Money Makes the World Go Around

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When fourth-quarter earnings reporting started last week, many analysts and prognosticators admitted that the economy looks better than they had predicted. The big banks were the first to report and the Wall Street Journal's lead article on Saturday was entitled: "Strong Economy Boosts Banks' Results" illustrating that consumers and businesses remain on solid ground. How could this happen after several economists proclaimed that we were in a recession with many more stating that we were just a couple of quarters away from a downturn? Now the latest consensus is for an economic "soft landing" -- whatever that means. The disruption brought about by the government's gift-giving response to the pandemic seems to have finally gone away and the economy appears to be back on a normal growth path.

One explanation for the economy's strength is that money is sticky. By that, we mean money is used to facilitate transactions. When the government funded the pandemic with $5+ trillion in spending two years ago, that money went into transactions over and over but did not disappear. Each recipient of that largesse either spent the money or saved it. In either case, these actions contributed to economic activity by transferring money to another entity, and so on as we have written about before in these Missives. One of the beneficiaries of these economic transfers is the government as there are tax revenues each time a transaction takes place. As the economy expands, the government's revenues expand as well. The record size of that pandemic spending keeps on giving as the economy is "funded" by that spending and ongoing tax collections.

An important implication of this process is that government spending contributes to overall economic activity especially if it is deficit spending. One key point is that deficit spending cannot be so large that it creates a demand surge that contributes to accelerating inflation which is exactly what happened this time around. Inflation surged close to double-digits indicating that the size of the government's response was too much -- especially since the private sector shrank due to the forced economic shutdown. For the next couple of years, there will be an interesting comparison between the amount of government deficit spending and the level of inflation.

The second headline in Saturday's Journal was: "Wary World Watches as Prices Fall in China." Somehow deflation had become a dirty word and only occurred because of falling demand. The misunderstanding about a price decline is whether that drop emanates from weakening demand or increasing supply. Often the supply side of the equation is ignored as there are few historical examples of deflation based on falling prices based on increasing supply. One strong example of this supply-side deflation was the Industrial Revolution which triggered an enormous increase in supply and much lower prices. If you have been looking for a TV lately or expanded computer memory you will see that prices have fallen dramatically. In other words, deflation can be good or bad depending on whether it originates from a demand shock or a supply shock.

Both monetary and fiscal policy can create or destroy money. High/low-interest rates or budget deficits/surpluses can do that and, in the process, undermine economic growth. In other words, keep the money coming!