Economics Myths

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Our original intention was to explain where we agreed and disagreed with the article by Cullen Roche at "Pragmatic Capitalism" (is there any other kind of capitalism?) titled "The Biggest Myths in Economics". Instead, while we are still going to refer extensively to the Roche article we will do so within the context of our own list of economics myths. We would have preferred to have kept our list to ten items, but it was a challenge just to restrict it to twelve. Unfortunately, our list is by no means comprehensive.

Myth #1: Banks "lend reserves"

This is the second myth in the Roche article. He is 100% correct when he states:

"*...banks don't make lending decisions based on the quantity of reserves they hold.* ***Banks lend to creditworthy customers who have demand for loans.*** *If there's no demand for loans it really doesn't matter whether the bank wants to make loans. Not that it could "lend out" its reserve anyhow. Reserves are held in the interbank system. The only place reserves go is to other banks. In other words, reserves don't leave the banking system so the entire concept of the money multiplier and banks "lending reserves" is misleading.*"

Any analyst who takes a cursory look at historical US bank lending and reserves data will see that **there has been no relationship between bank lending and bank reserves for at least the past few decades.** We live in hope that the economics textbooks will eventually be updated to reflect this reality, although compared to some of the other errors in the typical economics textbook, this one is minor.

Myth #2: The Fed's QE boosts bank reserves, but doesn't boost the money supply.

We've dealt with this myth at length in previous commentaries. Anyone who believes that the Fed's QE adds to bank reserves but not the money supply does not understand the mechanics of the asset monetisation process. **It's a fact that for every dollar of assets purchased by the Fed as part of its QE, one dollar is added to bank reserves at the Fed and one dollar is**

added to demand deposits within the economy (the demand deposits of the securities dealers that sell the assets to the Fed).

A related myth is that the Fed is powerless to expand the money supply if the commercial banks aren't expanding their loan books. It is certainly the case that prior to 2008 almost all new money was loaned into existence by commercial banks, but this wasn't because the Fed didn't have the ability to directly expand the money supply. From the Fed's perspective, there was simply no reason to use its direct money-creation ability prior to September of 2008.

In order to maintain the false belief that US monetary inflation requires commercial bank credit expansion an analyst must not only be unaware of QE mechanics, he must also ignore the readily available monetary and credit data. As evidence we point out that from the end of August-2008 through to the end of January-2014 **the US money supply (the sum of physical currency in circulation plus bank demand deposits plus bank savings deposits) increased by about $4.4T and commercial bank credit increased by about $1.1T, leaving about $3.3T of new money that cannot be explained by commercial bank expansion.** Not coincidentally, over the same period the Fed monetised about $3.3T of securities via its various QE programs.

Myth #3: The US government is running out of money and must pay back the national debt

This is the third myth in the Roche article. The reality is that no government will ever run short of money as long as its spending and debt are denominated in a currency it can create, either directly or indirectly (via a central bank). **The lack of any normal financial limit on the extent of government spending and borrowing is a very bad thing.**

Myth #4: The federal debt is a bill that each citizen is liable for

This is similar to the fourth myth in the Roche article, although the Roche explanation contains statements that are either misleading or wrong. Before we take issue with one of these statements, we note that a popular scare tactic is to divide the total government debt by the population to come up with a figure that supposedly represents a liability of every man, woman and child in the country. For example, according to http://www.usdebtclock.org/ the US Federal debt amounts to about $55,000 per citizen or $150,000 per taxpayer. For most people this is a lot of money, but it doesn't make sense to look at the government debt in this way. Rightly or wrongly, the government's debt will never be paid back. It will grow indefinitely, or at least until it gets defaulted on. **There are negative indirect consequences of a large government debt, but it is wrong to think of this debt as something that will have to be repaid by current citizens or future citizens.**

The Roche statement that we take issue with is: "*...the government doesn't necessarily reduce our children's living standards by issuing debt. In fact, the national debt is also a big chunk of the private sector's savings so these assets are, in a big way, a private sector benefit.*"

The government doesn't create wealth and therefore cannot possibly create real savings. To put it another way, real savings cannot be created out of thin air by the issuing of government debt. What happens when the government issues debt is that savings are diverted from the private sector to the government. In any single instance the government will not necessarily use the savings less efficiently than they would have been used by the private sector, **but logic and a veritable mountain of history tells us that, on average, government spending is less productive than private-sector spending. In fact, government spending is often COUNTER-productive.**

Myth #5: QE is not inflationary

Our fifth myth is the opposite of Cullen Roche's fifth myth. According to Roche, it's a myth that QE is inflationary. His argument:

"*Quantitative Easing (QE) ... involves the Fed expanding its balance sheet in order to alter the composition of the private sector's balance sheet. This means the Fed is creating new money and buying private sector assets like MBS or T-bonds. When the Fed buys these assets it is technically "printing" new money, but it is also effectively "unprinting" the T-bond or MBS from the private sector.* ***When people call QE "money printing" they imply that there is magically more money in the private sector which will chase more goods which will lead to higher inflation. But since QE doesn't change the private sector's net worth (because it's a simple swap)*** *the operation is actually a lot more like changing a savings account into a checking account. This isn't "money printing" in the sense that some imply.*"

There is a lot wrong with this argument. For starters, in one sentence he says "*when people call QE "money printing" they imply that there is magically more money in the private sector*", and yet in the preceding sentence he states that the Fed adds new money to the economy when it purchases assets. So, there is no need for anyone to imply that there is "magically more money" as a result of QE, because, as Mr. Roche himself admits, **the supply of money really does increase as a result of QE. (As an aside, recall that in the previous myth Mr. Roche implied that the government could magically increase the private sector's savings by going further into debt.)**

The instant after the Fed monetises some of the private sector's assets there will be more money, the same quantity of goods and less assets in the economy. Until the laws of supply and demand are repealed this will definitely have an inflationary effect, because there will now be more money 'chasing' the same quantity of goods and a smaller quantity of assets. However, the details of the effect will be impossible to predict, because the details will depend on how the new money is used. We can be confident that the initial effect of the new money will be to elevate the prices of the sorts of assets that were bought by the Fed, but what happens after that will depend on what the first receivers of the new money (the sellers of assets to the Fed) do, and then on what the second receivers of the new money do, and so on. **It's a high-probability bet that the new money will eventually work its way through the economy and lead to the sort of "price inflation" that the average economist worries about, but this could be many years down the track.** This type of "price inflation" problem hasn't emerged yet and probably won't emerge this year, but the price-related effects of the Fed's QE should be blatantly obvious to any rational observer. One of the most obvious is that despite being 6 years into a so-called "great de-leveraging", the S&P500 recently traded 17% above its 2007 peak.

Myth #6: Hyperinflation can be caused by factors unrelated to money

This is almost the opposite of Roche's sixth myth. He argues that hyperinflation is not caused by "money printing", but is, instead, caused by events such as the collapse of production, the loss of a war, and regime change or collapse.

While the events mentioned by Cullen Roche tend to precede hyperinflation, they only do so when they prompt a huge increase in the money supply. To put it another way, if these events do not lead to a huge increase in the money supply then they will not be followed by hyperinflation.

The fact is that hyperinflation requires both a large increase in the supply of money and a large decline in the desire to hold money. Over the past several years there has been a large increase in the US money supply, although certainly not large enough to cause hyperinflation, along with an increase in the desire to hold money that has partially offset the supply increase.

Myth #7: Increased government spending and borrowing drives up interest rates

This is almost the same as Roche's seventh myth. An increase in government spending and borrowing makes the economy less efficient and causes long-term economic progress to be slower than it would have been, but it doesn't necessarily drive up the yields on government bonds. This is **especially so during periods when deep-pocketed price-insensitive bond buyers such as the Fed and other central banks are very active in the market.**

Myth #8: The Fed provides a net benefit to the US economy

It never ceases to amaze us that people who understand that it would make no sense to have <u>central planners</u> setting the price of eggs believe that it is a good idea to have central planners setting the price of credit.

The real reason for the Fed's creation is of secondary importance. No conspiracy theory is required, because the fact is that even if the Fed were established with the best of intentions and even if it were managed by knowledgeable people with the best of intentions, it would be a bad idea. This is because the **Fed falsifies the price signals** that guide business and other investing decisions.

Myth #9: Different economic theories are needed in different circumstances

The myth that different times call for different economic theories, for example, that the valid theories of normal times must be discarded and replaced with other theories during economic depressions, has been popularised by Paul Krugman. However, he has only gone down this track because **he is in the business of promoting an illogical theory.**

A good economic theory will work, that is, it will explain why things happened the way they did and provide generally correct guidance about the likely future direct and indirect effects of current actions, under all circumstances. It will work for an individual on a desert island, it will work in a rural village and it will work in a bustling metropolis. It will work during periods of strong economic growth and it will work during depressions.

Myth #10: The economy is driven by changes in aggregate demand

The final three myths are the most destructive in our list.

The notion that the economy is driven by changes in aggregate demand, with recessions/depressions caused by mysterious declines in aggregate demand and periods of strong growth caused by equally mysterious increases in aggregate demand, is the basis of the Keynesian religion and the justification for countless counter-productive monetary and fiscal policies.

Rising consumption is an effect, not a cause, of economic growth. More specifically, an increase in consumption is at the end of a three-step sequence that has as its first two steps an increase in saving/investment and an increase in production. **For higher consumption to be sustainable it MUST be funded by an increase in production.** By the same token, an artificial boost in consumption (demand) caused by monetary and/or fiscal stimulus will be both unsustainable and wasteful. It is like eating the seed corn -- it helps satisfy hunger in the short-term, but ultimately results in less food.

A related point is that **there has never been "insufficient aggregate demand"** and there never will be "insufficient aggregate demand", at least not until everyone has everything they want. **In the real world, the ability to demand/consume is limited only by the ability to produce the right things.** Consequently, what is typically diagnosed as "insufficient aggregate demand" is actually insufficient production, or, to put it more accurately, a production-consumption mismatch resulting from the economy becoming geared-up to produce too many of some things and not enough of others.

Myth #11: Consumer spending is about 70% of the US economy

This and the previous myth are related, in that the wrong belief that consumer spending is 65%-70% of the total economy lends credence to the wrong belief that economic growth is caused by increasing consumption.

Consumer spending involves taking something out of the economy, so it is mathematically impossible for consumer spending to be more than 50% of the economy. Consumer spending does account for about 70% of US GDP, but that's only because the GDP calculation omits about half the economy **(GDP leaves out all intermediate stages of**

production). Due to the fact that the GDP calculation includes 100% of consumer spending and only about half the total economy, 35% would be a more accurate estimate of US consumer spending as a percentage of the total US economy.

Myth #12: Inflation is not a problem unless the CPI is rising quickly

The conventional wisdom that "inflation" is not a major concern unless the CPI is rising quickly is not only wrong, it is also dangerous. It is wrong because monetary inflation affects different prices in different ways at different times, but the resultant price distortions always end up causing economic problems. It is dangerous because it leads people to believe that there are no serious adverse consequences of central-bank money printing during periods when the prices included in the CPI are not among the prices that are being driven skyward by money printing.

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