While the American economy is not experiencing a recession, many people are talking as if it is. Or at least as if a recession is close at hand. Officially, a recession requires six months of decline in gross domestic output. The American economy continues to grow. Only the rate of growth lately has been about one percent per year, where earlier it had been running around five percent. This relative slowing down of growth feels like recession even if it isn’t one.

In response to this near recession, the Federal Reserve has several times cut the interest rate at which banks can borrow from it. The Treasury, moreover, with great fanfare is mailing out tax rebates. Both the cut in interest rates and the tax rebates are supposed to stimulate spending. There are reasons to be skeptical about this. Banks make little use of borrowing from the Fed. The tax rebates do not represent new spending, but simply give money to taxpayers instead of to bondholders.

In any case, a wrong-headed idea lies behind this concern about looming recession and the need to inflate spending to combat it. This idea, whose modern statement is associated with the 20th century British economist John Maynard Keynes, is that recessions are caused by sudden collapses in the desires of people to spend. This idea holds that production will be encouraged only so long as desires to spend are strong. When those desires slacken,
production will fall. The antidote for recession is for government to inflate the stream of spending to combat the decline in private spending.

This presumption that government can spend us to prosperity illustrates a terrible confusion of cause and effect. The simple fact of the matter is that nothing can be consumed unless something has first been produced. Production must precede consumption. Moreover, people have pretty much unlimited desires to consume, provided only that producers produce the right things. It is production in accordance with consumer desires that is the source of prosperity.

This erroneous idea about the predominance of consumer spending is both reflected in and promoted by our system of national income accounting. This system is based on the principle of value added. Suppose a loaf of bread sells for $1. This amount is incorporated into national output. Further suppose that the flour obtained from the miller, along with other needed ingredients, sold for 40 cents. Carrying the illustration back one further stage, you can likewise assume that the miller obtained the wheat from the farmer for 20 cents. The method of net value added would attribute 20 cents of value to the farmer and another 20 cents to the miller. The remaining 60 cents would be attributed to retailing as the contribution of consumption to national output. When the net value added method is used to construct our national accounts, consumption occupies about two-thirds of total national output. Consumption would appear to be where the economic action is centered.

The method of value added excludes many transactions that nonetheless have economic significance. One person buys a new car while another buys a
used car of equal value. Net value added is much higher for the first transaction. For market participants, however, the two transactions are of equivalent significance. When all transactions are considered, consumption accounts for only about one-third of economic activity. The real action in our economy lies in the producer sectors and not in consumption. This is where most of the capital is located and where most of the people work. The ebbs and flows of economic activity stem mostly from producer actions and not from consumer actions. Recessions don’t threaten because consumers want to curb spending. Recessions threaten because producers curb spending, and they curb their spending because their prospects for commercial success seem weaker.

It is not enough to take the threat of a recession as a given, and ask how to respond. We must ask why a recession threatens in the first place. It is necessary to understand the causation first before we can apply the right remedy. A recession is not caused by people suddenly coming to lose their desire to spend or to consume. It is caused by an increased belief that profit prospects have weakened, which in turn leads to lower spending within the intermediate stages of production. And it is in those intermediate stages where most of the economic action lies.

And how do we account for such changes in profit prospects? The prime culprit here is a preceding inflationary expansion of credit. The initial effect of such inflation is to brighten profit prospects through the lowered price of credit. What results is a boom of optimism that is unwarranted when these are appraised against the underlying economic realities. Further inflation is not a
remedy to a recession that threatens due to unprofitable investments that were promoted by the preceding credit inflation. What we need instead is less effort by the Federal Reserve to manage the economy, and to let the economy manage itself.