The New Normal

An era of debt-fueled consumption has come to an end, and with it the economic culture that created it. If government is going to fill in for consumers, it will need to be smart about how it spends.

BY MARTIN WALKER

The economist, historian, and diplomat John Kenneth Galbraith coined the phrase "private affluence and public squalor" in his 1958 book *The Affluent Society* to capture a paradox of contemporary American life. Throughout most periods of civilization, the greatest share of investment and adornment went into structures that served an essentially public purpose, from temples to palaces, government offices to banks, barracks to transport terminals. Most people, however, lived in considerably humbler and even squalid surroundings. The coming of the mass middle class and widespread prosperity began to change this pattern, particularly in the United States. The private home and its furnishings, the vacation home and its associated toys, became the focus of the great shift from public to private consumption.

In the 25 years from 1983 to 2008, this process entered a new and even extreme phase. For several decades after World War II, private consumption measured as a share of gross domestic product had remained within a range of 61 to 63 percent. But in 1983 consumption began a steady rise, peaking at 70 percent in 2007. Initially, this increase was fueled by the erosion of private savings, which declined from nine percent of GDP in 1982 to nearly zero in 2005. The rate change is explained by the fact that homeowners were cashing in on the assumed increase in the value of their homes; by the end of the period, Americans were taking out some $500 billion annually in home equity loans.

But the collapse of private savings was not the only distinguishing feature of this extraordinary period. Public investment, particularly in essential infrastructure, also declined. A report by the American Society of Civil Engineers puts the deficit in infrastructure investment at $2.2 trillion this year, up from $1.7 trillion in 2007. The report assigned a grade to each of 15 essential public services, including transit, bridges, and schools. The highest was a C plus, for solid waste disposal. Eleven of the 15 services rated a D, with drinking water, roads, inland waterways, and levees the worst, each graded D minus.

The United States in recent years has taken Galbraith's paradox of private affluence and public squalor not simply to an extreme, but almost to an absurdity. Like the grasshopper in Aesop's fable, who played as if the happy days would never end while the industrious ant prepared for the future, Americans stopped saving and stopped investing as they consumed on credit. The Great Recession has put an end to this. The personal savings rate has bounced back to almost six percent of GDP and personal consumption is declining, while President Barack Obama is committing more federal money to infrastructure and

Martin Walker is a senior scholar at the Woodrow Wilson Center and senior director of A. T. Kearney's Global Business Policy Council. His latest novel, *Bruno, Chief of Police,* was published earlier this year by Knopf.

other public investments.

The decline in U.S. consumption is tough for everybody. It hurts American businesses and thus increases unemployment. It also hurts exporters from China and other countries who have grown accustomed to the ever-open maw of the American consumer, whose heroic appetite hauled the world economy out of the recessions of 1980–82, 1991–92, and 2001. One of the key questions hanging ominously over the global economy is whether Americans will permanently lower their consumption level toward the norm of other developed economies, which on average consume 60 to 63 percent of their GDP (basically, America's pre-1983 range).

SAVING MONEY IS GOOD for individuals but grim for the economy when millions of others do the same thing.

Some key American business leaders believe that the change is permanent. Steve Ballmer of Microsoft says it represents "a fundamental economic reset," a theme echoed by Jeffrey Immelt of General Electric. "If you think this is only a cycle, you're just wrong. . . . There are going to be elements of the economy that will never be the same, ever," Immelt noted this year. "We're going to come out of this in a different world."

In cash terms, U.S. consumption in 2007 amounted to $9.7 trillion—70 percent of the $13.8 trillion GDP. At a rate only two percentage points lower, Americans would have spent $300 billion less that year. At a "normal" rate of 63 percent, they would have spent $1 *trillion* less. Enter "the paradox of thrift," a term coined by the economist John Maynard Keynes to describe the problem that follows when many individuals reduce their consumption and increase their savings. This may be good for their personal finances, but it can be grim for the economy as a whole when millions of others do the same thing, as companies reduce output and lay off workers, which reduces demand yet further in a vicious circle. At this point, Keynes maintained, the government should step in as the spender of last resort. The Obama administration, with its $787 billion stimulus package, is following Keynes's advice.

But the stimulus is only part of what has been a massive increase in spending by the federal government, including loans and other bailout packages for the auto industry, banks, and other financial institutions. This year's federal budget deficit projection has climbed to an unprecedented $1.8 trillion. Big government is back, and bigger than ever, just 13 years after the last Democratic president, Bill Clinton, said its day was over.

This expanded role for the federal government is unlikely to shrink anytime soon. President Obama has made it clear that he intends to pursue his campaign pledges to impose new controls on greenhouse-gas emissions, spend more federal money on education and college grants, and enact health care reform. This year's federal budget is expected to amount to $4 trillion, a post–World War II record 28 percent of America's GDP. In 2000, the government spent just 18 percent. State and local expenditures will bring total government spending up to 45 percent of GDP this year, which begins to approach the levels of the European welfare state, but then the total is projected to shrink back to 40 percent of GDP. That is still several points higher than the post-1945 average. If the recession is forcing American families to recall the virtues of thrift and frugality, their government is spending like never before except in times of total war. From Galbraith's private affluence and public squalor we have gone to private thrift and public largess.

While government is getting bigger, many of the other traditional pillars of the U.S. socioeconomic system are shrinking. Big Oil hardly deserves the title anymore, now that more than 80 percent of the world's known reserves are controlled by national oil corporations in countries such as Russia, Saudi Arabia, and Venezuela. Big Steel went long ago and Big Auto has followed suit. Big Media has been declining for years, with metropolitan newspapers collapsing and the three major televi-

In Lake Billy Chinook, Oregon, an entire community has gone off the grid, a harbinger of the thrift economy's transformation of American energy use.

sion networks losing their grip on the national audience to upstarts from Fox to YouTube. Big Pharma is under assault by smaller rivals and generic drug producers here and abroad. Big Banks have been dealt a body blow and some are still on government life support; they also face new competition. The old industrial economy with its familiar giants is ever more quickly transforming into a postindustrial system with new giants such as Microsoft and Google, Cisco and Amazon.

There is a measure of justice in the decline of these traditional big industries, because they bear a lot of responsibility for creating America's credit-fueled consumerism in the first place. For the auto industry, we can date this process precisely, to 1954, when industrial designer Brooks Stevens gave the first of what would become many lectures on his concept of "planned obsolescence." He defined this as "instilling in the buyer the desire to own something a little newer, a little better, a little sooner than is necessary." More cars, more credit, more debt—this was part of the formula that became the target of Vance Packard's 1960 bestseller *The Waste Makers*. Corporate America was engaged, Packard maintained, in "the systematic attempt of business to make us wasteful, debt-ridden, permanently discontented individuals."

The U.S. economic system of the past 50 years has been designed to destroy the culture of thrift by promoting the culture of debt-enabled consumption. Banks and other financial institutions bombarded Americans with enticing offers for credit cards, home equity loans, and seductively easy mortgages that would permit them to buy the ever-larger houses with ever more bathrooms that became characteristic of the age. Big Media fattened itself on the advertising that promoted ever more consumption, ever more new models, and ever more "must-have" products.

It is not only the recession that has made clear how unsustainable this culture was. Before globalization, American consumerism at least meant an American manufacturing boom. After globalization, it meant an Asian manufacturing boom. But the shift from the old industrial system based on Big Auto to the new information economy based on Big Broadband encourages the revival of a thrift culture. It empowers individual consumers by giving them online access to price and product comparisons and the freedom to pay bills and shop from home rather than drive to bank branches and shopping malls. This makes price competition more intense, impelling retailers to find the cheapest possible wares, whether in China or Mexico. Technology and globalization enable the consumer to be thrifty, and the frugal consumer, price conscious and well informed, is becoming the new norm. And if that habit of frugality

persists, it will accelerate even further the systemic crisis now under way.

The clearest example of the direction in which we are heading is the transformation of our energy systems that is likely to occur over the next two decades, as we painfully make the transition to a carbon-light economy. One possible outcome of the change is that Big Utilities will be the next to go. Energy is going to be increasingly decentralized, with homes and buildings becoming producers as well as consumers. The growth of sustainable sources of energy such as solar and wind power can be overstated, but it is not far fetched to assume that within another decade, solar roof tiles, backyard windmills that generate electricity, and other small-scale technologies will be commonplace. And since buildings consume about 40 percent of energy in most developed societies, thorough insulation and home-produced energy can make an extraordinary difference in the total demand.

The United States is fortunate in its great size, which means that peak demand is staggered at different times across the country. With a "smart" national energy grid, "smart" appliances, and efficient long-distance energy transmission, the overall U.S. demand for energy can be dramatically reduced. But this won't be easy. The national grid is structurally little changed since Thomas Edison's day, although vastly bigger. It is a dumb system; for example, most utilities do not know where and when they have an outage until a customer calls to complain. A smart grid will change that, and by managing the shifting peak power use across regions will cut the need for excess generating capacity and thus reduce electricity bills.

Why should utilities invest in a future so unpromising for their revenues? That is where a smart federal government could step in. But there lies the problem. The Department of Energy's publication *The Smart Grid: An Introduction* cites a study suggesting that the cost of building the grid would be around $1.5 trillion over the next 20 years, or $75 billion a year. But there is just $4.5 billion for the Smart Grid Investment Program in President Obama's $787 billion stimulus package. Under a generous interpretation, the stimulus funds available for the smart grid system and related improvements come to a total of $11 billion. That is not even enough to make up for the decline in transmission investment over the last decade. Meanwhile, existing technology is aging. The average age of substation transformers in the United States is now 42 years, two years beyond their expected life span. Too much of the new federal money is likely to be spent fixing up the old rather than investing in the new.

It is the same with rail technology. The government recently designated 11 high-speed rail corridors for development. The maps look impressive. But the total funding is a puny $8 billion, barely one percent of the overall stimulus package. This will hardly begin to make a difference. California voters last year authorized a bond issue for $9 billion to help finance a 225 mph rail link between San Diego and San Francisco. But the full cost is estimated at $45 billion.

In June, Vice President Joe Biden kicked off his well-publicized Road to Recovery tour in Carlisle, Pennsylvania, where he hailed a new bridge being built with stimulus funds. He then went on to celebrate new highway projects in Kansas and Michigan. But roads and bridges combined got just $27.5 billion of the stimulus package, about three percent of the funding. In fact, the largest item in the package was a $116 billion tax cut (or credit) for individuals and the third largest was a $70 billion adjustment to take some of the sting out of the alternative minimum tax. That's $186 billion of potential consumption. Despite the complaints about federal deficit spending and the debts piling up for the future, the sad fact is that the Obama administration is still underfunding the kinds of infrastructure—roads, rail, bridges, mass transit, and energy transmission—that the economy needs and that can pay for themselves over time.

Big Government is spending ever greater amounts, but it has barely begun to spend them intelligently. Thrift is becoming the new normal for the American consumer, at least until the debts are pared down. But lavish spending is becoming the new normal for the federal government, which remains wedded to the conviction that GDP growth must be promoted. If increasingly thrifty American consumers decline to open their wallets and go deeper into debt, their government is evidently ready and willing to do it for them. How long this can be sustained looks like the big political question looming ahead for the United States. ■