Armchair Economics

Perspectives from an economic everyman

Causation and Correlation

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"If policy makers can at least get the diagnosis right, it would be a major step on the road to recovery." – Kenneth Rogoff, from his article "The bullets yet to be fired to stop the crisis," *Financial Times*, August 9, 2011.

Kenneth Rogoff and his co-author Carmen M. Reinhart published a book, *This Time is Different: Eight Centuries of Financial Folly,* that many people believe best defines today's economic problem, which in their opinion is a debt problem. The book has been embraced as the voice of reason by a great many people in the economic community, throwing significant fuel on the fire of sovereign debt fear.

The authors take a historical view of debt crises. Their prognosis is that the U.S. is very close to the point of no return when it comes to managing our fiscal challenges. To Rogoff and Reinhart, if we don't stop growing government debt, the country's economic crisis will escalate. But Rogoff's comment has the Armchair thinking. Is too much debt really the right diagnosis of our ailment? Is government debt the disease, or is it just a symptom of the disease? And if debt is nothing more than a symptom, then what truly is the disease? Why can't we pay our bills without borrowing more and more money?

The answer for conservatives and libertarians is that government is spending too much. This seems a reasonable conclusion when Washington is spending $1 trillion more annually than it takes in. So conservatives and libertarians wave their arms in the air that too much government is strangling the private sector. They champion the idea that government spending is at best a wash in influencing economic activity. One dollar spent by government equals no more than one dollar of economic value, while private sector spending and investing is much more stimulating. To these folks, the answer is pretty simple – reduce government spending. The theory is that by doing so, more capital will be available to the more efficient private sector. So today the strategy du jour is government austerity. But Europe is rapidly driving itself into recession with this strategy, so clearly the strategy has a problem.

GDP is traditionally counted as Government Spending + Consumption + Investment + Net Exports. If you decrease government spending, you automatically create a huge challenge. Cutting one major GDP input could cause it to fall. This is currently happening in the U.K. They have scaled back government spending and now GDP is falling faster than was predicted. At this stage, the idea that taking money away from government is naturally going to result in higher economic activity seems pure theory, quite possibly more correlation than causation. An economy must have other reasons to increase consumption, investment and/or net exports.

To the liberal crew, the answer is also obvious – we need to raise taxes. A recession and prolonged period of economic stagnation have caused tax receipts to contract. Federal tax receipts in the U.S. peaked out at about $2.6T in 2007. In 2011, they amounted to about $2.3T. We're $300B down in tax receipts, yet our budget deficit remains close to $1T. To liberals, the obvious solution is to raise taxes. But since many liberal voters don't pay federal income taxes, it is easy for them to support policy that doesn't affect their personal financial situation.

Increasing taxes might seem the way to "solve" our growing government debt problem, but when you take money away from the private sector, you either reduce private sector consumption or investment. Both are major components of GDP, and arguably more efficient at driving economic activity than

government spending. So raising taxes means transferring money from the most to the least efficient allocator of capital. If we tax more to bring down our budget deficit, we're not increasing economic activity; we're just paying for the least efficient allocator of capital to maintain its profligacy.

Increasing taxes can easily reduce economic growth, which only serves to lower future tax receipts. This is why supply side economists are always arguing for a reduction of taxes. Give the private sector more capital and it will either increase consumption, increase investment, or both. Either or both will eventually increase overall economic activity and tax receipts.

So if neither increasing taxes nor reducing government spending is the panacea, what is left?

Maybe the key to our challenge can be found in the term given to describe our economy – a developed market. Where exactly did that term come from? It seems logical that the term arose to contrast the more robust economies of Europe, the United States and Japan to those that were once called the Third World. The robust economies were developed. The Third World was not.

Up until the recession, people in Europe, the U.S. and Japan led comfortable lifestyles, while most of those in the Third World were still trying to get their hands on a little more rice and hopefully some clean water. But now the Third World has become the emerging markets, and the developed markets have stayed…developed. We are developed. They are emerging.

What really differentiates the two? It seems to be the level of lifestyle comfort in both markets, that proportion of population in the middle class. But at what economic level are we comfortable?

Comfortable should be defined as having our basic needs met. Anyone with adequate food, clothing and shelter should be living comfortably. Today, energy, transportation and communication needs have also become fundamental. So anyone that has an adequate supply of all these needs should be defined as comfortable, as middle class.

Few if any in the developed markets lack these basic needs, while an ample number in emerging markets still struggle to obtain them. An economy that is still trying to supply needs adequately throughout its population is obviously still emerging, while one where needs are adequately fulfilled is developed.

The reason growth is greater in emerging over developed markets is two-fold: 1) The more people in a society who still have needs to be fulfilled, the more runway there is for new economic activity, creating a virtuous cycle of growth; 2) People become more productive as their needs are met, and productivity is one of the primary drivers of economic growth. The first point is obvious. The second, somewhat less so; a family's first car provides a huge personal productivity boost, as does their first telephone and computer. The new car owner can now travel further, to a different job, or to consume in more places, or a computer and phone can make them more efficient. The process of fulfilling needs across an economy is highly stimulating. Yet needs are practically ubiquitously met in the developed markets, where consumption has become dominated by needs replacement, and, more importantly, by wants.

As the Armchair pointed out in a previous essay, the replacement of needs and the consumption of wants are not as powerful of economic drivers as the initial social proliferation of basic needs. The productivity value of one's very first car is far greater than the second. The second just maintains productivity captured by the first. If the $20,000 Honda has the same economic utility as the $50,000 BMW, then $30,000 of capital has, to some extent, been wasted. That extra $30,000 has improved the top line, but not as much

the overall economic margin. It's a diminishing return event.

This should make obvious why today's developed market economies have a debt problem. As more and more of an economy becomes needs replacement and wants-based, capital efficiency declines. You need more and more capital to achieve the same growth. So in order to keep an economy growing, one must either borrow or print more money. And what have we done today in the developed markets?

From the Armchair perspective, our politicians, policy makers and economic critics are spending too much time focused on the symptom and not the disease. The problem is not so much too much debt as it is a lack of growth. Growth cures all that ails an economy. Growth pays off debt.

Liberals champion more government spending. Their approach is to borrow, tax, and spend until something magical happens to get the economy growing again. That's not running a country on economic policy, that's running a country on faith that eventually things will turn around. It hasn't worked for Japan. Conservatives and libertarians who want to cut government spending are also relying on faith that doing so will turn things around. That hasn't worked for the U.K.

Is there any way developed market economies can turn the tide without relying on policy that requires faith to turn things around? Is there a way economies that are driven more by needs replacement and wants consumption can sustain themselves without incurring more and more debt? Yes there is. These economies should increase exports, and, more importantly, strive to develop a healthy trade surplus.

Having a trade surplus means other people are giving you more money than you are giving them. With a trade surplus, you are increasing your capital availability. You are bringing in more capital with exports than you are sending out with imports. If your economy needs more and more capital to make up for the less capital-efficient government spending, needs replacement and wants consumption, then you need someone else helping you pay for them, someone other than a government that is borrowing and/or printing more money.

Increasing exports and building a trade surplus is the best way developed markets can pay for the lifestyles they have become addicted to when their consumption is less capital efficient than that of emerging markets. Developed market leaders need to focus on policy that can quickly increase exports.

Debt is not the cause of our economic problems; it is merely a correlation to our real problem – lack of growth. The most powerful way to fix this problem is by instituting policy that rapidly increases exports and seeks to develop a healthy trade surplus. Of course this doesn't mean over-indebted developed market economies should let government keep spending way beyond their means. Certainly attention should be given to reducing the cost of government. But by focusing on growing exports and developing a trade surplus, economies would increase employment, which would lessen the government safety net requirements. Government spending would naturally decline. And tax receipts would naturally rise.

Focus on the disease, policy wonks, and the symptoms will likely abate.

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