The Chicken and the Egg

August 2013

If one takes the time to extract the central purpose behind our current economic policy, its almost singular focus seems to be consumption. Consumption supposedly represents 70% of our economy, so at first glance, focusing on it would appear a logical approach to our challenges. Keep consumers shopping and economy will be fine.

This seems to be the theory that drives the Federal Reserve's dramatic monetary stimulus policy. Reducing the cost of a mortgage and/or reducing the cost of an auto payment puts more money in a consumer's pocket. And by forcing interest rates low and buying up mortgages, the Fed has propped up the housing market. When houses trade hands, people have to consume all sorts of things, from moving services to landscaping to new furniture and appliances.

Also working to keep consumption up is what we call Keynesian stimulus, government deficit spending. Government spending supports the economically disadvantaged, in addition to keeping more people employed, both of which keep people in stores. Cut government spending and there will be fewer jobs and less overall consumption. Increase government spending and consumption will increase.

So long as there is sufficient consumption, there will be a need for worthwhile production, the effort that creates things to consume. Maintain consumption and economy will be in good shape. Simple. At least that's how today's progressive economic minds think.

Policy has now been focused on the consumer for at least the last decade. So how have things improved? Personal incomes have been stagnant for more than ten years. Job growth is not only too sluggish to materially improve economic conditions, but it is also much weaker than the numbers indicate, with very low paying and temporary jobs dominating "growth." Recently, we've even seen an increase in consumer debt. Shouldn't consumers instead be building savings in a healthy economy?

It's hard to build a case that the trillions of dollars we've spent in stimulus to shore up consumption is the solution to our problems. We're four years from the last technical recession, still talking about a coming recovery and still dependent on massive government stimulus.

Our monetary and fiscal stimulus policies are not just pulled out of thin air. They come from years of experience, years of dealing with previous economic slow downs, as well as the study of past economic calamities. Federal Reserve Chairman Ben Bernanke spent considerable time studying the mistakes of the Great Depression. The likes of John Maynard Keynes, Milton Friedman and many other great economic minds have contributed to what today forms our economic policy. But again, it isn't working. Why?

A good deal of economy may be about consumption, but consumption isn't always the primary economic catalyst. Just look at China. What has driven their economy for the last thirty years is not consumption, but instead the building out of an enormous economic infrastructure. China has pulled itself up from the Third World to an emerging market, and ever closer to a developed economy.

This is typical economic evolution, the normal transition from an emerging to a more developed economy. Infrastructure development comes first because there really can't be worthwhile production or consumption without an infrastructure to support it. The infrastructure that China has built now supports a massive production effort. Just look at the labels on all manner of products bought in stores around the world.

But now China's economy is slowing, partly because the global economy is slowing, and partly because they may now have adequate infrastructure, or maybe even more than is needed since markets tend to overshoot. Time will tell how long all those see-through buildings remain empty.

So what's China to do now that its infrastructure growth is waning? It's time to take that next step in economic evolution. It's time to focus on incentivizing more internal consumption. China will do this by increasing the social safety net and making credit much more available to individual citizens.

If we look back on United States history, we see a similar pattern. First came a significant period of infrastructure development, starting with railroads and telegraphs and finishing with our modern agriculture, housing, energy, transportation, and communication systems. A good part of this infrastructure was complete by the 1970s, although communications infrastructure was significantly upgraded during the 1980s and 1990s. But once infrastructure is reasonably developed, this economic growth catalyst looses steam. Time to bring in consumption.

American Express issued their first credit card in 1959, but it wasn't until 1968 that the Federal Reserve began tracking revolving consumer credit, which that year totaled $1.3 billion. Forty-five years later, revolving consumer credit now sits around $800 billion. In 1968, median annual income was $8,600, meaning today's average wage earner would be making $5,300,000 a year if wages had grown at the same rate as revolving consumer credit. Consumer debt has obviously exploded since the late 1960s.

Once infrastructure development is mature, internal consumption is unleashed to keep an economy growing. This is what we did in the United States. This is what China will do. But as we're now seeing in the United States, as well as in Europe and Japan, consumption only takes us so far. At some point, the capital productivity of consumption obviously declines.

Infrastructure in the developed markets is mature and reasonably capable of supporting existing economy. Certainly it needs maintaining, but the economic multiplier effect of original infrastructure development is much greater than follow-on infrastructure maintenance. The former increases productivity significantly, while the latter just maintains productivity that has already been captured.

One could argue that consumption in the developed markets is also mature. What do American consumers need that they don't already have? Between the 1940s and 1990s, household consumption exploded. Now the great majority of our population already has adequate food, clothing, shelter, energy, transportation, communication, information, leisure and entertainment products and services.

Supporting consumption in an economy that doesn't need much would seem a huge misallocation of capital. A much better policy would be to focus instead on increasing production. Remember, production has to happen before there can even be consumption. And as pointed out earlier, there are economies like China ready to increase consumption. Well then, why don't we produce more to sell them?

For one, the cost of labor and regulatory burden in the U.S. make our production more expensive than that of China's, a good reason to increase our minimum wage and force companies to buy health insurance for everyone. Joking, of course. Consider the detrimental effects on production of increasing fixed costs (particularly by way of government edicts) in a market competing with the global work force. These are just more policies to boost consumption, quite arguably of detriment to production. But there is an even bigger obstacle to increasing production activity in the U.S.

Production is under attack by a very powerful political group. You see, most production requires some or all of the following: the extraction of natural resources that changes the area from which they are drawn; the carbon creating process that turns natural resources into raw material; the carbon creating process that turns raw material into a finished good; and the carbon creating process that moves extracted natural resources, raw material and finished goods anywhere. Production is a bad thing, an evil effort that destroys and pollutes our environment. It has created climate change that will soon destroy us. We best stop all activity that contributes to this destruction.

Maybe the most powerful argument for economy's sustainability is Schumpeter's theory of "creative destruction," which says that by nature, human ingenuity will innovate new things that improve upon previous old things. Innovation will create more economy, but at the expense of destroying a previous part of it. Automobiles destroyed the horse and buggy business, but significantly increased human productivity. It is called creative *destruction* for a reason. There can be no worthwhile creation, and there can be no worthwhile production, without some form of destruction.

Today's hypersensitivity to each and every individual's prosperity has us focused on stimulus to the individual, to the act of consumption. At the same time, today's hypersensitivity to the environment has us focused on eliminating that nasty destructive production. Stimulate consumption that isn't really needed, but eliminate production that is. Welcome to the dysfunctional world we live in.

Doug

Douglas A. Leyendecker
713-862-3030
doug@armchaireco.com