Constraining Credibility

Keith Rankin, 14 November 2014

Most economists and members of the public – on both the right and the left – believe that economies are constrained by resource scarcity most of the time. In this view, economies are supply-constrained, and that the economic problem is resolved by a mix of more work, more saving and more productivity.

The alternative to a supply-constrained economy is a demand-constrained economy, in which total spending (not total available resources) is the main determinant of the level of production. I believe that economies are demand-constrained most of the time. Further it is not difficult to distinguish demand-constrained economies from supply-constrained economies; it's an exercise in ticking boxes.

(Having said that, economics – even at its most basic – is perceived as difficult and dry; too unrewarding to engage with, in spite of its admitted importance. Public discussion on economic matters is substantially limited by these perceptions; perceptions that stultify our imagination to the point that we have few images of what societal economic success actually looks like. In particular and by default, we presume that production – indeed growth – is a measure of success, and that enjoyment is something frivolous.)

The issue is very important, because solutions to the major economic problems that we face must address the actual constraints that bring about these problems. (Following my radio interview on 2 November, one of the panellists disputed my contention that employment levels are in the main determined by "aggregate demand".) In a demand-constrained economy, the young and the old compete with each other for employment. In a supply-constrained economy, unemployment is essentially voluntary.)

Economists who I admire – such as Paul Krugman and Richard Koo – believe that modern economies are demand-constrained much of the time. I go further in suggesting *most* rather than *much*, and close to *all* of the time since the mid-1970s; a view dismissed in the past as *underconsumptionism*. (Krugman writes of "Depression Economics" as distinctly different from neoclassical economics, applicable to demand-constrained economies. Koo has uncovered the "Balance-Sheet Recession" which turns out to be not as rare as he initially presumed.) I also take the view that satisfactory resolution of the demand-constraint problem requires more than removing the sources of demand-constraint. (Here we can take our lead from Robert and Edward Skidelsky's 2012 book *How Much is Enough*, and through the writings of one interesting writer from over 100 years ago, Simon Patten. Patten's best-known work is *The New Basis of Civilization* [1907]; Daniel Fox wrote about Patten's work in *The Discovery of Abundance* in 1967.)

(I should add to this list of economists I admire New Zealand's Paul Dalziel and Caroline Saunders, whose recent book *Wellbeing Economics, Future Directions for New Zealand* emphasises that consumption – or more correctly 'wellbeing' – is the appropriate achievement of economic activity, with production being one means to that end rather than an end in itself. My only disappointment with their book is that it focusses its analysis on the national and sub-national economies. I favour using the closed global economy as a starting point; globally, the otherwise popular option of export-based solutions is a non-starter.)

Economists in the classical tradition – conservatives in the American sense – believe that economies work *as if* they are supply constrained <u>*all*</u> of the time, and therefore understandings of demand-constrained economies are not required. They refuse to engage in this core discussion, and they dominate the world's policy think-tanks. Career economists tend to be rewarded best by adhering to the classical tradition.

Identifying a Supply-Constrained Economy

The classic 'economic problem' is that of resource scarcity; shortages of land, labour and capital.

In a supply-constrained economy there is a scarcity of labour; employment is constrained by our own inadequacies (which may include both a lack of skills and a lack of aspiration) and our immediate trade-offs (such as choosing higher education or child-bearing and rearing). The ongoing employment of the old has no impact on the employment and self-employment opportunities of the young.

Essentially, a supply-constrained economy is a ***full-employment*** economy. Further, supply-constrained economies teeter on ***inflation***. Wages would be high and ***inequality would be low***.

In a supply-constrained economy there is a scarcity of savings; more demand to incur debt than willingness to forego present consumption. Savers can be and should be rewarded generously, and there cannot be 'too much' saving. Debt is substantially confined to business debt, house mortgages and hire-purchase. ***Borrowing is undertaken mainly by businesses***, though also to fund the building of houses.

In a supply-constrained economy, competition between buyers (as in auctions for Auckland real estate) is more intense than competition between sellers. Thus buyers have more need to advertise their wants than sellers have to advertise their wares. In popular parlance, such an economy is characterised by ***sellers' markets***. Further, competition for imports would be stronger than competition for export markets. ***Imports*** would be clearly understood as the principal purpose of trade.

In the predominant left-version of the supply-constrained economy there are powerful bad guys out there creating opportunity barriers to ordinary folk. The bad guys resist attempts by governments to correct for market failure. They control scarce resources to create monopolies and inequalities. Deal to these guys and the above-mentioned benign characteristics of a supply-constrained economy would prevail.

In the right-version of a supply-constrained economy any observed barriers to participation are mainly self-imposed, and therefore inequality is presumed not to matter.

It is widely accepted that, in a supply-constrained economy, and although the 'economic problem' of unlimited wants is by definition insoluble, growth should everywhere and always be powered by our three economic cylinders: increased labour supply, increased saving, and increased productivity.

A variant to the predominant left-version is the Malthusian green view which emphasises the natural resource ('land') constraint. This version says we should accept the futility of trying to solve the economic problem by maximising output everywhere and at all times, and be content with less.

Visualising a Demand-Constrained Economy

A demand-constrained economy is usually but not always characterised by 'cyclical' ***unemployment***, the kind of unemployment generally associated with recession or below-average economic growth. ***Very low inflation***, under 2%, especially in the world's largest economies, is another pointer to demand-constraint.

Another key feature of demand-constrained economies is the disproportionate size of the ***marketing*** industry, in its various guises. Intense competition between sellers, under conditions of constrained spending, creates what is popularly known as ***buyers' markets***; to facilitate sellers, extra resources must be committed to inducing demands which would not otherwise be there. High levels of ***consumer debt*** represent an important part of this process of creating demand.

Government deficits – at all levels of government – are also symptomatic of a lack of private-sector spending. Governments are by nature debt-averse, yet must incur substantial debt in order to mitigate the problems caused economy-wide by too much unspent private income.

An important part of the way that banks induce spending through the ***marketing of debt*** lies in the creation of ***financial bubbles***. These are symptomatic of demand-constrained economies.

Another symptom is ***vendor-financing***, whereby sellers finance the purchasers of their goods. This is particularly prominent in international trade, where countries like Germany, Sweden, Netherlands, Switzerland, Singapore and China accumulate credits in the countries they export to, while showing no indication that they will utilise their credits in (which means purchasing imports) any time soon. In trade, success is understood as ***exports***, not imports.

Another feature of demand-constrained economies is the extent that ***excessive incomes are generated within the finance sector***. The finance sector pushes the excess debt that is necessary to validate the excess saving. In doing so it provides services to those savers who generate demand for financial services.

We can tick the boxes on all these; they have become commonplace features of the twenty-first century global economy.

Global Savings Glut

Demand constrained economies arise because of excess saving. Indeed the world economy throughout this century has been characterised by a savings glut, the root cause of the 2008 global financial crisis. The process of saving is both the non-spending of income and the repayment of debt.

Normal saving – saving to meet the economy's requirements – is saving by today's income earners that facilitates: (i) the dissaving of households, in particular the spending of retirement savings and the use of past savings to fund large purchases, and (ii) the normal debt requirements of businesses and house purchasers. An important feature of the 21st century world economy is that the business sector alone has become a substantial net saver; in most years it has saved more than enough to fund both household dissaving and normal business borrowing.

The rest of saving – excess saving, in effect all household saving (given high levels of business saving) – stands to become the unpurchased slice (up to 20%) of the economic cake. The essential role of the financial system is to ensure that this otherwise unpurchased chunk of goods and services is consumed. Capitalism collapses if buyers cannot be found for our glut of saved goods and services. New Zealanders, through high interest monetary policies, have disproportionately taken up the cudgel of induced debt. We have consumed the excess savings of others.

So the unsavoury behaviour of the finance sector as a whole – and the big American investment banks in particular – in the mid-2000s (well-documented in Charles Ferguson's movie *Inside Job*) was not the cause of the global financial crisis. The finance sector was doing its very best [though not with any noble intent] to allocate the huge saved portion of global economic production. The 2008 crisis represented the temporary unravelling of the unsustainable balance sheets of global finance. We are now in the middle of a re-ravelling phase. Finance sector excesses are symptomatic of our saving glut problem; not its cause.

One important tactic to induce spending was the direct hard-sell of debt to people who clearly could not afford it; hence the sub-prime housing loans in the United States, and many of the bad loans made by finance companies in New Zealand.

More significant for us today (as well as 7-10 years ago) is the indirect effect of financial bubble creation. The banks prefer to lend to people with inflated assets as security, rather than lend unsecured. Most of these loans therefore are used to purchase things or promises that already exists: used cars; used houses; shares; bonds. The proceeds of these bank loans therefore go to the sellers of these assets, who may be induced to buy extra goods and services on account of the capital gains realised; or may buy more assets.

More significantly, many people who do not sell their assets that are valued at inflated prices decide to borrow and spend against the security of those 'assets'. In their eyes they are net savers because their unrealised capital gains exceed the new debts that they take on. *This indeed is the classic way that demand-constraints are resolved; through financial bubbles in what are fundamentally demand-constrained economies.*

Auckland's Property Bubble

This understanding of financial bubbles is very topical in New Zealand at the moment, or at least in Auckland, because the latest house (and land) valuations were issued by the Auckland Council this week. Indeed the Auckland Council's computer crashed on the day of release, so eager were people to count their new inflated 'net worth'. The word on the traps is that people were not checking because of concern about their 2015 rates. Rather they wanted to know what their collateral is worth so that they can borrow and spend while believing that their stock of savings continues to rise. The utility of bubbles is that they, like nothing else, induce savers to spend. The economy, on consumer debt steroids, comes to mimic a supply-constrained economy.

It's the oldest trick in the book of the money cycling profession: make people believe that they are worth more than they really are, so that they will go out and buy what would otherwise be unbought.

Conclusion

The financial collapse of 2008 took place when the ability of the financial sector to substitute for the missing demand was exhausted. The crisis was mercifully brief, because in 2009 the governments of the world took on the borrowing that, despite record-low interest rates, households and businesses were eschewing big-time.

A key feature of most demand-constrained economies is high levels of induced consumer debt; the necessary flipside of the saving glut. When the debt dissolves, when the critical moment arises, many savers get what financiers call a 'haircut'. We observe the glut of savings by seeing the huge price inflation (bubbles) in so many of the world's prime asset markets, simultaneous with low inflation in goods and services markets. High house prices are just a symptom of too many 'investors' with too much 'wealth'.

The preponderant view that economies continuously suffer from insufficient savings – the central premise of the supply-constrained view of economies – is simply not credible in the twenty-first century.

Our economies are now for the most part demand-constrained. Induced debt-fuelled consumption – albeit interspersed with financial crashes – facilitates the illusion that our basic problem is our unconstrained desire to spend. Attempts to cure the wrong problem substantially aggravate the actual problem.
