How Do We Boost Economist Growth?

By Harlan Green

There is a tremendous misunderstanding of how to boost economic growth. The best way to understand growth is with a concept used by economists, aggregate demand, that we have mentioned in past columns. Aggregate demand can be thought of as income and assets earned by consumers, private business, government and the financial sector. And it can be either hoarded in mostly MZM accounts (Money at Zero Maturity—i.e., earning 0 interest), as it is now, spent on things, or invested in facilities that produce more things.

Our economy has become seriously skewed during the past 10 years because corporate profits zoomed, while household incomes have not even kept up with inflation.

This is not the column to discuss the whys, including why so much income has migrated to the top 1 percent income bracket. But the result has been that corporations haven't invested in their employees. And because not, aggregate demand—which is the source of economic growth—has suffered mightily.

We know that consumers make up 70 percent of GDP growth, for example. And because their incomes were stagnant, they had to borrow to keep their standard of living. And because they indebted themselves so heavily while their incomes remained stagnant, most have not been able to boost their spending.

So business spending, which makes up the other part of aggregate demand (along with government spending) hasn't been expanding because of so much excess industrial capacity. We know that excess capacity is still a problem today, as evidenced by the latest industrial production numbers.

Industrial production posted a healthy 0.8 percent gain, following a 0.3 percent rebound in November. The December figure came in higher than analysts' estimate for 0.5 percent. However, the boost was led by a monthly 4.3 percent surge in utilities output, following a 1.5 percent increase in November. By market groups, strength was widespread. Production of consumer goods increased 1.0 percent in December; business equipment, 0.6 percent; nonindustrial supplies, 0.1 percent; and materials, 1.0 percent.

Overall capacity utilization continued to improve, rising to 76.0 percent in December from 75.0 percent in November. December's figure beat expectations for 75.6 percent. Capacity utilization is at its highest since a reading of 77.9 percent for August 2008, but is still far below the 82 percent long term average.

And so because most income has not been flowing back to consumers, employers are not producing enough to warrant hiring more workers. That is the major reason for the entire government stimulus—to boost aggregate demand. The $787 Billion American Recovery and Reinvestment Act (ARRA) was in fact not enough to bridge the so-called lost output gap between potential and actual GDP growth over the past 2 years. The Fed's purchase of government securities has held down interest rates, enabling businesses to borrow cheaply, and preventing real estate values from going into free fall.

Then what is the answer on how to boost aggregate demand? The major push should be reestablishing the middle class that has been so decimated by loss jobs and much of its wealth—both in stocks and real estate. New York Times' David Leonhardt is one of the few pundits to voice concern in his most recent column—"In Wreckage of Lost jobs, Lost power," in which he laments the loss of labor's bargaining power.

Whereas employment in most other developed countries, including Japan and Russia, is much higher than in the U.S., corporate profits are lower. This is because U.S. domestic workers' bargaining power has been severely diminished, in part because of laws that give employers the advantage in hiring and firing. And Germany and Canada, who barely had a recession, encourage companies to cut work hours for all—called short work—rather than lay off some, so that the pain of reduced incomes is spread over the entire workforce.

There are many other ways to cure insufficient aggregate demand, such more progressive taxation. For instance, the top income bracket during the Eisenhower years had a 95 percent tax rate on its top income bracket. This had the effect of siphoning off money from the richest whospend the least percentage of their income, and putting it into more productive use of building infrastructure, such as the interstate highway system.

A better-run health care system would reduce health costs, which are double in the U.S. per capita vs. other developed countries. This would have several benefits, including increasing the competitiveness of U.S. products, while boosting workers' incomes.

Disposable income growth (i.e., after taxes) slowed in November after a sizeable October boost, and has flattened out since its initial spurt in May 2010. But consumer spending was relatively healthy heading into the holiday shopping season. As in recent months, core inflation is quite soft and still below the Fed's target range. Personal income in November rose 0.3 percent, following a 0.4 percent boost in October. However, the wages & salaries component was sluggish, edging up 0.1 percent after jumping 0.5 percent in October.

The 'real' question is when wages & salaries growth will exceed inflation with the increased hiring, since incomes are adjusted for inflation. Year on year, personal income for November posted a 3.8 percent gain, compared to 3.9 percent in October. In fact, it is only because inflation is muted that incomes are improving at all.

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