OPINION OPINION

Why Recessions Are Not About Declining GDP

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Commentary

Most economic commentators consider a decline in economic statistics, such as gross domestic product (GDP), as indicative of a decline in the health of the economy. According to most experts, this decline in the GDP—which is called a recession—as a rule, arises because of an overall decline in the aggregate demand for goods and services. This is seen predominantly as a decline in the private sector's buying of goods and services.

Consequently, it is recommended that the central bank should step in and strengthen the private sector's demand. This, it is held, will pull the economy out of the slump. The means recommended by experts are the lowering of interest rates by increasing the growth rate of money supply.

The problem—central to economics—is that goods are not readily available. These goods have to be produced by transforming various things in nature into goods, either capital goods (to make other goods) or consumer goods. The transformation of things undergoes various stages and takes time. In an economy, which operates in the framework of the division of labor, some individuals are employed in the extraction of various raw materials such as coal and iron. Some other individuals are employed in the conversion of raw materials into various tools and machinery. Still some other individuals are employed in the transformation—using tools and machinery—of various things into consumer goods.

In order to support this process of production through time, saving is required to sustain producers. Saving supports individuals in all the stages of production—from the producers of immediate consumer goods, to the producers of raw materials, and the producers of tools and machinery. This saving to support capital accumulation and growth has been called a "subsistence fund" because it sustains individuals in the various stages of the production structure.

Capital goods—like consumer goods—are also scarce. In order to make these goods, it is necessary to save and sacrifice. The goal is to create capital goods which will ultimately make production more productive and efficient—saving time, energy, and resources. As we can see, simply getting people to consume or spend more to increase aggregate demand, thus increasing the GDP metric, does not grow the economy. Production and saving must take place prior to consumption, in fact, that is what enables greater consumption.

What Is a Recession?

A recession is not really a weakening of GDP and various other economic indicators, but the liquidation of various non-productive activities that have emerged on the back of the loose monetary policies of the central bank. We label these activities bubbles. When the central bank loosens its monetary stance, this lays the foundation of exchanges of nothing for something, which amounts to a diversion of savings from wealth-generating activities to non-wealth-generating activities. This undermines the wealth generation process.

Once the central bank slows this process of monetary and credit expansion—which had built up a distorted structure of production—a recession reveals the malinvestments. Activities that sprang up on the back of the previous easy-money policies are now getting less support as a result of a tighter monetary stance. These activities fall into trouble—an economic bust, or a recession emerges. Regardless of how big and strong an economy appears, a tighter monetary stance will undermine bubble activities.

It follows, then, that recessions or economic busts are not about the strength of an economy as such. It is about the liquidation of activities that emerged because of the previous easy monetary policies of the central bank. The recessionary process is set in motion once the central bank reverses its easy-money stance. Ironically, recessions are good news for wealth-generators. A tighter monetary stance slows the diversion of savings from them towards bubble activities. This, in turn, strengthens the wealth-generation process.

According to most commentators, however, as long as consumer spending is increasing, there is no risk of a recession ahead. This means that as long as there is a growing demand by consumers, good times will follow. But demand cannot be independent, it is restricted by the previous production. The only way to raise the ability to consume more is to raise the ability to produce. On this James Mill held,

> But if a nation's power of purchasing is exactly measured by its annual produce, as it undoubtedly is; the more you increase the annual produce, the more by that very act you extend the national market, the power of purchasing and the actual purchases of the nation.... The demand of a nation is exactly its power of purchasing. But what is its power of purchasing? The extent undoubtedly of its annual produce.

Once more, what limits demand is the ability to produce. Greater production of consumer goods depends on production of capital goods. In order to produce more capital goods, saving is required. The answer is not more consumption and spending fueled by inflationary monetary policy.

GDP and the Money Supply

The key variable that most commentators pay attention to is the gross domestic product (GDP). Given that this indicator is based on monetary turnover, then obviously changes in the money supply are followed by changes in the GDP. Policies aimed at preventing the emergence of a recession make things much worse. These policies not only provide support to existing bubble activities but allow the emergence of new bubbles, worsening the situation.

As long as wealth producers can generate an adequate amount of savings to support productive *and* bubble activities, the inflationary policies of the central bank (which strengthens GDP) are regarded by most experts as a success. Once the ability of wealth-generators to support overall economic activity weakens, the economy is starting to slide into a recessionary hole. No central bank expansionary monetary policy can reverse this slide. On the contrary, it will deepen the economic slump.

Conclusion

A recession should not be defined as two consecutive quarters of negative GDP growth, but as the liquidation of bubble activities that emerged on the back of the previous easy-money policies of the central bank. The recessionary process is set in motion once the central bank reverses its easy stance, however, this inflationary policy cannot be continued forever or it risks undermining the entire monetary economy. What matters for true economic strength is not strong economic data but freedom from the central bank and government policies that tamper with markets and money.

From Mises.org

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