Ominous economic questions moving from world of hypothetical to reality

By Todd Hirsch
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An old joke around university economics departments pokes fun at the hypothetical realm in which the discipline lives.

A chemist, a physicist and an economist are stranded on a desert island, with no provisions other than a case of canned beans. Lacking a can opener, the three professors set out to solve their problem. The chemist attempts to create a corrosive salt water solution to eat away at the lid of the can, but fails. The physicist devises an elaborate slingshot using palm trees to smash the cans against a boulder, but fails as well.

The economist steps forward. “My friends, this problem is easy to solve.” The other two academics sit up with interest. “First, assume we have a can opener …” he starts to explain.

Economics at the academic level is full of conjecture and assumptions. Most students of the discipline will recognize the hypothetical questions posed on their exams. The questions all start by asking them to assume an imaginary situation – one that doesn’t exist in reality, but is useful to consider in the abstract because it broadens our understanding.

But today, events are moving out of the realm of the imaginary and onto the pages of the business section. Consider three questions that could show up on any undergraduate final exam.

Question 1: Assume Country A, the world’s largest economy, has a massive trade surplus with Country B, the second largest economy. Now, assume a 45-per-cent tariff is imposed on goods coming into Country A. Describe what will happen to prices, exchange rates and wages in Country A.

Such a situation is imaginable in theory – yet unobservable in practice because no country would possibly do this. But now, of course, we might indeed see this implausible situation play out between the United States and China.

In a few years, scholars could have data on what happens when ridiculously high tariffs are imposed in the global economy of the 21st century. This will enrich our understanding and provide even greater evidence of the benefits of trade – as well as the extreme drawbacks of protectionism.

A second plausible exam question from monetary theory asks students to analyze a situation that, until now, would have been conceivable only at the abstract level.

Question 2: Assume a central bank starts charging (rather than paying) institutional depositors to hold their cash – that is, interest rates are negative. What are the short- and long-term implications for such a country on capital flows, currency exchange rates and inflation?

The idea of negative interest rates lived only in our imaginations a few years ago. Academics would have mused curiously about them in concept, but had no factual evidence on which to build better theories or models because negative interest rates didn’t exist. But as some central banks have run out of rope on which to pull aggregate demand higher, we are now down a rabbit hole that was previously the stuff of wild make-believe.

The third exam question, one closer to home, comes from a course on Canadian Public Finance.

Question 3: Assume oil prices plunge by 70 per cent, and as a result Alberta, Saskatchewan and Newfoundland and Labrador are thrown into recession. Describe the impact this will have on the federal Equalization Program and calculate how Ottawa's transfers to the have-not provinces will be curtailed in a few years time.

Since the formula to calculate payments is based on the average per-capita revenue available to all provinces, the drop in oil prices will bring the average down. (As a bonus question, the students could be asked to describe the howls of complaint that will arise from many of the have-not provinces, particularly ones with mayors who oppose oil pipeline construction.)

All of these hypothetical economic situations are about to move out of the world of make-believe and into reality. This will produce observable data sets with which we can hone our models and thus improve our understanding of the economy.

The world is a shaky place right now. Plenty of question marks hang ominously over the economy, and businesses, politicians and taxpayers all have reasons to feel anxious. Not much good is likely to come from these developments in global trade, monetary policy or Canadian regional transfers.

But the academic economists should be pleased. At least in theory.

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