



Untangling the Most Pervasive Economic Fallacy

What is true for an individual is not necessarily true for the economy.

IVORY TOWERS

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Milton Friedman, during one of his many public talks, gave an insightful explanation for why a particular economic fallacy is so prevalent.¹ Each of us, Friedman said, experiences economic life from our own perspective, so it is only natural that we tend to extrapolate from these experiences to try to make sense of the economy as a whole. But in many cases, what holds true for an individual is not true for the economy. In fact, they are often the opposite.

I believe that if economists have but one duty, it is to alert people to this fallacy, especially because it lurks behind many, if not most, instances of faulty economic reasoning. Unfortunately, by and large, economists have been shirking their responsibility, and even occasionally succumbing to the fallacy themselves.

My goal in this article is to expose the flawed reasoning behind this fallacy. I discuss two ubiquitous examples, in each case providing a review of the relevant economic principles. The first example focuses on how spending decisions affect individuals versus the economy overall. The second examines how transactions in financial markets appear from an individual perspective, and how this can be misleading for understanding the financial system as a whole.

Example 1: Spending

It is often said that economic activity is “driven by spending.” In a way, this is a tautology, because all measured economic activity involves the production and trade of a new good or service, and each transaction is counted as spending. What is more likely implied by those who use this phrase is that economic activity depends on people’s willingness to trade assets for newly produced goods and services. Wouldn’t the economy be bigger and better if only people and companies did not “sit on their assets” so much?

Intuitively, a statement like this sounds reasonable. Every time someone exchanges money for goods, it is counted as GDP. Thus, to increase GDP shouldn’t people simply spend more money? Unfortunately, it’s not that simple. What may seem clear from an individual’s perspective is not as clear for the economy overall.

Take this example. In the produce section of my local supermarket, I observe that a table is stacked with hundreds of bananas. A sign states that the price of the bananas is 49 cents a pound. To me, there is an endless supply of bananas (I can reasonably buy as many as I like) and the price is fixed (the sign says so). Suppose I decide to buy \$5 worth of bananas. In that case, \$5 of economic activity is recorded and added to GDP. But suppose instead that the price is too high for me, and I keep the \$5 bill in my pocket. Won’t GDP then be \$5 lower?

In short, the answer is no: If I decide against buying the bananas, other people will purchase them instead. Moreover, in the aggregate, the number of bananas sold will equal the total number of bananas produced (more or less, the world isn’t perfect). In short, the aggregate amount of economic activity does not depend on whether I choose to buy the bananas or not.

Why do economists believe this? What ensures that the total quantity produced equals the total quantity that people want to buy? The answer is that, as with any good, the *price* of bananas adjusts in order to equate demand and supply.

If, for example, prices are too high, then sellers will be left with a surplus, something they wish to avoid.

In the end, economics always boils down to supply and demand. Although this may sound simple and familiar, its implications are often misunderstood, so let us briefly review.

Consider supply. As people observe changing prices, they adjust which goods they produce and bring to market. For example, if the price of shoes is persistently high relative to the price of t-shirts, some people will switch toward making shoes, while others will switch away from making t-shirts. Conversely, for demand, as people observe changing prices they adjust which goods they buy. A higher price for shoes induces people to switch away from buying footwear.

Here are some more examples of how changes in behavior affect supply, demand, and prices. Suppose there is a shift in demand, specifically, people decide they want to consume more today and less in the future. What effect will this have? The price of goods today will increase relative to the price of goods in the future. This particular price is the interest rate: the greater the interest rate, the higher the price of goods today relative to goods in the future. In general, the more people are willing to postpone consumption, the more resources can be employed in the production of additional machinery and the development of new technologies—in other words, capital.

Now let’s suppose the government decides to increase its purchases of a particular good. In the short run, the quantity of this good is fixed. Therefore, because the government wants more, private individuals will have to consume less. To induce lower private consumption, the price of the good will have to increase. In the longer run, the quantity is not fixed, and the increased price will induce people to shift resources toward the production of this good, and the quantity produced will increase. This could be more or less desirable, but it is never free. The cost is that

¹ See the video “Milton Friedman – Money and Inflation (Q&A),” YouTube, starting at the 25:45 mark.



resources used to produce the good demanded by the government could have been deployed elsewhere in the economy. The government is spending more, but we have to always ask: Do the benefits of this spending outweigh the costs?

The spending fallacy is heard most frequently during times of economic recession. Couldn't high unemployment be alleviated by increased government spending, in particular on goods that unemployed people are good at producing?

Again, what looks logical at an individual level gets more complicated for the economy as a whole. The reallocation of labor is a highly complex process, and government involvement will alter it in important ways. It is questionable whether any government has the requisite knowledge and expertise to direct resources more effectively than a decentralized economic system. There is scant empirical evidence that governments are capable of doing this well (arguably quite the opposite appears to be true).

Suppose the government offered to employ the services of unemployed people who used to make t-shirts. What should the government have them do? Any choice will affect a wide range of prices and consumption and production choices. As employment increases in one sector, it could easily decrease in other sectors.

The reason the spending fallacy persists is most likely that we control our own spending decisions and see how they affect our lives, but do not observe how our decisions affect other people's decisions and lives, and vice versa. Each decision we make has a minute effect on the market as a whole, in particular on prices. So, when we go to a store, it looks like the price is fixed and the quantity that we choose to buy is up to us to decide. But in fact, for the economy as a whole, it is exactly the opposite: the quantity is fixed, at least in the short run, but prices are flexible.

Example 2: Financial Markets

Discussions of financial markets are rife with

examples of fallacious economic reasoning. Again, the source of confusion is usually the fact that what is true from an individual's perspective is not true for the market as a whole.

Probably the most common example occurs when stock prices rise; we often hear that this is because there was "a lot of money going into stocks." And when stock prices go down, there was a "sell-off." From our own individual perspective, financial assets may seem a bit like pillowcases that can be stuffed with more or less amounts of money. But in reality, changes in stock prices do not imply anything about the total quantity of money or shares that exist, and there cannot be a net sell-off, because every trade involves both a buyer and seller.

A possible reason why financial markets are poorly understood is that it is unclear what financial assets actually are. So, again, let us review. An asset is a legal ownership claim to goods and services. This may be a claim on existing goods; for example, the title to a house confers on its owner the right to live in that house, or rent it out. Alternatively, the holder of an asset may be promised delivery of a (possibly uncertain) quantity of goods at a future point in time, in which case it is called a financial asset.

How are financial assets created? The simplest example would be this: Two people engage in a trade. Person A provides a service on the spot, while person B issues a "B" note promising the delivery of goods or services at a future point in time. Continuing, suppose person A uses this B note in an exchange with person C, who in return issues (to A) a new "C" note promising goods in the future. The number of financial assets in existence has thus increased from one to two. Vice versa, the quantity of financial assets decreases whenever a person pays off some of his or her outstanding liabilities; for example, when someone pays off his or her mortgage.

At its core, the financial system is best understood as a scorekeeping device. Selling goods

(and services) increases the quantity of goods one is entitled to receive from others, while buying goods decreases one's balance.

Now that we understand what a financial asset is (a promise to deliver goods or money in the future), we may wonder what determines the value of a financial asset today. Various factors are involved, including the quantity of goods (or dollars) that is expected to be received, the uncertainty about that quantity of goods, and the rate at which people are willing to forsake consumption today for consumption in the future.

Finally, the value of financial assets could be measured in many ways. Typically, money is used as the unit of account. In addition, the vast majority of transactions involve the "buying" party paying in money, so that the unit of account and medium of exchange coincide. Money is just another financial asset. Specifically, money is a liability of the federal government, just like Treasury bills, notes, and bonds. Essentially, money is zero-maturity debt.² Money represents only a fraction of financial assets. A deposit account at a bank, for example, is an ownership claim to that bank's assets, which consist mostly (at least traditionally) of personal and small-business loans, which are not money.

Exposing a Flaw

Many years have passed since Milton Friedman provided a persuasive reason for why most economic misunderstandings are examples of a singular fallacy—namely that what is true for an individual is not necessarily true for the overall economy. Nevertheless, this fallacy has persisted and is as widespread as ever. This is unfortunate; society is better off when people have a solid grasp of economic principles. ■■

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2 The best way to see why money is a government liability is the fact that the government accepts money (in fact, only money) as payment of taxes. Government liabilities would decline to the extent the government does not spend its tax revenues.