

The Questionable State & Abusive Use Of Economics

Part 2



[Real Investment Advice](#) welcomes Ben Masters to our growing list of contributors. • Benjamin Masters is the creator, designer, and writer for [Third Wave Finance](#), With over ten years of experience working as a lead Portfolio Analyst, Ben brings additional insights into the discussion of economics, markets and portfolio management.

[Part 1 Of The Series](#)

The Continuous and Immediate Democracy of the Price System

So often the devastating social and economic events of our past have occurred due to • a misplaced • desire to ?fix? a problem. • For an illustration of the mechanism just look to • the disastrous implications of • forest fire suppression (also addressed by author and hedge fund manager Mark Spitznagel) ? an attempt to prevent damage to ecosystems by only allowing small fires to occur has allowed more • kindling to be built up to stoke even larger more disastrous fires. In a similar

fashion, current economic policies have ? in an attempt to ?fix? a problem ? moved the economy away from the continuous and immediate democracy of the price system; a system that can be thought of as a constantly adjusting balance. Every minute, of every hour, of every day individuals are *voting* on whether more or less of a product should be produced. •Every time they purchase an item they encourage its continued production at the expense of another item, and every time they decide not to buy they discourage its production, to the encouragement of another. If more individuals want a particular item, it is •difficult to keep it in stock, and the retailer is pushed to move the price up (if they don't then •they will underperform the competition who will move the price up). •But the price moves up because the majority of individuals agree *that it should be higher*; they desire the product more, •which draws individuals into the industry (seeking profits) and increases •production to meet demand. •By *voting* the price higher they are signaling desirability; when the •price moves up, the profits of the company selling the product •move up, more individuals enter the industry to follow •profit potential, and the price then moves *down* when more have entered the industry than are necessary to meet demand. •It's a cycle of adjustment based on the continuous and immediate *voting* of the individual ? the *voter* decides whether the price is reasonable. The shrinking or expansion of an industry depends on the desires of the majority. •If more people think that industry's product or service is reasonable, the price transitions up, encouraging individuals to leave less desirable industries behind to pursue the industry with more profits ? accommodating the desire of the majority. •If more people think the price is unreasonable, they refuse to buy, the price transitions down, and the industry shrinks as individuals move to pursue other industries that the majority does desire. So, in this fashion, the decisions of individuals ? on a moment-to-moment basis ? cause the change in prices and production. •If more people desire computers rather than •typewriters, the price of typewriters falls until it reaches the point where they are desirable again, and the typewriter industry is forced to lower prices based on the desire of the majority ? the industry shrinks based on the majority's preference for other items and services. **The continuous and immediate democracy of the price system is what calls into question the results •of artificial adjustment schemes ? those •results being that any adjustment to •this •voting system would, in effect, benefit a small group of individuals at the expense of the larger group; yet this is the nature of the •adjustment •schemes championed by all sorts of different groups and governments.** •The adjustments pursued include ?parity? pricing, tariffs, ?stabilizing? commodities, and price ?fixing?, among many others; their commonality is that they disrupt the democratic price system, allow a smaller group to inhibit the desires of the larger group, and are still being used. Leaving a much lengthier discussion to other sources, a few examples may be of use here. •Of the many examples of adjustment (or manipulation) previously listed, one would be the attempt to keep a price level artificially high. •In an attempt to save a dying industry the price for the product is held above the price *voted* on by the majority. •In this case the industry benefits (a minority of the population) at the expense of the majority who now have to pay more than they would otherwise deem reasonable. •The money above what they were willing to pay will now flow toward the ?adjusted? industry and away from a different, more desirable one. The effect •of this attempt to manipulate the democratic price system is a temporary •(short-term) •benefit to the supported industry (the small group) at the expense of the larger group; yet since the majority is negatively affected, and the smaller group is not isolated (they are also dependent on others), the smaller group will eventually be negatively affected as well as the cycle continues. •This is, in essence, the *wildfire suppression scenario* ? •prevent •fires (prevent the death of an undesirable industry) only to have to deal with larger fires (the majority is negatively affected and in turn •negatively affects the smaller group). **The significance is that the manipulation of the equilibrium moves the majority to a lesser-desired state, encouraging a waste of raw materials and a squandering of time, both of which are used up on industries that are not as desirable as others ? a misallocation of capital and an aggregate hindrance to the economy.**

Technological Progress: Cessation of Industries = Progress for Others

Unfortunately, due to the custom of ?specialization? (a person typically works in one industry), the individual effects of technological progress and invention can often be disastrous for some (those working in the industry with reduced demand), even though the change provides an aggregate benefit to the majority. **By its very nature that reduced demand for the failing industry is due to a demand for other more-desirable items. •This is not a new process. •It has occurred throughout history. •The mechanical revolution displaced so many that people that some thought work would become obsolete.** The same progress has continued to occur: the dwindling of the typewriter industry due to the boom of the computer industry and the loss of cashiers to automation, among many, many others. •But there are other jobs created that are not so easily recognized; the machines created to replace cashiers have also created jobs ? designers, manufacturers, etc. •Labor moves to the desirable industries and creates new ones. •Technological advancement can even create demand in an industry if it reduces the price of the item to the point where individuals want more. **The cessation of undesirable industries results in progress for desirable ones; the outcome is a social benefit to the majority and an unfortunate, temporary, expense for a smaller group. •The best solution isn't to prevent progress, but to allow for mobility between industries ? to ease the transition, to encourage movement •to existing *in-demand* industries and to those new industries yet to be created.** Unless everyone's desires are completely satisfied there is still progress to be made. •It's when individuals are freed from undesirable industries that their faculties are applied to the desires of the majority. •The worse outcome is for groups and governments to manipulate and encourage undesirable industries to use up finite raw materials and time when the actual demand of the majority lies elsewhere.

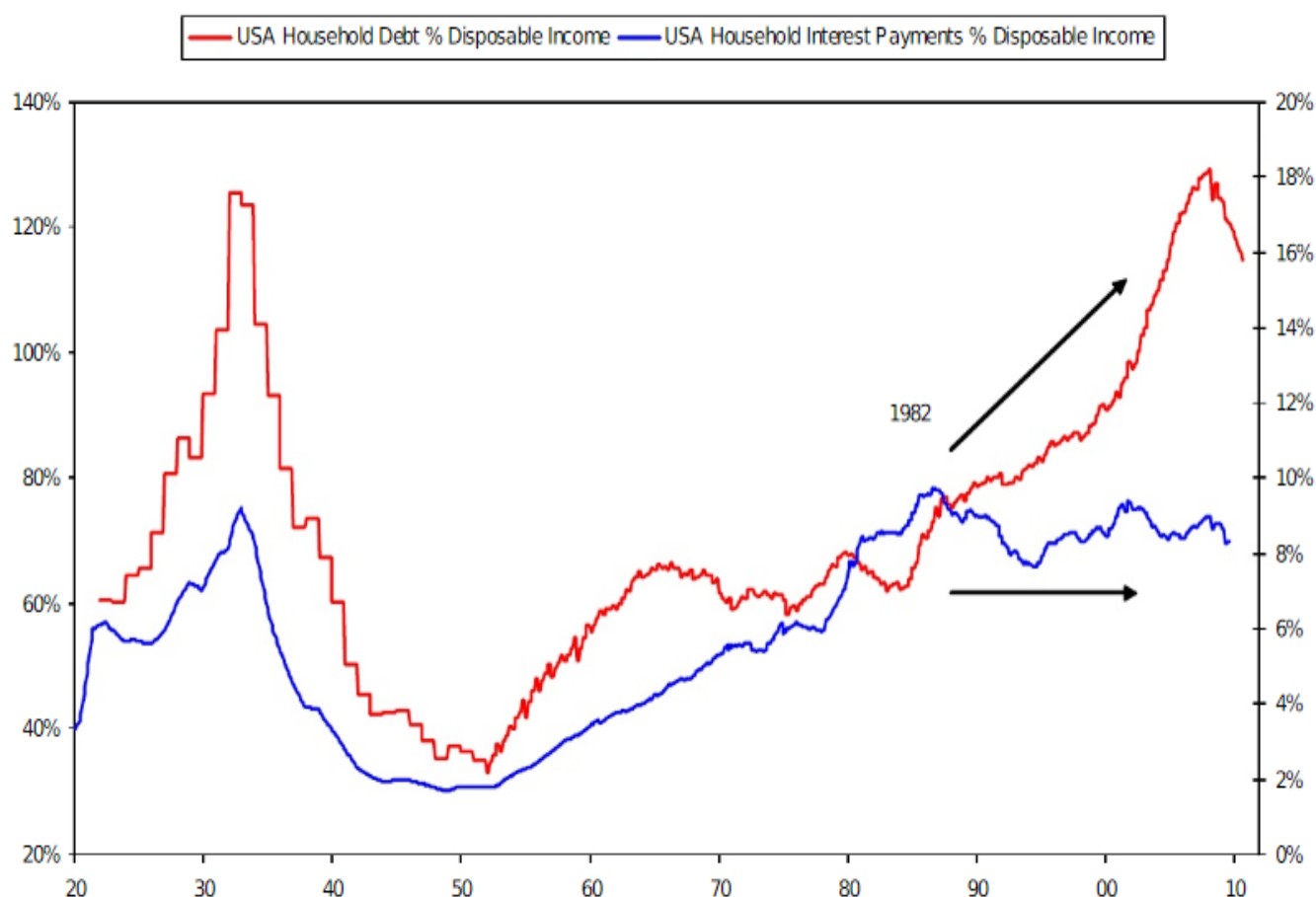
?If it were indeed true that the introduction of labor-saving machinery is a cause of constantly mounting unemployment and misery, the logical conclusions to be drawn would be revolutionary, not only in the technical field but for our whole concept of civilization. •Not only should we have to regard all further technical progress as a calamity; we should have to regard all past technical progress with equal horror? ?It follows that it is just as essential for the health of a dynamic economy that dying industries should be allowed to die as that growing industries should be allowed to grow. •For the dying industries absorb labor and capital that should be released for the growing industries.?? Henry Hazlitt (H.H.)

Returning to the topic of economic policy, one can see the *wildfire suppression scenario* occurring once again. •The attempt to pull growth forward by reducing interest rates (and using •experimental policies, i.e. large-scale asset purchases) is •effectively encouraging short-term benefits (fire suppression) at the expense of long-term benefits (a worse outcome, larger fires). •One could argue that the market crises and stock manias of the 21st century have been more •severe because risk (kindling) has been allowed to build. Since the 1980s the Fed has been encouraging debt-based spending to attempt to counter slowing economic growth ? they influence interest rates lower (*you get paid less interest in your bank account*), and by doing so they're attempting to make debt more attractive due to it being more ?affordable? (*individuals pay less in interest when they take on debt*) ; individuals may then borrow more and spend more to boost economic growth.

Effective Federal Funds Rate (%)

25.00

DEBT LEVELS ROSE RAPIDLY WHILE DEBT SERVICE DID NOT



Source: Global Financial Data Inc. and Bridgewater Analysis.

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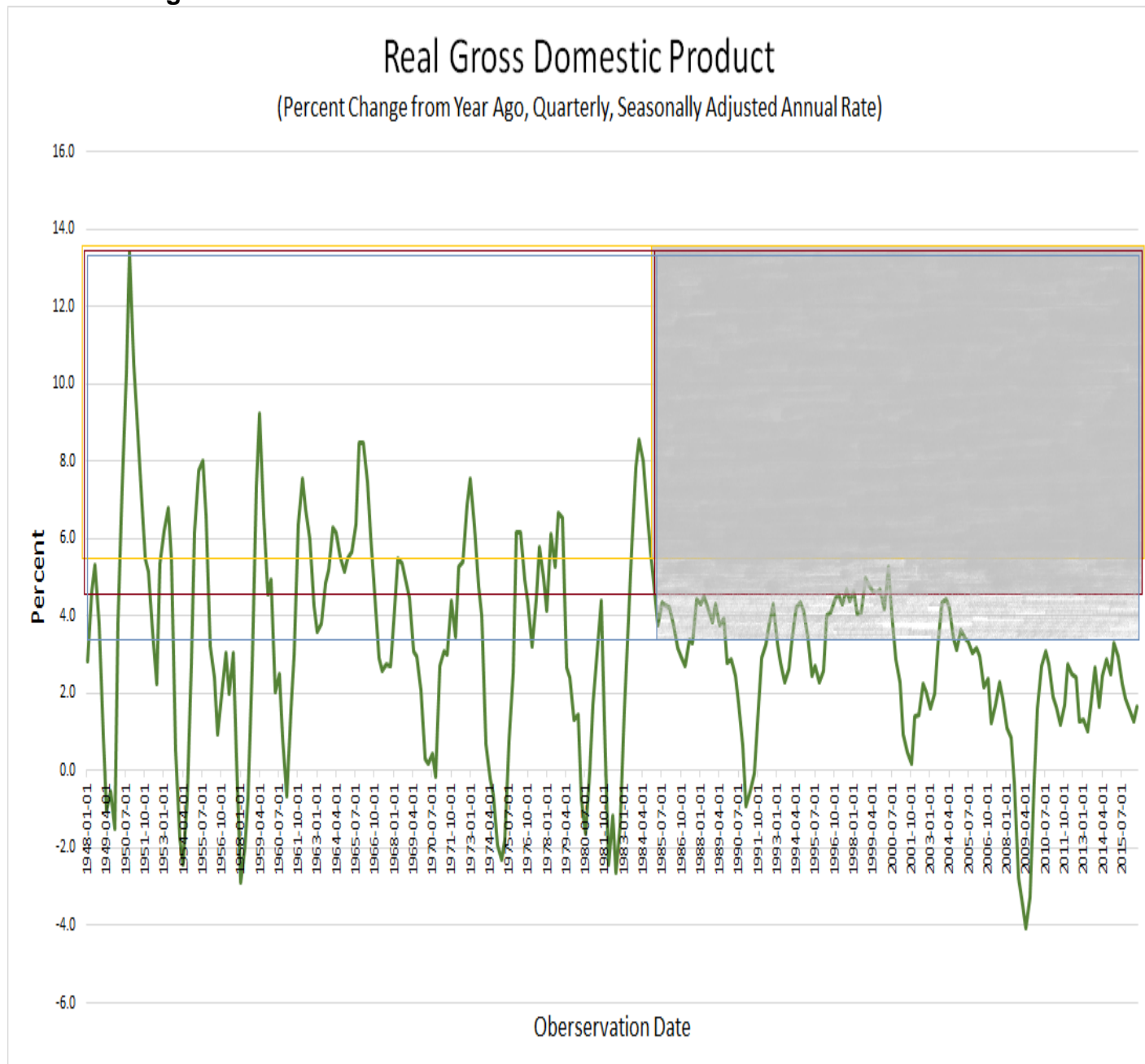
However there is a ?catch?: although more debt and more economic growth may occur **temporarily** due to the reduction of the interest rate target, the **productiveness-of-the-debt** determines the long-run outcome. • If the debt is productive ? i.e. creates an income stream to repay the principal (*original amount borrowed*) and the interest on the debt ? then long-run growth may not flag due to the debt; yet if the debt is unproductive and/or counter-productive then economic growth is constrained in the long run. • One of the most important measures of the productiveness-of-debt is the velocity of money.

M2 Velocity of Money

(Velocity = GDP / M2 Money Stock; Quarterly, Seasonally Adjusted)



The more serious implications of economic policy, however, are for the broad economy and country (the stock market is only a portion of the economy). **A misallocation of capital and investment, due to economic policy, slows growth and results in zombie industries kept alive by the continued attempt to manipulate the democratic price system; it creates an undesirable imbalance ? a temporary benefit to a small group at the expense of a larger group, which in turn inhibits growth.**



Citation: U.S. Bureau of Economic Analysis, Real Gross Domestic Product [GDPC1], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/GDPC1>, January 15, 2017.

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