

ECONOMIC PERSPECTIVES

The Twin Deficits: Myth, Facts and Fallacies

Victor A. Canto, PhD | September 2026

KEY TAKEAWAYS

- **The twin-deficit narrative is too simple.** Budget and trade deficits do not, by themselves, establish that the U.S. is being harmed or that higher interest rates must follow.
- **Trade deficits can reflect capital strength.** Under a floating exchange rate, a trade deficit is mirrored by capital inflows that may finance investment, employment and economic expansion.
- **The interest-rate evidence challenges conventional wisdom.** The historical relationship between budget deficits and Treasury yields is not consistently positive; spikes in deficits are often associated with declines in real yields.
- **Economic growth may be the common driver.** Faster real GDP growth can reduce the budget deficit while raising real interest rates, producing relationships opposite to the standard twin-deficit story.

The times are reminiscent of the 1980s, when the financial press referred to the U.S. trade and budget deficits as the Twin Deficits. We are “back to the future,” talking about the twin deficits, their causes, and consequences.

The view among many politicians and policymakers is that an increase in the U.S. budget deficit as a percent of GDP leads to an increase in interest rates. The quotes below show that this is a bipartisan consensus.

Person	Role	Quote
Paul Volcker	Fed Chair	“Large budget deficits put upward pressure on interest rates.”
Alan Greenspan	Fed Chair	“The federal deficit is putting upward pressure on long-term interest rates.”
Ben Bernanke	Fed Chair	“Large deficits can lead to higher long-term interest rates.”
Lawrence Summers	Treasury Sec.	“Budget deficits raise interest rates.”
Martin Feldstein	CEA Chair	“Budget deficits increase interest rates and crowd out private investment.”
Ronald Reagan	President	“High deficits lead to high interest rates.”
Bill Clinton	President	“If we don’t reduce the deficit, interest rates will go up.”
Barack Obama	President	“Rising deficits will push up interest rates.”
George W. Bush	President	“Large deficits could lead to higher interest rates.”
Joe Biden	President	“If the deficit keeps rising, interest rates will rise with it.”

Some critics go further and argue that we are stealing from future generations. Here are some quotes:

Person	Role	Verbatim Quote
Ron Paul	Congressman	“Deficit spending should be viewed as a tax on future generations.”
Paul Ryan	Speaker of the House	“Endless borrowing... will compromise our economy... the debt is literally getting out of our control.”
Keith Raffel	Political commentator	“What he’s stealing from future generations of Americans.”
Laurence Kotlikoff	Economist	“Deficit spending... is just a wealth transfer from future taxpayers to current consumers.”
Laurence Kotlikoff	Former CEA staffer	“Accumulating debt to pay for current expenses is like a Ponzi scheme... the young pay the old.”

The assertions about the implications of the other twin are just as strong. On this issue President Trump has been quite vocal. Here is what the President said:

“Canada has been ripping off the United States of America for years. Their ridiculously high tariffs on our Farmers and farm products... has long created a 60 Billion Dollar Deficit between our two Countries.”

A clear example of President Trump’s mercantilist view. He explicitly uses the trade deficit as evidence that America is being taken advantage of. Then there is his statement:

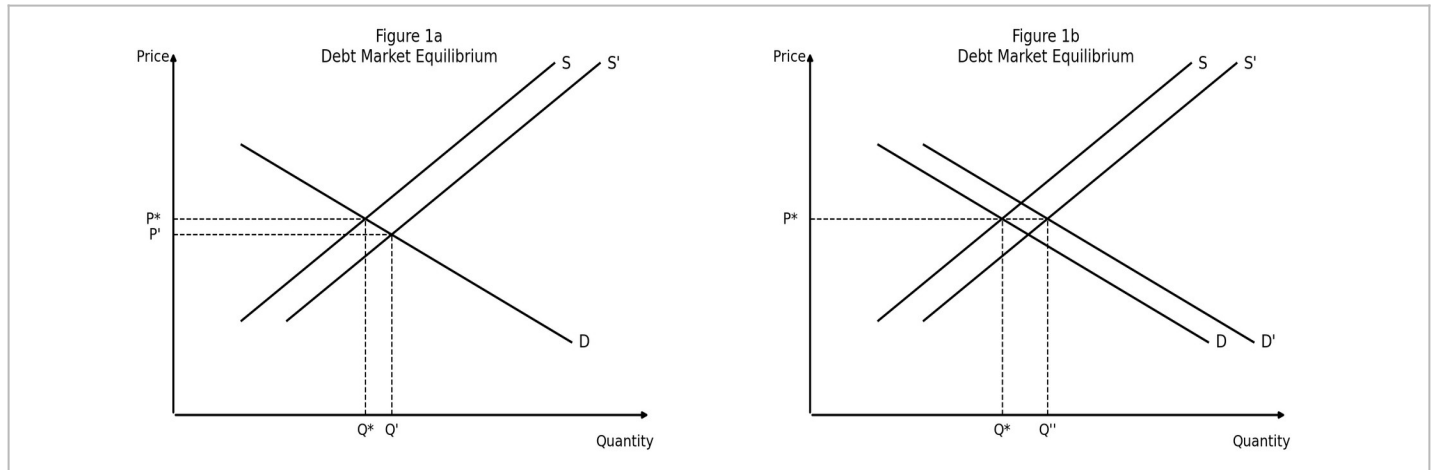
“America is being ripped off... We’re a debtor nation, and we have to tax, we have to tariff, we have to protect this country.”

In this quote the President is clear: he links U.S. indebtedness and the trade imbalance to the idea that other countries are exploiting and hurting America.

Are the Twins as bad as the critics say?

Let us review some of the counterarguments. The argument and counterarguments about the effect of the budget deficit on interest rates can be shown graphically. An increase in the budget deficit results in an outward shift in the total supply of public debt. There is no question about it; all parties agree to this. The difference of opinion concerns what happens to the supply of savings. We consider two possibilities. As Figure 1a shows, everything else the same, an increase in the supply of public debt leads to a decline in the price of public debt. Given the inverse relationship between bond prices and their yield, Figure 1a leads to the conclusion that the public-debt yield will rise.

Figure 1 — Debt Market Equilibrium: Conventional and Ricardian Cases



Source: La Jolla Economics

Furthermore, those who share this view quite often argue that we are stealing from future generations—that the deficit is just a wealth transfer from future taxpayers to current consumers. But not everyone shares these views. David Ricardo argued that people understand that today's borrowing means tomorrow's taxes. As a result, when the government runs a deficit, households that anticipate future taxes will save more in order to pay the future tax increases. The argument is easily extended to future generations. If people care about their descendants, they will increase the inheritance they leave in order to spare their descendants the burden of future taxation. In doing so, they reverse the government's initial transfer from future to current generations. This increase in private savings leads to an outward shift of the economy's aggregate savings and, in turn, offsets the increase in government securities generated by the government's deficit, leaving the market-clearing interest rates unchanged, as illustrated in Figure 1b.

Now on to the second twin. Mercantilists tend to view trade as a zero-sum game: one country's gain means another country loses. This approach does not consider the possibility that both parties could be better off when the economic pie expands as a result of international trade. Furthermore, static zero-sum mercantilists focus on the trade balance and equate a deficit to a loss of jobs, income and wealth. Ironically, their analysis is incomplete. They tend to ignore the effects of capital flows on the economy.

Under a floating exchange rate, the balance of payments is always zero. The National Income and Product Accounts, NIPA, tell us that the trade balance and capital account are the mirror image of each other. Thus, a trade deficit means an inflow of foreign capital. If the latter is attracted by opportunities in the local economy, the investments it finances will lead to an economic expansion. Those benefits have to be accounted for when evaluating the economic well-being of an open economy that trades in goods and allows for capital flows or foreign investments.

The NIPA double-entry bookkeeping of international relations also yields an interesting insight that mercantilists tend to ignore. Measures that succeed in reducing the trade deficit will simultaneously reduce capital inflows and the benefits of free trade. Therefore, a country that successfully adopts measures such as tariffs and other trade restrictions and, as a result, improves its trade balance will also slow the capital inflow, which in turn could slow economic expansion.

Mercantilists also believe that lowering a country's terms of trade or real exchange rate will improve its trade balance and, as a result, improve the country's well-being. But this analysis does not consider the loss of economic well-being from a reduction in capital flows.

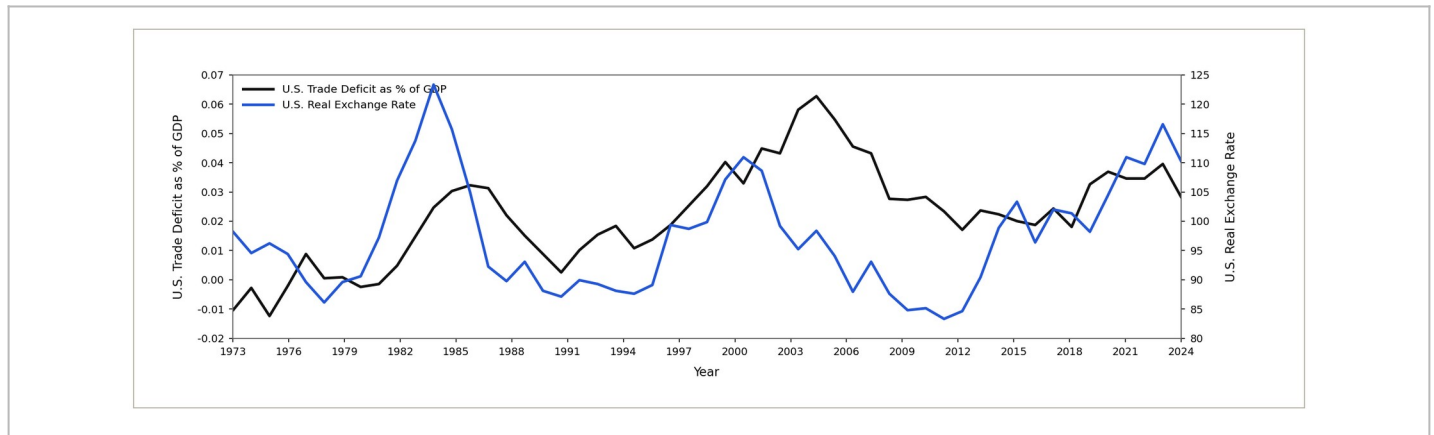
A lower term of trade makes a country's exports cheaper and thus leads to an increase in foreign demand for the country's exports. In turn, the lower terms of trade make the country's imports more expensive, the net result being a reduction in imported products. More exports—but what about the capital flows? The reduction in the terms of trade means that a unit of domestic good buys a smaller amount of foreign goods. This means a reduction in the rate of return generated by producing domestic goods. A lower return will attract less capital and result in a lower valuation of domestic assets. Ultimately this leads to less investment, lower employment and slower GDP growth relative to the rest of the world.

We have argued that under a floating exchange rate the balance of payments is zero and capital flows are a mirror image of the trade balance. Viewed this way, the improvement in the trade balance may be more than offset by the reduction in capital flow. In any event, it is clear that mercantilists overstate the benefits of trade-balance improvements.

What does the data say?

Next, we explore the relationship between the terms of trade, or real exchange rate, and the trade balance, see Figure 2. The data show a strong correlation consistent with both the mercantilist and our analysis, suggesting that the terms of trade or real exchange rate and the trade balance are positively correlated. Notice that the peaks and troughs in the real exchange rate precede those of the trade balance. If one is willing to equate time precedence with a causal relationship, the data suggest that the real exchange rate drives the trade balance. The policy implication is that a national government, through tariffs and other policies, may be able to control a country's terms of trade or real exchange rate and that, in turn, allows it to manage its trade balance. However, the ability to control the trade balance does not answer the question of whether a trade deficit makes the nation worse off.

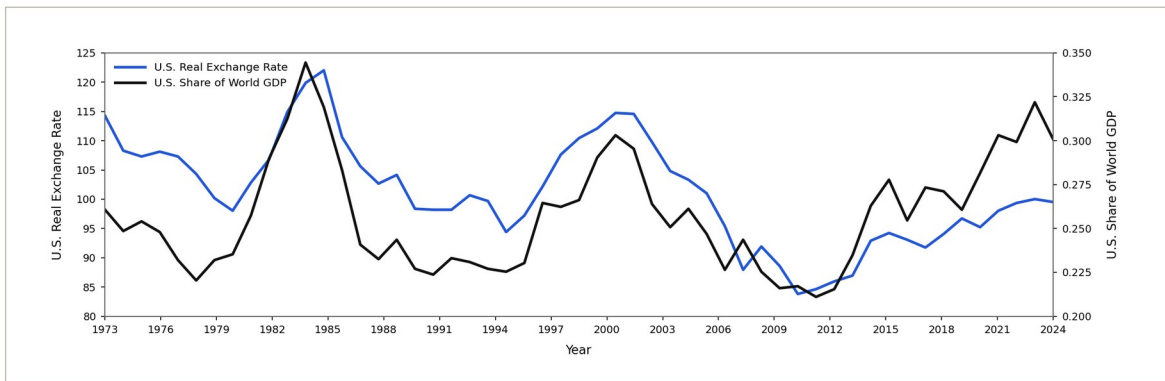
Figure 2 — U.S. Trade Deficit as % of GDP versus U.S. Real Exchange Rate



Source: La Jolla Economics

Changes in the terms of trade or real exchange rate also affect other economic variables. Figure 3a reports the correlation between the U.S. Real Exchange Rate and the ratio of U.S. GDP to World GDP. The data show a positive correlation between the two variables. The correlation is consistent with our interpretation that an increase in the terms of trade increases the number of foreign goods that can be acquired by a domestic good. The real exchange-rate appreciation represents an increase in domestic rates of return and an increase in incentives to produce goods for exports. The correlation also contradicts the mercantilist view that a deterioration of the trade balance reduces the U.S. share of world GDP.

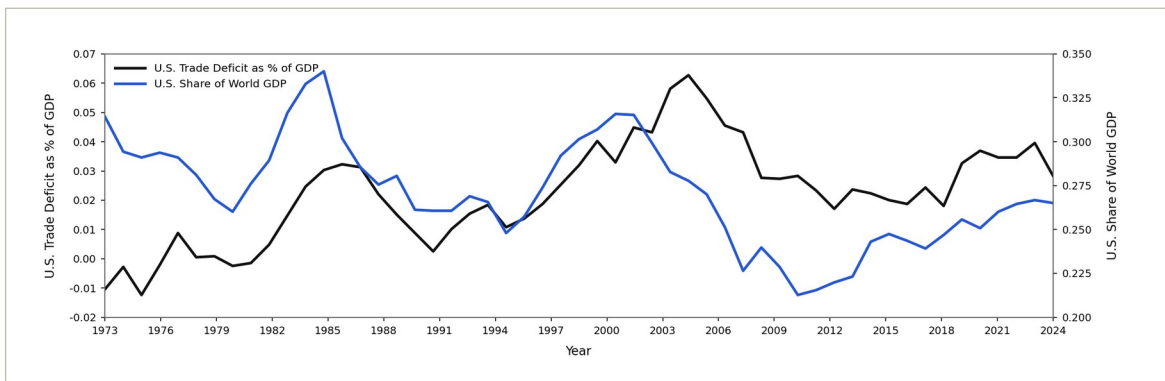
Figure 3a — U.S. Real Exchange Rate versus U.S. Share of World GDP



Source: La Jolla Economics

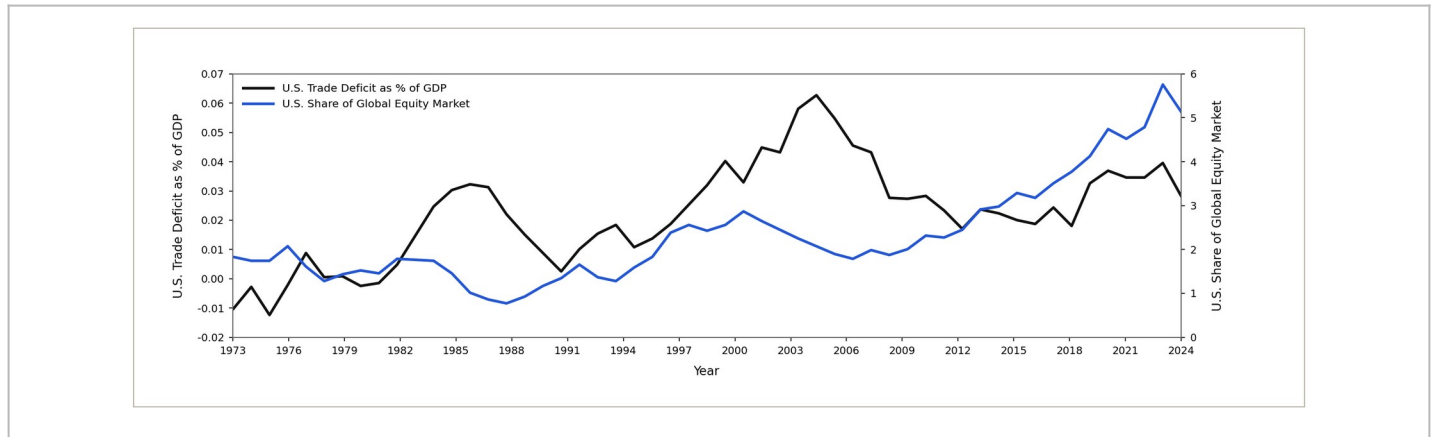
So far our interpretation of the data suggests that a rising real exchange rate or a deteriorating trade balance, rather than being bearish, is quite bullish. It suggests that a unit of a U.S.-produced good can buy a larger amount of foreign goods. That leads to an increased incentive to produce U.S. goods and points to an increase in U.S. economic activity relative to the rest of the world. The higher rates of return also point to a higher valuation of U.S. stock prices relative to the rest of the world. The U.S. share of world GDP, Figure 4a, and the U.S. share of the global stock market, Figure 4b, rise as the U.S. trade balance worsens, Figure 2.

Figure 4a — U.S. Trade Deficit as % of GDP versus U.S. Share of World GDP



Source: La Jolla Economics

Figure 4b — U.S. Trade Deficit as % of GDP versus U.S. Share of Global Equity Market



Source: La Jolla Economics

Taken at face value, these relationships contradict the mercantilist view of the world. A trade deficit does not necessarily mean that the rest of the world is ripping off the U.S.; quite the contrary. The trade deficit reflects a capital surplus, where capital is flowing to the U.S. because of its higher rates of return. The inflow fuels investment, employment and higher GDP, Figure 4a, and as the rates of return are realized, it also yields a higher valuation relative to the rest of the world, Figure 4b. Again, if we are willing to assume that temporal precedence identifies the causal direction, then the trade balance is caused by capital flows and a faster growth rate.

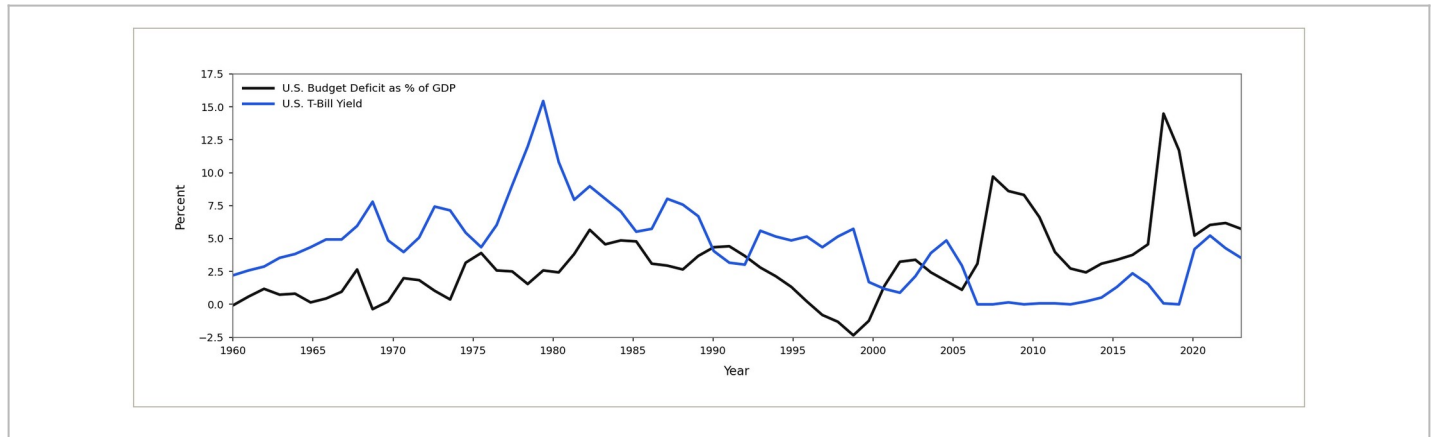
Our interpretation of the data has remarkably simple and dire insights. Mercantilist attempts to improve the trade balance, if successful, will result in a lower real GDP growth rate, lower employment and lower valuation—and that is not what voters want or the economy needs.

Now on to the other twin.

The conventional wisdom is that a higher deficit causes higher interest rates, see Figure 1a, and that results in an intergenerational transfer from future generations to current generations. However, not everyone shares that view. Ricardian equivalence argues that the deficit means future taxes and that the current generation will set aside revenues to pay for the future taxes it may incur as a result of the deficit. Also, if people care about their descendants, they will leave a greater inheritance so that their heirs will be able to pay the taxes. The increased saving will tend to reverse or neutralize the transfer from future generations. If fully successful, the savings increase will match the increased budget deficit and market-clearing interest rates will remain unaffected by the deficit, see Figure 1b.

Below we report the relationship between the budget deficit as a percent of GDP and compare it with alternative proxies for the yield or interest rates on government securities. Figure 5a reports the relationship between the deficit as a percent of GDP and the 3-month T-Bill yield. Inspection of the relationship shows that spikes in one of the variables tend to be negatively correlated with spikes in the other. That result contradicts the underlying consensus view that increases in the budget deficit lead to higher interest rates. The spikes suggest the opposite.

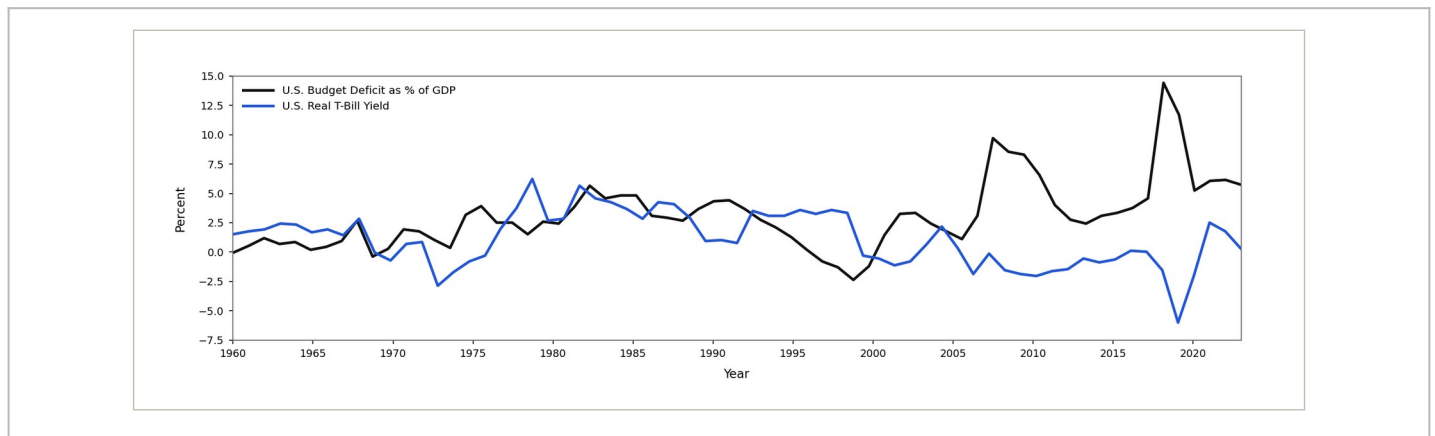
Figure 5a — U.S. Budget Deficit as % of GDP versus T-Bill Yield



Source: La Jolla Economics

One point to make is that the deficit as a percent of GDP is the ratio of two nominal variables and, as such, the impact of the inflation rate is netted out. But the same cannot be said for nominal yields. To net out the impact of the underlying inflation rate, we subtracted it from nominal yields in order to obtain an estimate of the economy's real yields. Removing inflation from nominal yields points to a tighter relationship where the negative relation between the spikes is still evident.

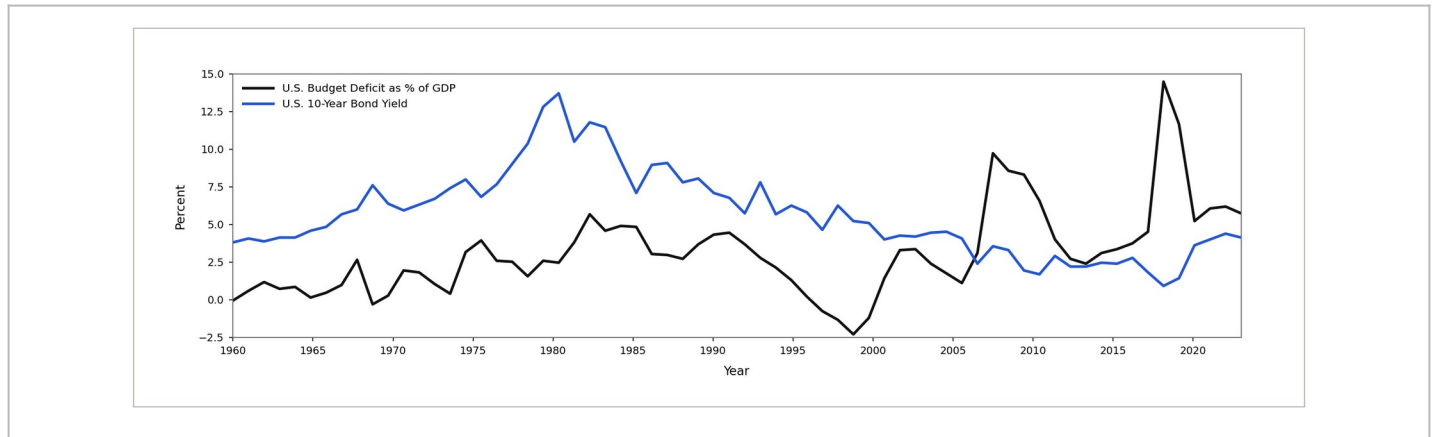
Figure 5b — U.S. Budget Deficit as % of GDP versus Real T-Bill Yield



Source: La Jolla Economics

The data also show that the two series tend to move together—i.e., sideways—and a divergence between the two series is noticeable during the new millennium. A result that we attribute to the Maestro losing its oar in the aftermath of Y2K and the subsequent Bernanke Rule following the Financial Crisis. Notice the pronounced negative correlation between the spikes and the mild negative trend between the two variables. Again, these results tend to contradict the conventional wisdom that increases in budget deficits cause higher interest rates.

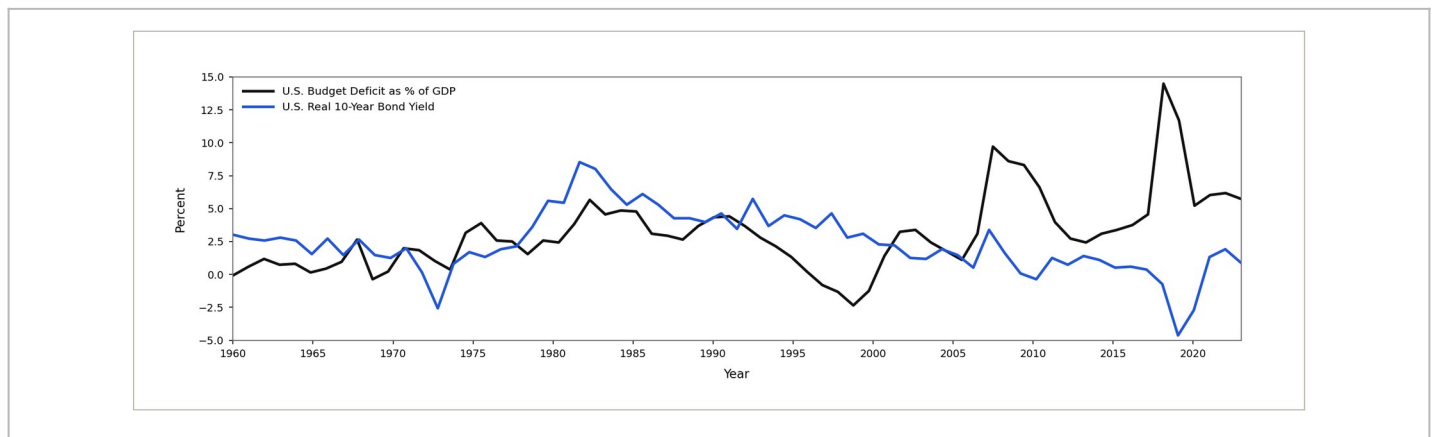
Figure 5c — U.S. Budget Deficit as % of GDP versus 10-Year Bond Yield



Source: La Jolla Economics

The relationship between the budget deficit as a percent of GDP and the 10-year bond yield tells a slightly different story. The bond yield rose steadily and peaked during the early 1980s. Since then, yields have trended down. These trend lines lead us to question a correlation between the two variables, but are they spurious? The graph also produces other vital information. Notice once again the negative correlation between the spikes in the data.

Figure 5d — U.S. Budget Deficit as % of GDP versus Real 10-Year Bond Yield

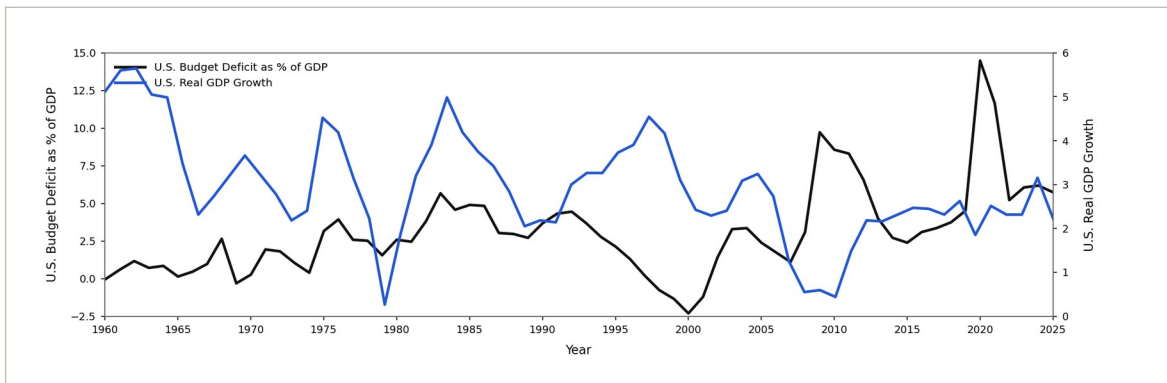


Source: La Jolla Economics

Then, as before, we netted inflation from the yields to obtain an estimate for the real 10-year bond yields. A benefit of this procedure is that it removed some of the trend in nominal yields produced by U.S. inflation. Doing so produced a different fit. A key point to note is that since the new millennium the relationship between the deficit as a percent of GDP and the real yield seems to have changed. The data show a weakening of the apparent positive correlation between the deficit as a percent of GDP and bond yields. More importantly, the data point to a relationship that is the opposite of what the deficit mongers suggest. Spikes in the deficit are associated with declines in the real yield.

The question we are left with is whether there is an alternative explanation for the deficits and interest rates. Figure 6a shows the relationship between the budget deficit and a trailing four-year moving average of the real GDP growth rate. The latter is estimated to reflect the impact of an administration on the real GDP growth rate. The data show that declines in the budget deficit are negatively correlated with increases in the trailing average real GDP growth rate. Hence, it suggests that real GDP growth is a key driver of the budget deficit. Policies that lead to faster economic growth are likely to reduce the budget deficit.

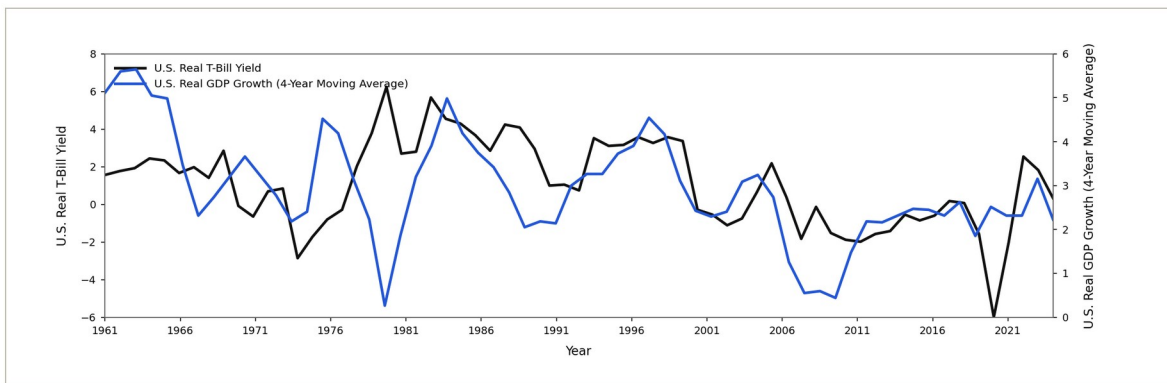
Figure 6a — U.S. Budget Deficit as % of GDP versus Trailing Real GDP Growth



Source: La Jolla Economics

Figure 6b shows the relationship between trailing real GDP growth and real T-Bill rates. It shows a close relationship that produces an interesting interpretation: the faster growth rate positively impacts the real interest rate. More importantly, if real GDP growth is the key driver, faster growth will lead to a lower deficit and a higher real interest rate. That would induce a positive correlation between the deficit and interest rates—the opposite of what the deficit mongers posit.

Figure 6b — Real T-Bill Yields and Real GDP Growth



Source: La Jolla Economics

Conclusion

The conventional twin-deficit story treats both deficits as evidence of economic weakness: a larger budget deficit is assumed to drive interest rates higher, while a trade deficit is treated as a sign that the United States is losing income, jobs and wealth to the rest of the world. The relationships examined here suggest that neither conclusion should be accepted so readily.

On trade, the balance-of-payments identity means that a trade deficit is accompanied by a capital surplus. When capital flows toward the United States because expected rates of return are attractive, those inflows can finance investment, employment and economic growth. The data presented here are consistent with the view that a stronger real exchange rate and a deteriorating trade balance can coexist with a rising U.S. share of world GDP and global equity-market value.

On the budget deficit, the historical evidence does not show the simple positive relationship between deficits and interest rates implied by conventional wisdom. In several cases, spikes in the deficit are associated with declines in real yields. The relationship with growth points to another possibility: faster real GDP growth may itself reduce the deficit while raising the real rate of return.

Myth, facts or fallacies? The data speak for themselves.

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Victor A. Canto is the founder of La Jolla Economics and a former CIO and Lazard adviser. A long-time professor and policy adviser, Victor holds a Ph.D. from the University of Chicago and brings deep macroeconomic expertise to Timber Point Capital Management's investment process.

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