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On Ricardian Equivalence and Twin Divergence

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6.1 Introduction

In 2007 the Spanish economy showed a large current account deficit (10 per cent of GDP), a public budget surplus (2.2 per cent of GDP), and a relatively low household saving rate (6.5 per cent of GDP), at least when compared with its investment rate (almost 10 per cent of GDP). However, with the economic crisis of 2008–9, the situation changed dramatically, as Figures 6.1, 6.2 and 6.3 show. The public budget surplus turned into a huge deficit, estimated at 11.2 per cent of GDP in 2009, the household saving rate increased enormously, to above 11 per cent of GDP, and the current account deficit, at 5.0 per cent of GDP in 2009, was correcting very quickly.1

This empirical evidence is very interesting, since it seems to contradict well-known economic theory, as, for example, the existence of twin deficits. At the same time, the rise in private savings and the accumulation of fiscal deficits during the crisis of the late 2000s is observationally equivalent to the Ricardian equivalence hypothesis, for which it is difficult to find robust empirical support (see Seater, 1993). In fact, the recent experience of the Spanish economy seems to corroborate the empirical findings by Kim and Roubini (2008) about what they call ‘twin divergence’; that is, the accepted empirical fact in the United States that when the public budget worsens the current account improves and vice versa (see also Corsetti and Müller, 2007, and Cavallo, 2005, 2007 on this issue). Thus the negative correlation between the public budget surplus and the current account was not a specific characteristic of the 2008–9 crisis, since it was also the rule in previous expansions and recessions, as Figure 6.4 shows. The correlation between both variables is −0.74 and falls slightly to −0.67 after controlling for the output gap. In
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Figure 6.1  Household saving and investment rates (% of GDP), Spain, 1987–2009
Source: BBVA Research based on INE.

Figure 6.2  General government balance (% of GDP), Spain, 1995–2009
Source: BBVA Research based on MEH.

a related paper, Erceg et al. (2005), using an open economy DGE model (SIGMA) for the USA, found that fiscal deficits have relatively small effects on the trade balance, irrespective of whether its source is a spending increase or a tax cut, even introducing non-Ricardian consumers, which