

# ***Creative Distraction XI***



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**Editors Note**

At the moment everything in some way seems to be married to economics. The news cycle is dominated by stories of inflation, an American downturn, the cost the living and taxing alcopops. Well, here we are in our 11<sup>th</sup> edition we've done things a little differently but still kept the dream going. It is a pleasure to showcase the ideas and opinions of UQ economics students in this edition of *Creative Distraction*. So before those exams start again grab a therapeutic ale sit down and relax. Reading *CD* is the most amount of fun one can have with there clothes on. Enjoy, before exams force us into the early hours of the morning and caffeine becomes our staple.

The ESA exec.



If you think you have something positive to contribute to *CD* just email: [esa@uqesa.com](mailto:esa@uqesa.com)

# A Chat in the BEL library

With Daniel Gold

I recently had the pleasure to discuss with Daniel Gold a postgraduate student about the Rudd Government's plans to introduce a national emissions trading scheme in Australia which is expected to start in 2010. This will be the feature item of Governments plans to tackle climate change, especially in addressing the need to curb emissions by big business. For his thesis, Daniel is currently investigating the implications that this will have for Australia's corporate landscape.

Daniel anticipates that carbon disclosure (the estimated amount of carbon produced by a firm) will have a material impact in how companies will be valued in the share market.

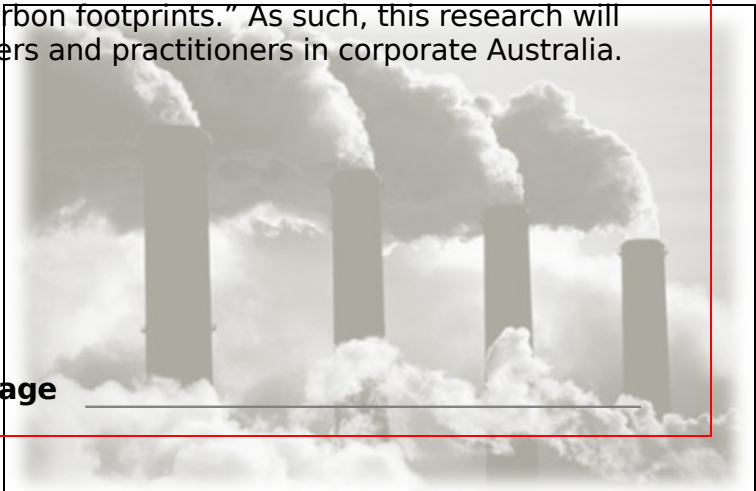
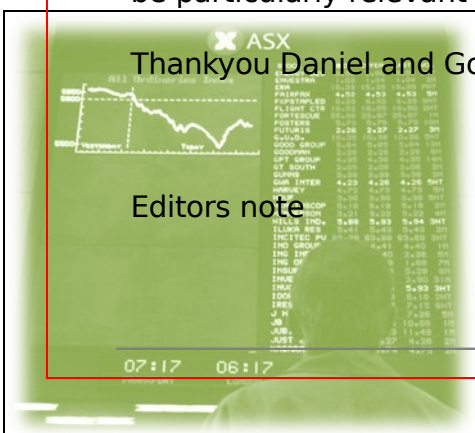
"I am unaware of any research which investigates the extent to which emissions data is being impounded in share prices. Notwithstanding, the connection between emissions trading and company valuation is relatively unexplored in an academic context. This represents a gap in the knowledge required for appropriate responses to emissions trading."

Daniel's hypothesis is that the share market assesses the existence of unbooked future liabilities – abatement and/or emission permit/offset spending obligations – for carbon intensive firms. "I plan to test this through a cross sectional regression analysis based on a modified version of the Ohlson valuation model. This will be followed by an event study to observe the share market performance of certain carbon intensive firms on key event dates."

Daniel's study adds to existing literature which to this point only assesses the carbon risk profiles of ASX100 firms and key industry sectors.

In addition to estimating the financial impact of an emissions trading scheme on carbon intensive ASX100 companies, Daniel's research will also provide insight into the scheme's policy specifics that the market is expecting to see implemented. In the course of discussions Daniel raised an interesting point: "at the moment consultancy/advisory work in this field has previously been handled by smaller/niche firms, and there are possibilities of market expansion are attracting larger mainstream financial services companies." As the world becomes increasingly carbon conscious it is bound to be reflected in share prices.

"When emissions trading becomes a reality, it will become increasingly important for all companies to understand their carbon footprints." As such, this research will be particularly relevant to industry leaders and practitioners in corporate Australia.



\*\*\*This is a new segment to *Creative Distraction*, if you have anything interesting to say about your studies or economics in general we can arrange an informal meeting and have it published\*\*\*

**EXOGENOUS AND ENDOGENOUS EXPLANATIONS FOR ECONOMIC GROWTH:  
A CHINESE CASE STUDY**

**James Strutt**

Despite only being a recent phenomenon, economic growth has implications for improvements in the public welfare of a nation. It is important to understand how economic growth is achieved and also how it is maintained, for it is a vital ingredient for both improved standard of living and long term prosperity. This essay will focus on two predominant theories evident in current economic literature that utilise the production function to explore the relationship between economic factors and growth; the Neoclassical Solow and Endogenous Romer Growth models. Robert Solow, in Jones (2008, p. 97) outlines that all theories depend on assumptions which are not quite true, and that the art of successful theorising is to make such assumptions in a way that leads the final results to be as insensitive as possible. With this in mind, this essay will explore the strengths and weaknesses of the two models for predicting economic growth in relation to one of the world's largest emerging economic giants; China. Post 1978, China has experienced phenomenal sustained positive economic growth. By utilising the Solow and Romer models, this essay will attempt to gain an understanding of the driver's of such growth from 1978, with the prospect of identifying suitable policy implications.

Prior to the death of Mao Zedong in 1976 and the subsequent fall of the People's Republic of China, the nation was focused on macroeconomic stability through a system of central planning. In late 1978 Mao's successor, Deng Xiaoping turned to markets as current conditions provided an unsuitable climate for economic problem resolution (Ying 2006, p. 328). These reforms decentralised the state sector, delegating more economic autonomy to the nation, which saw markets become increasingly competitive in the absence of price and wage controls (Fung, Ho & Zhu 2001, p. 61). Fung et al. (2001, p. 55) outline that in the period 1981 to 2001, China's GDP grew at an average annual rate of approximately 10 percent per year compared with the United States averaging approximately 3.3 percent per year. Such statistics suggest that the move from a controlled to a market economy has resulted in vast improvements in the economic health of China. The compounding effects of growth suggest that the rapidly expanding Chinese economy is on track to become the largest economic entity by the year 2020 (Angang 2005, p. 32). Through the use of the Solow and Romer economic growth models, this essay will explore possible explanations for China's phenomenal growth and determine whether it is sustainable.

The first model presented, the Neoclassical Solow growth model, is fundamentally a capital accumulation economic growth model based on the production function. It is an entirely aggregate construction outlining that the growth in output of an economy is determined by growth in inputs (Solow 1956, p. 65). The Solow growth model is an exogenous model with economic growth a direct result of increased levels of capital stock. Ying (2006, p. 327) aligns the Solow theory with China's performance between 1984 and 2001, where the largest contribution to growth came from the increase in capital stock, which contributed 60 percent of per capita output growth over the period.

The Solow growth model identifies capital stock as entropic, in that over time it depreciates and a flow of savings is required to maintain such levels through

investment. Hence, in order to increase the level of capital, the level of national savings and therefore capital investment needs to increase. China has recorded high levels of national saving at approximately 36 percent between 1982 and 2000 (Lu & McDonald 2006, p. 283). The Neoclassical Solow growth model identifies a golden rule of savings which equates to the optimal savings rate and occurs when the marginal product of capital is equal to a nation's depreciation rate (Schroder 1972, p. 449). It should be noted that an economy will not naturally converge to this rate of approximately 35 percent, though China appears to be saving in line with the theoretical optimum level to maintain highest possible levels of capital.

The Solow model outlines that diminishing marginal product of capital provides the basis for the idea of convergence between developing and developed countries. Figure 1 portrays the model graphically and highlights the diminishing marginal product of capital such that economic growth is an eventual transition to the point  $K^*$ ,  $Y^*$  where the level of savings is just enough to offset the depreciation of capital. This point is known as the steady state of an economy and represents, for a given level of savings, the highest level of income maintainable. The implication here is that the only way an economy can increase income and therefore sustain economic growth, is by having a continuously increasing rate of savings (Jones 2008, p. 109).

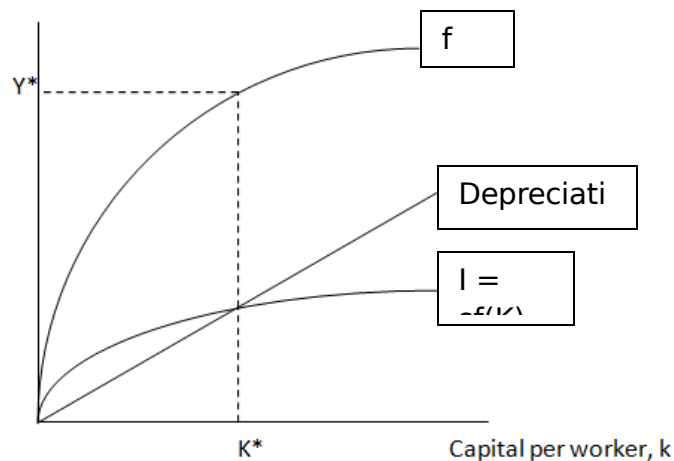


Figure 1: Solow Growth Model (Jones 2008, p. 105)

The concept of a continuously increasing rate of savings is not realistic and represents the fundamental limitation to the model in its inability to account for long term sustained economic growth (Jones 2008, p. 109). By the early 1990's, productivity's share of output growth within China exceeded 50 percent suggesting that an exogenous component was driving economic growth beyond capital accumulation (Zuliu & Mohsin 1997, p.3) Therefore while the Neoclassical Solow growth model can be used to explain at least the initial period of economic growth within China, it fails to explain why it has been sustained and calls for a model that incorporates other factors to increase explanatory power.

The second model under analysis, the Endogenous Romer growth model, identifies long run economic growth as a result of accumulation of knowledge through the production of ideas (Jones 2008, p. 133). Ideas are the elements of technology and are non-rivalrous goods in that their use by one does not diminish their potential use by another. Despite individual firms in an economy facing constant private returns to investment in knowledge and capital, public returns can be positive due to the spill over effect when similar firms use non-rivalrous goods (Romer 1994, p. 15). Increasing returns are possible through fixed costs in knowledge discovery and low marginal reproduction costs. However, in order to provide incentives for knowledge discovery through such methods as research and development, a monopolistic competitive environment is preferred as profits arising from such protective techniques as intellectual property rights and branding provide incentives to research (Jones 2008, p. 137).

Akin to the Solow growth model, the Romer growth model is also based on the production function, but redefines capital as knowledge and ideas; including human capital (Romer 1994, p. 20). Gary Becker in Blair (2005, p. 607) outlines that expenditure on education, training and medical care can be considered as investments in human capital, which is linked with increasing labour productivity. In China between 1995 and 2001, human capital grew by 2.8 percent as China became a global leader with the most tertiary students of any country (Angang 2005, p. 29).

The Romer growth model highlights the importance of increased productivity and technological innovation for sustained economic growth, as capital feedback becomes an input into capital (Jones 2008, p. 133). During the period 1979 to 1994 productivity gains accounted for more than 42 percent of China's economic growth and by the early 1990's had overtaken capital accumulation as the most significant factor. Angang (2005, p.32) identifies that knowledge and productivity mutually reinforce each other and suggests China needs to shift from a capital-driven economy to a technology driven economy.

Another implication of the Romer model is that the growth in one nation, by the production of new ideas, spills over to the growth of all other nations as they copy and reuse those ideas (Jones 2008, p. 139). China began to open up to the world market in the late 1970's, shifting from a completely isolated entity to a partially open model of socioeconomic development (Fung et al. 2001, p. 81). Moving from 0.66 percent of total world trade in 1975 to 6.5 percent in 2004, China became the world's fourth largest exporter. This foreign money has "built factories, created jobs, linked China to international markets, and has led to important transfers of technology" (Zuliu & Mohsin 1997, p.5). The Romer model additionally suggests that urbanisation of a nation is correlated with economic growth. Romer (1994, p. 19) argues that cities are where knowledge and ideas are developed due to spatial proximity and the clustering of people which leads to network externalities. Between 1978 and 2003, due to rapid urbanisation in China, the share of employment held by primary industries fell by 22 percent, while the share of employment by secondary industries increased by 5 percent and the share held by tertiary industries increased by 17 percent (Leith 2006, p.57).



The policy implications surrounding the Romer growth model suggest public support for the production of knowledge through research and development and higher education. In 2005 Chinese expenditure on research and development was \$133.2 billion, up from \$21 billion in 1996, passing Japan to claim second largest expenditures globally (Yoshida 2007, p.3). In addition, in 2004 China guaranteed property rights in its Constitution providing an ultimate incentive to invest in research into new technologies (Leith 2006, p.57). It should be recognised that the major limitations to growth in China include the existence of environmental pressures including overpopulation and global warming, and also high levels of uncontrollable inflation as a result of a widening gap between supply and demand (Zuliu & Mohsin 1997, p. 6).

The analysis of Chinese economic growth through the Solow and Romer models has provided an insight into growth drivers and policy implications. The Solow model provided a theoretically suitable foundation for economic growth in the accumulation of capital. However, a major limitation identified was that this could not explain long term economic growth as an unrealistic condition was required through a continuously increasing rate of national savings. Building upon the Solow model, the Romer model redefined capital and highlighted the important characteristics of ideas in their ability to provide increasing returns through spill over effects and low marginal cost of reproduction. Romer also emphasised the importance of a knowledge based economy through heavy investment in research and human capital. By opening up an economy to the international stage, a nation is able to utilise global technological spill over effects to increase productivity and foster economic growth. The Romer model essentially completes the story laid out by the Solow model in identifying how China has been able to experience and maintain phenomenal positive economic growth since 1978. Whilst this study has been confined to a single nation and time period, it provides global implications for improving public welfare in developing nations. If China can get past the threats of inflation and environmental destruction, it will inevitably become the largest global economic entity in the near future.



# THE U.S. CURRENT ACCOUNT DEFICIT

BYRON HEWSON

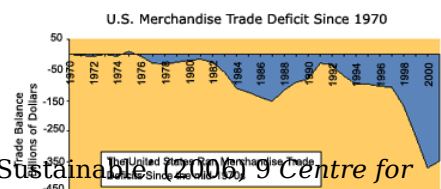
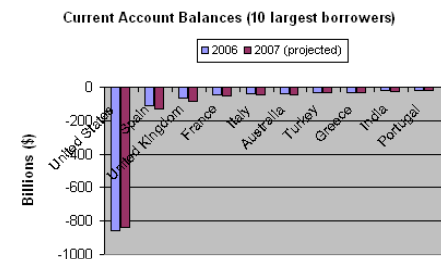
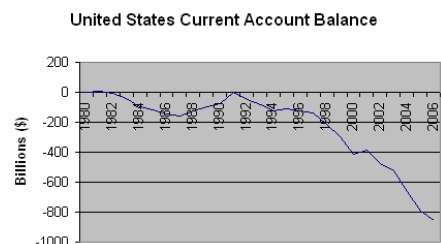
## Introduction

The current account deficit of the United States, the world's wealthiest and oldest industrialised economy, has grown consistently larger over the past 26 years. In its broadest sense, this means that the U.S. is borrowing to buy goods today by promising to pay for them with more goods in the future. While there are many countries currently running current account deficits, notably Australia, the United Kingdom, Spain and Italy, the U.S. current account deficit is unique in its absolute size and structure (The U.S. attracts more net capital than all developing countries combined and in 2005 the U.S. had a net debt of over 2.55 trillion dollars)<sup>1</sup>. The magnitude of this phenomenon has fuelled academic debate over whether such a deficit can be sustained and if not; exactly what consequences will any adjustment have on both the U.S. and global economy. The first part of this paper examines the rise, composition and causes of the current account deficit, while the second part will examine arguments for and against its sustainability. Finally, the consequences if the current account deficit is unable to be sustained and possible options to close the deficit are explored.

## The Rise of the Current Account Deficit

The rise of the U.S. current account deficit can be traced back to 1982.<sup>2</sup> Before this time, current account deficits were generally small and temporary. However, from 1982 this historical pattern changed both in terms of the size and the persistence of the deficits. From 1960-81, the U.S. averaged a current account surplus of \$1.7 billion per year in contrast to the period from 1982-94 which averaged a deficit of \$96.7 billion per year.<sup>3</sup> While clearly the U. S. economy grew significantly during this period (it was around 13 times larger in 1994 than 1960), even accounting for GDP growth, the current account deficit has grown significantly.<sup>4</sup>

Additionally, it can be seen, through analysing the components of the



<sup>1</sup> Daniel Gross, 'Why the US Current Account Deficit is Not Sustainable (2006)', Centre for European Policy Studies 241, 252.

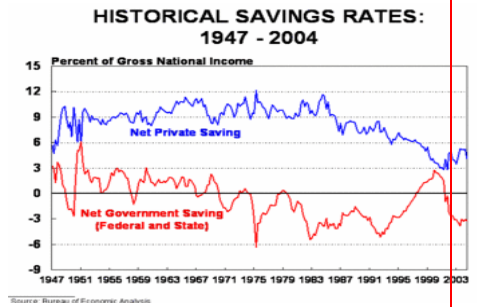
<sup>2</sup> Craig Hakkio, 'The U.S. Current Account: The Other Deficit' (1995) Third Quarter *Economic Review* 11,11.

<sup>3</sup> U.S. Department of Commerce, Bureau of Economic Analysis. 1994. Survey of Current Business, June.

<sup>4</sup> U.S. Department of Commerce, Bureau of Economic Analysis 1990. The Balance of Payments of the United States: Concepts, Data Sources, and Estimating Procedures.

current account, that the shift from an average surplus to an average deficit was driven by deterioration in the merchandise trade balance, which accounts for around two-thirds of total trade.<sup>5</sup> Further, in contrasting the two periods, it is evident that the investment income account, while still remaining in surplus, diminished significantly while the service account demonstrated considerable surplus gains.<sup>6</sup>

Additionally, it can be concluded that the escalating current account deficits are the result of a decline in savings, rather than growth in domestic investment. While large government budget deficits played a significant role in the early 1980s, the current account deficits are primarily driven by declining private saving. Private savings fell by 2.4 per cent while budget deficits rose by 2.4 per cent of Net Domestic Product between the periods 1960-81 and 1982-94. Moreover, during this period, net investment fell 2.9 per cent.<sup>7</sup>



### ***Effect of the Current Account Deficit on the U.S. Economy***

The position that the U.S. current account deficit is unsustainable is held by the majority of economists who are wary of a trillion dollar free lunch. While the structural arguments considered below may justify the position that the deficit, as it currently stands, can be sustained, it is clear that its current growth rate cannot. Daniel Gross estimates that the deficit widens by around 0.5% of GDP per annum and concludes that eventually U.S. absorption can no longer increase by more than U.S. income.<sup>8</sup> Further, aspects concerning the nature and the composition of the deficit may affect its sustainability.

There are several major problems the U.S. current account deficit poses to the U.S. economy. Firstly, the deficit leads to excessive borrowing and declining creditworthiness of American households and some firms. This overleveraging reflects that fact that banks and consumer credit companies can, either directly or indirectly, sell liquid dollar deposits and other financial instruments to foreigners to finance the propagation of consumer credit and mortgage lending in the U.S.<sup>9</sup> Further, this softened mortgage lending resulted in higher rates of home construction and higher home prices which drove the recently burst U.S. housing bubble. Higher house prices, in turn, increased domestic consumption which has meant that much of the massive capital inflows into the U.S. have been spent on residential investment and domestic

<sup>5</sup> Craig Hakkio, 'The U.S. Current Account: The Other Deficit' (1995) Third Quarter *Economic Review* 11,14.

<sup>6</sup> Craig Hakkio, 'The U.S. Current Account: The Other Deficit' (1995) Third Quarter *Economic Review* 11,14.

<sup>7</sup> U.S. Department of Commerce, Bureau of Economic Analysis. 1994. Survey of Current Business, June.

<sup>8</sup> Daniel Gross, 'Why the US Current Account Deficit is Not Sustainable' (2006) 9 *Centre for European Policy Studies* 241, 242.

<sup>9</sup> Sergio Da Silva, Gabrielle De Lima and Roberto Meurer (2008) 'Winners and Losers from Dollar Depreciation' *Journal of Economic Affairs* 63,64.

consumption which provide little long run productivity gains.

Moreover, Craig Hakkio argues that the risk of financial instability is heightened by the fact the U.S. current account deficit has been increasingly financed by highly liquid, short term capital flows.<sup>10</sup> He observes that between the 1980s and 1990s, short-term capital inflows (U.S. Treasury securities and foreign and domestic banking flows) increased by \$51.4 billion while long-term capital inflows (direct investments) fell by \$6.9 billion. While the U.S. corporate sector may be less affected by overleveraging, because foreigners can buy equity as well as debt claims in U.S. corporations, the proliferation of debt poses a significant, and perhaps recently realised, threat to U.S. financial stability

Secondly, Ronald McKinnon argues that the deficit is having a 'Dutch Disease' affect on the U.S. economy.<sup>11</sup> He explains that as a current account deficit broadly indicates, for any given level of income, a reduction in exports and an increase in imports and because the U.S. shelters its agricultural industry under strong protectionist measures, it is the industrial sector that has borne the brunt of the deficit. McKinnon points to industries such as photographic equipment, which the U.S. has effectively left, as evidence of the shrinking American industrial base. Ben Bernanke notes that future repayments to foreign creditors will require the U.S. to have a healthy export industry.<sup>12</sup> Thus, he expects that the shrinkage in the industrial base will have to be reversed and will 'impose real costs of adjustment on firms and workers in those industries'. Additionally, the deficit has a political effect due to the perception that large trade deficits are the result of unfair foreign practices (particularly from China) which increases the popularity of protectionism at the expense of free trade.

Thirdly, because, as previously noted, the current account deficit appears to be primarily due to increased domestic consumption rather than increased investment, it may pose a threat to the future living standards in the U.S. Historically, large and persistent current account deficits have not been such a problem. For example, capital inflows were 13 per cent of GNP in the 1860s, 4 per cent in the 1870s and 11 percent in the 1880s.<sup>13</sup> However, these capital inflows were used to finance major construction projects, such as the building of a national railway system, which increased the productivity of the nation and more than offset the interest payments on the inflows. Indeed, some developed economies, notably Australia, have consistently run current account deficits and yet continue to display strong economic growth. This contrasts with statistics from the U.S. which indicate that Americans are essentially borrowing from future consumption to finance excessive current consumption.

Finally, Ben Bernanke has argued that the current account deficit

<sup>10</sup> Craig Hakkio (1995) 'The U.S. Current Account: The Other Deficit' Third Quarter Economic Review 11, 19-22.

<sup>11</sup> Ronald McKinnon (2001) 'The International Dollar Standard and the Sustainability of the U.S. Current Account Deficit' 1 *Brookings Papers on Economic Activity* 227,233.

<sup>12</sup> Ben Bernanke, 'The Global Savings Glut and the U.S. Current Account Deficit' (2005), *Sandridge Lecture - Virginia Association of Economics*, Richmond, Virginia.

<sup>13</sup> Craig Hakkio (1995) 'The U.S. Current Account: The Other Deficit' Third Quarter Economic Review 11, 21.

has a positive effect on the U.S. economy in that it has allowed developing countries to stabilise their currencies and reduce the risk of financial crisis.<sup>14</sup> Despite this, Bernanke concludes that ‘developing countries’ lending large sums on net to the mature industrial countries’ is undesirable as it conflicts with what should be the natural flow of capital. That is, capital moving from developed countries with already high capital to labour productivity and an aging population, to developing countries with relatively low capital to labour productivity and young populations.

### ***Can the Current Account Deficit Be Sustained?***

There is a prima facie conclusion that any imbalance, including in this case, an external imbalance, cannot be sustained. To quote Stein’s Law, ‘If something cannot go on forever, it will stop’.<sup>15</sup> However, several possible structural explanations have been posited to justify the argument that the U.S. current account deficit is sustainable.

### ***Will There Be a Dollar Crisis?***

There is general consensus that the reduction in the U.S. current account deficits will require the depreciation of the dollar.<sup>16</sup> Indeed, the assertion that the required change in trade deficits can be achieved through redistribution of world spending without a change in real exchange rates has been appropriately derogated as ‘the doctrine of immaculate transfer’.<sup>17</sup> However, there is disagreement over whether this depreciation will be sudden or gradual. Those who predict a sudden depreciation argue essentially that foreign investors have upwardly shifted their desired proportion of U.S. assets in their portfolios. While foreign investors continue to move to this new higher share the dollar denominated assets, large capital inflows are generated. However, capital inflows needed to achieve the share are much greater than those required to maintain the share in portfolios. Thus, when the desired level of U.S. asset holdings is achieved, capital inflows will drop abruptly and the dollars’ decline will also be abrupt. Indeed, the International Monetary Fund has warned that without the presence of active policies, the current scenario would unrealistically assume firstly, that foreigners are willing to accommodate a substantial increase in U.S. foreign liabilities (from less than 30 percent to eventually around 85

<sup>14</sup> Ben Bernanke, ‘The Global Savings Glut and the U.S. Current Account Deficit’ (2005), *Sandridge Lecture - Virginia Association of Economics*, Richmond, Virginia.

<sup>15</sup> Herbert Stein, ‘The Public Interest’ (1989) 97.

<sup>16</sup> See Generally: Maurice Obstfeld and Kenneth Rogoff, ‘The Unsustainable U.S. Current Account Position Revisited’ (December 2005). CEPR Discussion Paper No. 5416 Available at SSRN: <http://ssrn.com/abstract=893570> and Olivier Blanchard, Francesco Giavazzi and Filipa Sa ‘The U.S. Current Account and the Dollar’ (January 26, 2005). MIT Department of Economics Working Paper No. 05-02. Available at SSRN: <http://ssrn.com/abstract=655402> and Ronald McKinnon (2001) ‘The International Dollar Standard and the Sustainability of the U.S. Current Account Deficit’ 1 *Brookings Papers on Economic Activity* 227.

<sup>17</sup> Paul Krugman, ‘Will there be a dollar crisis?’ (2007) *July Economic Policy* 435, 438.

percent of U.S. GDP) and secondly, that foreigners allocate an increasing share of their asset portfolios to U.S. assets without demanding a significant risk premium, despite potentially facing continued foreign exchange losses.<sup>18</sup>

Those who believe the depreciation will be gradual argue that investors will expect this change and thus, the expectations of future depreciation will dampen the initial shift into dollars and capital inflows. Therefore, the sudden depreciation scenario assumes investor myopia. As Krugman states, 'the real question is not whether the dollar must eventually depreciate, [i]t is whether the dollar must eventually depreciate at a rate faster than investors now expect'.<sup>19</sup> Krugman concludes that there is a 'pretty good though not ironclad case for believing that markets are failing to take account of the needed future real depreciation of the dollar'. Thus, inevitably investors will recognise that their returns for holding dollar-denominated assets are insufficient and the dollar will depreciate steeply. Indeed, some may see evidence of this in the fairly dramatic decline of the dollar since 2002. From 2002-2008, the dollar (when measured against a trade weighted index where the exchange rate in 1997 is taken as 100) has fallen around 35 points or around 27 per cent.<sup>20</sup>

If, as theory and current trends indicate, there is a dollar depreciation crisis, it is important to examine the effect it will have on U.S. spending, income and output. In the medium run, it is generally agreed that dollar depreciation in real terms will lead to a rise in net exports whilst simultaneously domestic demand will be compressed, perhaps through interest rate rises. Thus, overall U.S. aggregate demand should be essentially unchanged, with higher net exports countered by reduced domestic spending. The short term transition to this point however, is a source of dispute.

The United States' primary concern is rather that the reduced willingness to buy dollar denominated assets, resulting in compression of domestic demand, will be rapid while the increase in net assets from dollar depreciation will be slow.<sup>21</sup> Indeed, standard estimates indicate a two year lag before depreciation has its full effect on trade flows. However, this scenario would require investor myopia as otherwise expectation of a future fall in savings would dampen current demand. As previously noted, Krugman has concluded that there is evidence that investors, in failing to properly consider the perspective decline in the value of the dollar, have displayed unrealistic expectations about future exchange rates.<sup>22</sup> This does not necessarily mean that the U.S. need experience a recession or significant slowdown in its transition to a reduced current account deficit. However, the size of the trade deficit is unprecedented and thus, the required increase in net exports may take

<sup>18</sup> IMF (International Monetary Fund) (2006). *World Economic Outlook*.

<sup>19</sup> Paul Krugman, 'Will there be a dollar crisis?' (2007) *July Economic Policy* 435, 438.

<sup>20</sup> Paul Krugman, 'Will there be a dollar crisis?' (2007) *July Economic Policy* 435, 438.

<sup>21</sup> Paul Krugman, 'Will there be a dollar crisis?' (2007) *July Economic Policy* 435.

<sup>22</sup> *Ibid.*



longer than usual as resources need to be shifted on a large scale back into tradable sectors. While the current account deficit pressures future increases in the interest rate, the need to soften the fallout from the collapsing housing market will require lower future interest rates. Thus, Krugman concludes that, very broadly, 'if the contractionary effect of a bust housing bubble arrives more quickly than the expansionary effect of dollar depreciation, a dollar plunge will be associated with an overall slump'.<sup>23</sup>

### **What Can Be Done?**

There have been numerous policy changes suggested to reduce the current account deficit to sustainable levels. Catherine Mann, among others, has argued that structural changes are required.<sup>24</sup> She stresses that the answer does not lie in fiscal discipline as the deficit is overwhelmingly associated with a lack of household savings. Indeed, it is difficult for government saving to match the effect of household dissaving as the import intensity of government output is around one-third the import intensity of consumer spending. This is a view echoed by Ben Bernanke who argues that, while reducing the budget deficit is a move in the right direction, it can only have a modest effect and will not, by itself, neutralize the current account deficit.<sup>25</sup> Indeed, a recent study suggests that a one-dollar reduction in the federal budget deficit would cause the current account deficit to decline less than 20 cents.<sup>26</sup> These results imply that even if the federal budget could be balanced tomorrow, the medium-term effect would likely be to reduce the current account deficit by less than one percentage point of GDP. Bernanke argues that this reasoning can be applied to similar policy recommendations that include, for example, increasing household saving through the creation of tax-favoured saving vehicles.<sup>27</sup> However, these policies, as well as diminishing the current account deficit, may have additional effects that improve productivity and future wealth creation.

Catherine Mann further posits that labour market reforms are required that prepare workers for the new, high skills and technology driven economy. She notes that U.S. service sector productivity has meant that the U.S. has been the world's leading exporter of business and professional services, which in 1999 contributed a surplus of \$76 billion while the goods trade deficit was around \$345 billion.<sup>28</sup> Mann notes that increased preparedness for the new economy may also decrease political tensions related to globalisation and diminish the potential backlash from

<sup>23</sup> Paul Krugman, 'Will there be a dollar crisis?' (2007) July *Economic Policy* 435,454.

<sup>24</sup> Catherine Mann (2002) 'Perspectives on the U.S. Current Account Deficit and Sustainability' 16 *Journal of Economics Perspectives* 131, 132-151.

<sup>25</sup> Ben Bernanke, 'The Global Savings Glut and the U.S. Current Account Deficit' (2005), *Sandridge Lecture - Virginia Association of Economics*, Richmond, Virginia.

<sup>26</sup> Christopher J. Erceg, Luca Guerrieri and Christopher Gust (2005) '[Expansionary Fiscal Shocks and the US Trade Deficit](#)' *International Finance* 8(3), 363,363-397.

<sup>27</sup> Ben Bernanke, 'The Global Savings Glut and the U.S. Current Account Deficit' (2005), *Sandridge Lecture - Virginia Association of Economics*, Richmond, Virginia.

<sup>28</sup> Catherine Mann (2002) 'Perspectives on the U.S. Current Account Deficit and Sustainability' 16 *Journal of Economics Perspectives* 131, 132-151.

the current account deficit. Indeed, she argues that without such structural reforms, dollar depreciation would not put the U.S. economy on a sustainable trajectory but instead would initiate a 'dangerous cycle whereby trade and current account deficits would initially narrow but would soon widen again as structural instabilities returned to the fore'.<sup>29</sup>

Additionally, the Federal Reserve's ability to respond to any dollar depreciation may be limited by both concerns over inflation and the bursting of the housing bubble. Certainly, housing is the principal channel through which monetary policy affects domestic demand and the collapsing housing market means the Federal Reserve's leverage on the economy is greatly reduced. Thus, Krugman has suggested that even a zero Federal funds rate may only have a modest stimulative effect on the economy.<sup>30</sup>

### **Conclusion**

It is clear that the U.S. current account deficit is unsustainable and that the necessary adjustment process may be currently affecting the U.S. economy. It is yet to be seen whether this adjustment will be severe and require significant dollar depreciation or whether the dollar will depreciate gradually, with the transition imposing a low macroeconomic cost on the U.S. economy. There may be several policies open to the U.S. Government and Federal Reserve in order to guide this transition. However, these may be limited by the housing market collapse which itself is intrinsically connected to the current account deficit. Clearly, there are no free lunches and the coming years will be a difficult period for the U.S. economy. However, from the short-term pain, structural changes may be achieved which may ultimately be greatly beneficial to the future health of the American economy.

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<sup>29</sup> Ibid.

<sup>30</sup> Paul Krugman, 'Will there be a dollar crisis?' (2007) July *Economic Policy* 435,454.



# Book Review

As usual over the summer break I reclined in an old wicker chair to thumb through the Christmas must-reads. My reading list included D H Lawrence's provocative *Lady Chatterley's lover*, Bram Stoker's *Dracula*, and Mary Shelley's *Frankenstein*, the fridge was full of beer and I was set. Amazingly, the finest book I read over the summer did not contain the pornographic musings of Lawrence, nor the exploits of a seductive vampire from Transylvania, but it was Alan Greenspan's *The Age of Turbulence*. As many would know, Alan Greenspan, the former head of the U.S Federal Reserve is an economic demi-god. Having presided over the longest period of post-war growth, the true calibre of Greenspan's stewardship is underscored in this compelling read. His story stands as a beckon for all aspiring economists and highlights the power of economics in affecting positive and lasting changes to our world. In the course of reading this book there was one nagging question: since when can an economist – a profession fixated on cpi and GDP, write such an engaging book? No doubt this guy made economics look sexy, and the impression I gained was that this man was on a mission to discuss economic issues on a different footing and bring economics forth from the anils of boring academia. After reading this book I had the boldness to proudly proclaim in a Mackay nightclub, whilst beating my chest to a seductive rhythm, that "I am a student of economics, hear me roar!" (I was later escorted out of the premises: charged on one count of indecent exposure and public drunkenness). Rather than the dense academic jargon muttered away by the economic elite, Greenspan is no veteran bore, his writing style is simple and his economic discussions are easily digestible. As a student of economics this book reinvigorated my interest in economics (before I was introduced to the ANOVA table) and would be an invaluable resource for students studying Political Economy or the Economics of Social Issues. Greenspan's book falls somewhere between an autobiography and a polemic, to which in the later chapters he furnishes with detail and opinion the issues that will shape our generation; such as climate change, the rise of China, demographic shifts and 'the long term energy squeeze'. And Finally, there were two outstanding chapters: "Irrational Exuberance"- which delves into the recurring phenomenon of financial crises and there symptoms; and "The Delphic Future" in which Greenspan peers into the crystal ball and delivers his future predictions of the direction of the global economy. This book indispensable and would be a star standout in the reference list of any assignment.

Ps. Creative Destruction and Dutch Disease are very interesting observations by Greenspan!



Check it out: Alan Greenspan: the age of turbulence.

# WANTED



## Inflation Genie

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**ESCAPED DETENTION AND IS CONSIDERED DANGEROUS AND ARMED  
PROCEED WITH EXTREME CAUTION,**

**REWARD: TREASURY WILL DO ANYTHING**