

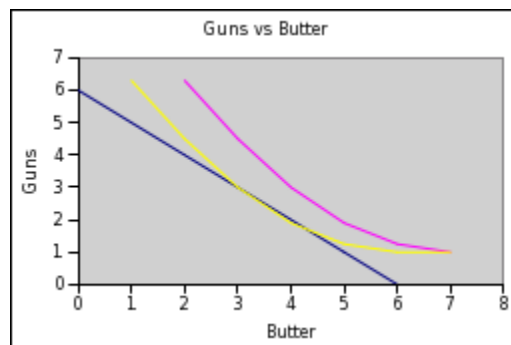
## The Inequality of Stimulating Demand

Politicians enjoy the idea that the economy can be “stimulated” with an injection of money that is supposed to shift aggregate demand in the short run (helping the economy avert a recession) and even out in the long run when inflation eats away the real value. The effect on the economy is supposed to be neutral in the long-term and potentially evenly distributed (fair) in the short term. The policy is supposed to have no real or lasting effects except to help avert a crisis.

The theory postulated is that people's preferences are already given and so increasing purchasing power should only shift demand but not affect the shape of it, and so the economy should be uniformly aided, without preference to particular industries, sectors or firms. Unfortunately, the reasoning which leads to this conclusion is too simplified. A stimulus package which gave every individual a debit card with \$500 to be used for consumption would still not affect the economy in a uniform way.

To understand why, we need to keep a few things in mind. First, this is an artificial stimulus produced by inflationary spending. It isn't an actual increase in purchasing power – it isn't supported by an increase in production. What this means is that the spending it produces isn't a response to the expected amount of supply for the given demand: more money is chasing fewer goods, and not necessarily proportionately. Second, we are trying to pull consumption forward in time. But the future is unknown. The future we have now may not be the same future we would have later.

But these are theoretical objections. To understand concretely the distortions that may take place, we can consider an example.



People's demands are commonly such that an increase in budget will favor one product over another. In the case of graph 1, the individual will purchase more butter (5 units instead of 4), but the same number of guns (2). If this were a real increase in his income, this would be natural and

expected. However, it is just a temporary increase in income which will be later corrected for by inflation. So, in fact, his income is really at the original budget line and he actually prefers 4 units of butter for every gun. His preference for butter has been artificially stimulated.

But this isn't the only effect on the economy. The increased demand for butter has an effect on butter firms. Able to get a higher price, butter firms produce more. Bakeries produce more bread. There is more demand on inputs for bakeries including machinery, and the wages of bakery employees. Inflation begins in these areas. However, there is not greater demand for guns.

An individual enjoys more than two preferences. And each preference has substitutes and complements which are intertwined with the core preference. If each part of that graph represents more than just one product, we can imagine bread, butter and other food on the one side and guns, ammo and related weaponry on the other. And now that bread is more expensive due to increased demand and steel as an input is more expensive, the budget is now squeezed on the one hand by inflation on the bread and butter side and on the other by the price of guns and ammo. Therefor the effect on the actual purchase won't be just a simple shift to the (5,2) position, due to the changes in price it could end up at (5,1).

Now, because demand for guns and ammo remained constant, they cannot raise their prices along with the “general” rise in inflation seen in the butter, bread and bakery industries. In fact, they will try to lower their prices in order to get back the lost customers.

There is another thing to keep in mind. Each of these industries has different returns to scale – and lump costs. While the “stimulus” was supposed to be short run, the effect of an artificial shift in demand may be lasting. It is far too easy for politicians to imagine that they are simply spurring on consumption without having any distortionary effects – but it simply isn't true. It is not possible to interfere in a complex system like a market economy without making waves and creating unexpected ripples.