

Production Can't Be Faked

A common assertion made about the U.S. economy is that current production levels are somehow unsustainable. These arguments are buttressed by sentences like “our economy is totally based on debt” or “the Fed is artificially propping up production with cheap money”. The people who say this are awfully confident and their gist is that “it’s all one huge bubble, and it’s going to pop, just you wait!”.

NGDP Adviser's position is that *Production Can't Be Faked*. What an economy is able to produce in one year, is a good estimate for the bare minimum of what it will be able to produce in another year. This is especially important in a diversified economy like the US, where exported oil and mining products (a fixed supply) are a trivial part of GDP. If the central bank tightens monetary policy and drives spending down, or substantially slows the growth rate in spending, it’s likely that the frictions in the economy would result in fewer goods and services produced, but the point is, in a demand-side recession, more goods and services *could* have been produced. The previous production wasn’t ‘fake’ or unsustainable, you simply need to give more fuel to the fire, you simply need to manage your monetary policy in a manner such that spending growth remains relatively stable.

Many worry about debt and rightly so. Consumer or government debt might well have implications for a specific business, but in terms of what the economy is able to produce (think of that production index we call real GDP), how many people are employed and so on, debt (an agreement to let other people have your nominal spending power) is not particularly relevant. Instead, what matters is the physical capital on the ground, and the skills, ideas and plans in peoples’ heads, along with the amount of money the central bank chooses to supply to allow those ideas, skills and capital to produce things.

This notion that production can’t be faked ties in with Adam Smith’s famous saying that “There is a lot of ruin in a nation”. The idea here is that government policy can be wrongheaded, for a long time, before burning through the accumulated cultural and physical capital of a nation. To show this point, let’s think about the tragic history of the two most interesting states of the 20th century: Germany and the Russian Empire/Soviet Union.

Russia entered the First World War with a lot of potential. Hundreds of millions of talented, hardy people who had shown great potential working in Russia’s budding manufacturing sector. Through the course of the First war, the civil war, the Trotskyist terrors, the Stalinist era and the unfathomable suffering and struggle of the war against Germany, the now-Soviet Union could be said to have “gone through the wringer”. Yet, by the early 1960s the Soviet Union was putting men into space, running a global empire and producing consumer goods, all without the benefit of a coherent pricing system or labor mobility. This is not to praise the Soviet system, merely to point out the extremes an economy can be subjected to while still retaining a basic level of productive ability. What mattered, at the end of the day, was the skills of the people and the capital on the ground. Russia could default on its debt, expropriate asset owners, and do all the rest, yet it wasn’t enough to cause some huge, enduring decline in living standards. The Soviet Union wasn’t a whole lot of fun, but it sort of worked.

Germany is perhaps an even better case because West Germany was a more unambiguous success. Think of all the losses in the First war, the political instability, the hyperinflation, the deflation, the economic planning, the war, the bombings, millions dead, massive territorial loss and post-war debt that Germany experienced. Yet, by the 1960s, the West German rump state was exporting goods to the whole world, servicing a mountainous national debt with ease, building an expensive welfare state and having a baby boom. A lot of ruin in that nation!

With these examples of industrial societies experiencing chaos in mind, which are frankly unimaginable for us 21st century people, it seems absurd to predict significant economic disturbances from people merely borrowing a bit too much to buy cars and houses. Where is the actual threat to the supply side?

Rather than looking at the high debt levels of the English speaking world, Scandinavia or Japan as harbingers of impending economic collapse, we should instead see them as the logical result of long-lived economic and political stability. Indeed, it is those countries which have living memory of chaos, where the fear of debt is highest: Hong Kong, Taiwan, South Korea, East Germany, the Former Soviet Bloc and Argentina.

Imagine if everyone in the US or UK decided to max out their credit cards, take out home equity loans, run their debt to the limit. What would happen? Would we all suddenly forget how to do our jobs? Would the equipment used at peoples' jobs disappear? Would the courts and government offices lose their ability to render judgments and move bundles of paper from Box A to Box B? Clearly the means to keep the economy going would still be in place. It would merely be a question of coordinating human activity in a manner to keep production of goods and services up. In other words, it would merely be a question of keeping nominal spending growing along a path in line with recent expectations.

I can't think of a single example of a country that gummed up the gears of its economy with debt, to the point where nominal GDP or employment fell and the central bank was powerless to do anything about it. The economy is complicated, and I'm inherently distrustful of models detached from real world examples, point to one to prove me wrong. Now, it is true that petro states can fall apart, like Venezuela has, but that's not a case of domestic production, that's a case of imports declining. The problem in Venezuela is they don't have the US dollars they need to bring in all the rest of the things their long-mismanaged economy can't produce.

Borrowing a lot is probably a bad idea for your long-term well-being, especially if it's for something of fleeting utility. High personal debt hinders the individual's ability to run a household, and it's probably true that America has caused a bit of a sociological problem by depressing the fertility of the "Millennial" generation through ruinous college debt. But those Millennials are still producing goods and services and the long term effects will be hard to estimate and probably not of huge significance. Production isn't ever 'fake'.