Insights on...

THE ECONTRARIAN
YOUR ALTERNATIVE TO THE ECONSENSUS

**Northern Trust**
**Global Economic Research**
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

**Paul L. Kasriel**
**Director of**
**Economic Research**
312.444.4145
312.557.2675 fax
plk1@ntrs.com

## Paradox Squared

*February 23, 2009*

Mainstream economists and the mainstream media continue to embrace John Maynard Keynes' notion of the "paradox of thrift." While most economists subscribe to the view that the pace of long-run economic growth is a function of productivity and thrift (saving), short-run growth can be retarded by too much thrift. According to this view, if households in the aggregate decide to cut back on their current spending, i.e., save more, aggregate economic demand will be negatively affected. Hence, the paradox of thrift. A little later in this commentary, I will try to dispel the notion that thrift retards growth in aggregate demand in the short run.

But before getting into this aspect of economic myth-busting, I want to call your attention to a February 19th *WSJ* opinion article by a member of the paper's editorial staff, Daniel Henninger, entitled "Obama's 'Hair of the Dog' Stimulus." Henninger essentially buys into the paradox-of-thrift argument. He cites the "Making Work Pay" element of the new fiscal stimulus plan as a way of giving a tax rebate to households with a lower probability that the tax reduction will be saved. Again, according to Henninger, an increase in saving would mute the stimulative effects of the new fiscal program. Is Henninger actually endorsing an economic plan that does not include reductions in marginal tax rates? Not to worry. He falls into line with *The Journal*'s monolithic editorial view that any stimulus plan devoid of marginal tax rate reductions is bound to fail in igniting aggregate demand because American households have rediscovered the virtue of thrift. To buttress his case, Mr. Henninger cites an authority on the subject of women's marginal propensity to consume/save, Anna Wintour, the editor of *Vogue*. Ms. Wintour's sampling, scientific, no doubt, suggests that ladies of leisure will be cutting back on their current spending. (To be complete, perhaps Mr. Henninger should have consulted *Playboy*'s octogenarian playboy, Hugh Hefner, as to what we men will be doing with our extra eight dollars a paycheck.) Moreover, Mr. Henninger says that President Obama has met the enemy of household spending and it is the president himself. You see, President Obama has an "austere persona" that evidently promotes household austerity! I found it paradoxical that anyone on the editorial board of *The Journal* would embrace anything Keynesian such as the paradox of thrift. Hence the title of this commentary, "Paradox Squared."

Let's get economically objective. Thrift or saving does not necessarily mute aggregate demand in the short run or the long run. As any economist of the Austrian school will tell you, saving simply implies one economic agent cutting back on its current spending and *transferring* its spending power to another economic entity. For example, suppose a household decides to cut back on its current spending in order to purchase an about-to-be issued corporate bond. The household is transferring its purchasing power to the corporation. Presumably, the corporation does not intend to simply sit on the proceeds of its bond sale. Rather, the corporation likely borrowed funds in order to *spend now* on some capital equipment or R&D. So, the act of increasing its saving on the part of the household does *not* lead to a reduction in aggregate spending in the economy, just a *redistribution* of spending.

There is, however, a special case in which an increase in thrift will result in a fall in aggregate spending. This is the case of "hoarding" money – currency and bank deposits. Hoarding in this sense is the term classical economists used to describe what hip-hop economists refer to as an

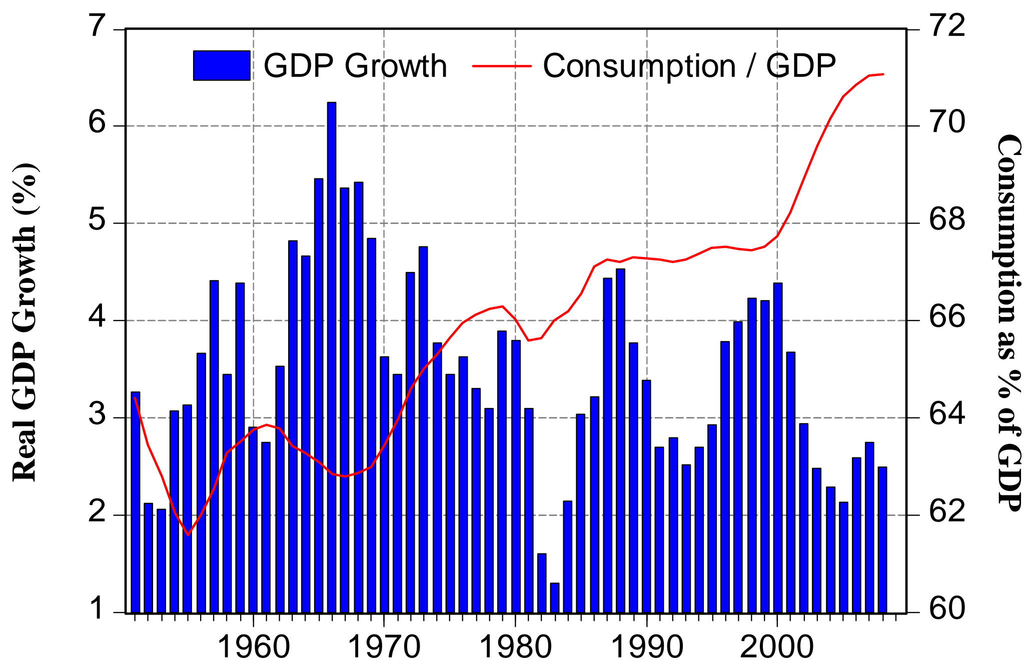
increase in the demand for money *to hold*, or a decrease in the *velocity* of money. If more and more households wish to curtail their current spending and increase their money balances, this will lead to a decline in aggregate spending in the short run if the *supply* of money is not increased commensurate with the increased demand for it to hold. The supply of money is created by the *new* lending actions of banks in cooperation with the central bank, the Fed in the U.S. case. An increased *demand* for money to hold does *not* automatically elicit an increase in the *supply* of money. Let's say that an employee of XYZ Company decides to save a larger portion of her paycheck in the form of increased money balances. On payday, XYZ transfers into the employee's bank account the employee's salary. So, XYZ's bank account is debited by the same amount that the employee's bank account is credited. *No new* money is created in this process. All that has happened is that the *ownership* of money has changed. *No net new bank credit* is created in this process. Although the employee's bank has gained some additional reserves in the process that would enable it to create some new credit, XYZ's bank has lost reserves, requiring it to *extinguish* credit, all else the same. Aggregate spending *does decrease* because the employee cuts back on her spending in order to increase her money balances.

So, the paradox of thrift, which mainstream economists and Mr. Henninger so readily embrace, is only paradoxical in the special case in which the public's demand for money to hold increases. How do these economists and Mr. Henninger know ahead of time that tax rebates will be accompanied by an increased demand for money to hold on the part of households? Even if the demand for money to hold does increase, I can make an argument that the *supply* of money available to be held is likely to *increase*. The Treasury is going to issue securities to finance its new spending and tax rebate programs. If, which is likely, banks and the Fed purchase a large quantity of these Treasury securities, then the supply of money will increase. **An increased demand for money to hold matched by an increased supply will *not* lead to a decrease in aggregate spending**.

There is one other tangential economic myth that I would like to bust – that the U.S. economy cannot grow rapidly unless there is a high level of consumer spending. I would ask you to turn your attention to the chart below. The line in the chart is the five-year moving average of the ratio (in percentage terms) of real personal consumption expenditures to real GDP. The bars are the five-year compound annual rates of growth in real GDP excluding federal government expenditures. Notice that in recent years, the consumption ratio has moved up significantly. Notice also that the real GDP growth rate has moved *down* significantly. **The most rapid real GDP growth we experienced in the 1951 through 2008 period occurred in the 1960s, a period when the consumption ratio was relatively low.** My bet is that when we come out of this current deep recession (Q4:2009?), the recovery and expansion will be accompanied by a much lower consumption ratio than we have experienced in recent years and higher export and business capital spending ratios than we have experienced in recent years. But most importantly, I expect that these changing ratios will be accompanied by higher growth in real GDP ex federal government than we have experienced in recent years. Why? Because, as I stated at the outset, the pace of economic growth is a function of productivity and thrift. And no less an authority than the editor of *Vogue* says that thrift is in vogue again!

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

Chart 1




**Note: GDP growth is 5-yr. compound annual rate; consumption ratio is 5-yr. moving average**

***Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy***

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.