Economics 101 Meets “The Art of the Impossible”

Here we are at the start of a new year. *Saturday Briefing* has been coming out every week for 25 years – nearly 1,300 issues since its debut on January 21, 1984 – and we now begin our second quarter century of publication!

This is going to be a challenging year. The U.S. Congress and the incoming Obama administration are already at work trying to come up with programs that will quickly solve the economic woes of our nation and perhaps the world. Unfortunately every proposal seems to include more government involvement, regulation, and spending. That does not sound like a good prescription to me.

In my college days, I learned in Economics 101 the basic facts about the relationship between supply and demand. Those facts are simple: In a free market, price will make the supply of goods and services equal the demand for them. If there is an oversupply of something, its price will drop, stimulating additional demand and eliminating the oversupply. If something is in short supply, prices will rise to reduce demand and eliminate the shortage.

The rules of supply and demand are based on human nature, they are as unchanging as the law of gravity, and they are still valid today.

University of California economist Hal Varian points out that in today’s world, there are:

Two sources of supply – domestic production and imports.

Four sources of demand – consumption, investment, government, and exports.

The banking, stock market, and real estate collapses and rising unemployment (currently 7.2 percent) have led people to consume less and save more. The drop in consumption has decreased demand. The increase in savings would normally lead to a rise in investment that would boost demand, let the free market flourish and lead the way to a recovery that would create new jobs and benefit everyone. Travelers would once again fill airline seats, cruise berths, Amtrak cars, restaurant booths, and hotel beds!

But this week Congress and the incoming Obama administration are focused on quickly passing a $1 trillion stimulus package, the details of which are not yet clear, but which, I fear, could hinder the increase in private investment needed for economic recovery.

To put $1 trillion into perspective, it is a million dollars a million times over, or a billion dollars a thousand times over. However you look at it, it’s a sum way too big for most of us to grasp.

The Wall Street Journal calculates that $1 trillion is nearly one-third of current government spending, 13 percent of the vast U.S. economy and more than the gross domestic product (GDP – the value of all the goods and services produced in a nation’s economy) of all but 12 of the world’s largest countries in 2007. It is also more than the U.S. government has ever spent on any single effort in history, except for the cost of fighting World War II.

This huge government-produced demand will make it hard for the other sources of demand (consumption, investment, and exports) to find the capital they need to lead the recovery. Why? Because government will compete with investment and consumption (i.e., our standard of living) for people’s money. What form does this competition take? First, taxes. And second, when tax revenues prove inadequate to fund the extra trillion dollars of government spending, the government will simply exercise its exclusive right to print money. The problem with printing too much money is that it leads to inflation, and in the long run inflation hurts both the economy and people’s individual financial well-being.

I can still see my Econ 101 professor drawing charts on the board driving home the lesson that when demand exceeds supply, prices go up (i.e., you get inflation).

Columnist Thomas Sowell says, “Politics is the ‘art of the impossible.’ Voters can get the possible on their own. You want the impossible? You got it. Politicians don’t get elected by saying ‘no’ to voters.”

Massive government spending to combat recession has been tried time and time again, even before British economist John Maynard Keynes made it popular in the 1930s. Keynesian spending fell out of favor after the 1970s as people realized that it led to reduced investment by the private sector, joblessness, and inflation.

By contrast, people found that a reduction in government size, taxation and spending, and a corresponding increase in economic freedom led to job growth and economic revitalization.

Regrettably, those lessons seem to have been forgotten, and once again our politicians are saying it’s possible to have massive government spending without inflation, joblessness, and loss of freedom. “We promise,” they say. “Cross our hearts. Yes we can!”