



The Paradox of Thrift¹

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Should Americans Let Loose to Boost the Economy?

In early 2009 several economists, the most notable being Nobel Laureate Paul Krugman, identified a trend in the U.S. economy that – in their view – threatened to extend and deepen the downturn if left unchecked. This risk, termed the “paradox of thrift,” was noted by Krugman² on the heels of government reports showing increased personal saving by U.S. consumers. What is the “paradox of thrift?” To borrow from *Wikipedia*, “The paradox of thrift (or Paradox of Saving) is a paradox of economics propounded by John Maynard Keynes. The paradox states that if everyone saves more money during times of recession, then aggregate demand will fall and will in turn lower total savings in the population because of the decrease in consumption and economic growth.”³

The debate over the notion’s validity has a contentious history in economic circles. As the *Wiki* quote indicated, those with Keynesian leanings tend to hold that personal saving constricts economic growth by reducing consumption. The opposing camp, which includes the monetarist, Austrian and supply-side schools, argue that saving is necessary to provide a capital base from which financial institutions lend to firms for investments to sustain growth. Statistics are frequently heralded by the latter camp that correlate national saving rates with growth rates and show those countries with higher growth rates have higher saving rates.

In our opinion, neither camp has a lock on the whole picture. There is no doubt that increased saving slows consumption *near-term*, that consumption in turn propels demand, and that demand propels economic growth. However, we would also maintain that without an appropriate level of saving there is no base from which to fund sustainable economic growth (more on this in the next paragraph). On the other hand, we would also observe that some studies correlating higher growth with higher saving rates fail to consider that those countries with higher growth rates are usually emerging economies with an emphasis on exports. Demand for their production is primarily external and so saving truly does build an investment pool for subsequent expansion. In the United States, by contrast, most demand is from internal sources and so saving does offset consumption to a certain extent. Hence, applying such

¹ The original version of this article, written by Delphi Advisors, appeared in April and May 2009 Economic Outlook and 4Cast newsletters. See Services page for more details: <http://www.delphiadvisors.com/servicenotes.html>.

² <http://krugman.blogs.nytimes.com/2009/02/03/paradox-of-thrift/>

³ http://en.wikipedia.org/wiki/Paradox_of_thrift

correlations as national saving rates and national growth rates to the United States may be inappropriate.

However, we would also maintain that consumption fueled by debt and a lack of saving set the stage for the economic fallout currently being felt across the United States and the globe. In the short-run, consumers can borrow to buy. This creates demand. Firms see this demand and want to expand to meet it; to do so, they frequently need to borrow to invest. However, without domestic savings in financial institutions to provide a funding base for investments, there are three choices: either interest rates must increase to ration the limited capital supply to those projects that can afford the higher borrowing costs, excess savings can be imported from other countries, or the money supply can be expanded by various “technical methods.”

Rationing limited capital via higher interest rates slows economic growth by choking off investment. Recall that the lack of funds is due to low saving rates. Because capital is rationed there is lower capacity to meet demand and so consumer prices for the demanded goods and services rise; prices continue to increase until a capacity investment can make a return sufficient to cover the higher costs of borrowing. Simultaneously, higher savings rates could expand the capital base, allowing interest rates to drop, and so permitting more investment.

Importing excess savings from other countries “keeps the party going” by holding interest rates artificially low, thereby allowing consumers to continue borrowing and firms to continue investing for longer than would be justified were imported funds unavailable. However, the façade eventually crumbles because consumers are forced by their debt overload to cut back on spending. The drop-off in demand ripples back through the supply chain, causing producers to “pull in their horns” while heightening concerns among the foreign lenders that their funds may be in jeopardy. They, in turn, either decrease the flow of funds, begin to call in loans, and/or demand a higher risk premium (interest rate) to protect themselves against possible default by borrowers. All of these responses have feedback mechanisms that further reduce both demand and supply.

Expanding the money supply by “technical methods” stokes inflation that brings with it a new set of problems. While official government statistics can be cited to argue the U.S. economy was not experiencing general inflation, the tech stock bubble, the stock market bubble, and the real estate bubble were all manifestations of inflationary policies caused by a money supply expanded largely through use of leverage. Investments to meet debt-supported demand were undertaken and capacity expanded; prices of most goods and services fell with their expanded supply, giving the sense there was no inflation. However, inflation was accumulating in pockets of the economy and in this case these manifestations of inflation gave a sense of “phantom” wealth (e.g., paper increases in real estate and mutual fund portfolio valuations) leading consumers to believe they could borrow more, creating yet more demand. However, saving rates continued to decline; without a source to fund further investments, the money supply again had to be expanded by “technical methods,” feeding the debt cycle. We feel this equity

trader stated the situation very succinctly: “The key for investors is ... remembering that debt destruction is the only true cure for what ails the global economy... [T]he process, while painful, is constructive on the margin.”⁴

Stepping beyond the theory, there is a practical application for all of this. At an individual level, whether personal or business, practicing thrift becomes a premium virtue when confronted with hard times. However, that virtue can be taken to such an extreme that a psychology akin to a “bunker mentality” dominates all decision-making. It is during the last half to one-third of economic downturns that winners of the next business cycle undertake steps to improve profitability in anticipation of the upturn; costs of goods and services needed to support opportunities and improve processes are generally cheaper at that time, and the opportunity costs of start-up and testing to implement new equipment or processes are not as high when markets are sluggish. The recent announcement of Pulte’s acquisition of Centex, creating the United States’ largest home builder, could be viewed as an example of this type of strategic move.^{5, 6} Centex’s stock price over the past five years averaged over \$40 per share. Depending on share prices and treatment of debt and other arrangements between now and closing, it would appear Pulte is purchasing Centex at roughly a 75 percent discount to its average share price of the past five years. Time will tell if this is a good deal, but it is an example of a strategic move that three or four years ago probably wouldn’t have been seriously contemplated. A mindset of “thrift only” will miss opportunities to improve competitive positioning because they inevitably involve spending money – in this case, making investments. On the other hand, imprudent expansion at such times by excessive debt – and the Pulte acquisition of Centex involves a lot of debt – can imperil the enterprise. The winners in the next business cycle find the right balance between too much and too little thrift.

For the forest products industry specifically, our take is that there has been significant over-capacity built in response to debt-supported demand; some portion of that idled capacity will not return to production for a long time (if ever). Further, we believe there was a demographic effect (i.e., “baby boomers” hitting their peak consumption years) that amplified apparent demand and exacerbated this over-capacity impact. For those reasons we expect winners in the next cycle will be those focused on margin-improvement rather than expanding capacity to gain market share. We anticipate winning investments will focus on streamlining processes to reduce production costs and improving processes to unlock top-line value through marketing and product differentiation. For manufacturers the question is how best to position their mills for a world with fundamentally less demand for the next 10 years than we’ve seen for the previous 10 years. For timber owners and investors the question is how to position assets in market regions that will offer a competitive mix of purchasers to maintain timber asset values.

⁴ <http://www.marketwatch.com/news/story/story.aspx?guid=%7B76D2F6AD%2D08E0%2D431B%2D9783%2DE83B64205E7F%7D&siteid=rss>

⁵ <http://www.bizjournals.com/tampabay/stories/2009/04/06/daily37.html>

⁶ <http://www.ft.com/cms/s/0/0e633ed8-2437-11de-9a01-00144feabdc0.html>