The United States economy

In March of 2000, the NASDAQ hit the 5,000 mark. In March of 2001, it hit the 2000 mark constituting a 60% decline in just one year. In the 3rd quarter 2000, the American GDP growth rate was 5.4%. In the 1st quarter 2001, it was basically 0%, a 5% slide in six months. This is what is known as a hard landing. The question is did Alan Greenspan screw up? Is the US headed for a big recession?

Inequality in the American economy

The 1990s have been a great decade for America but one of rising inequality. But why should we care? Some say that inequality can lead to social (economic) unrest but this has historically never happened as unrest is usually caused by race, religion, or oppression. Some argue that inequality provides an incentive work and that we shouldn’t care. A 19th-century economist named Spencer coined the phrase “survival of the fittest” to describe economic success. He said that we shouldn’t worry about inequality and should drive the unfit into extinction. Indeed, in the 1990s, even though inequality was burgeoning, poverty was dropping. The income ratio of the 50th percentile to the 10th percentile was actually dropping (it’s the 100th to 50th ratio that was skyrocketing) so only really the middle class was losing, not the poor. Consequently, it is hard to demonstrate that inequality itself will lead to bad things so the only argument against inequality must be an ethical one – how can allow some people to have so much and some to have so little.

What has contributed to inequality?
1. Skill shift – more and more skilled workers are being demanded while demand for unskilled is falling.
2. Shift to services – the service industry is growing fast causing inequality as these jobs are mostly for unskilled.
3. Factor price equality (globalization) – leads to greater labor supply at a lower price

What can you do about inequality?
1. Different skill distribution – educate the people to give better skills to the bottom ¾ of the population.
2. Income distribution (taxes) – in the United States, this mostly flows from young to old.
3. Work incentives – focus aid on the people you want it to help. However, this can often lead to high (>100%) marginal tax rates. If you broaden the aid, though, to give lower marginal tax rates, you end up helping people you don’t want to help and it costs a lot. This is why the benefits for the elderly are so high and for the young so low (we don’t expect the old to work anyway so we don’t giving them more). In general though, there is a trade-off between cost and focus.
The dot-com revolution

In general, in the past year we have gone from over-hyped to under-hyped. The major problem is that we don’t understand the new industry and we haven’t learned from history in how new industries develop.

In any new industry, there are always lots of startup. It’s a lottery in the beginning as to who will be successful and it takes about 30-50 years to stabilize on those companies. The auto industry started out with 200 automakers and even by 1929, was only down to 100. Then, it would have been impossible to predict which three would eventually succeed and end up being the largest companies in the world.

Additionally, the internet hasn’t really revolutionized anything. The telegraph first provided communication at the speed of light and typing out messages was probably faster than typing today. In fact, the telegraph explosion was very similar to the internet explosion today. Even if it is a revolutionary development, it can often take a long time to take hold. It was 30 years before the majority of the people in the US had a telephone after it was introduced.

Another challenge facing the online economy is that habits are very hard to change – sociology will always beat economics. People shop for the human interaction and atmosphere that they can’t get with the click of a mouse. But sociology is subject to change and the companies driving the new industry have a keen interest in making it change. In fact, some industries have already started. Airline tickets, PCs, and financial services are now almost all sold online.

The major point is that it is not obvious in the beginning who the winners will be. Some will win big but we have no way of knowing ahead of time (in 1981, Commodore was thought to be the company to lead the PC industry). The key is to proportions and not get all worked up. The internet revolution is not new – it has happened many times before.

The trade deficit – is this the next great global crisis?

The problem with a very large trade deficit is that you know it can’t go on forever. You need capital inflow equal to the deficit to finance it. In subsequent years, though, you have to pay compound interest on the borrowed money so if the trade deficit doesn’t fall, the amount you have to pay gets larger and larger every year. In theory, if your rate of growth is greater than the interest rate $(r_{growth}>i)$, you could do this forever. The current inflow is a result of US interest rates greater than the rest of the world $(r_{USA}>r_{ROW})$. However, at some point, you want to bring your money home for your own consumption and to reduce your risk. People often say that the US is different in this regard because we borrow in our own currency and there is no possibility of default but we still have significant foreign exchange risk. The problem is that $i<r_{growth}$ currently so we have fallen into a debt trap.

What caused all of this?

1. $G_{USA}>G_{ROW}$ – the growth rate here has been much higher than anywhere else.
2. As the dollar has appreciated, imports have gone up and exports have fallen. This was caused by a combination of the low American savings rates combined and the high growth rate, which leads to capital inflow.

3. Income elasticity of demand for foreign goods in the US (2.6) is greater than the elasticity of demand for US goods abroad (1.6) – so if both places grew at the same rate, you would get a trade deficit. This disparity may be due to the fact that American companies tend not to design products for the rest of world and also that Americans are very good at off-shore manufacturing. People also argue that we have a much more open economy but this is not completely true. In terms of tariffs and barriers, we are not more open than anyone else. But we are much more open because we truly believe in capitalism: everything in the US is for sale, foreign companies can get market share overnight, and foreigners can head up major American firms. There is almost no other country in the world where this could happen.

4. Trade restrictions by other countries – the three reason above account for only 2/3 of the trade deficit. The rest can be explained by trade restrictions by other countries. China and Japan run trade surpluses ($220 billion total) but they don’t spend their surpluses – they hold them in their central bank. America has to absorb these surpluses because no one else would be able to do it.

Soft vs. Hard Landing

In a soft landing, things adjust slowly over the period of a few years. In the United States, however, this is unlikely to happen with regards to the current account deficit and capital inflow. Even if the US current account goes to zero, we would still need a trade surplus of $100 billion to pay the interest on the $2 trillion that we already owe. But this shift is huge (-450 to +100 billion)! The range on this is too big to make this a viable option. Additionally, since most trade is in manufacturing, to eliminate the deficit, the US would need to build capacity and competence to provide products for the rest of the world (which is highly unlikely). This shift in trade could, however, be driven by dollar depreciation but the dollar would need to fall by 40% to account for the deficit. If this were to happen, even if we knew it would happen slowly, people would get their money out now and the soft landing becomes hard very quickly.

Another way to erase the trade deficit is to have a recession so that \( \text{USA}<\text{ROW} \). But for this effect to be big enough, US GDP would need to fall by 20%. Even if this was spread out over four or five years, people would rush for the exit right away and again, a soft landing becomes hard. Already, with the slowing of the economy, people are starting to get their money out and this has caused the hard landing that we are now seeing.

Soft landing advocates argue that since our debt is denominated in our own currency and there is no possibility of default, people will not be so quick to pull their money out of the country. Of course, no one knows in advance what the real story is so the only question now is what’s going to happen?