

The Paradox of Thrift

There are many ways of looking at a situation, and how we look at a situation provides us with particular insights into specific aspects of a situation. Take the current credit crisis. We could look at it from the point of view of the financial markets, the banking industry, the real economy, and so on. Very often, I like to simplify or even oversimplify a problem because it amplifies certain important aspects. Today, let's look at the credit or debt crisis from the point of view of savings.

The US consumer spent the last 5 years spending at an unprecedented rate with respect to their income. The savings rate in the US has fallen steadily since 1981 from 12% to 0% in 2008. In contrast, in China for example, the savings rate has exhibited some volatility, particularly in the early 1990s as the SOEs were being restructured and there was massive unemployment, but has otherwise increased from 5% in 1994 to over 12% today.

So the US consumer is now forced to save, since they hadn't been saving before and will now need to do so for a host of reasons, and this increase in the savings rate is having an impact on consumption and economic growth. That's the simplistic view but it illustrates an important concept. If the US consumer is forced to save, and to carry on saving for some time, then to get global economic growth going again, someone somewhere will have to do some consuming. Who has the ability to consume and who has the propensity to consume? It is natural to turn to the group that has been saving while the US consumer was spending, the Asian consumer.

While the Asian consumer may have the ability to consume, why would they? They fear for their jobs as their largely export driven economies suffer due to a moribund US consumer. How is that for circular! They fear for their stock of wealth, it was

in their DNA to save and hoard in the first place and the additional uncertainty is unlikely to get them out shopping. Without the intention to spend, no amount of interest rate cutting will get them to the shops.

Somebody needs to spend. Spend their money. Who else has any? Enter government. Some Asian governments have the wherewithal to pursue reflationary deficit spending sprees in the hope of reviving their economies. Others don't. The Indian government is about as broke as any European government, for example. Spend and tax. Or spend and borrow. But if you tax then tax tomorrow. Taxing today is like trying to get fat on laxatives. We need profligate consumers and profligate governments. Why? Because the last bunch of profligate consumers and profligate governments just got carried out flat on their backs.