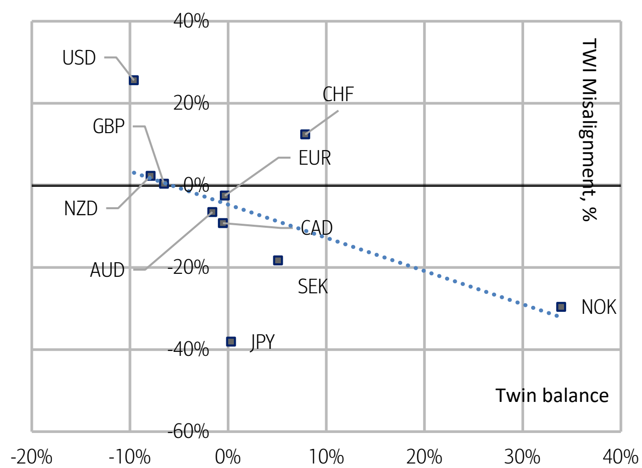
Exhibit 6 plots FX misalignments using our Bilateral Effective Exchange Rate Models versus twin balances in G10. What is striking is the coalescence of G10 currencies around the trendline with CHF, SEK and JPY the notable outliers. Based on this framework – twin balances would favour higher JPY & SEK and lower CHF & USD. On CHF, we find this result interesting – a strong twin surplus position, yet CHF is significantly overvalued relative to the trend.

Exhibit 6: G10 Twin balances (2025F) vs TWI Misalignment (%)
Higher JPY & SEK vs lower USD and CHF



Source: BofA Global Research, Bloomberg, IMF WEO

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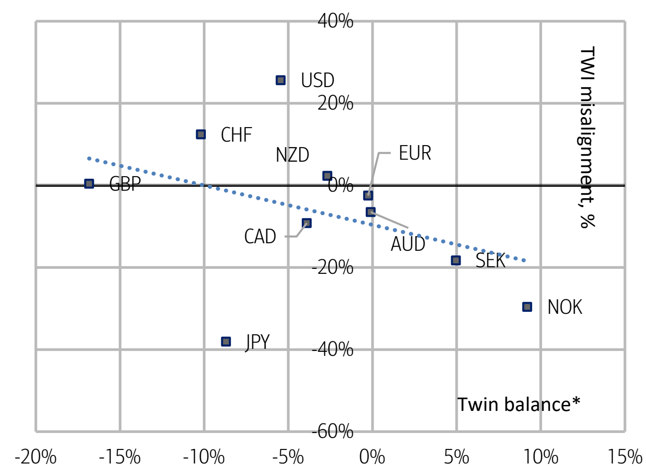
Exhibit 7: G10 Twin balances* vs TWI Misalignment (%)
Basic balances suggest less TWI misalignment for most G10 FX



Source: BofA Global Research, Bloomberg. *Using basic balance rather than current account

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Can we trade dual deficits?

Our medium-term framework leverages heavily on FX misalignment yet we find ourselves in a situation where FX misalignments have been persistent, most notably for JPY and USD. In Exhibit 7 we modify the twin balances, substituting the current account with the basic balance which adjust for net portfolio flows. One of the key drivers for FX performance over the last 10yrs has been the impact of the portfolio/FDI channel and the flow of funds into the US asset market. As the chart shows, many G10 currencies appear to be consistent with this modified twin balance metric, the obvious outliers being USD & JPY.

Our Japan colleagues has placed great store in the structural FDI outflow story weighing on JPY (see report: FX Watch: Japan BoP: Capital flow from Japan to US backed by US-Japan relations 10 February 2025). Exorbitant privilege; US exceptionalism and AI revolution are all factors which have sucked current account surpluses into the US. Confidence in the US productivity story remains key to market perceptions on its twin deficits.

As discussed above, context matters. Twin deficits in and of themselves will not trigger an FX event, if deficits are caused by “good reasons” – strong internal demand dynamics, productivity growth. Markets have fretted about the size of the US twin deficits for over two decades, yet the USD has not faced a pivotal moment nor has been subjected to market discipline. As we describe below, the USD’s reserve status and lack of anchor of a fiscal target are important reasons.

As the Asia Crisis and the recent tumult in the UK and France have shown, markets have tended to gravitate towards some form of notional anchor – be it fixed exchange rates or fiscal rules. This gives investors a better sense of whether twin balances are inconsistent with those anchors. For Asian currencies – exchange pegs were seen as preventing necessary depreciation in Asian FX.

More recently, the market has focused on the UK and France as potential soft spots in the fiscal spectrum, with the UK also having to contend with a current account deficit. Why have the UK and France been singled out by markets for particular attention? In our view, ruled based fiscal policy in both countries has provided the anchor that the fixed exchange rate regimes in Asia did in 1997.

Fiscal headroom in the UK and the growth trade-off due to large spending cuts in France to meet Maastricht targets have weighed on sentiment in both the rates and FX markets. The Eurozone debt crisis perhaps provides the clearest example of systematic risk –breakup risks – for contagion throughout the region. Whilst the Credit Crisis exposed these fault lines, this episode clearly illustrates the risks of a challenging cross-border flow environment.

The twin deficits hypothesis and rates

Twin deficits can evolve in different ways. How they come into being and their relative sizes will have an important bearing on their market implications. The classic narrative, under a Mundell-Fleming framework with perfect capital mobility and free-floating exchange rates, starts the process with an increase in the fiscal deficit.

The rising budget deficit increases yields in the economy (strictly speaking, we should say it increases real yields relative to those in other economies). This rise in yields can be because the fiscal stimulus boosts growth and inflation expectations and/or because the consequence of a greater government call on savings to finance the deficit is a higher clearing yield for government bonds. Likely both.

Higher yields attract foreign capital inflows and the currency appreciates. Leakage of the demand boost from the fiscal stimulus into imports and the loss of currency competitiveness then causes the current account of the balance of payments to deteriorate.

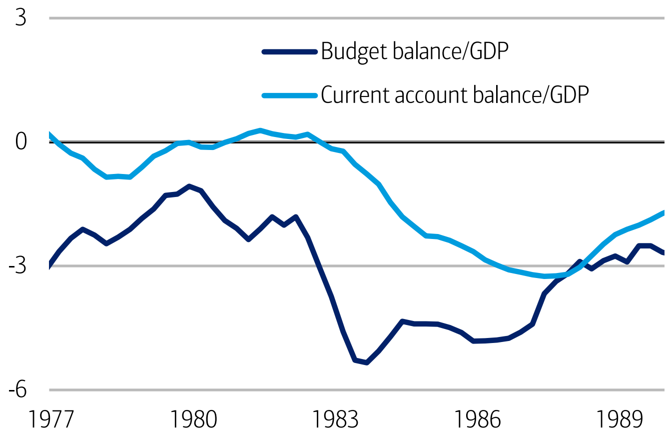
Evidence of the hypothesis in the wild

Although economists agree on few things, perhaps the clearest real-life example of this framing of the evolution of twin deficits is the early 1980s Reaganomics episode – the period that led to the coining of the term “twin deficits”.

1981’s Economic Recovery Tax Act cut personal and business taxes substantially, starting the rise in the budget deficit/GDP ratio that peaked in 1983, as shown in Exhibit 8. This sharp increase in the government call on savings drove yields higher (Exhibit 9) peaking in 1984, attracting foreign capital and pushing up the dollar.

The dollar's rise was so profound because, initially, the current account was close to balance (Exhibit 8), with no meaningful net sale of dollars associated with the external sector. It is necessary to be circumspect when interpreting messages from flow of funds relationships, which are after all identities, but it appears that improving consumer and business confidence as a result of the fiscal stimulus (and the exit from recession) meant that private domestic sectors were encouraged to spend and invest, so did not wish to accumulate domestic savings that might have financed the fiscal expansion.

Exhibit 8: The 1980s era that gave us the "twin deficits" term
Budget deficit grew, prompting rising yields, taking dollar to uncompetitive levels. In turn, this plus deficit-fuelled demand hurt the external balance, %.



Source: BofA Global Research, LSEG Data & Analytics

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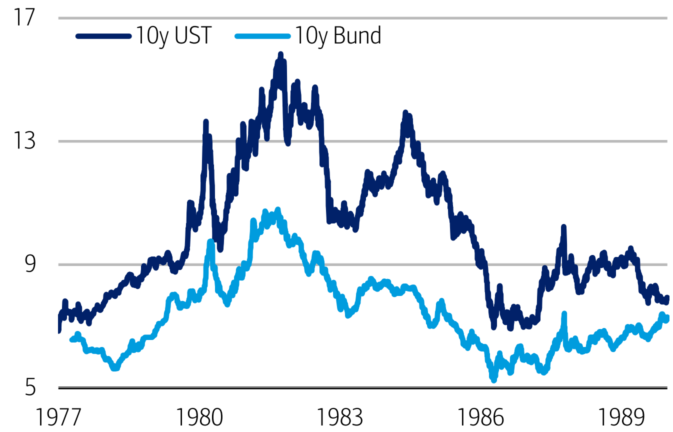
Exhibit 9: Twin peaks, different causes
Early 80s yield high caused by punitive policy rates from Fed's Volcker to deal with inflation. 1984 peak caused by fiscal deficit expansion, %.



Source: BofA Global Research, LSEG Data & Analytics, Bloomberg

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- **Global Rates Year Ahead 2025** – Continental Drift, 24 November 2024
- **G10 FX Year Ahead 2025** – Policy Uncertainty, 26 November 2024
- EUR needs some stability, **Liquid Cross Border Flows**, 17 February 2025

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For a complete list of our open trade recommendations as well as our trade recommendations closed over the past 12 months, see the reports below:

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