Capitalism is bad at fiscal and monetary policy

Capitalism is bad at fiscal policy. Capitalism is also bad at monetary policy but that’s less apparent. You cannot hear a loud hum but you can hear a small bang.

I often wonder how effective central bank policy is at maintaining economic stability and price stability. Unfortunately I cannot observe comparable economies of size and complexity which do not have central banks actively managing inflation. Central banks who do not target inflation by and large manage dirty floats which import developed world monetary policy often to address mismatched sets of problems.

Perhaps it is a good idea for policy to be active only when price changes falls outside accepted bands, say +8% inflation to -3% deflation. Perhaps policy has no impact when price changes are within the range 0 to 5%. Perhaps policy is not necessary in the neighbourhood of this range. This is speculation that is hard to test.

The money multiplier measures the ability of the fractional reserve banking system to take a buck of real money and turn it into 8 or 9 bucks of … real money. Central banks control over this multiplier is via a required reserve ratio. It tells banks how much of each buck of cash deposit they can lend out. If the ratio is X, then the multiplier is 1/X. The proof is simple. Bank 1 lends out X which is deposited in bank 2 which can lend out X^2 and so on. The sum of this series is 1/X in the limit. But here is the problem that we face today. It requires that for every 1 buck, there is X bucks demand for credit. The appetite for credit just isn’t very robust. Companies have just come out of an acute recession.

Individuals have been over levered and over spending and now need to save. If the savings rate is increasing, the marginal propensity to consume must be falling and demand for personal credit must be falling. Even as central banks are expanding their balance sheets, banks just aren't. The actual money multiplier is shrinking.

The pessimist is worried that monetary policy is not working and that the disconnect between M0 and M2 is storing up future inflationary pressures of dangerous proportions. The optimist is happy that the printing of money has not had immediate inflationary effects and that households have increased their savings rates as they should to address the imbalances between East and West that had built up to the crisis of 2008. These, however, are the dynamics of household credit. What about corporate credit?

A low interest rate presents a low hurdle rate for investment. Corporate demand for credit will be dependent on product demand which is dependent on domestic and export demand. Domestic demand is a function of household propensity to consume. Export demand is dependent on a whole bunch of exogenous factors. It is sensitive to the terms of trade and thus exchange rate and inflation. As global growth recovers from the recession of 2008 and it becomes apparent that growth either is less robust than expected or less robust than necessary for tax receipts to pay down public debt, desperation often leads to beggar-thy-neighbour exports policies.

On the consumption side, one of the imbalances leading up to the crisis was a negative savings rate of the US consumer and a generally low savings rate in developed countries. Economists at the time prescribed prudent financial management and raising the savings rate. At the same time, they prescribed lowering savings rates in emerging economies like China as a means of correcting trade imbalances. The credit crisis had an instantaneous effect of reversing the direction of trade imbalances and addressing the domestic savings rates. Faced with lack of credit, US and rich world consumers had no choice but to increase savings rates. In addition, sudden risk aversion and uncertainty over investment portfolios, performance of pensions and employment prospects helped to raise savings rates. This manifests in a reduced marginal propensity to consume. What is individually rational collectively self defeating and detrimental to aggregate demand in what is known as the paradox of thrift. The paradox of thrift has several well known counterarguments.

– Slack demand leads to lower prices spurring demand.

– Savings are loanable funds representing an increase in potential lending. Consumer spending is offset by institutional lending.

– Assumes a closed economy. Savings may be invested abroad.

The problem faced today is that:

– Quantitative easing is balancing deflationary pressures. Moreover, price inflation is more prevalent in asset prices (claims on future goods) than in goods (current goods).

– Savings are loanable but its not just individuals who are hoarding money, institutions are hoarding money as well, as evidenced by the reduced multiplier. The expansion of central bank balance sheets has not found an analogous or proportional expansion of commercial bank balance sheets.

– The paradox of thrift actually holds for closed systems and the World is a closed system. In addition, trying to break the paradox at the domestic level leads to a beggar thy neighbour approach towards trade policy.

So the paradox of thrift is a real issue and likely to mean weaker real growth and less inflationary pressure.

In emerging markets, a larger proportion of income is spent on subsistence hence the marginal propensity to consume is not only higher but more stable. In more mature economies where incomes are higher, the proportion of income spent on subsistence is lower and thus the marginal propensity to consume is less stable. As government spending seeks to fill the deficiency, the transmission mechanism, the velocity of money, is a function of the marginal propensity to consume. Much as the fractional reserve system of banking has a multiplier, fiscal policy passes through a spending multiplier. That multiplier has in the current economic climate, been reduced. Where once government spending was multiplied, today it is being saved. Why? Because we can. Because greater uncertainty encourages more saving. Because the reaction to more inflation may perversely encourage cash hoarding. Because people make strategic errors. The result is a realization of the paradox of thrift at a global level.

The loss of the multiplier is not catastrophic as long as it is not counted on. It is therefore crucial that Government therefore directs its fiscal efforts at productive expenditure. If a road is built, it should be a toll road and a profitable one. If a railway needs to be built it has to be a profitable project. Bridges to nowhere lead to nowhere physically and fiscally.

Time is necessary for savings and consumption rates to stabilize and to reflect income and employment prospects and inflation expectations. It takes time for businesses to stabilize their demand for credit, for lenders to stabilize their risk aversion, for the banking system’s multiplier to re-establish itself. In the meantime there is little that capitalist systems can do to steer an economy in the path they wish.

For centrally planned economies the problem is not easy but it is easier. They have better short term control over the path of development of the economy, but over the longer term are hostage to the same noise and uncertainty, perhaps more so, than their capitalist counterparts.