Title:
Market Failures And Business Cycles (Part 2)

Word Count:
1737

Summary:
Continued from Part 1 ....

Something reverse can happen which would be even more damaging than the just discussed case. Instead of Consumption growing at a faster rate than Savings, it might so happen that Savings and Investment grow at a much faster rate than Consumption. For example, prior to Great Depression, the importance of aggregate demand as explained by Keynes was not understood. As a result government policies normally favored huge Investments and were not geared...

Keywords:
business cycles,economics,threeway economics,economy,business,capitalism,economic theory

Article Body:
Continued from Part 1 ....

Something reverse can happen which would be even more damaging than the just discussed case. Instead of Consumption growing at a faster rate than Savings, it might so happen that Savings and Investment grow at a much faster rate than Consumption. For example, prior to Great Depression, the importance of aggregate demand as explained by Keynes was not understood. As a result government policies normally favored huge Investments and were not geared towards propelling aggregate demand. It is well documented that one of the reasons for the Great Depression was US government policies which led to uneven distribution of income heavily in favor of the rich and the consequent depletion of the buying power of the households. So Great depression could have easily resulted from Investment/Savings growing at a much faster rate than Consumption. Huge Investment/Savings would mean that huge surpluses are realized by the producers of the Consumption sector. This would prompt them to invest in an even bigger way in plant and machinery and this huge Investment/surplus pattern continues for a few years. After a few years, we have huge capacities with insufficient Consumption or buying power!

The capacities of production rise to an extent where the producers would not really be interested in investing their surpluses as they already have huge unutilized capacities much in excess of the buying power of the households. As a result Savings are not invested i.e. Investment lags behind Savings. Money is hoarded, the circular flow of income in the economy stops and the economy gets paralyzed. Demand gets constricted which in turn constricts Supply. These constrictions worsen the situation even more because, on account of drop in production, the percentage of unutilized capacities increases even more than before which makes Investment in new capacities even more unattractive further increasing the hoarded money. The economy gets involved in a vicious downward spiral that can dramatically reduce incomes and severely aggravate unemployment. Ultimately after a few years, some huge Investment opportunity prompts entrepreneurs to start investing all of the Savings and the economy restarts on the expansionary path. Or it can so happen that the huge excess capacities get destroyed on account of lack of demand – for example, some new technology makes plants with older technology unsuitable to the new needs and such plants and factories become useless. This way excess capacity is weeded out making the economy conducive for Investment and growth. I believe that most business cycles in US and Europe prior to 1930s occurred in this way, they were all mostly Investment propelled. I would call those cycles – the Investment led Business cycles.

How can stagflations occur? During the Consumption led cycles, after several years of growth, Consumption eats away into Savings and surpluses realized would fall short of expectations for the producers of Consumption sector. Savings are low and a correction is required by cutting Consumption and increasing the Savings. The extent of correction defines the strength of the next boom. If the correction is big and Savings are piled up in a large manner during the downturn, then, at the beginning of the next boom, it gives the chance for Consumption to nibble away at Savings slowly and steadily for a large number of years – booms can last very long. If the correction is very small, if Savings are not too large at the beginning of the boom, the boom is then nipped in the bud itself. As there are no large Savings made, as soon as Consumption tries to nibble away Savings, Savings would immediately fall below the danger mark and the surpluses expected by the Consumption sector are not realized and a recession would start as immediately as the boom starts. In such cases, the booms might not last for more than one or two years. Such cases of insufficient corrections can occur on account of government intervention. Government tries to arrest the downward slide by trying to propel the aggregate demand using expansionary policies such as cutting down interest rates or indulging in deficit spending. Government’s intention in doing so would be to arrest the downward slide and decrease unemployment. However the effect of the government intervention would be that, economy starts expanding even before the Consumption is cut and Savings are increased to the required extent. As the economy starts expanding, Consumption tries to eat away at Savings and this immediately brings the Savings below the danger level and an immediate onset of recession. More workers are fired and a downward slide starts once again. Once again the government intervenes and tries to arrest the slide and once again the same thing would repeat itself and more workers are fired. Unemployment keeps soaring. Ultimately the producers realize that low surpluses are here to stay along with expansion.

Apart from low surpluses there is the problem of rising interest rates. As the economy tries to expand, there would be good amount of Investment demand. However as Savings are low and Investment demand is high, there is a huge demand for the limited funds available causing the interest rates to rise vertically. Government borrowing and deficit spending in order to boost the economy eats into the already low Savings and aggravates the situation even further. The situation mimics that of a boom time when both short term and long term interest rates are very high. Abnormally high interest rates lead to cost-led inflation. Very high interest rates coupled with low surpluses make Investment as well as production expansion unattractive to the producers of the Consumption sector. They start pocketing their profits without either investing or expanding production and the economy starts stagnating without growth. Under normal circumstances, pocketing of profits would lead to hoarding of money and paralyze the economy on account of stoppage in the circulation of money. However in this case, on account of government’s expansionary policies as well as cost-led inflation, capitalists do not hoard the money as money would lose its value on account of inflation. They start spending the pocketed profits and the circulation of money is not disrupted.

However the demand does not increase despite the lack of hoarding – why? What should have been saved and invested is now being spent directly by the capitalists. The income that would have reached the hands of a hundred Investment workers is now in the hands of a single capitalist. As a result, where hundred toothpastes would have been purchased by hundred Investment workers, only one toothpaste is purchased by the solitary capitalist! As a result the demand for goods suffers despite the fact that money is not being hoarded. Capitalists are high earners; they consume a small portion of their income and start spending the rest of their income on speculation in real estate and shares. Shares and lands are bought and re-bought at higher and higher rates leading to a speculative bubble and soaring inflation. Housing becomes very costly and the workers find their buying power reduced as a large portion of their incomes goes in providing housing for themselves. Workers then start demanding for higher wages and periodic wage hike agreements become part of the wage agreements making inflation a relatively permanent phenomenon. Unlike what some economists say about the unreasonability of wage hike demands by labor unions, the wage hike demands of workers were actually beneficial to the stagflationary economies of the 70s. The hike demands of workers actually act as some sort of a small check on the speculation of capitalists – instead of wild speculation, some money in the hands of the capitalists gets diverted towards wage hikes. Overall, stagnation and inflation co-exist together. This is how you get stagflation.

There was a continuous boom for two decades in US and other nations during the 80s and 90s. How could the booms last so long during this period? The booms during this period were Investment led. Huge amounts of Investments in IT infrastructure propelled these booms. However these huge Investments in IT are completely different from those that propelled the Investment led booms prior to 1930s. The huge Investments prior to 1930s led to piling up of new capacities in a big way. This gave in to the chance of there being over-Investment on account of huge unutilized capacities which ultimately led to further Investment being unattractive thereby resulting in Investment lagging behind Savings. However the Investment of the 80s and 90s was not that way. Investment in IT technology did not increase the plant capacities. For example, more cars cannot be produced just because car companies invest huge sums in IT. Therefore depressions of the type that occurred prior to 1930s are ruled out and the boom lasts as long as the IT spending lasts. Why couldn’t Consumption eat into Savings during this period? On account of the fear of being replaced by computers, the bargaining power of the workers reduced dramatically upon which wage led and the subsequent cost led inflations were completely absent. Therefore producers could save their surpluses and invest them without having to spend them on increasing costs. Also the prime reason for Investment in IT being cost cutting, cost cutting ensured that Consumption would never eat into Savings. This way neither Consumption would eat into Savings nor would Savings/Investment lead to excess capacities. Both types of downturns are ruled out. Booms would last as long as the IT spending would last. This is how booms lasted so long during the 80s and the 90s leading to a virtual absence of business cycles.

That roughly sums up two and half centuries of Business Cycles!

A small note before closing out. From the capitalists’ point of view, it would be great if the households immediately spend all that they earn on Consumption – sales would get boosted. So household savings make a dent or a hole in Consumption. This hole is then filled by the immediate Investment of those household Savings. So the phenomenon of investing the household Savings is like digging a hole and filling it up. Therefore household Savings do not affect the financial position of an economy as much as the Capitalist Savings. A shrinkage in household Savings would not directly affect the margins of the firms. So just make a mental note that the above discussion on Savings had more to do with

Capitalist Savings and less to do with Household Savings.