

## Does stimulus cure recession? [1]

Type: [Think Pieces](#)<sup>[2]</sup> Written by **Terry Arthur** | Friday 6 January 2012



*"If people won't spend, the Government must spend in their place" ? Christopher Smallwood*

Let us take a small fishing community as an example of how recessions work. They have a money in the form of tokens (easily manufactured and branded by their Government at negligible cost). We all know what happens if the number of these tokens is suddenly doubled. Prices double. If the doubling took place individually so that everyone got double overnight, then the prices ? all prices ? would double pretty quickly and, apart from the dreadful inconvenience, it would not matter too much (as long as repeats were not expected). But if the doubling occurred unevenly and if the process took a few months, say, then the path to universal price doubling would be very rough and fortunes and disasters would be commonplace.

If, for example, the under 30s got all the new tokens they would gain; but the spread of the corresponding loss would not be clear. If the under 30s bought fish then the fishermen would eventually react and some of the smart ones might even do a bit of stockpiling until prices rose. The boatbuilders would be even further down the queue. The original price relativities might never return, but eventually things would settle down much as before except for the one-off gains and losses caused by the uneven distributions of the new tokens.

But what would happen if the new tokens were not dropped down people's chimneys, but made available for lending ? at a knock down interest rate? I suggest something like the following sequence:

- Some of the boatbuilders will calculate, using these knock down rates and current ?token prices? of wood and fish, that they can continue what they are doing and invest in making some megaboats which take five years to get sea-borne. They borrow the tokens, buy some wood, take on labour and set to work.
- The labourers, hired from the fishing industry by offering higher rates, soon feel quite flush with tokens. They too hear about the loan facility and decide not only to eat more fish but also to build themselves some bigger and better wooden huts.
- Soon, however, the new demand from both the boatbuilders and their labourers begins to affect the price of wood. It also begins to affect the price of fish now that there is more demand and fewer fishermen since many of them have gone off to build boats. It has also affected the price of trees and land to build the huts on.
- To cap it all, the new loans of tokens have been exhausted. The private loan market has got very expensive as everyone wants fish today and not tomorrow, so time-preferences widen. The original loans to the boatbuilders also suffer a hike in their rates. The price of their input, wood, has gone

up and they are having to spend more on fish to stay alive because its price is higher too. They hastily recalculate and find that the megaboat idea is not on and will have to be abandoned.

- They dump their stocks of wood on the market and the price collapses. They hastily seek tokens (cash) to stay alive and this gives another twist to time-preferences and interest rates. They dump their labour back to the fishmarket which will not take them all on and which offers lower wages to those they accept.
- At the same time the labourers have to abandon their ideas about bigger huts, for similar reasons. The situation intensifies.
- A lot of the specialist tools which the boatbuilders made to help with their megaboat project become useless and they are no good for anything else.

I hope that some of this is familiar. With sincere apologies to F.A. Hayek, Ludwig von Mises and all those other wonderful economists of the Austrian School for my simplifications, this illustrates their theory of the business cycle. Injection of new money via credit expansion introduces false signals about interest rates to entrepreneurs, who then undertake projects and bid up the prices of the associated resources including labour. This in turn bids up the prices of consumer goods; it also adds to the clamour for credit and bids asset prices up further. The rise in the prices of consumer goods causes a compensating rise in nominal interest rates which triggers the collapse of the whole pack of cards. The following recession is inevitable and is in essence a restructuring following the liquidation of the original malinvestments caused by the false interest rate signal.

The important points to note concern capital goods. Firstly, at the outset there are no additional capital goods and the aggregate of the entrepreneur's plans (including the continuation of existing operations) is unattainable because resources are insufficient. Secondly capital goods are to some extent inflexible or inconvertible and those used in the new (false) projects are partially wasted. This fact, plus the rearrangement required for production to fit true consumer demand including their time-preferences, causes the recession.

### **Spare Capacity and Stimulation**

It may be argued: 'This is all very well in theory but it assumes that the economy was working to full capacity prior to the credit expansion. But if there were idle resources then the stimulation would work?'. This is the argument for stimulating a recession away once it has arrived. The stimulation need not be in the form of credit expansion. It could be in the form of crude inflation or contracyclical expenditure. Nowadays we do not hear so many arguments for crude inflation, although the old Keynes argument for stuffing pound notes into bottles, burying them and putting people to work to find them is now being revived. Marginally more sophisticated is the idea for 'contracyclical' public spending, especially 'capital' spending, like building new roads, railways, hospitals or other infrastructure. All of these arguments are based on the premise that there are idle resources - land, equipment and, most importantly, people. Would stimulation work, in these circumstances? The answer is no - whether we are formally in a recession or not.

In a market economy entrepreneurs normally see to it that resources are fully utilised. (They do not always get it right but who does?) 'Fully utilised' means that there is no additional activity which could be undertaken with costs (i.e. resources used) lower than prices (i.e. resources diverted from elsewhere including idleness).

A recession is different, of course; there are, unquestionably, idle resources including a significant percentage of the workforce and there are certainly potential productive uses. The problem is that you cannot 'ring fence' either the resources or the productive uses even if you know what they are. You

cannot put specific people to particular work, leaving the rest undisturbed. You cannot give them the right 'idle' tools ? you have to buy them and bid them away from other activities. And that assumes you can find them to buy, bearing in mind that capital goods are fully or partly specialised and never entirely flexible. If you pay the people to work without tools, or pay them not to work, you are back to crude inflation. If you resort to credit expansion you are adding insult to injury by compounding the original error. (That is not an argument for maintaining the absurdly high interest rates of 1991/92. In real terms, with inflation probably around nil in autumn 1992, they are still miles too high.)

The key to ending a recession is to know what caused it, namely malinvestment caused by credit expansion and now being liquidated. The only way of arresting these liquidations and ending the recession more quickly is through more saving and hence more capital goods which will make more of the existing projects profitable and thus avoid their liquidation. This is the exact opposite of the conventional cries for more consumer spending and cancellation of debt, because debt cancellation removes the need to save.

All the Government needs to do is remove interest rate distortions, get out of the way and watch the market work. On second thoughts, whilst you are removing distortions, how about clearing some of the barriers to employment you have erected over the years, from tax rates which rake off half the benefits of the division of labour in the first place, to a hundred and one pettifogging employment regulations?

Any economy is always in transition and this means, inevitably, some attendant additional idleness. Usually this 'unnecessary idleness' is relatively small; sometimes, like now, it is not. But it too is transitional. The problem with all talk about 'getting the economy going' is that it means getting yesterday's economy going, which is of course a futile quest. Yesterday was a Government- induced unsustainable boom and we must not forget that in the UK pretty well any period since the last World War has featured some form of stimulation by credit expansion and thus pretty well any period features transitions which would be described more accurately as 'corrections?'. These corrections are merely delayed and hampered by further stimulation or even the possibility of it.

## **Back To Saving**

They are not hampered, however, by a surfeit of saving. As suggested in Fable 1, it is ridiculous to talk of 'over-saving?'. Any extra saving simply nudges things in the direction of higher order goods from lower order goods. There is no such thing as being over-capital-intensive. In any sophisticated economy the role of plain saving (under the bed or stocking up of beans) is minimal and the vast bulk is 'capitalistic' saving which cannot fail to end up in capital formation. New capital goods take time, and labour, to build. There can be no question of having nothing to do!

In any case there are no ill effects of consumers paying off debt or even hoarding 'under the bed or elsewhere. Paying off debt to others who will thus take up any spending slack is clearly what the authorities like to call a 'transfer payment' which disappears on consolidation. Paying off net debt to the banking system (ultimately the Central Bank) may be 'deflation?' but there is nothing wrong with that since it is voluntary deflation ? another correction of mal- investment ? and the money relation (RPI if you like) will adjust accordingly. Hoarding will have a similar effect. Most modern 'hoarding?' is saving via the banking system but even if it is not there is no waste. Any excess of production over consumption means immediately and inevitably (however the excess is dealt with) that capital goods are created. (Stocks of baked beans are capital goods; they give the capacity to consume whilst building better methods of production.) All true wealth is fully embodied in capital goods and none of it becomes disembodied by shuffling around the paper claims to it.

There is no doubt that a sharp move towards increased saving could have severe short-term dislocations

because of the necessary shift up the order of capital goods (away from immediate consumption goods along the spectrum towards longer-term capital goods). But such a sharp move is hard to envisage (unless it is compensating for an earlier opposite sharp move; hence the long recession). Sharp moves like this have the Government behind them, not the market. In any case it is best that the economy restructures as quickly as possible (help to those dislocated is another issue) unless it is seen as a temporary fad and I would bet strongly against the Government being able to distinguish between a fad and a forever!

Any restructuring caused by a consumer-led savings increase is eased, co-ordinated and dampened by the market in the shape of market interest rates. Consumer preferences for greater saving mean lower time-preferences for the present against the future and thus lower interest rates. Or if you find it easier to follow supply/demand terminology, greater saving at attractively high interest rates will be accompanied by lower interest rates until demand for funds matches supply. These lower rates push entrepreneurs into longer projects to satisfy the new consumer preferences and all is smoothly achieved.

Here again (1990-92), the Government has been preoccupied with its own fad, namely the ERM. Interest rates were kept artificially high and the natural co-ordination referred to above was not being achieved. These high interest rates do not permit entrepreneurs to respond with longer-term projects and ? to the extent that they affect the private supply and demand for loans ? curtail economic activity anyway by ensuring (through price-fixing) that the market is not cleared.

This article is an extract from Terry Arthur's [\*The Consumer Failed to Deliver Last Year, And Other Fables\*](#) <sup>[3]</sup>, which was originally published in 1993.

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