Armchair Economics

Perspectives from an economic everyman

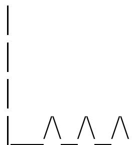
The Keynesian Trap

June 2012

Well here we go again. It's economic déjà vu. Each of the last three years started off looking like we were moving into economic recovery, but by late spring, the bloom has fallen away. For three years, fall/winter monetary and/or fiscal stimulus has provided us a more optimistic economic start to the year. But the stimulus just doesn't seem to last. It has not been able to fertilize any true, organic green shoots. Many folks think we just haven't had enough "rain."

Several years ago in an email dialog with David Rosenberg, former Chief Economist of Merrill Lynch, now same with Gluskin Sheff, one of Canada's largest money managers, the Armchair suggested our "recovery" was going to look much different from recoveries we had previously experienced. At the time people were debating a V versus a U economic recovery, the V obviously having a quick rebound while the U would take a bit more time. And then a few folks talked about the W…recession, recovery, recession and then the ultimate recovery.

None of these scenarios seemed plausible to the Armchair. Instead, I thought we would not have any recovery at all, but rather a continuous pattern of government stimulus battling it out with the new normal. So the Armchair's alphabet recovery prediction has always been an L with a saw-toothed lower leg. Government stimulus would lead to something that appears to be recovery and expansion, but once the economic fertilizer wore off, we would be back to the new normal. Below is what I suggested to Mr. Rosenberg we were in for.



The real question is whether the lower leg of this L runs horizontal, or develops an upward or downward trending slope. Unfortunately, since our overall debt-to-GDP keeps growing, the answer today would seem the slope of our "recovery" is falling. The debt hole we are in only continues to get deeper. It may be shifting from the private to the public sector, but it's growing by at least $1T a year. And here we go again talking about government stimulus coming to rescue a stumbling economy.

As suggested above, there are two types of government stimulus, fiscal and monetary. Fiscal stimulus is when the government increases its spending, hoping to take up the private sector slack. Monetary stimulus is when the Federal Reserve uses its many "tools" to trigger more economic activity. The Fed's two main tools are interest rate and money supply management. The lower the interest rates and the more money available in the system, the more likely people are going to borrow and spend, or the more likely they are going to invest in something.

GDP is calculated as Consumption + Investment + Net Exports + Government Spending. The first three components of this equation represent private sector economic activity. The last is obviously not. But if for some reason the first three are stumbling, then government stimulus can in theory keep the overall economy afloat long enough for an organic growth catalyst to return.

The Armchair has suggested before that ***both economic expansions and contractions have a tendency***

to feed off themselves. Expansion leads to job growth, which leads to more expansion. Contraction leads to growing unemployment, which leads to more contraction. Of course the self-perpetuating contraction-unemployment cycle is disastrous. This is when government is supposed to "come to the rescue."

John Maynard Keynes was a British economist credited with this government stimulus idea. Keynesian theory is championed by a great number of economists, including some of today's most vocal. It is the strategy governments all over the world have employed since 2008 to keep the game going.

But so far, all Keynesianism seems to have accomplished is make us feel like we're living in an economic version of "Groundhog Day." Stimulus gets fed to economies, but only enough to provide hope, not enable sustainable growth. Economic metrics fall short, the rug gets pulled out, and we're back to the new normal. Then it all repeats itself. Why is this the case? Why does this pattern of stimulus, hope and then disappointment continue? Why can't the powers that be make an organic growth economy happen? Why are we stuck in this new normal?

We probably first need to define new normal, an excellent term originated by the smart folks at PIMCO, one of the world's largest money managers.

The new normal is generally defined as an economic period that will not be as robust as the last several decades. It refers to a period of slower overall economic activity, slower for several reasons, but primarily because of too much debt and not enough savings.

Since 2008, consumer debt has been falling and government has been stimulating and stimulating. Why, then, can't we get that natural growth engine started again? Why aren't we consuming more? And of course, if consumers are not consuming enough, then businesses are not going to invest more. What's wrong with consumption, which supposedly makes up about 70% of our "normal" GDP?

As the Armchair has written several times, the economic value of consumption fluctuates over time. There are three types of consumption: needs, needs replacement and wants.

Emerging market economies are mostly spreading the supply of basic needs throughout their populations. This process is highly stimulating. As more people gain access to basic needs (car, telephone, electricity), their personal productivity increases, allowing them to earn more wages, which increases their consumption power. This provides an emerging market with a natural rising tide lifts all ships economy. But these economies, like all market economies, will fall into a cyclical contraction when production capacity has grown faster than demand.

Keynesian stimulus might be worthwhile policy when an economy is still emerging, still building and feeding off natural expansion economic momentum. A little juice to demand gets the expansion feeding frenzy back in gear. One might even suggest this was the case in America's economy when Keynesian Theory became so popular. After World War II, America had a robust, rising tide economy, when families were buying homes, cars, washing machines, electronic appliances and all sorts of things that increased personal productivity.

But once everyone had those needs met and those personal productivity gains had been realized, the capital efficiency of further consumption declined. Needs replacement and wants consumption provide

a diminished return on capital because they lack the personal productivity gains achieved from purchasing those initial needs. That second car isn't capturing any more personal productivity; it's just maintaining productivity already captured in the first car purchase.

There is also a point in consumption where personal productivity starts to decline because of the time demands on maintaining all your wants, all your extra stuff. The more stuff you have, the more time it takes to maintain it, stealing time away from more productive activity.

The battle today between government stimulus and the new normal exists because consumption in developed market economies has lost capital efficiency. Consuming needs replacement and wants is not very economically stimulating. At best, it is consumption that just maintains already captured productivity. At worst, when an economy is too oriented towards the consumption of wants, ever more stuff means ever more time spent maintaining that stuff.

For Keynesian stimulus to work and make sense, an economy better have a solid amount of organic economic momentum already in place. But this isn't the case in today's developed markets. Instead, momentum broke when needs were widely met, thereby rendering these economies developed. And now the developed markets getting a constant supply of stimulus are in hock up to their eyeballs, digging that hole deeper with every attempt to stimulate. Might government stimulus for developed market economies do nothing more than set a giant Keynesian Trap?

Once again it seems we are trying to placate our economic symptoms rather than tackle the real disease – a lack of organic growth. The growth disease must be addressed with policy that makes us more competitive within the global market. We need to reduce the cost of our labor. We also need to reduce our fixed costs. Anyone with too much debt and not enough income has to decrease their fixed expenses. We need to unleash our natural resources economy to bring down those fixed costs. And we should be moving toward market solutions for industrial policy, health care and education rather than layering in more and more government. More government and more regulation just increase our fixed costs. Where in economics did we learn that increasing our fixed costs is going to make us more competitive?

Since we are an over leveraged developed market – a middle-aged economic system rather than some spry emerging market – The Keynesian Trap is going to continue to make our situation worse. Only by liberating the market economy from the shackles of government and regulation might we be able to make room for *real* economic activity. And as the Armchair suggested last month, only by growing exports and a trade surplus can a developed market economy continue to finance consumption that produces a lower overall economic return.

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