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The Paradox of Thrift: Lose weight by eating more

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- Keynes' influence weakened temporarily in the 1980s, increased quietly again for a while thereafter, and had a roaring comeback with the financial crisis. Today, most practical men (and women)—and the odd madman—are the slaves of Keynes.
- Policy makers are especially drawn to Keynes' "paradox of thrift". According to this paradox, it may well be appropriate for individuals to save with a view to raising their incomes in the future. However, if all actors in an economy engage in a competition of saving, aggregate demand drops and everybody is worse off.
- There is no reason for the defenders of the virtue of saving to despair. Recent developments do not support the case of their adversaries.
- But even when it is disputed by facts, Keynes' paradox of thrift is politically very powerful: It promises a diet, with which you lose weight by eating more. How can this possibly be topped?

According to John Maynard Keynes, "practical men who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back". Today, most practical men (and women)—and the odd madman—are the slaves of Keynes. His influence weakened temporarily in the 1980s, increased quietly again for a while thereafter, and had a roaring comeback with the financial crisis. Policy makers are especially drawn to Keynes' "paradox of thrift" as it offers them the opportunity to bestow gifts upon their constituencies.

The paradox of thrift

According to this paradox, it may well be appropriate for individuals to save with a view to raising their incomes in the future. However, if all actors in an economy engage in a competition of saving, aggregate demand drops and everybody is worse off. Instead of stable incomes now and higher ones in the future, people have lower incomes and fewer jobs at present and in the future.

The idea that less (saving) effort translates into more fun (i.e., higher income and employment) would be a no-brainer for vote hungry politicians if many voters had not been brought up in the belief that saving is actually a virtue. To avoid any problems of cognitive dissonance of the electorate that could influence the result of an anti-saving campaign, astute policy makers and their advisors have replaced the likeable word “saving” with the harsh sounding word “austerity” and turned the focus on fiscal policy. It is the task of the latter to offset undesired increases in private savings by “deficit spending” so as to protect aggregate demand.

“Advocates of austerity”, who (in the words of their critics) either have not read Keynes or who have read but not understood him and who are suspected to reside predominantly in Germany, are a much easier target than preachers of the virtue of saving. With the attack being delivered with great political and academic authority from virtually any of the numerous “summits” fashionable among the movers and shakers today, the “advocates of austerity” are being given a hard time. No wonder, some of them are inclined to throw in the towel.

Some empirical evidence

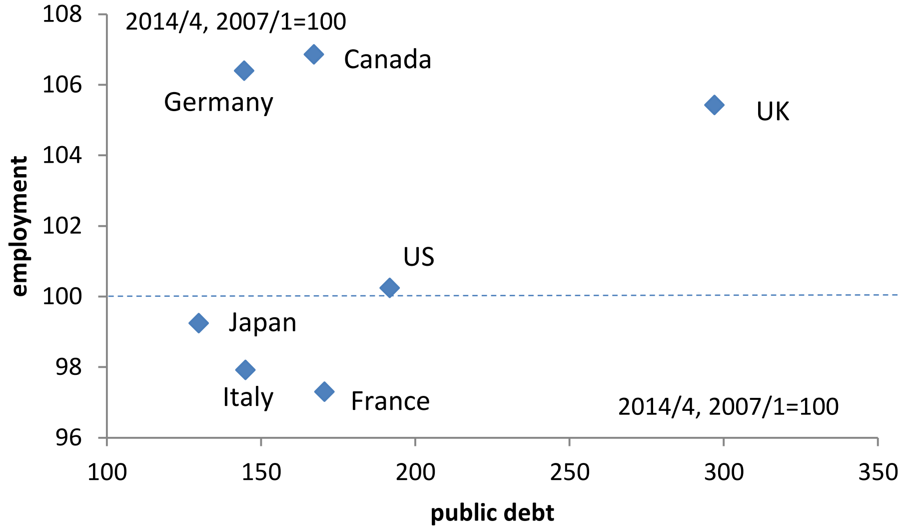
Yet, there is no reason for the defenders of the virtue of saving to despair. Recent developments do not support the case of their adversaries. Let’s first take a look at the G7 countries. Figure 1 plots developments of employment against those of the outstanding actual general government debt in current prices. Time series run from the first quarter of 2007—the last quarter before the start of the financial crisis—to the fourth quarter of 2014—the end of our data series. The first quarter of 2007 is indexed to 100. The paradox of thrift would suggest that countries with a more expansionary fiscal policy and hence a larger increase in public debt were able to create more jobs than the other countries, because they were more forceful in offsetting increases in private savings during the financial crisis.

As Figure 1 shows, all countries reacted to the financial crisis some extent with deficit-spending that led to an increase of their outstanding public debt. But there were considerable differences. During our observation period, the nominal debt of Germany and Italy each increased by around 47%. During the same time period, however, employment grew by 6.6% in Germany and fell by 2.0% in Italy. Debt rose by 68.8% in Canada and by 72.3% in France. However, employment fell by 2.7% in France and increased by 7.3% in Canada. Debt almost doubled in the U.S. (94.6%) while employment rose by only 0.8%. Adding Japan and the UK to the sample does not alter the picture. For all G7 countries, the correlation coefficient between employment and debt is 0.36, which is statistically not significant (t-value of 0.92). Thus, job creation in countries with more “austere” fiscal policies during the observation period was not systemically worse than in countries with more expansionary policies.

In the euro area, there is a particularly vivid debate about the “austerity” apparently imposed on other EMU countries by German policy makers. Ruling politicians not only in Greece but also in France and Italy question the targets for budget deficits and debt ratios agreed in their adjustment or stability programs.[1] Surely, they argue, fiscal consolidation will kill growth and therefore be

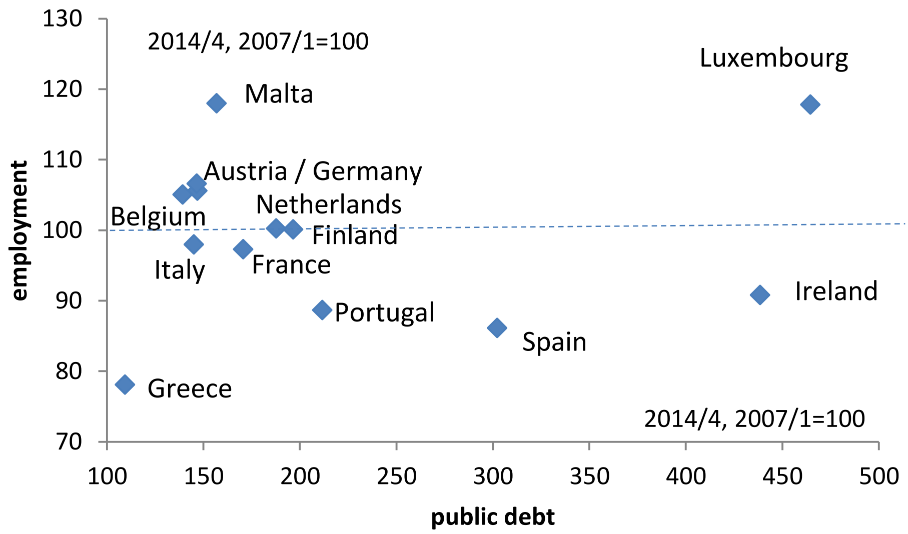
[1] The Syriza-led Greek government refuses fiscal „austerity“ outright, France keeps negotiating extensions of deadlines for the reduction of the government budget deficit below 3% of GDP, and Italy has abandoned a more ambitious target for deficit reduction required in its stability program because of the country’s excessively high public debt.

Figure 1. Employment and debt in the G7 countries, 2007/1 – 2014/4



Source: Haver, own calculations

Figure 2. Employment and debt in euro area countries, 2007/1 – 2014/4



Source: Haver, own calculations

self-defeating. However, a closer look at a group of 13 euro area countries, for which the necessary data are available, does not reveal the alleged negative relationship between fiscal consolidation and employment growth (Figure 2).

For instance, in Spain debt roughly tripled between the first quarter of 2007 and the fourth quarter of 2014 while employment declined by 13.9%. Against this, debt rose by only 39.3% in Belgium while employment increased by 5.0%.

For the 13 countries as a whole, the correlation coefficient between employment and debt is 0.10, well below any level of statistical significance.[2]

There is more than meats the eye

The developments reviewed above suggest that the relationship between fiscal consolidation and employment is a bit more complex than suggested by the Keynesian paradox of thrift. The idea behind this paradox is that savings generally are hoarded, hence taken out of economic circulation, and therefore depress aggregate demand. This may happen under extreme circumstances, but is not the case in general. Savings are generally lent on to fund investment. In this case, saving changes the composition of demand—away from consumption towards investment—but does not lead to a fall in aggregate demand. However, for savings to turn into investment demand, the conditions for investment and for the funding of investment must be right.

An offer you can't refuse

The data above show that it is much more important to get the conditions for investment spending and funding right than to pump up debt through an expansionary fiscal policy. The environment for investment appears to have been more favorable in Canada and Germany than in France and Italy. However, the effectiveness of a policy is no sufficient condition for its implementation. Often, the popularity of a particular policy is much more important. And in this rests the power of Keynes' paradox of thrift: It promises a diet, with which you lose weight by eating more. How can this possibly be topped?

[2] Note that the relatively high correlation coefficient between debt and employment changes for the G7 sample is strongly influenced by the UK, where a very large increase in debt was associated with an increase in employment. For the group excluding the UK the correlation coefficient drops to 0.03. For the combined sample of G7 and euro area countries including 17 data pairs, the correlation coefficient is 0.10.

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