Real Working Capital and the Boom and Bust Elephant

Polly Cleveland 6/29/16

I. In a modern economy, we take real working capital for granted: the inventories of finished goods and inputs that are continually produced and replaced. But in a catastrophe like hurricanes Katrina and Sandy, supplies of real working capital become a matter of life and death.

II. I offer four theories of the boom and bust cycle: the Conservative/Republican theory of inadequate supply; the Keynesian/Democratic theory of inadequate demand; the Austrian/Libertarian theory of "malinvestment"; and the Elephant theory. The Elephant theory draws on parts of the preceding three theories. It holds that investments by the One Percent cause or aggravate boom and bust by creating periodic shortages of real working capital. Policies that reduce inequality will dampen the cycle. [1]

Part I: Lifeblood of the Economy

In Venezuela today hospitals struggle to function without electricity. Hungry crowds loot supermarkets. Venezuela may sit atop one of the world's largest oil reserves but the people can't eat oil in the ground. They need refined oil to operate drills and pumps and generators, tractors and harvesters. They need stocks of food and water for the workers who operate the machinery. In short, they need real working capital.

Disasters like Venezuela, or hurricanes Katrina and Sandy, or the great Northeast blackout, -- remind us how we depend on a steady supply of essential material things, starting with food, water, and energy. These are the core of what I will call real working capital, to distinguish it from financial working capital. Real working capital consists primarily of stocks of physical goods. It's the bread, beer, lettuce, laundry detergent and cat food on the supermarket's shelves It's container loads of new socks, shirts and pants that cross the Pacific from China destined for Walmart, and later, old and stained, cross the Atlantic to Africa. It's the gas, oil and spare tires at the garage. Real working capital also includes stocks of inputs to finished goods, such as flour and sugar for the baker, or steel and plastics for car manufactures, or specialized computer chips from Taiwan for computer makers all over the world. It includes vital supplies for both consumers and producers, like water for farming and drinking, and fuels, for cooking, transportation, and manufacturing.

Financial working capital serves to transfer claims on real working capital. Financial working capital is defined as the difference between a business's short term assets and liabilities, that is, the cash it can obtain short-term from revenue it expects shortly and/or a line of bank credit, minus the urgent bills it must pay. Imagine the keeper of a small clothing shop. Every month she draws on her line of bank credit to pay rent, to buy a shipment of dresses and to pay herself and her assistant. As she sells dresses, she pays down the line of credit. Next month, she draws on her credit again to pay rent, buy a new shipment of dresses and pay wages. That revolving line of credit is her financial working capital. If the bank cuts off her credit, she's out of business.

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[1] See Mason Gaffney, How to Thaw Credit, Now and Forever and Causes of Downturns: an Austro-Georgist Synthesis for a fuller account of the economic concepts presented here.

The classical economists like Adam Smith had a special term for real working capital: "circulating capital", a central concept. They distinguished it from "fixed capital" like buildings, roads and bridges, heavy machines, or fruit trees. Except for items like ships and trains, fixed capital does not move and is durable. The classicals further distinguished both fixed and circulating capital from "land", their shorthand for all natural resources; land of course cannot move and lasts forever.

The classicals called it circulating capital for two reasons: First, it often moves to new locations between production and consumption. Second, it is short-lived; it is used up and replaced on a regular cycle, such as the annual crop cycle, the monthly cycle of the clothing shop, or the daily cycle of a newspaper. If that replacement cycle is interrupted, the result can be catastrophic. In fact the classicals also called circulating capital the "wages fund", acknowledging its importance as a stock of finished goods to maintain workers until their current efforts pay off.

The classicals better understood this essential quality of circulating capital because they lived closer to feudal eras of limited, poorly-functioning markets and bad transportation. Imagine a feudal lord who grows wheat. At harvest time he sends three horse carts of grain to the king for taxes, and maybe another cartload to the nearest town to buy armor for his knights, but he keeps most of it. Why? Because he needs it not only to provide seed for the next crop, but to feed his serfs and retainers for the year until the next harvest! If the crop fails, or an invader seizes the stored grain, the serfs will go hungry. In the worst case, there won't even be any seeds to plant or serfs to plant them. In a modern society, of course, a farmer will sell the crop and pay wages to the workers, who will go out and buy their own food in the market. The market obscures the reality that there must always be a stock of food to carry us from harvest to harvest. Venezuela appears to have fallen victim to a worldwide collapse in oil prices, coupled with mismanagement of domestic food production and perhaps political sabotage.

By separating circulating capital from fixed capital and land, the classical economists also recognized the importance of a concept that has virtually disappeared from modern economics: the rate of turnover of capital. The more rapidly capital is replaced—"turns over"—the more production and employment it can generate. For example, if a farmer can grow two crops a year on the same land, that will produce more output and employment than only one. In Adam Smith's famous passage about the "invisible hand" of the market, he is actually saying merchants will generally prefer domestic trade to foreign trade because in the same period of time they can make many more round trips trading with nearby destinations than with foreign ones. Part of the original case for "laissez faire" and "free trade" was that governments should not obstruct this productive exchange. Adam Smith denounced mercantilist urban guilds that restricted manufacturing to their members. He despised royal monopolies granted to favored corporations like the British East India Company of Boston tea party fame.

While the classical economists preached free trade, their nations practiced something other. The European colonial powers, led by Great Britain, imported raw materials from their colonies on unfavorable terms: ores, cotton, sugar, tobacco, indigo from the New World; tea, silks, opium, spices and more from the East. And they transported slaves from Africa to work New World plantations. In short, the colonial powers forcibly extracted real working capital to turbo-charge their home economies. The extraction goes on today in neo colonies like Greece, or Puerto Rico, where a web of international contracts allow outsiders to suck out the juices, that is, whatever

real working capital the victims can produce. (Oil made up some 30% of 2015 exports from Greece—who knew?)

Shipments of real working capital can however play a critical positive role in public policy. After the guns fell silent in May 1945, armies of the hungry, cold and unemployed rampaged across Europe. The victorious Allies initially sought to cripple German recovery by embargoing imports of raw materials, but soon reconsidered. Thus began the U.S. Marshall Plan, named for U.S. Secretary of State George Marshall. Between 1948 and 1952, the plan delivered some 13 billion in consumer goods and raw materials to Western Europe—setting off a dramatic twenty year period of growth.

Part II: The Elephant in the Boom and Bust Cycle

Real working capital—notably the supply of food and energy—plays a major role in the boom and bust cycle. To understand that role, consider four theories. There's the Conservative/Republican theory, the Keynesian/Democratic theory, the Austrian/Libertarian theory, and the Elephant theory.

The Conservative/ Republican "ConRep" theory likens a nation to a family on a fixed income. In a boom, the family has spent and borrowed too much; the bust is a "reckoning" in which the family must "tighten its belt." Policy-wise, that means cutting public spending, especially redistributive social spending (but not military spending). It also means freeing big producers from onerous taxes and regulations that hinder production, because there's a lack of "aggregate supply." The ConRep theory holds that the Federal Reserve Bank should set interest rates to protect property values. That means high interest rates in a boom to limit inflation, and low rates in a bust, to support the stock and bond markets. ConReps frowns on high national debt, likening it to excessive debt of a family, claiming that such excessive debt "crowds out" potential private borrowing for productive investments. There's a partial truth in the ConRep theory: nations that have been suckered into taking on heavy debt, and have no recourse in bankruptcy or devaluation—like Greece and Puerto Rico—now suffer cruel austerity. And there's a partial truth in crowding out, which I will address below.

The Keynesian/Democratic "KeyDem" theory says a nation is not like a family on a fixed income, because the government can do things a family can't, notably control public spending and monetary policy. So yes, in a boom there may be too much spending and debt, leaving people unwilling to keep spending in a bust. That is, there's a lack of "aggregate demand." But, runs KeyDem theory, that's when government must fill the demand gap with public spending, *no matter on what or how financed*. The KeyDem theory also holds that the Federal Reserve Bank should set rates to stimulate the economy and protect jobs. That means moderate rates in a boom—a little inflation is a good thing—and low rates in a bust, to increase lending and investment. There's a partial truth in the KeyDem idea of spending to mitigate a bust: Adam Smith pointed out that economies grow by cooperation and specialization, limited by "the extent of the market." Vital cooperation and specialization break down when people cut back spending. But the benefit of government spending depends critically on what kind of spending and how it is financed.

The Austrian/Libertarian "AusLib" theory is named for the Austrian school of economics of economists like Friedrich Hayek and Ludwig von Mises, who espoused an extreme free market anti-government view. Unlike the ConRep and KeyDem theories, the AusLib school does recognize the importance of real working capital. The AusLib theory of boom and bust

originated with the observation of the great Swedish economist Knut Wicksell that in a boom banks provide loans at below what he called the “natural” rate of interest. Consequently, businesses borrow heavily to make bad investments, particularly investments in land and large construction projects—at the expense of investments to maintain stocks of real working capital. The inevitable shortage of real working capital eventually turns the boom to bust. This is the “malinvestment” theory.

Let me illustrate the malinvestment theory by returning to our feudal lord of Part I. He’s expecting visit from the king next year—yes, medieval kings did ride circuit, imposing enormous expense on their vassals. So our lord puts half his serfs to work building a new wing of the castle for the royal retinue. He sets carpenters to furnishing a new banquet hall, and tailors to sewing new livery for his retainers. The remaining serfs work overtime in the wheat fields, but the crop still falls short. By the time the king and his retinue depart, wheat stocks are depleted. The lord has dismissed the carpenters and tailors, and put the serfs on short rations (supplemented by poaching rabbits on the lord’s hunting preserve). That’s right: the lord’s splurging to please the king has created unemployment for more specialized workers and lowered wages overall. It may take years to recover—just in time for another visit from the king! Modern markets would obscure a pattern like this, because today’s castle-builders are not the wheat-growers.

But what does AusLib theory propose as a solution to the boom and bust cycle? Austerity with a vengeance, including no social spending and no military! No Federal Reserve Bank and a return to the gold standard for money. Yikes! No wonder the ConReps and KeyDems don’t take the AusLibs seriously!

So what about the fourth theory, the Elephant theory? Yes, Elephant, like the one in the room, or the one the six wise men of Indostan couldn’t see, or the one associated with a certain political party. The elephant is the One Percent operating through their giant banks and businesses. In a boom, the One Percent speculate heavily on durable things like raw land, or new office towers, or new housing developments, or mortgages on existing housing or hot new technology. Consumption rises in the optimistic first phase of a boom—at the same time that investment is diverted to durables. Consequently stocks of real working capital fall. Mason Gaffney puts it like this: “It is as though grocers ate up part of their own wares, instead of selling and replacing them, leaving some shelves empty.” As the boom progresses, rational investment turns increasingly to fraud and waste. Eventually, the bubble starts to collapse, workers are laid off from construction projects, and mortgage payers start to default. The One Percent cut back lending, first to the failing durable ventures, then to all businesses including food and fuel producers. After the crash, the One Percent are too spooked to invest much, while a shortage of real working capital hinders recovery by the Ninety-Nine Percent.

Consistent with the Elephant theory, note that the crashes of 1929 and 2008 were both preceded by huge real estate bubbles; real estate is the ultimate durable fixed investment. In the 1920’s the automobile suddenly opened up vast suburban areas to development; buyers snapped up speculative lots in Florida or elsewhere with “shoestring” mortgages. At the same time General Motors pioneered installment buying. Fraud was rampant. During the early 2000’s, the invention of collateralized debt securities set off another huge real estate bubble. Fraud was rampant. Both bubbles peaked about three years ahead of the crashes of 1929 and 2008. During those three years, consumption of real working capital steadily declined as workers were laid off in the housing and mortgage industry and debt-strapped consumers and small businesses cut

back. But hardly anyone noticed in the euphoria of booming stock markets—least of all mainstream economists.

According to the Elephant theory, the ConReps are right about a lack of supply, the KeyDems are right about a lack of demand, and the AusLibs are right about malinvestment. The One Percent malinvest—at the expense of the Ninety-Nine Percent. Supply and demand collapse simultaneously as real working capital runs low. Then the One Percent prolong the slump by holding back lending and investment.

How can we tame the Elephant?

First there's prevention. It's no coincidence that 1929 and 2008 happened after a long run of rising inequality. As Joe Stiglitz and Bernie Sanders remind us, it's past time to revoke the One Percent's tax and regulatory privileges and break up the monopolies that allow them to squeeze workers and consumers. It's also past time for the SEC and other regulatory agencies, the Federal Reserve Bank, and state attorneys general to enforce laws against fraud.

Then there's treatment. The Elephant theory blames the slump on a shortage of real working capital for the Ninety-Nine percent. Ordinary people and small businesses—precisely because they have so little capital to begin with—invest what little they have far more productively than do rich people and big businesses. But in a recent article, Joe Stiglitz argues that the Federal Reserve's super low interest rates simply do not get capital to the small to medium enterprises that need it, because the banks aren't lending. The low rates merely keep up the value of One Percent assets, notably the bad real estate ventures of the bubble years. Instead, government should support the Ninety-nine Percent directly with loans to small businesses, income guarantees like food stamps, and free college education, and indirectly with high job-creating investments such as renovating urban infrastructure.

What about deficit spending? The ConReps say debt is bad because it crowds out private investment that could boost aggregate supply; the KeyDems say it's good because it allows government spending to boost aggregate demand. Actually, it depends how the money is spent. Many public investments—as in education, health care, pensions, police and fire protection, courts, science, urban infrastructure, and many more—complement and enhance private investments. On the other hand, investments in bridges to nowhere or military adventures do in fact crowd out productive private investments. Whether public investments are good or bad, it's far better to pay for them by taxing the One Percent instead of borrowing from them. It's surely not a coincidence that the economy boomed when the Clinton Administration cut back on military spending in the 1990's and actually reduced the national debt.

Real working capital is the lifeblood of the economy. Today in the U.S. it is congealed and sluggish, circulating slowly, leaving the extremities cold and blue. Let us hope the young Bernie followers will muster the strength, persistence and sophistication needed to revive the patient.