<u>Stimulus Spending: Just how does that work?</u>

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Current dogma among our economist class informs us that when economies turn downward, deficit spending by governments is necessary to "stimulate" the economy: to support jobs, to keep people employed, to save us all. Well, I just don't see it. Perhaps degrees from Georgia Tech and MIT make me a little dense, but let's take a look at how this economy thing works.

Our nation produces a wide variety of goods and services. It takes a combination of capital and labor to produce these goods and services. If the producers can successfully exchange their goods and services for someone else's (at some price), income is obtained. Now, once we have income, we can consume or invest. That's really about it.

Now suppose I'm an ambitious soul and would like to increase my income next year and the years after. The only way for me to accomplish this is to increase my production. To do that, I need more capital. What I mean by that is that I need rental houses or a new tractor or a bulldozer or a new lath or new skills and knowledge; I need things that will enable me to provide a larger quantity of goods and services with my limited quantity of labors. Now the question arises as to how I can obtain this new capital? There are basically two ways: 1) I can consume less of my own income and invest the remainder in capital assets or 2) I can borrow excess income from someone else (their savings) and invest in capital assets. Either way, the means for me to acquire capital assets and increase my future production involves someone saving: not consuming a portion of their current income.

Back to the recession, a recession is a period of time where the nation produces less income than it did before. There are a variety of ways that this could come about. Perhaps the money supply shrinks and prices all decline. In this situation, we start out producing the same but that same production generates less income. This wouldn't be a problem except that wages tend to be a little "sticky". That is they tend to lag in their adjustment to prices. This causes unemployment to develop because there simply isn't enough income to pay everyone at current wages. At some point, as wages fall and unemployment rises, a new balancing point is reached. From there the economy can slowly begin to recover. A second path to recession might be mal-investment. Say a nation over-invests in housing. One day, everyone wakes up and there are too many houses for the number of people seeking one. This means a lot of production capacity goes idle: it can't produce because no one wants to buy its goods and services. Hence, production falls and so does the nation's income. With less income and those pesky "sticky" wages, unemployment develops and re-enforces the falling income. At some point, falling wages and rising unemployment balance out and the nation can begin to recover.

But what drives recovery? First, what is recovery: rising employment, rising production, rising income? Let's say we're trying to increase a nation's income. There are a couple ways we could go about this. One, we could inflate the money supply. This will drive prices (and income) upward and because of those pesky "sticky" wages, real wages will fall. This makes it cheaper to employ more people. With more people working, more is produced, thereby generating even more income. We're off to the races. A second path would be to increase capital assets so that the people currently employed could produce more. This requires investment, which requires savings, which requires consuming less of current income. Once the new capital assets come on line, more goods and services are produced, driving up income. Since we still have those pesky "sticky" wages, more income can employ more people at current wages. We're off to the races.

Now how does deficit spending by a government affect all of this? Well, if we're trying to go down the second path; the one where we invest our way out of the recession. Deficit spending is a killer. This is because deficit spending is financed from the savings that were going to finance the new capital assets. Instead of financing new capital assets and future production, savings get re-routed to consumption via government spending. Our recovery gets stalled. If we're trying to go down the first route, deficit spending might work. The government prints money and spends it. This increases the money supply, producing inflation, lowering real wages, increasing employment, and we're off to the races.

But are we really off to the races with inflation? This is a situation where too much of a good thing can bite you. Inflation offers an illusion of wealth without real wealth and this has consequences. When people feel wealthy (rising stock market, rising home prices, rising incomes), they tend to save less and consume more. Fewer savings means less investment and fewer new capital assets. In the long run, this process can slow the accumulation of capital assets, future production, and future income. If inflation is high enough so that the illusion is made clear (hyper-inflation), no income is saved. Income is consumed as fast as possible because it will buy less tomorrow. This kills the accumulation of new capital assets and completely stalls the growth in production. A widening divide grows between production and income. Income rises via price inflation, but production stalls and eventually falls due to the lack of savings. Everyone should take note that our ability to live (eat) is driven by production, not income.

One final point on consumption versus savings, some argue that when we save, income is not being spent. Baloney, saved income gets spent too. It by and large gets spent on capital assets. The ratio of consumption to investment drives how we orient our economy's production between consumer goods and services versus producer goods and services. When we consume more, fewer people work for Caterpillar, Deer and Co., and

Ingersoll Rand while more work for Southwest Airlines, McDonalds, and Sears. When we save, more people work for companies producing capital goods and services while fewer work for companies providing consumer goods and services. All income is spent every year; it is just a matter of on what and by whom.

If my fellow citizens want to put an end to the great recession, get the government to quite spending and borrowing so much. Our savings will flow into investments, new capital assets will accumulate, production will increase as will income, and employment will grow. If you like the great recession, keep growing the government and you'll be in heaven.