

The solution to our market crisis: more spending

By: KEITH RANKIN

Sometimes, to understand the big economic events, we need to think small, to reflect a little on the basic principles that underpin the economy.

In a global crisis, we must think globally rather than nationally. However, we need to think only of a small traditional market (and try not to think of the logistics of accommodating six million people on one site).

Traditional markets work because people go to the markets in the morning with goods or services to sell, and go home in the evening having bought other goods and services of equal market value. Everyone is a winner, because, to each individual, the goods bought are of greater value than the goods sold.

In the modern global economy, for most of us, our salaries represent the value of what we sell in the market. We sell services that others buy.

The equilibrium in a traditional market is upset when too many people sell more than they intend to buy. Such people are commonly called savers. Where savers are present, the market will clear only if enough other people intend to buy more than they sell. Such people are commonly called spenders.

If there is more saving than spending in the marketplace, some goods or services offered for sale remain unsold. The situation may be resolved, in part, by sellers discounting their unsold wares. The result is that some participants may end up buying more than they intended. Such a general process of discounting is known today as deflation.

More generally, surplus goods and services offered for sale simply remain unsold. The market experiences what in traditional times was known as a general glut. Today, it is called a recession. Deflation and excess supply together act as signals to produce and sell less. What happens more often than deflation and recession is that key institutions facilitate the process of spending that is required to balance the behaviour of the savers. The two main institutions that do this rebalancing are financial institutions - banks, for our simple purposes - and governments. The global economy has many governments, but no institution that can be called "the government".

Banks, through lending to the public, create debtor spenders that balance, without deflation, the underspending of creditor savers. Ideally, a large proportion of these debtor spenders will be business firms. Such firms' investment in capital goods leads to productivity growth and rising living standards.

One difficulty, however, is that, having spent their loans, debtors are required to underspend. Debtors are expected to service their debts rather than take on additional debts and become savers.

What this means is that, if banks are to successfully act as long-term economic stabilisers, today's savers are required to become tomorrow's spenders. If today's habitual underspenders who expect to receive interest from the banks refuse to buy sufficient goods and services from those to whom the savings were lent, the financial system becomes unstable. Crisis looms.

Financial crisis may be forestalled, however, by several years of banks lending to high-risk, subprime debtors, many of whom will inevitably default.

We can now understand 2003 to 2007 as years in which financial institutions maintained a sense of prosperity by creating new highly risky classes of debtor spenders to compensate for the continued underspending of the savers.

In the meantime, governments stabilise in two ways. First, by modifying the distribution of income through progressive tax and benefit payments, a new category of spenders, commonly known as beneficiaries, is enabled. Beneficiaries, by definition, buy more than they sell. And, because they do not have to go into debt to do this, their participation in the marketplace is commonly categorised as automatic stabilisation.

The final stabilisation role of governments is for governments themselves to become debtor spenders. To what extent should they do this? The simple answer is that to avert a general glut, governments should do this until the total excess spending of the spenders, including government, achieves a balance with the total amount of excess saving by the savers. In the present global crisis, governments are addressing this challenge, but on nothing like the scale required to fully alleviate a glutted market.

Globally, saving behaviour stands well in excess of spending behaviour in 2009. If habitual underspenders could bring themselves to spend more, the required size of the combined government response would be much less.

In the absence of a sufficient response from the world's governments and from the world's habitual savers, the global market economy can only shrink. To make matters worse, if savers, who are in a position to choose, respond to such shrinkage (global recession) by buying less, rather than by selling less, the logical endpoint is a global market that balances at zero.

It is spending, not thrift, that creates a market and gives energy to it. Markets with more sellers than buyers are unsustainable. This is equally true for the modern global economy as it is for traditional markets. Banks and governments can do only so much to prevent economic crises. Those of us who can buy much more in a glutted market, but choose not to, must take a share of the blame for the financial crises that beset us.

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