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Saving is good!

In a stagnant economy, reducing debt usually requires spending cuts. However, reducing debt over several years only hinders growth for one year!

I can still remember a conversation I had with a fellow student during my college days. He had just come out of a lecture, where his professor had explained convincingly that government debt was important for the economic development of a country. It didn't make sense to me at the time, and I made it clear to my fellow student that I did not share this very broad-brush view. He then accused me of delusions of grandeur for questioning, as a student, the views of a highly qualified and experienced professor. Today, 15 years later and in the midst of one of the worst debt crises in history, a conversation like this seems virtually unimaginable. I've learned some important lessons from this experience, one of them being never to put aside my own healthy common sense, especially in the face of "experts."

The entire world has now got its eye on Europe, particularly Greece. Not only Europe's fate, but that of the entire global economy, seems to hang on what happens in Greece. We keep hearing warnings of an uncontrollable domino effect that could lead to the downfall of the financial sector and, subsequently, the entire world. I personally do not believe in such an extreme scenario – not to say it couldn't happen. The more people believe in this scenario, the greater the confidence crisis. And, as an advertisement for a financial institution once taught us, “everything begins with confidence”. Once that is lost, the economic Armageddon won't seem too far off. It barely matters anymore whether it's lost in the financial sector, among investors, consumers or anywhere else – a deep confidence crisis will eventually impact economic development. Moreover, the real economy currently appears to be more vulnerable to attack than almost ever before. The measures adopted at the last European summit, despite their immediate recovery effects on the stock markets, appear to have brought about few changes.

Even if the government debt crisis is being talked about as a European conflict, at its core it's all about Greece. Now let's try to classify Greece on the basis of its economic importance alone, i.e., without taking into account any domino effects that aren't quantifiable anyway. The world's gross domestic product at the end of 2010 was just

over USD 63 trillion; Greece's was only USD 300 billion. Now let's assume (apologies to my Greek friends and readers for this little mental exercise) Greece falls completely into the ground along with its entire economic output. Even in this extreme scenario, the effect on the world economy would amount to less than 0.5%. Current economic data suggest that the world economy has already incurred damage from the entire discussion, perhaps even more than the 0.5%. In fact, the fear of default by Greece may have already caused greater damage than the potential default itself. Rational market behavior would surely produce different results.

In its economic outlook for 2012, Deloitte is already predicting a clear slowing of growth in the eurozone. According to Deloitte, the outlook is so bad, particularly for the highly indebted countries, that a recession is to be expected.

The US is blowing the same horn and making the eurozone explicitly responsible for the weakening of the global economy due to its debt crisis. However, those who live in glass houses shouldn't throw stones. Compared to the US, the eurozone, despite all its problems, is doing better in the most important indicators.

As Jürgen Stark, Chief Economist for the European Central Bank, said recently in an interview, the debt-to-GDP ratio in the eurozone is around 84%. By comparison: the current debt-to-GDP ratio in the US is around 100% and an astronomical 230% in Japan. Even in terms of the cumulative budget deficit, the eurozone at 4% is in much better shape than Japan at 6% and the US at around 10%. I am not trying to downplay the problems plaguing the eurozone. However, investors who are avoiding the eurozone should be steering further clear of the US, given that its key economic data is worse.

I'd like to end on a positive note with regard to the debt crisis. Not least because of the necessary spending cuts that have already been implemented in many countries, the outlook for economic growth is increasingly negative. It's true, of course, that saving is bad for growth. But on the one hand, the events in recent years have shown that lower but more stable growth is clearly preferable to unsustainable, debt-financed growth. On the other hand, the fact that long-term spending cuts do not necessarily have long-term negative effects on growth is often forgotten. In September, Goldman Sachs[1] pointed out that while debt reduction does hinder growth in the first year, in subsequent years it becomes virtually factored in. This is based primarily on the fact that growth is typically evaluated in comparison to the previous year. Economic performance may therefore fall to lower levels due to spending cuts. However, after the first year a country may once again begin to show positive growth rates. This doesn't mean investors will emerge completely unscathed – as we know, it is the future, not the past, that is traded on the market. And the future, given the latest spending cuts – at least in the long term – doesn't look so bad.

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[1] See: Global Economic Weekly, 11/29, page 5