Foundation for Teaching Economics

introducing young individuals to an economic way of thinking

Saving and Spending: A Good News/Bad News Story

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Student Reading

Consumers Are Saving More and Spending Less

Jack Healy, The New York Times, February 2, 2009

American consumers and business are embarking on an era of thrift as the recession deepens, saving more money as they cut spending on purchases as varied as sweaters, new homes and office towers. ... The personal saving rate in the last three months of 2008 rose to its highest level in 6 years.

. . . "If households are shying away from spending, what's going to cause business to start spending again?" asked Aaron Smith, senior economist at Moody's Economy.com

Putting away money and paying down debt may be good for one family's kitchen-table economics, but the broader economy suffers in the short term when millions of families do it.

A dollar saved does not circulate through the economy and higher savings rates translate into fewer sales and lower revenue for struggling businesses.

...Still some economists said the rising rate of savings was a natural reaction, penance for America's spendthrift ways.

"If American consumers are less indebted, live within their means and have more money in savings, they are better positioned to spend on a sustainable basis for years to come," said Greg McBride, senior financial analyst at Bankrate.com. "As painful as that is economically in the short run, these developments will better serve us in the long run."

. . . In the last three months of 2008, the economy contracted at its fastest pace in a quarter-century. As Americans spent less, companies cut jobs and reduced their investment in equipment, software and buildings to trim their costs.

. . . The unemployment rate, at 7.2* percent is at its highest in 16 years, and some economists say it is likely to top 9 percent in this downturn.

. . . . Over all, personal spending fell 1 percent or an annualized $102.4 billion in December, after a drop of $77.8 billion in November, the Commerce Department reported.

. . . "Consumers are rational," said Joshua Shapiro, chief United States economist at MFR. "They respond to incentives and conditions, and right now the conditions and incentives are: spend as little as you can, and pay down as much as you can. You hunker down. That's what the consumer's doing."

* As of February 2nd

www.nytimes.com/2009/02/03/business/economy/03econ.html

Recently, a late night talk show host quipped: "There's good news and bad news out about the economy today. The good news is: It's still afloat. The bad news is: It's only being buoyed up by Sarah Palin's shopping sprees." The brouhaha over Ms. Palin's campaign clothes shopping is now history but our economic problems are very much still with us and they're getting to be a little too serious for joking. In fact, according to some recent headlines, we may be getting hit with an economic double whammy as we experience what's sometimes called *the paradox of thrift* - where doing what seems to be right can turn out all wrong!

> . . . thrift may be a virtue for the individual, but could damage the economy as a whole, according to the economist John Maynard Keynes, writing in the midst of the Great Depression in the 1930s.
>
> He called it the paradox of thrift. The more people saved, the more they reduced effective demand. This was one reason, he pointed out, that a recession can become self-reinforcing.
>
> Keynes also argued that, faced with slowing demand, businesses would not necessarily use the extra savings available in the economy to invest.
>
> In the Keynesian theory, as the slump in demand cascaded through the economy, the resulting slowdown would mean that everyone had less income . . . news.bbc.co.uk/1/hi/business/7745858.stm

The joke about Governor Palin's campaign wardrobe contains the important nugget of truth that spending is good medicine for an ailing economy. By far the largest of the three spending components (consumer + investment + government) that economists measure is spending by consumers like you and me . . . and yes, political candidates, too.

The important effect of people's shopping and spending is the message it sends to producers and sellers: "MAKE AND SELL MORE STUFF!" That's good for the economy because in order to "make and sell more stuff" more people must be hired; more machinery and supplies for production must be purchased; more entrepreneurs will start new businesses; the stock market will expand by volume and price; housing starts will increase; more innovations will occur . . . and on and on. In short, the message sent to the economy by way of spending is GROW!

Sounds like a simple enough cure for an ailing economy. But, the problem is that in tough economic times, spending isn't high on people's "to-do" list. That makes sense, doesn't it? One of the things you learn as you grow up, get an allowance or work at part-time jobs is to budget your money, spend carefully, and consider future needs. During uncertain economic times, then, it's not surprising that people reduce their spending. They try to pay down their debt and to save for the future.

The value of saving - that's another thing you learn about as you grow up. Saving allows you to create a cushion of safety for unforeseen events, and to make investments so that you'll be better off in the long run. In addition to being a good strategy for you, individually, it's also true that savings are absolutely essential to the *long-run* health and growth of an economy. Savings is the source of long term investment capital that allows businesses to expand production and the economy to grow.

So, saving is all good, right? . . . Not so fast with the "Yes" answer there. Like many things in economics, it depends. It depends on whether we're talking about you, individually, or the economy as a whole, and it depends on whether we're considering the short term or the long term.

The problem is the *paradox of thrift* we mentioned at the beginning of this reading. Remember that we said spending sends "PRODUCE, HIRE, GROW!" messages through the economy? Well, if consumers are putting more money into savings by reducing their spending, the "produce, hire, grow" message fades away. The paradox, then, is that savings is a wise choice in the long run, but can create problems in the short run. And, while increased saving is a good strategy for individuals in a downturn, it can actually be detrimental to the economy as a whole - and thus to the individuals' long-term well-being. Money placed in savings is money diverted away from the spending that is so important to economic growth. In fact, savings can have an *exponentially* negative impact on the economy, because for every few dollars put into savings many jobs are eliminated to decreased demand and the lost income further reduces demand. See the problem?

Resolving the Paradox of Thrift

Justin Fox, Time.com, February 12, 2009

...The savings rate is on the rise. Great, right? Not exactly. The sudden sobering up of the American consumer happens to be the No. 1 force driving the U.S. and global economies downward. We're saving more, yet we're all getting poorer.

. . . Paul McCulley, an economist and portfolio manager at bond giant Pimco, defines it like this: "If we all individually cut our spending in an attempt to increase individual savings, then our collective savings will paradoxically fall because one person's spending is another's income-the fountain from which savings flow."
www.time.com/time/magazine/article/0,9171,1879195,00.html

We noted earlier that businesses are spenders in the economy, too. If consumers are saving instead of spending *and* businesses are not using those savings for investment spending, then the economy takes a double hit. In that situation, total spending can fall very fast and that means further loss of business income, jobs, and workers' income.

Some evidence indicates that we are currently experiencing this "double whammy." First, the bad news on consumer spending: The U.S. Commerce Department reported that construction spending continued its downward trend, falling an additional 16.8% in January. In the same month, new orders for manufactured goods fell by 1.9% ($6.9 billion), continuing a six-month downward streak. As predicted, that's not good for employment and income:

March 6 (Bloomberg) -- The U.S. unemployment rate jumped in February to 8.1 percent, the highest level in more than a quarter century, a surge likely to send more Americans into bankruptcy and force further cutbacks in consumer spending.

Employers eliminated 651,000 jobs last month, the Labor Department said today in Washington. Losses have now exceeded 600,000 for three straight months, the first time that's happened since the data began in 1939.
www.bloomberg.com/apps/news?pid=20601087&sid=acVqoYIAwBzo&refer=home

Think about what the data might be telling us. Are we caught in the *paradox of thrift*? As you consider the news excerpts try to sort out the key indicators:

- What is happening to savings and spending rates in the United States?
- What effects are those changed rates having on the economy as a whole?
- How, in turn, are the changes in the economy impacting individual people's incomes?

Pay careful attention to the difference in the short-run and long-term effects of consumer reactions to our current economic uncertainty.

Discussions Questions:

1. In the face of the economic slowdown do you think your family *will* be spending less and saving more? Why? Why not?

2. Do you think they *should* be? Why? Why not?

3. Draw a circular flow model to show the impact of reduced consumer spending and increased consumer saving.

4. If people's decisions to save reduce production and employment, what is likely to happen to total savings in the long term?

5. What *might* reverse the trend and start consumer spending on an upward trend? (Brainstorm a list.)

6. Check the Internet, newspapers, and news magazines. How does President Obama propose to restart the engine of consumer spending and economic growth?

Teacher Guide

1. In the face of the economic slowdown do you think your family *will* be spending less and saving more? Why? Why not?

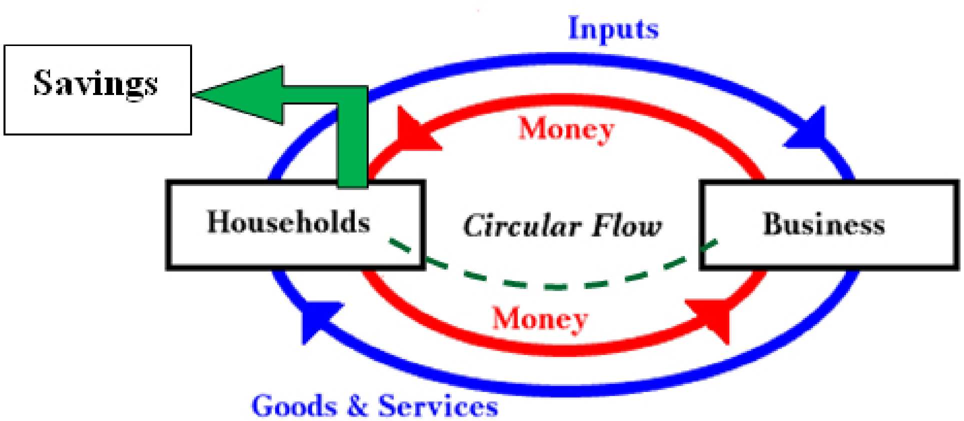
> *Answers will vary. Help students to concentrate on the trade-off between spending and saving, and emphasize how the opportunity costs change if the family's income is reduced or threatened.*

2. Do you think they *should* be? Why? Why not?

> *While this question also calls for an opinion response, help students to see that individual answers to this question can't be easily categorized as selfish/unselfish or patriotic/unpatriotic. The definition of a paradox is a situation with contradictory aspects and a situation in which individuals making rational choices to be thrifty collectively produce an undesirable outcome certainly qualifies as having "contradictory aspects."*

3. Draw a circular flow model to show the impact of reduced consumer spending and increased consumer saving.

> *Students should modify the standard circular flow model, shown in red and blue below, by adding an outflow of savings from households (green arrow). The immediate effect will be to reduce the flow of money (spending) to businesses (as indicated by the weaker green dotted line replacing the bold red flow line in the diagram below.) In discussion, help students recognize that this first step will ultimately reduce the flow of goods and services to households, and reduce business demand for the resources (workers) that households provide, so the effects will spread throughout the economy.*



4. If people's decisions to save reduce production, employment and income, what is likely to happen to total savings in the long term?

> *TOTAL savings is likely to fall. Note that this is true even when people are trying to save more. When production, employment and income are reduced, households try to save more in response to the slowing economy. This causes less consumer spending and production. Employment and income are reduced further so that even at a higher rate of savings by those who still have income, the total saved is less than if more households had income but saved a smaller share of it.*

5. What *might* reverse the trend and start consumer spending on an upward trend? (Brainstorm a list.)

Encourage students to be creative. Their answers will vary but are likely to focus on plans to reduce the uncertainty consumers and businesses face. Help them see how consumers' and businesses' view of the future impact their willingness to spend. Ask what things might influence their view of the future. You may wish to introduce the Consumer Confidence Index, tracked by the Survey Research Center at the University of Michigan and published by the St. Louis Fed at research.stlouisfed.org/fred2/series/UMCSENT/

6. Check the Internet, newspapers, and news magazines. How does President Obama propose to restart the engine of consumer spending and economic growth?

President Obama's plan primarily increases government spending through government funded programs, designed to create jobs and relieve hardship, increase incomes and then, in turn, increase consumer spending. One big question that remains is whether or not households that receive some form of increased government spending will actually spend the money or continue to save more. Also unknown is whether increased government spending can influence businesses to spend more investment dollars. However, remember that consumer spending is by far the largest spending component in the economy and the stimulus must produce a hefty increase in consumer spending to give the economy the desired "MAKE AND SELL MORE STUFF" message that leads to economic growth. Wikipedia provides a reasonably straightforward summary of the provisions of the stimulus plan (officially the "American Recovery and Reinvestment Act of 2009) at en.wikipedia.org/wiki/American_Recovery_and_Reinvestment_Act_of_2009

Suggested sites/articles relevant to this *Hot Topic*:

Greg Mankiw's Blog (There's a cool cartoon here on The Paradox of Thrift and links to other resources as well.)gregmankiw.blogspot.com/2009/02/paradox-of-thrift.htm

Bureau of Economic Analysis, **BEA** www.bea.gov/newsreleases/national/pi/pinewsrelease.htm

The British Broadcast Corporation, **BBC** (To get an idea as to the global nature of the current economic crisis.) news.bb.co.uk/1/hi/business/business/7745858

The Brookings Institute (for economics research)www.brookings.edu

NPR (National Public Radio) www.npr.org/money

Outlook for Government on Facing Global Economic Crisiswww.wikio.com/video/869278-22k

Pres. Obama's remarks on the Stimulus Package of '09www.cnn.com/2009/POLITICS/02/17/obamastimulusremarks/-87k-

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