

[Time preferences and bad economics](#) [1]

Written by [Terry Arthur](#) [2] | Friday 8 October 2010



I didn't know whether to laugh or cry last week after reading two mutually exclusive, incorrect views of economics in the papers. They were both on time preference, one of the most important factors in economic growth, and both showed a profound ignorance of their topic.

The first, by Tom Stevenson, a professional fund manager, [said that](#) [3]: "The trouble is that humans are seemingly hard-wired for short-termism. Ask someone if they prefer £10 in a year or £11 in a year and they will, rightly, opt for the £11. But ask them if they would prefer £10 today or £11 tomorrow and they will invariably put out their hand for the money straightaway."

I don't know who Mr Stevenson asked, but the latter claim is a fairytale. Quoting Adam Smith, Stevenson exhorted us to learn "self-command, by which we are enabled to abstain from present pleasure in order to obtain a greater pleasure in some future time". How much time is apparently not an issue, although £10 today versus £11 tomorrow implies an interest rate (i.e., a time preference) of 10 per cent per day. Plenty of people would accept this bargain rate on a £10 windfall. [\[Cont'd...\]](#) [1]

Two days later the deputy governor of the Bank of England Charles Bean stepped up to the plate with [this](#) [4]: "Savers should stop complaining about poor returns and *start spending to help the economy*" (my italics). So here again we have millions of people who, earning interest of less than a tenth of 10% are still refraining from spending on consumer goods, despite the encouragement of Mr Bean "encouragement which demonstrates almost unbelievable ignorance."

The point which is seemingly lost on both these worthies is that, as mentioned above, interest rates are reflective of people's time preferences, i.e. the price of time. In a market system, people's preferences are aggregated into a single price "in this case, a single interest rate for any given term and any given degree of risk. All those with longer time-preferences will save more at this rate, while those with shorter preferences will save less, and indeed many will be in borrowing territory."

In the long run, you cannot buck the market; all interest rates set from on high will have to gravitate to consumer preferences. But until they do, the market's normal signals are shot to pieces, misleading consumers, investors, and businesses. The structure of the economy, especially the time-structure, has no anchor. Broadly, this time-structure represents the size and nature of the capital employed and the period of production from raw materials to finished products. The developed world is simply a world that has developed very long production periods, which means more waiting time but huge pay-offs as the goods eventually come on stream in enormous quantity and quality. All of this is made possible by savers.

Yet here is the Bank of England, which is able to print money and able to rig the prices of time preferred by consumers, thus (presumably unknowingly) distorting the production structure of all goods until the

economy rebalances. Hence the recession and its continuation. And here is the deputy governor, encouraging savers to take action that will lower the living standards of us all. In case you didn't know, Mr Bean, savers do spend ? their savings are loaned to investors who buy capital equipment for production. Anybody can see that under a switch of consumer preferences from tea to coffee, the market makes a corresponding switch of the associated capital (and labour).

There would be mayhem if this shift were hijacked by the Bank of England. Yet here is Charles Bean, telling us that (via cashing in our savings) we should become latter-day Luddites, impoverishing ourselves and everybody else by removing capital equipment wholesale and across all industries. There is already evidence in the USA that the time-structure of goods has fallen and no doubt the same has happened here; perhaps our Central Bank would make itself useful and find out.

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