The Journal of Portfolio Management

Mind-Sets over Matter

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Although what follows deals with a particular issue—the presumed linkages between the government's fiscal position and the massive American trade deficit—my real point is a more general one. Habits of thinking run deep. The more embedded the mind-sets, the more dangerous they can become. None of us is immune from this habit, but we would do well to avoid succumbing to it. Herewith an important example.

The op-ed page of *The New York Times* of April 9, 2001, carried an article by Nobel Laureates Franco Modigliani and Robert Solow, entitled "America is Borrowing Trouble." My problem is not with the diagnosis of the serious problem that worries these distinguished economists, but rather with how mind-sets have colored their prescription for cure. The mind-sets are so dominant, in fact, that macroeconomics get lost in the shuffle.

The authors open with an examination of the risks in our steadily mounting trade deficit, especially the perils awaiting the U.S. if this deficit ignites a flight from the dollar. They then emphasize that we may be unable to avoid a dollar crisis without an increase in the national savings rate.

But how do we accomplish an increase in the savings rate? Modigliani and Solow have no doubts: "President Bush is galloping in exactly the wrong direction with his advocacy [of] a deep, permanent tax cut." The tax cut must wait until the trade balance has turned positive. This notion of the "twin deficits" was conceived in the early 1980s, and it dies hard.

The facts have blasted the myth of an inevitable bond between fiscal deficits and trade deficits. The coefficient of correlation between these two variables dove headlong from a positive 0.55 during 1965-1989 to a *negative* 0.89 during 1990-2000. This surprising outcome is probably due, at least in part, to the way the personal savings rate and the fiscal position have also moved in opposite directions during the 1990s. But there is nothing new in the tendency of private sector savings as a whole (business plus household) to move in the opposite direction from government saving. Private sector savings and government saving sported a negative coefficient of correlation of 0.54 even during the years 1965-1989. In short, the U.S. economy is too complex a system to enable us to have any confidence in simple linkages between any two variables.

Yet Modigliani and Solow go even further. They contend that the tax cut "would raise consumption by roughly one dollar for every dollar of tax reduction." This remarkable assertion ignores the way households frequently use their savings as a balance wheel between taxes and consumption, especially among people in the highest income groups. These individuals, who account for by far the largest share of household saving, can afford to spend what they want and tend to save the rest after their taxes have been paid. Thus, the income tax cuts of the 1980s, which did benefit the people at the top, were accompanied by a higher personal savings rate than during the second half of the 1970s. As the largest share of the 1993 tax increase also hit the people in the top brackets, the sharp drop in personal savings rates should come as no surprise. By the same token, a future tax cut favoring the top brackets may lead to a less than one-for-one increase in consumption. In any case, these relationships are too intricate and too variable to justify the mechanics of the Modigliani-Solow prediction.

We do not know how all of this will work out, and the Bush proposals are indeed controversial. Nevertheless, mind-sets based on short-lived if theoretically appealing relationships of the past are the wrong base from which to launch unqualified predictions of an uncertain future.