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Commentary

Recession And Recovery

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In 1931--before he was befuddled by Keynesian economics--John Maynard Keynes explained that "The fall in prices relative to costs, together with the psychological effect of high taxation has destroyed the necessary incentive to production." There was, he added, "no possible means of curing unemployment except by restoring to employers a proper margin of profit."

By emphasizing *incentives to produce*, rather than incentives to consume, the early Keynes was evoking classical, supply-side analytics. Whenever profit margins are tightly squeezed--whether by costs of labor, energy, taxes and/or debt service--the result is a periodic episode of cost-cutting called "recession." Once the cost-cutting and inventory trimming achieves its purpose, profits and the economy recover.

Keynes was writing about an absolute "fall in prices relative to costs," during deflation. But the effect is the same if costs rise *relatively* faster than prices. Among U.S. nonfinancial corporations, for example, *unit labor costs* rose 3.4% in 2007 while prices rose only 1.7%. In 2008, labor costs rose 1.1%, but prices received by nonfinancial firms did not rise at all. After subtracting additional costs for energy and interest expense, *nonfinancial corporate profits per unit of output fell 8.8% in 2007 and 10.4% in 2008*.

The one thing that *all* recessions have in common is that profits shrink, often becoming losses. In last year's fourth quarter alone, corporate profits fell 29.5%.

Profits are the spark and fuel that keeps the economy's engines running.

Profits do not simply depend on sales volume, as commonly believed, but also on the critical relationship Keynes emphasized between marginal costs and prices. *If General Motors is losing $2,000 on every small car it sells, it won't help to sell more small cars.* Car companies and home builders could sell many more cars and homes if they'd cut prices by 25%, but they'd go broke in the process.

Firms have been laying off workers because they were facing falling profits or losses. And stock prices were falling until March 9 because earnings per share were falling. The stock market is an excellent predictor of consumer confidence, not the other way around.

Consumers rarely lack incentives to spend, but producers sometimes lack incentives to produce (i.e., after-tax profits). Households *postpone* buying new homes or cars when firms are laying off workers and stock prices are falling. Improving the "incentive to production" generates the income and wealth to *finance* consumer spending.

Unfortunately, those who view such facts dimly through the prism of *demand-side* economics are habitually inclined to see no way out of recession. The consumer is responsible for over 70% of GDP, they remind us endlessly. Yet unemployment will keep climbing for a year or more, supposedly slashing incomes of the jobless and making others too fearful to spend. To make matters worse, they say, people are saving more (horrors!) and borrowing less.

The fundamental error behind this familiar mantra is what I call "the demand-side fallacy." It involves confusing the *use* of income (consumer spending and saving) with the *source* of income (profitable business).

Viewed from the supply side, *private industries accounted for 87.1% of GDP* in 2008. Retail trade--what many people erroneously think of as consumption--accounted for only 6.2% of GDP; the federal government for just 4.1%.

So long as so many private industries were *not* generating a "proper margin of profit," the government's costly efforts to "stimulate" federal spending and retail shopping could not possibly have much sustained impact on the *sources* of GDP, particularly since those nostrums involved borrowing against future income and future taxes.

Even on their own terms, demand-siders' skepticism about the incipient recovery is inconsistent with the curiously unreported fact that real disposable personal income has increased since last August. Real DPI increased at 2.7% annual rate in the fourth quarter and 6.2% in the first. Regardless of rising unemployment (a lagging indicator), *real consumer buying power is going up* not down. That rarely mentioned good news, in turn, is largely due to *lower inflation*--a welcome cyclical phenomenon demand-siders often decry as deflation. People respond well to bargains, including discounting California's overpriced homes.

The 2007-2008 squeeze on profits margins was a *real* phenomenon with financial consequences. Profitability did not begin falling in 2007 because of insufficient corporate borrowing--quite the contrary as I've shown before. Many indicators commonly described as measures of financial stress, such as wide spreads between high-yield and Treasury bonds, are likewise measures of *real* rather than financial problems (namely, risk of default due to costs exceeding revenue).

Unlike politicians, business managers have both the information and incentive needed to repair threats to their firms' profitability. But the process is painful and time-consuming since it involves cutting inventories and waste, laying off redundant employees, selling marginal properties to better managers, etc. When profitability is restored, the economy recovers. That is, in fact, what the stock market rightly senses is starting to happen right about now.

Alan Reynolds is a senior fellow with the Cato Institute. (Brian S. Wesbury and Robert Stein's column will appear tomorrow.)