

*Macroeconomic Dynamics:*

*What to do when the economy slows down...*

**The Golden Lecture 2009**

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## The Golden Lecture

Thank you for the opportunity to think out loud with you this afternoon. I must say that it is daunting to try to speak meaningfully about economics these days to such an informed audience. I mean everybody's doing it, not least in the Church, and one might suspect that everything worth noting has already been said a zillion times already.

Although I am principally a theologian, a social-ethicist to be precise, one of my fields of research is meta-economic theory, which is economic theory that takes into account not just economic science, but also the kinds of ethical concerns that arise from the humanities and the social sciences. I'll address some of the ethical concerns later, but I'd like to begin by focussing on macroeconomics instead of meta-economics. Specifically, I'd like to discuss the economic thought of Bernard Lonergan, a Canadian full-time theologian, full-time philosopher and part-time economist.<sup>1</sup>

Lonergan did the bulk of his early economics work in the early 1930s and '40s, engaging with Keynes and Schumpeter especially. He then revised and updated his research later in the 1970s and early '80s, partly in an attempt to understand why depressions occur, and subsequently to understand the larger macroeconomic dynamics that explain why economies expand, slow down and even contract – and why they then repeat the cycle all over again, sometimes at a faster rate, other times at a slower rate.

Indeed, one of the things that has characterised macroeconomics in general has been the search to understand and prevent great recessions and also

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<sup>1</sup> I shall be basing most of my comments on two collections of Bernard Lonergan's works: *For a New Political Economy*, ed. Philip McShane, vol. 21 of *Collected Works of Bernard Lonergan* (Toronto: University of Toronto Press, 1998) and *Macroeconomic Dynamics: An essay in Circulation Analysis*, eds. F. Lawrence, *et al.*, vol. 15 of *Collected Works of Bernard Lonergan* (Toronto: University of Toronto Press, 1999).

to find ways of smoothing out the smaller booms and busts that have characterised our economies over the past century. You can see this mirrored in Gordon Brown's now embarrassing, though still potentially worthy, goal of ending the boom and bust cycle. I say 'potentially worthy' because, if anyone were to try to get rid of economic cycles entirely, he or she would end up stultifying the economy completely. But, again, more on cycles later.

Loneragan's contribution to the debate arises from his analysis of circuits of payments in an economy, and from his distinction between the basic circuit and what he called the surplus circuit. You can begin to understand what he's talking about by imagining the economy as two interpenetrating systems: one system is the basic circuit of producing and consuming for households or for governments (which, for our purposes, are another type of consumer household). If this is profitable, some of those profits get reinvested in the basic circuit, paying salaries, keeping equipment up to date and the like. But some of these profits are surplus to the basic circuit: they aren't needed to buy basic goods and services. They can be used to pay dividends or higher managerial salaries, but they can also be used to invest in new enterprises.

These new enterprises are also funded by banks, of course (which lend more money than they actually have in reserve, with the expectation that they will, in time, get more back). The role of banks is crucial, and they must lend more than they have on hand – otherwise economies simply cannot grow. And if you're trying to get out of a recession without the banks lending more than they have, it won't work. But if they're already leveraged to the hilt, then they're stuck and we're stuck.

At any rate, if there is finance, then these new enterprises can get off the ground and they will be part of the surplus circuit: you might think of it as an expansion or growth circuit, but Lonergan calls it a 'surplus' circuit, chiefly to indicate that the source of investment is surplus savings (or anticipated future savings, bringing in the banks again) – savings that really are surplus to our needs or ability to consume basic goods and services. These new enterprises invest in new technologies that produce new goods and services. This surplus circuit pays people, who then feed some of these new goods and services into the basic circuit and who feed in their earnings as well.

Even though the two circuits interact, the surplus circuit has a dynamic all of its own, as it spawns industries that service the expansion itself: producing so-called producer goods, as opposed to consumer goods. Such surplus production tends to accelerate growth, as it multiplies output – at least after a bit of a delay.

Everything we produce is either consumed in the basic demand and supply circuit or it is part of the surplus demand and supply circuit – or, indeed, it could be a combination of both, and any given industry can include both or shift back and forth. A circular saw, for instance, can be bought by a DIYer and is part of the basic circuit, but if it is bought by a building contractor and is used to build something new, then it is a producer good and is part of the surplus circuit. Similarly, a firm of lawyers can prepare divorce papers for you, a basic service, or they can arrange the sale of land for a new factory – part of the surplus circuit.

This is all fairly obvious, so what has Lonergan added? Well, he makes much tighter distinctions between consumer and producer goods than most economists do, and he doesn't much care where the activity occurs. That's because he's not so concerned about who's purchasing, but about the function of the thing being purchased. For instance, if a producer makes automobile tyres, conventional economics would classify that as a consumer good (or they wouldn't be fussed about classifying it except for VAT purposes). But Lonergan is deeply concerned about whether that tyre is on a car that is used for business purposes, used to generate new business. If that's its function, then the tyre is not a consumer good, but a producer good: it can generate new growth. For Lonergan, then, the end-use makes all the difference.

Again, these are not esoteric distinctions: they're difficult to determine and measure, but they're actually fairly obvious once stated. Lonergan nonetheless keeps these variables in the conceptual forefront of the economic picture; and he differentiates between these two different functions and these two different circuits when he studies what happens in the market.<sup>2</sup>

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<sup>2</sup> Lonergan is using what might be termed a 'critical realist' approach to economics inasmuch as he identifies 'the real' in economics not just by pointing to the things being exchanged, but by answering questions about the use (or the 'meaning') of

There he finds not just two distinct circuits of supply and demand, but various ways in which these circuits interact; he distinguished key ways in which capital circulates within and between the two circuits (even if the differentiated capital is not labelled as such); he discovers factors that affect the velocities and accelerations of capital through and between the two circuits; and he notes different kinds of equilibrium that need to be established so that each circuit doesn't derail the other.<sup>3</sup>

It seems clear to a few of us who study Lonergan that how these two circuits interact is extremely important. And it's extremely important because standards of living can only be improved by economic growth, which is to say by growth in the surplus circuit. The increase in the standard of living occurs (or can occur) not during the expansion phase per se (capital is being channelled into the means of increased or new production), but rather after the surplus expansion slows down, and when that increased overall level of activity is transferred to the basic circuit.

This is a key transition: When the rate of growth slows, how do we maintain the increased level of economic activity to prevent the slowdown becoming a slump or a depression?

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particular things. Obviously 'meaning' is not out-there-somewhere, waiting to be 'seen'. Rather it requires subjects who are intelligent, who ask questions, who use theory to answer those questions.

<sup>3</sup> In contrast to Keynesian economics, Lonergan does not divide matters into determinate and indeterminate variables and givens. The numbers associated with these variables merely describe magnitudes and frequencies and the like (of interest, he says, more to accountants than to economists, not to disparage the former nor to inflate the importance of the latter); and even though these numbers change and even though one cannot deduce one from the other, that does not mean that the relationships between these variables are likewise indeterminate. For instance, even if we cannot predict the investment behaviour of those, say with a lower marginal propensity to consume, that does not mean that there is no systematic relationship between the level of excess liquid capital and the possibility of higher investment.

There are ways to do this: for instance, during surplus expansion prices need to be high enough to generate enough profits to fund the expansion. In other words, profits have to be over and above the cost of maintaining the plants, paying people, and generating ordinary returns on the investment. Wage demands have to be tempered during this development phase as capital needs to be concentrated. But once things are up and running, once innovative development trails off (as it inevitably will), then to maintain or consolidate the same level of economic activity, the extraordinary returns on investment need to be used not to over-produce, but to shift that economic activity into the basic circuit, by finding ways to provide basic goods and services to more and more people.

At times of sustained economic expansion, and indeed at all times, there is a production lag, a time-lag, between the expansion and its effects on the basic circuit. When things are eventually up and running in the surplus circuit, gradually more and better salaries are being paid. That will eventually lead to an increase in demand for basic goods and services (the basic circuit will expand slightly in sympathy with the surplus circuit), but that limited expansion in salaries is not enough to underpin the increased consumption of the increased goods and services that the expansion has enabled.

In any event, at some point the expansion begins to slow down, or even stop, as supply reaches saturation (you can't produce more and more of the same things forever). But now, as mentioned above, the challenge is to shift the investment from the surplus circuit to the basic circuit, managing the transition from the economic activity focussed on expansion to economic activity that focuses on enabling consumption. For, if you don't manage this transition, you will have a recession. Guaranteed. You won't just get the rate of growth contracting, but you will get the whole economy contracting.

You prevent larger economic downturns by increasing the demand for basic goods and services. And when you stop to think about it, this is a opportune time to increase the demand for these goods and services: there is (or there should still be) loads of capital available (the current banking crisis has ensured that our current difficulties are not examples of a 'natural' slowdown), productive capacity is at an all-time high, there is a specialised workforce

(though they are now having to look for other kinds of jobs), and there is some room for efficiencies, for prices to fall without jeopardising acceptable levels of profit.

The problem is, however, business executives, investors and bankers don't always manage this transition particularly well: they tend to overreact to the surplus contraction, anticipating doom, and thereby almost guaranteeing it.

What is interesting is that underpinning all of this is a natural economic rhythm not of boom and bust, as exists too often in the usual business cycle, but of related, sequential growth in either circuit. Lonergan realised this when he identified what he called 'a pure cycle' of expansion at the surplus stage, a subsequent contraction at the surplus stage, and then an expansion at the basic stage and so forth. These are not merely psychological mood-swings. Rather the shifts form a cycle, an underlying pattern; and knowing where you are in a cycle, or where you could or *should* be in a cycle – these ought to inform your economic decisions.

However, that natural underlying rhythm can too easily become a cycle of boom or bust if the dynamics of the two circuits are misunderstood, if expectations of accelerating growth are stubbornly held, if business people and investors run scared as growth decelerates.

I should say that I take it as written that we want to increase the standard of living of more and more people. Some of my church colleagues have recently called for a decreased standard of living, for a greater emphasis on living within our means. They're not entirely wrong, but it is one thing to question whether we are producing and consuming the right goods and services (it really doesn't matter economically, though it might matter ethically and ecologically, what we produce), but if you want people to participate in an exchange economy by actually working, then economies must grow. It makes sense that people not borrow more than they can afford to borrow, but that doesn't necessarily mean that we ought to be content with a lower standard of living. We ought not to imperil the planet by the way we consume goods and services, but economic growth does not necessarily imperil the planet. Writing better software or producing a new West End musical does not automatically imperil rain forests.

Hardly, for increased standards of living include everything we exchange, whether it be music, health, information, education, advice, or potatoes. And if we want to share more widely the benefits of culture, the benefits of science, the benefits of health and education, then we need to invest in and expand the economy – admitting, full-well, that there are better and worse ways of doing so.

To backtrack a bit, how do you expand the economy? First, we need to realise that the profits generated in the expansion phase are not simply personal profits. If all the profits went into salaries or were regarded as normal rates of profit and consumed in one way or another, then the basic circuit would be draining the expansionary circuit slowly but surely. Expansion would be limited and short-lived. No, for standards of living eventually to increase in an economy, some of the profits must be reinvested in the surplus circuit, where they will have a multiplier or accelerating effect. Obviously ordinary levels of profit need to be made to keep companies afloat, to prevent decapitalisation of an ongoing business, and to pay workers, managers and so on. But during an expansion phase, there are extra-ordinary levels of profit available overall to be invested anew; and these additional profits will make possible an eventual overall increase in the standard of living – what Lonergan considered a broad, social dividend. This social dividend can only be realised by the continued reinvestment of extraordinary profits in the surplus circuit while the expansion continues, and it will only be *fully realised* after growth slows down and when the surplus capital is invested in the basic circuit instead of in the surplus circuit.

At boom times, when there is a high level of expansion, there also tends to be inflation: demand is high, production is high, prices are high enough to generate the surpluses needed for expansion, money is relatively expensive. If you're not careful, though, and if you expect perpetual growth, if you expect ever-increasing mega-profits, then you'll end up over-producing: demand will level out or drop off, profits will decrease (perhaps just to ordinary levels), employment will begin to tail off, and surplus expansion will begin to slow down and eventually end. If you don't expect any natural slow-downs, you could overreact and interpret this as the beginning of a slump. This same pattern can occur within a few industries or throughout much of the economy, and it will occur not just because people make bad economic decisions (though some will

do so), but because it eventually has to occur because markets need to shift to meet new expectations and so on, and such shifts always take time.

A particularly interesting aspect of all this emerges when you ask who is going to do all this investing in the surplus circuit. Is it going to be your low-income earners? No, they'll be consuming. The only ones who can fuel growth in the surplus circuit are the relatively wealthy (as Keynes realised), those who are able to invest their real surplus resources in new industries; as they do, they will get richer and richer faster than those on salary, faster than those whose economic lives are lived more or less entirely within the basic circuit. But when growth is tempered, when there is less money flowing from the surplus circuit to the basic circuit, then the key to continued market activity is (a) lowering prices/increasing demand (profits don't need to be as high now for they don't have to fund accelerated growth) and (b) finding ways to ensure that enough people have enough money (and that there are still enough jobs) in the basic circuit to compensate for the shift from surplus production during the expansion/development phase. Income distribution is required in this second phase to enable mass distribution; and making that transition is the key way to avoid a recession. But it's interesting to note that the growth and concentration of wealth that makes the surplus cycle actually possible can backfire in the basic cycle: as said, income redistribution is truly necessary after the development stage, and the benefits of growth have to be shared if a recession is to be avoided.<sup>4</sup> We're not that good at redistribution. And sometimes governments end up having to force the redistribution by taxation, by borrowing (which is to say, delayed taxation), and by seed-funding investment.<sup>5</sup>

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<sup>4</sup> Here the work of F. H. Hahn on income redistribution is apt (and similar).

<sup>5</sup> The question about incentives for wealthy individuals to invest is interesting. I think we keep looking for market incentives (chiefly enlightened self-interest) to provide these incentives so that we can leave ethics out of the picture. Lonergan's framework can give the wealthy broad long-term motives for investing (i.e., to keep the economy afloat, which ought to benefit them and everyone else in the long-run), but that means that they must be willing to sacrifice short-term consumptive power for longer-term economic goods, and even longer-term social goods. I don't see any way around the need to have good people making good decisions – decisions that optimise say individual good, the good of a particular industry and the good of the economy as a whole. I suspect we're always looking for a market mechanism, for a shorter-term self-interest, that sort of guarantees decisions that are automatically beneficial for the

The thing is you will always have peaks and troughs in the economy: they are part and parcel of a dynamic economy; and they stem in part from the interaction between investment and consumption, from the way money flows or doesn't flow between the basic cycle and the surplus cycle and back again.

The key to all of this is to understand that the market cannot transfer funds between the basic cycle and the expansion cycle and vice versa. The market cannot decide whether you consume or invest. Understanding the market can inform your decisions, but it won't make your decisions. And we have to make them the right way and at the right time – in ways that complement the natural dynamics of an economy. This is not laissez-faire capitalism, but a form of respect for the intelligible dynamic structure of economic activity.

Why is this important? Well, if economies pulsate, as it were, according to dynamics that urge expansion and other dynamics that urge contraction, and if we know that's going to happen 'naturally', and if we want to smooth over these pulses so that we manage the transitions as best we can, then perhaps we need to be doing something different during an expansionary phase of the surplus circuit– different from what we do during a contractionary phase. The interesting thing is that, during an expansionary phase, money is expensive (people can charge more interest not because the risk is greater, but because the expectation of profit is greater) and production is squeezed; workers can demand higher salaries in both circuits; the cost of raw materials is higher because of demand, and so on. Though this is a costly time to expand, confidence is up, expansion is in the air, and there are profits to be made with only a modicum of financial nous. But when the surplus circuit is slowing down or even contracting, prices fall, money is a bit cheaper, and there is surplus supply of the means to produce at almost every level.

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longer-term health of an economy. But that's to expect a lot of markets, and not very much from human beings.

As was mentioned earlier, not only is there a need to transfer economic activity from the surplus circuit to the basic circuit when things begin to slow down, but this contraction period is arguably a propitious time to expand the basic circuit. This is when industry can actually ‘most profitably’ shift from focussing on supplying other industries to focussing on supplying more (and more *appropriate*) consumer goods and services by shifting to mass production, which reduces unit costs.

Again, these cycles will occur. Sooner or later every economy undergoes what is termed a larger correction. But what if the cycle is natural? What if we’re dealing with a rhythm rather than a problem? What if we can work with the systematic cyclical nature of expansion and contraction, by varying the flow between the basic cycle and the expansionary cycle and vice-versa?

And that’s really the fundamental question I want to pose today: If we know there are going to be these cycles of expansion and contraction, what should we be doing with our profits, with our surplus, during those expansion years and then later? In the early years, you reinvest; but as the expansion slows, there are fewer and fewer *new* growth areas worth investing in. What you have though is an expanded economy, and you now have a chance to raise the standard of living as savings are circulated and re-circulated in the basic cycle. As Lonergan said, surplus expansion requires savings; massive surplus expansion requires massive savings; but expanding the standard of living requires not new saving, but a re-distribution of savings in order to increase basic consumption.

What goes for companies and big-league investors goes for us too. Not only is the contraction phase an interesting time to invest, but if we had the capability and the will to invest, we’d be helping to smooth out the boom-and-bust cycle. In other words, if we as economic agents want to smooth out the cycles, then we must be willing to invest when and where the economy needs investment.

If you’ve been following my train of thought, you’ll appreciate a problem with all this. The problem is that, as an investor, you’d want to be

investing at the bottom or just on the way up the next curve rather than on the way down. But that’s to think not in terms of investment, but in terms of gambling. Investing is making something happen, providing capital for growth. Guessing whether the stock market is going to go up or down is about moving your capital around or hedging your investments. Obviously, your capital is going to be invested by someone at some point, but these days with unit trusts and the like, many of us don’t know how or by whom, and you generally don’t know whether it’s going to bolster the basic or the surplus circuit. But if enough of us invested in industries that were successfully anticipating the transition from producing for the surplus circuit to producing for the basic circuit as the economy began to contract, if we knew how to identify such ‘promising’ firms, the curve would moderate – and we’d do financially well by it. In contrast, if we all ran like hell from all investments at the first sign of a slowdown, then we won’t get a natural, manageable contraction, we won’t get a chance to expand the basic circuit. Instead, we’d get a recession. Hence all the contemporary talk about confidence, about herd mentalities, about the psychology of the marketplace.

I want to end here. There are loads of loose ends. Many of the things I’ve mentioned have been oversimplified, and much of the devil is in the detail of how prices vary during the cycles, how wages rise, how and whether redistribution occurs, the effects of foreign trade and foreign investment, and so on. But I hope I have said enough to justify the following claims:

1. If churches want to get involved in economics, then they have to know some economics. There are micro- and macro-economic dynamics that need to be understood correctly by the churches if they want to play a role in economic policy formation. And given that economists themselves don’t understand (or can’t agree on) some of these cycles very well, churches aren’t likely to understand them any better. If the churches want to play a role, they’re going to have to do some hard work with business and with economists – and not just preach to them. That does not mean that churches need remain silent most of the time or that they cannot play a prophetic role: there are good, hard questions that need to be asked, and churches don’t need to know the answers before they ask the hard questions....

2. The whole debate about greed is perhaps misplaced. Obviously there is greed, and some of the pay mechanisms have rewarded greed by rewarding short-term gains rather than long-term, sustainable growth: the set-up encouraged people to be greedy, so why are we so surprised morally that the system worked as designed? That said, many of our problems have to do more with fear than with greed: there is a kind of acquisitive fear that arises because we don't understand business cycles well enough, because we feel as though we're at their mercy. We can't manage them as we should, so we turn to self-preservation. Moreover, it needs to be said that greed is not just a banker's or a fund-manager's problem: many millions of people have lived off of far too much credit for far too long (exacerbated, it must be said, by the short-term rewards offered to financial advisors and salespeople).

3. Ethical concerns certainly have a huge place in economics. But before you can decide what you ought to do, you need to understand how things work so that you can figure out the possibilities for action. For instance, if Lonergan is right about growth coming almost entirely from those with surplus capital to invest, and if this investment in the expansionary surplus circuit is what gives you step-changes in growth, then we need to be suspicious of any we-they talk between the haves and the have-nots. It's more complex than that: those who have capital, those who play key investment functions in our society, need to invest for growth rather than spend it all on personal consumption. Part of our disdain for the super-wealthy is well-placed if they're abusing the social potential of capital through excessive personal consumption. The wealthy have a unique and massive duty to invest what Lonergan has called the 'pure surplus',<sup>6</sup> for this is how the broad, overall social dividend emerges when markets settle down from an expansionary cycle, when the basic cycle comes into its own. I want to reiterate this point: those who have access to capital have a huge moral responsibility to use that capital to benefit society, not just to fuel their own consumption. A few people consuming Ferraris get us nowhere fast.

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<sup>6</sup> This is the real surplus over and above what is needed for purchasing all basic goods and services, paying taxes, etc. In a sense, it can only be spent by being invested.

4. Thus there is a hugely-important ethical imperative to invest for growth. The social dream of enabling the vast majority of the world to have a decent standard of living cannot occur by simply producing goods and services to be consumed. Very few people would be able to buy them. Nor can we simply stop the train, agree on a sustainable level of production and redistribute all the money and all the goods and services more equitably. That won't happen because (1) we're not producing the right sorts of things in the right ratios in sustainable ways, and (2) to shift any of that, we'd need to invest; but (3) you can't invest if you're channelling the bulk of your resources into lifting the standard of living for the poorest, by providing more and more supposedly-affordable consumer goods and services to them: you're just consuming not creating wealth. Nor would innovation occur. At some point, you really do have to divert capital into the expansionary surplus phase to get the growth you need to increase standards of living further down the line. And that requires pure surplus capital available for investment. Lonergan has shown that any effective preferential option for the poor requires an anti-egalitarian (what will seem like an unfair) setup for the sake of any effective pro-egalitarian (fairer) reorganisations later on. The key that prevents this from being an ideological justification for the maintenance of poverty is the 'for the sake of' – an anti-egalitarian setup for the sake of a later measured egalitarian shift.

The wealthy thus have a key role in poverty alleviation. In the first place, their role is to invest. But they can invest most effectively and most charitably not by giving capital away to be consumed, but by reinvesting capital in ways that expand either the surplus or the basic cycle of the economy *at the right time, at the right phase of the economic cycle*, so that more people can later share in the wealth that was created earlier during the expansion phase.<sup>7</sup>

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<sup>7</sup> For instance, aid aimed at providing sustenance is no doubt worthy; aid aimed at developing small-scale local industry is again worthy. But we should realise that the level of investment needed to address poverty significantly on a large scale will have to come from somewhere, and repeatedly-so, and such massive investment needs to come from pure surplus income, which means a less than egalitarian distribution of wealth.

And, finally, (5) some of the negative press about unlimited growth can be a misdiagnosis of the real problem. Growth does not necessarily mean consuming more and more physical resources; it means using the market and the exchange mechanism to its full potential to ensure that more and more people participate in the exchanges that give them access to what they need to live a decent and fulfilling life. Growth is not bad; it is essential. *How* we grow, *what* we consume, *when* we enable more people to benefit from the economy, *how* we do all of that sustainably – these are all crucial economic and ethical questions, but they all presume certain kinds of growth. Growth and sustainability are not necessarily opposed to one another.