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Essay on Saving and Consumption

Abstract: Consumption and saving decisions are at the heart of both short- and long-term macroeconomic analyses. Since the global crisis outbreak, one of the main issues for indebted countries has been whether to pursue a policy which promotes saving or to try to induce economic growth by increasing consumption. Consensus has not been reached on this issue, which is based on an old debate of whether a country should pursue a policy of Keynesianism or monetarism.

Ergo, this essay discusses arguments supporting both approaches, primarily through theoretical arguments of Keynesianism and monetarism. The authors concluded that in a crisis environment, consumption policy should be given priority; however, a precondition for this is that a country was not overburdened prior to the crisis outbreak, i.e. a successful crisis management policy should, in fact, be pursued over the periods of expansion.

Key words: consumption, saving, Keynesianism, monetarism, crisis.

JEL code: E21 and E00

1. Introduction

The Greek crisis has deepened the debate of which policy should an overly indebted country pursue: should a country lean on the policy of saving in the effort to stabilise public finances or use policy of consumption to encourage economic growth and additional employment? On one hand, increase in consumption is needed to stimulate a sluggish economy, while on the other hand, increase in public spending leads to the public debt increase and may deepen the crisis.

Unfortunately, in today's macroeconomics there is no consensus on how to pursue macroeconomic policy. Such a consensus was last reached in 1960s and the collapse of Keynesianism brought about the collapse of macroeconomic consensus. Nowadays there are numerous concepts dealing with the role of government and the manner of pursuing economic policy in a crisis. The most important macroeconomic schools of thought are: Keynesian Economists, New Keynesians, Post-Keynesians, Monetarists, New Classical Economists, Austrian School of Economics, and Supply Economy.

Regardless of differences between these concepts, they can be divided into two large groups: the schools of Keynesian orientation (the first three) which support the idea of necessary government intervention and increased consumption during a crisis, and the schools of monetarist - classical orientation, which are against government intervention and believe that the government should create a stable environment, curb excessive consumption, and encourage saving. The majority of these schools stem from two basic concepts, the Keynesianism and the monetarism. Bearing in mind that these two concepts recommend the use of completely different instruments of economic policy for achieving the same goals, it is safe to say that they actually represent two perceptions of reality.

Therefore, this paper will provide a detailed analysis of the Keynesian concept which emphasises countercyclical economic policy and increase in public expenditure, and of the monetarist policy which opposes excessive public spending and suggests creating stability and balanced public finances.

The analyses of the Keynesian concept shall be given in the first part of the article and followed by the monetarist concept analysis. The third part shall provide an overview of the economic policy pursued by modern countries, while the concluding remarks shall give the authors' position on the issue.

2. Keynesian concept of crisis consumption

In the 19th and the early 20th century, there was a general opinion that economic activity fluctuations, characteristic of economic cycles, represent natural phenomena which have to be endured. Such fluctuations caused enormous damage to some societies, but they were accepted as inevitable. It was generally conceived that government interventions are futile, since the classical model economists believed that the economy has the ability of self-recovery. The understanding of classical theory that the economy is able to automatically provide full employment by means of market mechanism pointed to the *laissez-faire* economic

policy, i.e. the government's refraining from intervening in the economic life. There is no need for the state to interfere because the market mechanism by itself provides full employment of the output factors and their most rational allocation.

However, the Great Depression revealed all the incapability of the market to act as a self-regulating mechanism. Classical economic theory had no explanation for the new situation. Immense decline in real output and employment did not seem like a temporary divergence from balance, as it was explained by the classical model. In his book "The General Theory of Employment, Interest and Money", Keynes explains why the situation unravelled as it did, how to move on and, most importantly, what to do so that it does not happen again. Economic cycle is now perceived as something that can be regulated, and more and more economists accept that monetary and fiscal policies can and should be used as instruments for changing aggregate demand in order to ensure high employment, high economic growth, and stable prices.

The idea behind the theory of Keynesianism is that market system functions in a way that the reproduction system, as a rule, is below the level of full employment of the output factors. This establishes a quasi-balance on a suboptimal level, whereby there is an accord between the base variables. However, this accord is accomplished below the level of full employment. The state of imbalance is not solely a result of unfinished processes of harmonisation, i.e. the fact that the system is in a transition period heading towards balance. This leads to a conclusion that the economy strives to permanently remain below the level of full employment, unless the government engages in pursuing interventionism policy of regulating economic processes. Keynes (1974 issue) stresses that the state of full employment is a rare and transient occurrence, and that therefore "an intermediate situation which is neither desperate nor satisfactory is our normal lot."

Keynes and Keynesians emphasize the inability of the market system to automatically (without the intervention of the state) provide the exact volume of investment needed to achieve full employment without inflation, and not – as it tends to happen – that the volume of investments is too low in one period and leads to unemployment, while in the other period it is too high and leads to inflation (Fabris and Pejović, 2013).

According to Keynesians, the main cause of cyclical fluctuations lies in the aggregate demand fluctuations. This position implies that in crisis conditions, the state must increase aggregate demand (public spending) by means of its own spending.

Keynesianism emphasises the role of friction factors which impede the action of the power of market mechanism towards natural balance, and in general, takes the theoretical stand that the system is, as a rule, in the state of imbalance, which gives rise to a conclusion that economic policy should permanently and in short term act in the aim of adjusting the performances of economy. It is necessary to pursue short-term monetary and fiscal policy of “fine tuning” of real processes, with the main intention to act towards stimulating real growth whilst ensuring that inflation growth is not excessive.

An available alternative – which should be given advantage in case of depression and reduction of cyclical fluctuation – is an aggressive use of fiscal policy. Whenever the economy shows signs of recession and sliding into depression a remedy should be sought in increasing public spending – which should compensate for insufficient private investments – and reducing taxes. Increase in public spending will boost the output of the private sector because the state will appear instead of private buyers. In this way, tax base and public revenues also increase through increased output. Simultaneously, the increase in output induces GDP growth which, with the unchanged level of public debt, leads to the reduction of its relative share. On the other hand, increase in output leads to increase in the number of employed persons, reducing welfare expenditures and thus reducing public expenditures.

Keynesians point out that pursuing saving policy during the period of crisis is wrong. To wit, every instance of consumption is someone’s income. If we reduce consumption due to excessive indebtedness, economic entities’ income will decline – and the decline in income may additionally deteriorate indebtedness because it causes unemployment.

Through public works (construction of roads, bridges, schools, etc.), major orders, and hiring large number of workers the state directly increases the aggregate demand, while by means of multiplier effect it induces increase in domestic product higher than the initial investment amount. Keynesians claim that the increase in public expenditures has more impact than tax reduction.

In the environment of prevailing unemployment and depression, tax reduction leads to the increase in available income of the population. Increase in available income gives rise to new initial consumption, which sets into motion an entire chain of secondary consumption, in the end leading to – and that is the result of the multiplier effect – new employment and domestic product which by far exceeds the initial consumption i.e. the tax reduction.

They point out that every tax increase means a reduction of available income of the population, which results in consumption decline. Every consumption decline in the environment of unchanged investments means a decline in domestic product.

Keynesians find it possible to stimulate aggregate demand in long term. Thereby the state should finance the budget deficit primarily by sovereign bond issuance. The state also has a possibility of direct borrowing from the monetary authorities, which leads to currency issue. The state would be able to establish balance by matching the amount of placed bonds placed to the accumulation surplus. Deficit recorded during recession should be covered by surplus recorded during the period of expansion. With the context of recession economy as its starting point, Keynesian theory implies that the expansion of aggregate demand shall not significantly affect the inflation rate increase. To wit, in the area of unused production factors the increase of aggregate demand primarily induces the increase in the level of economic activity while its effects on inflation generating are relatively weak.

Although the Keynesian theory stresses out the importance of fiscal policy as the main lever of macroeconomic galvanization of economic processes, it requires the monetary policy to also support and promote the stimulation of economic activity, which can be achieved primarily by reducing interest rates and/or by increasing loan availability (Dimitrijević and Fabris, 2009). Ease access to loans and lower interest rates have a stimulating effect on investment activity, which ultimately leads to the increase in overall output, i.e. in real national income, and employment.

It is assumed that this will lead to the additional cash injection into the system and the creation of a temporary cash surplus over market sectors' demand. According to Keynesianism, there are two complementary mechanisms used to establish new equilibrium. The first mechanism of equilibrium refers to the financial sector, while the second refers to the real economy (these two mechanisms cover two concepts of demand for money). In the area of finances, a part of additional currency issue is absorbed through increased financial sector demand by market transactors. This occurs because the inflow of additional amount of cash in the financial market causes the interest rate decline and increase in the prices of bonds. The second more important mechanism acts in the real economy – currency issue induces the interest rate decline, which has a stimulating effect on investments. Certain investment projects which were not viable under the previous higher interest rate are now profitable. Additional investments have multiplier effects on the rise in economic activity. By means of both of these equilibrium

processes, additional amount of money was absorbed in both financial and real sector of economy, whereby economy reached higher levels of employment and production (Ćirović 1997).

3. Monetarist concept of liberalism and saving

As a result of the 1970s' Keynesian policy failure to tackle both rising inflation and unemployment, the generally accepted Keynesian orthodoxy had to step aside for a new one – monetarism. “Money management” was recommended instead of “demand management” policy. As stated by Ćirović (1997), monetarism developed mainly as a reaction of the liberal right and neoclassical economics to Keynesianism and its dominant position in theory and politics up to the late 1960s. Permanent income hypothesis, the abandoning of liquidity preference, the introduction of stable function of demand for money, the negation of the Phillips curve in the long run, and prioritising rules over discretion represent the theoretical arguments which arose from the direct debate with Keynesians.

Both Keynesians and monetarists have the same conceptual economic model, which enables the same terminology and the approach to problems. However, the differences between these two views of economic policy are reflected in different assumptions of the efficiency of government intervention on one side, and the market on the other. According to Keynesians, full employment is a prerequisite of a healthy society, while monetarists regard price stability as a precondition for a sound market (Dimitrijević and Fabris, 2012).

Monetarists emphasize that the state tends to create inflation and increase public expenditure that leads to permanent deficit. Reasons for pursuing such policy occur due to: insufficient understanding of economy, political cycles (in order to remain in power, the government tends to try to reduce unemployment by increasing inflation), organised actions by powerful lobbies, etc.

Monetarists discarded the position that a decrease in public spending generates additional weakening. According to monetarists, in advanced countries, significant declines in public spending were followed by expansion, not contraction. They point out that decisive fiscal saving creates confidence in the private sector, and this strengthened confidence overcomes a decline of activity due to reduced public expenditure.

The fundamental premise of monetarism is that the liberal market, unless disrupted by the state, shall always lead the economy towards the equilibrium of

full employment and production factors, unless in case of a transition shock. In the case of the latter, balancing powers require a short period of time to establish long-term equilibrium. According to monetarists, transition phases of disequilibrium may occur in the short term, because automatic action of the market mechanism cannot instantly return the system into the state of equilibrium.

Monetarism rests on a premise of economic stability and full employment. Market system is not only inherently stable, but it also has built in shock absorbance mechanisms. It is a system, which by itself eliminates exogenous influences and aspires to stability whenever it is destabilised in crisis conditions, because initial shocks (e.g. government intervention) may temporary throw it out of balance.

Monetarism stresses out the key role of monetary policy in establishing stability as well as in its disturbing it. As regards disturbing the monetary equilibrium, central bank plays the key role, while the real economy plays the key role in its re-establishing. Monetary disequilibrium spills over to the entire economic system. At that point the automatic market processes come into force, struggling to bring the economy into a new equilibrium. Establishing new equilibrium is achieved exclusively by means of changing the nominal price level.

In such circumstances, the government intervention (increase in public spending) makes no positive impact; on the contrary, it acts destabilising and induces inflation as solutions imposed by the government are always inferior to the solutions offered by the liberal market. Thus the monetarists support the idea of the discretion fiscal policy – which contributes to, maybe even causes the cycles – being replaced with the policy of balanced budget. Even the policy of deficit bonds-based financing has adverse effects according to monetarists. Sovereign bonds' appearance on the financial market cause interest rate increase, and higher interest rates discourage spending and investment endeavours, and thus annul the effect of the aggregate demand increase created by the budget deficit. According to monetarists, regardless of the manner of deficit financing, total volume of aggregate demand remains unchanged, although budget expenditure increases continuously. The economy loses all that it gained through government investments due to a decline in private investments and personal consumption.

Excessive government interventions and interference in the choice of individuals are counterproductive, because they result in non-rational allocation of limited resources, and weaken the entrepreneurship initiative. At the same time, they induce an increase of the budget deficit, which leads to an increase in the public debt. This means higher indebtedness of the country, with the increasing debt becoming more and more expensive, which can lead to closing the financial mar-

kets due to the assessment that the country will not be able to service its debt, like it happened with Greece. Such conditions call for pursuing saving policy, which means that the state should act as every other individual and adapt its consumption to its income. If not, monetarists argue that the country will fall in a crisis even deeper than the one it tried to overcome by increasing public spending.

Excessive government initiative, over-pronounced fiscal policy, and significant social welfare are counterproductive because they weaken the entrepreneurship initiative on one side, and lead to the accumulation of budget deficits on the other. Monetarists support the reduction of budget expenditure, the reduction of tax burden, and the reduction of government transfers aimed at increasing competitiveness. Labour market reforms are of particular importance. They are reflected in: the reduction of labour force expenditure (lowering of guaranteed wages), limiting the powers of trade unions and increase in the labour market competitiveness.

Liberalist economic policy is the underlying philosophy of monetarism. The state is obliged to prescribe the minimum regulations and protect citizens and institutions. Interventionism policy is inefficient due to our incomplete knowledge of economy and the existence of long-lasting and variable time delays. Monetary policy represents the central means of economic policy, but while in Keynesianism it was aimed at anticyclical regulation of the economy, now focuses on anti-inflation tasks.

Monetarists distinguish the economic policy effects in long term from those in short term. Expansive monetary policy's effects in the short term are divided into an increase in real and in nominal variables, while in the long term, only nominal variables record increase. This is the essence of the monetarist hypothesis on nonneutrality of money in the short term and its neutrality in the long term. Therefore, monetarists justifiably point out that expansive policies should not be resorted to, since although they may seem as a remedy, their effect is only short-term. In the long term, the effects of the "remedy" (expansive policy) are by far worse than the "illness" we tried to cure in the first place.

Monetarists deem fiscal policy to be inferior, although it is a subject of research.¹ It influences the economy only as much as it influences the movements of money supply. Friedman points out: *To have a significant impact on the economy, a tax increase must somehow affect monetary policy—the quantity of money*

¹ Monetarists find fiscal policy to be inefficient because it leads to the forcing out of the private sector and acceleration of inflation.

and its rate of growth... The level of taxes is important—because it affects how much of our resources we use through government and how much we use as individuals. It is not important as a sensitive and powerful device to control the short-run course of income and prices (Bajec and Joksimović 1997, p. 178).

Monetarists support the idea of operating on the basis of market criteria, disregarding social considerations. The existence of transfers from the government necessarily causes budget deficit which leads to government intervention and suspension of market mechanism. In this context, organised groups such as trade unions represent potential danger, because they may require redistribution of revenue by means of various institutional and extra-institutional structures. Although this seems atypical for human societies, here monetarists also emphasise the distinction between effects in the long and short run. They expect that this will lead to new jobs in the long run and thus individuals will not be social welfare beneficiaries for an indefinite period of time.

4. Economic policy in modern countries

Practice of today's modern state supports none of the extreme situations – neither liberal market nor the government intervention which completely suspends the action of market mechanism. The *laissez-faire*² concept, which is the synonym for the ideology of absolutely liberal market, has never been applied in practice, not even during the period of liberal capitalism. The ideal of free trade has never been achieved because regardless of the overall liberalisation trend, government kept a large number of functions in the area of foreign trade, country defence, preservation of public peace and order, infrastructure construction, export sector subsidizing, development of certain activities of public interest which are not considered profitable for private equity, etc.³

On the other hand, the system of full government intervention in which the market system does not function at all existed during the period of centrally planned

² The origin of *laissez-faire* concept is tied to the 17th century protests of French entrepreneurs against the government intervention. *Laissez-faire* concept marks lack of confidence in interventionism, i.e. anti-interventionism. For more details see *Razvoj ekonomske misli* (M. Jakšić, 1997).

³ Even the founder of the Classical School of Thought, A. Smith, approved of government intervention when it came to protecting domestic output by imposing customs duties, and also approved of English ships' monopoly on transport (Vučo, 1975).

economies. Nevertheless, this system proved to be rather faulty and it practically disappeared with the collapse of socialism.

Throughout history, periods of liberal policy alternated with periods of government intervention, but generally, the policy of government intervention prevailed in the periods of crisis. A crisis increases uncertainty and affects the delay in individuals' deciding on consumption. An IMF research (2010) showed that private consumption dropped abruptly in 2009 following the US crisis outbreak. Carol (2006) clearly demonstrated that most of the people who were on the verge of buying a car should be willing to postpone their purchase in response to even a very modest increase in uncertainty. Blanchard (2005, p. 289) states that many economic decisions depend not only on what is happening today but also on expectations of what will happen in the future. This is the Friedman's concept of permanent income according to which individuals adapt the level of their consumption to the permanent (expected) income. Clearly, expectations play a major role in economy and economic policy should be pursued in line with the private sector's expectations.

During the expansion period, we should turn to saving to protect the economy from overheating and price bubble bursting. That is exactly what was missing on the eve of the global financial crisis and what could have prevented or mitigated its impact. Stiglitz (2002) states that liberalization of capital and financial markets went too far, which contributed to global financial crises.

While the Great Depression outbreak was followed by measures which only worsened the situation – raising interest rates in the effort to preserve gold reserves, cutting consumption, and increasing taxes in the effort to balance the budget – the Global financial crisis was marked by expansive monetary and fiscal measures, especially in the USA, where the Federal Reserves not only reduced the interest rates but also launched a programme of extensive securities purchase, while the US Government adopted a comprehensive 800 billion US dollars tax reduction programme. The EU also implemented expansive measures although somewhat less extensive. Many argue that this policy is a result of lesson learned from the Great Depression.

However, many economists stressed out the insufficiency of these measures, which was proven as their effect of expansion weakened with time lapse. With regard to fiscal policy, the current and projected paths of government expenditures in the advanced economies are quite different than during past recoveries, when policy was decisively expansionary, with increases in real primary government expenditures (IMF 2013, p. 33).

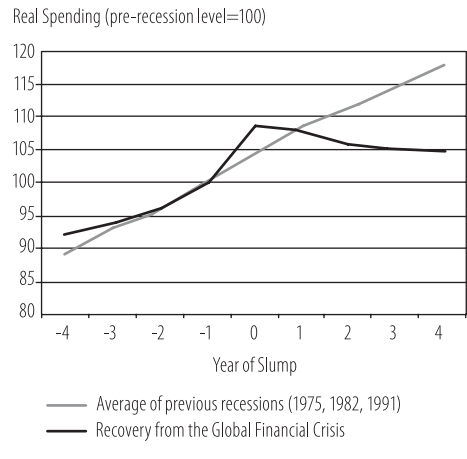
Chart 1 shows that after a short surge in 2009, public spending started declining in advanced economies to reach the level below the trend (from the previous recessions). Deflection towards saving was rather dramatic. Perhaps even this chart answers the question why did the global financial crisis continue for so long even though it was not as intensive as the Great Depression. The chart 2 provides an even more obvious answer.

The horizontal axis shows austerity measures – consumption cuts and tax increase – in percentages of GDP, as per the IMF estimates. As shown, countries forced to apply severe austerity measures later on experienced serious backslides, which were more or less proportional to the level of saving (Krugman 2013). It is clear that saving was not an adequate solution in the environment of significant private consumption decline.

On the other hand, monetary policy was significantly more expansive than in the previous crisis episodes. Interest rates were on their record low and central bank balance sheets in the major advanced economies have been dramatically expanded compared to prior crises.

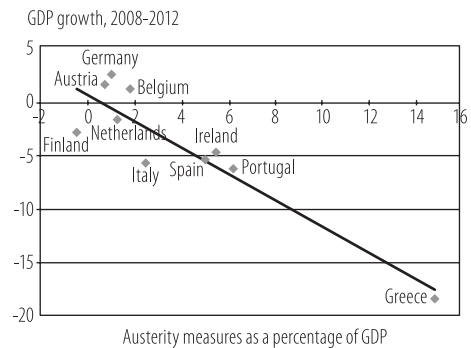
That was an unlikely combination of “fiscal tightening” and monetary expansion. At the same time, the fact that interest rates were zero or close to zero level gave no room for further influence on the economy via monetary policy. This combination apparently did not give satisfying results. Krugman (2013) pointed out: „At this point, then, austerity economics is in a very bad way. Its predictions have proved utterly wrong; its founding academic documents haven’t just lost their canonized status, they’ve become the objects of much ridicule”.

Graph 1: Advanced Countries: Real Government Spending



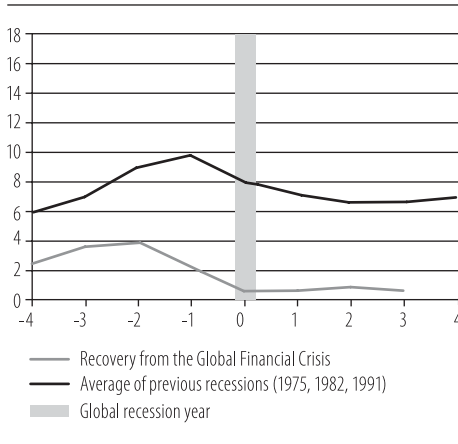
Source: IMF, World Economic Outlook, April 2013

Graph 2: Austerity and Growth



Source: IMF Fiscal Monitor, October 2012

Graph 3: Short-Term Interest Rates during Global Financial Crises and Recoveries⁴ - Advanced Economies (Percent; years from global recessions on x-axis)



Sources: Haver Analytics; IMF, International Financial Statistics; and IMF staff calculations

This essentially means that crisis policy should be pursued in the period of expansion. In their report (2009), the World Bank clearly stated that inadequate economic policies pursued in the expansion period lead to the global financial crisis outbreak: *We now have a reasonable understanding of the origins of the global financial crisis: lax macroeconomic policies, in a context of weak prudential and regulatory oversight, led to excessive leverage, mispricing of risk, and the build-up of global systemic risk.*

5. Conclusion

Throughout economic history, periods of government intervention alternated with periods of liberalism. The Classical School of Thought which prioritised liberal market over government intervention prevailed up to 1930s. The Great Depression brought radical changes in that point of view, and from mid-1930s, the supremacy in economic theory and practice was taken by the Keynesian concept

In every developed nation, personal consumption expenditures represent by far the largest sector of GDP. In the US, consumption equals 70% of GDP; 65% in the UK; 58% in Germany; and 57% in Japan (Skousen 2010, p. 1 – 2). The decline in personal consumption during the crisis period inevitably causes a decline in GDP. Therefore, the task of economic policymakers, as Keynesians pointed out, is to use the third element of consumption, i.e. public spending, to increase the level of aggregate demand. And as Keynes stated out, the period of growth, and not that of a crisis, is the real time for saving. During the period of expansion, fiscal reserves should be created and a low share of public debt in GDP should be maintained so that it has room for increase in the crisis period.

⁴ Aggregates are market weighted by GDP in U.S. dollars; observations are dropped for countries experiencing inflation 50 percent greater than in the previous year. Policy rate used as the principal series. Three- or four-month treasury bill data used as a proxy if data series was longer.

of government intervention which implied increase in public spending. However, in the late 1960s and early 1970s, this concept led to the stagflation and high budget deficits, and was therefore replaced by monetarism, i.e. a concept of economic liberalism which advocates saving and budget balancing. This concept prevailed until the global crisis eruption that proved (confirmed) that the market was not able to resolve current deviations by itself, and that another turn towards government intervention was inevitable.

The economic history has shown us that a macroeconomic concept universal to all countries and periods has yet to be created. The past has clearly proved that the liberalist and interventionism concepts have alternated over certain time cycles. Usually, the chosen concept initially yields favourable results, but over time it starts generating a series of problems and contradictions, which accumulate to the point when the concept itself becomes unsustainable and requires a complete change in the economic policy direction.

It is obvious that, in crisis, the advantage is given to economic policy concepts aimed at consumption increase because accumulated problems cannot be resolved by market itself or by saving in such circumstances. The prerequisite for such a policy is the pursuit of “sound” economic policies during the expansion period which will not lead a country in the state of excessive debt. If the country’s is overly indebted, it will not be able to finance additional consumption because it will be denied access to both domestic and foreign markets. This is best shown in the example of Greece. Thus, the important conclusion of this paper is that the best crisis policy is in fact pursued during a boom period (by creating fiscal and monetary room to react in case of recession). Economic history has shown that a rapid growth or, more exactly, too rapid economic growth is always followed by an even faster economic collapse (Luburić and Fabris 2014, p. 238).

In addition, economic policies in modern countries tend to be less oriented towards the postulates of only one school of thought but combine various concepts, putting the emphasis on, or giving the supremacy to, one of those concepts.

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