Replacing the Binge and Bubble Economy

by Keith Rankin, 26 November 2008

The latest United States Treasury rescue package (25 November) reveals just how important consumer debt was as a fuel to world economic growth in the mid-2000s (2003-07).

The US Treasury seeks to reignite the consumer credit market as a means to achieving economic recovery. The problem with this solution is that the banks and other lending institutions then had a very cavalier attitude to risk. Now those financial intermediaries have become risk-averse. They will not lend sufficiently to the financially stretched households whose spending our economies still need. Further, many if not most such households will not be seeking extra debt, even if interest rates are very low.

It will take several years before banks once again adopt the risky lending habits that had been an essential part of the growth rates that western governments have been quick to take credit for.

What really happened was that the banks had become a de facto social welfare agency. Income recycling by the banks happened in large part because of the marked increase in income inequality that dates back to the 1980s.

Business fixed capital investment – crucial to economic growth – depends on business confidence which is the faith that spending by ordinary households will continue to grow.

Current bank lending criteria prohibit the banks from replaying that income recycling role in the foreseeable future. So an alternative mechanism is required to enable the recycling of the vast savings of the world's rich to those low and middle income households (the relatively poor) whose spending is central to the generation of future profits and growth.

There are two ways this can happen. Governments may guarantee risky consumer lending, removing that element of risk that deters banks now and in the foreseeable future. This solution is unsatisfactory because it simply validates loose lending practices.

Alternatively, governments themselves borrow heavily (so long as the downturn lasts), and channel a significant portion of those borrowed funds to those relatively low income households whose spending is a prerequisite to recovery. This means a substantial program of income security – tax cuts or tax credits that specifically target relatively poor households.

It is not hard to design tax regimes that achieve these aims. Nevertheless they are seen as radical by most politicians. Non-refundable tax credits (otherwise known as personal tax rebates) were a part of New Zealand's tax landscape from 1974 to 1978, and are an important feature of some countries' tax systems today (eg Canada, Ireland). These credits can enable many low-income recipients to pay no income tax at all.

A tentative system of non-refundable tax credits will be introduced in New Zealand in April. It's called the Independent Earner Rebate, and, by April 2010, will take $15 per week off the tax liability of many New Zealand tax payers in the "relatively poor" target group.

Even better than non-refundable tax credits would be a comprehensive system of refundable tax credits, which would see some low income recipients "paying" income tax at negative rates. New Zealand Superannuation is a limited form of refundable tax credit.

Whatever the exact details, the recovery of the capitalist economies requires a return to financial intermediation on a scale approaching that of the mid-2000s. A large proportion of new lending will either have to be government guaranteed, or, better still, lending directly to the governments who are best placed to recycle those loans to where they are most needed. Governments are perfect customers for banks during recessions.

Thus, governments will need to run large fiscal deficits over the next five years or so. We know from history that even the deficits run by the Roosevelt Government in the USA in the 1930s (the New Deal) were insufficiently large to pull the USA out of the 1930s' Depression. It was only war spending in the 1940s that created Budget deficits sufficiently large to meet the task at hand.

The fundamental problem is the concentration of spending power among people who do not want to spend, and the paucity of spending power among people with unmet needs. In the long run, the profits of the rich depend critically on the spending of the relatively poor.

In recent years, capitalist economies have grown through debt-fuelled binge spending on housing and consumer goods. The recipients of this debt-fuelled spending saved their profits and capital gains by buying financial assets to an unprecedented extent, creating the asset price bubbles that became valued in the aggregate at levels quite unconnected from the amounts of goods and services that were available in real economies.

The world's financial system became an unstable money-recycling system.

Governments – through their Inland Revenue departments – can run better money-recycling schemes than can profit-seeking banks. By allowing the relatively poor to have more of the world's spending power *as of right* – rather than as debt – then the circular flow of spending and income can operate in a more stable fashion. Successful capitalist economies depend on good public-sector institutions.

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