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## An almost brilliant analysis of the American economy

*From Mr Dan Aronoff.*

Sir, In his brilliant analysis of the what caused the US economy to go haywire during the housing boom and what should be done to prevent a reoccurrence, Martin Wolf, like many other analysts, touches only lightly, almost as an afterthought, on something so fundamental and tautological that keen minds seem to pass over it without noticing ("Financial reform: call to arms", Analysis, September 4). It is this: the housing boom could not have occurred without the unprecedented increase in the US current account deficit – from 2 per cent to nearly 7 per cent of gross domestic product – that accompanied it.

The reason is a matter of simple arithmetic. By 2003 the US was operating at full employment while consumption, investment and – with the start of the Iraq war – government spending were all on the rise. Therefore, the only way possible to accommodate the surge in home building was by importing goods from abroad, since the housing boom required the US economy to spend beyond what it was able to produce.

In the absence of a rising current account deficit, the competition for domestic resources that would have been kindled by a nascent housing boom, would have damped activity by generating inflation and rising interest rates. There might have been a boom, but it would have been smaller in magnitude and shorter in duration. No profusion of financial alchemy or irrational exuberance would have been able to overcome that arithmetic resource constraint.

This line of reasoning leads to two conclusions. One is that the fundamental fragility in the economic system has been the removal of the natural brake on bubbles caused by unbalanced trade. The second is that post-crisis policy (at least in the US) has been improperly focused; lawmakers should be grappling with how to bring down the current account deficit without unduly harming trade. Financial reform – which is vitally important for the reasons stated by Mr Wolf – is nevertheless a second order concern because balanced trade would place a check on any wayward tendencies promoted by leverage or financial innovation.

**Dan Aronoff, President, The Landon Companies Royal Oak, MI, US**

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