ASPERA BULLETIN

Intelligent, Independent Investment Management

The Output Gap

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I don't want to single out any specific 2008 Nobel Prize-winning economist for criticism, so let's just call this anonymous person Paul Kr_gm_n. Paul, as we'll refer to him, has been busy of late blasting any economist who dares offer a critique of his recommendations or dares to provide an alternative solution to our economic ills. He hasn't been bashful. He's been critical of some of the most respected names in the profession. It seems that shaking hands with the King of Sweden (yes, Sweden has a King) instantly confers a sense of infallibility upon the shakee.

Paul belongs to an overwhelmingly large group of blathering wisenheimers known as Keynesians. Keynesians can be easily recognized due to the fact that they answer every question the same way. How do we get the economy moving again? "The government should spend more money." What do we do about insolvent banks? "The government should spend more money." What's the capital of Latvia? "The government should spend more money."

Keynesians are arguing that massive fiscal stimulus is needed to fight the current economic downturn. That's hardly surprising. That's what Keynesians do. That's what they've always done. They're the best shoppers in the world with the biggest credit card.

Let's focus on just one of the concepts that the Keynesians rely upon to justify their shopoholism-- the output gap. The output gap is a measure of the potential GDP of the country less actual GDP. In other words, it's a measure of the difference between actual economic output and potential economic output. Not to get too academic, but actual GDP consists of consumption, investment, government spending and net exports. During a recession, consumption and investment typically fall. Government spending, of course, never falls. The fall in consumption and investment lead to a drop in actual GDP to levels below potential GDP. Keynesians have a solution for this shortfall. "The government should spend more money."

Keynesian posterboy, Paul, recently summed up the current situation:

> Bear in mind just how big the U.S. economy is. Given sufficient demand for its output, America would produce more than $30 trillion worth of goods and services over the next two years. But with both consumer spending and business investment plunging, a huge gap is opening up between what the U.S. economy can produce and what it's able to sell. And the Obama plan is nowhere near big enough to fill this "output gap."

> Even the CBO says, however, that "economic output over the next two years will average 6.8 percent below its potential." This translates into $2.1 trillion of lost production. "Our economy could fall $1 trillion short of its full capacity," declared Obama on Thursday. Well, he was actually understating things.
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> To close a gap of more than $2 trillion - possibly a lot more, if the budget office projections turn out to be too optimistic - Obama offers a $775 billion plan. And that's not enough.

Paul is arguing that government spending should be increased by over $2 trillion over the next couple of years to make up for lost output, but shouldn't we be questioning whether recent levels of GDP are even defensible? Didn't we just experience a massive credit bubble? In recent years, both residential and nonresidential construction experienced a tremendous and unsustainable debt-driven boom. Consumption was pushed up to unsustainable levels in recent years with people racking up revolving debt and pulling equity out of their homes to buy plasma TVs, take vacations, and pay for a lifestyle they couldn't afford. This historic credit bubble most certainly goosed GDP in recent years. Is this really a level of GDP that we should be trying to support?

There is an analogy here between GDP and the financial system. We now all realize that the profits reported by the financial system between 2002-2007 were grossly overstated due to the fact that asset values were being overstated and loss reserves understated. Similarly, sustainable and productive GDP has been overstated in recent years as consumption and investment have been driven unsustainably higher through the use of massive amounts of nonproductive debt. It's madness to try and sustain this level of economic activity.

So, now GDP is likely to fall a couple of trillion dollars over the next couple of years. Great! It shouldn't have grown to this level in the first place. Yes. More plants and businesses will close, and more people will lose their jobs. That is unfortunate, but a sustainable level of demand doesn't currently exist to support these plants or jobs, and it would be fiscal madness to plug this gap indefinitely. The government should let the market clear away the excess. Trying to sustain economic activity at an unsustainable level and growth rate will just lead to larger levels of government debt, higher inflation (and/or higher levels of future taxation), lower future growth, and a less productive economy as government spending displaces the private sector. There is no free lunch.

If our economists and politicians want to focus on an output gap, I recommend they spend some time looking at the difference between the GDP forecasts of economists and actual GDP. Now that's a huge output gap.

Best,

Ken Bell, CFA, CFP
President
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