A Perspective on the Low U.S. Saving Rate

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The personal saving rate has been drifting downward for two decades, and in 2005, it was negative for the first time since the Great Depression. Yet household net worth has increased sharply due to rising home prices and the recovery in stock prices since the last recession. These are strange circumstances, with negative saving and record wealth. Should we be alarmed or happy? Well, I am a carefully trained economist, so don't expect a straight answer.

But I would like to give you a perspective on this situation. I will make two key points. First, the outlook remains favorable—the negative saving rate is not a sign of impending disaster. But second, higher saving is desirable to help our nation prepare for long-term challenges, such as providing for an aging population and reducing our large trade deficit. Before we delve into the topic of saving, let's briefly review recent U.S. economic performance and the outlook for this year and next.

Recent economic conditions

Real GDP growth slowed sharply in the fourth quarter of 2005. But for the year as a whole, real output grew by a solid 3.2 percent, and that growth was broadly based. Consumption, business investment, and housing contributed to the expansion, and net exports was less of a drag on growth. The fourth-quarter slowdown was mostly due to temporary factors, such as disruption by the hurricanes and an incentive-related drop in auto sales.

The labor market has gradually improved. The unemployment rate was a low 4.7 percent in March, and payroll employment grew by 211 thousand jobs, well above the average pace in 2005. Because labor force participation has not increased, this solid employment growth tightened labor markets. As a result, many economists are watching labor costs closely, but increases in labor costs have been fairly moderate so far.

Core consumer prices have also risen moderately despite the higher energy prices. The CPI rose 3.6 percent over the year ended in February. But if you exclude volatile food and energy prices, the core CPI rose a moderate 2.1 percent over the last year. All in all, both growth and inflation have done well, considering the shocks from the hurricanes and oil market developments.

The national outlook

The economic outlook also is favorable. As I mentioned, the fourth-quarter slowdown was largely due to temporary factors, and economic indicators so far in 2006 have been stronger. Most economists expect real GDP to grow at or above trend in 2006.

As you know, the Federal Open Market Committee has been removing monetary accommodation, and the federal funds rate now stands at 4 ¾ percent. Because monetary policy operates with long lags, past accommodative policy may still be having a stimulative effect on growth. With inflation expectations contained, long-term interest rates remain low, supporting housing, business investment, and other interest-sensitive spending. After its meeting on March 28, the Committee stated that “some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance.”

Although housing may be losing some momentum, the level of activity remains high. New home sales declined sharply in February, and inventories of unsold homes have been rising. Housing starts also declined in February after a large gain in January, but rebuilding after the hurricanes and solid employment growth may support housing activity. Weaker home price gains may lead to less equity extraction and some slowdown in consumption growth this year.

Business investment should contribute solidly to growth. Orders for nondefense capital goods, excluding aircraft, are trending upward, and are back to the levels of the late 1990s. Aircraft orders also picked up last year, good news for Boeing and our nation's exports. And other factors will encourage investment spending, including strong corporate balance sheets, rising capacity utilization, and continued productivity gains.

As a result, real GDP will likely grow slightly above trend in 2006, and growth should slow toward trend in 2007. I expect that real output will grow by about 3 ½ percent this year and 3 to 3 ½ percent next year. With growth near trend, the unemployment rate should stay at about its current level through 2007.

Consumer price inflation is expected to remain moderate through 2007. The economy should be operating at full resource utilization. Manufacturing capacity utilization has recovered since the last recession. Capacity is not strained—utilization is about average for the last 30 years—but there's not a lot of excess capacity either. Although unit labor costs grew by a modest 1.3 percent last year, tighter labor markets also may put some upward pressure on wages.

Energy prices are a major uncertainty in the inflation outlook. Higher oil and natural gas prices boosted overall inflation, but any pass-through to core inflation was modest. Many forecasters expect some further effect of energy prices on core inflation this year, but assuming no further disruptions to world energy supplies, these effects should diminish in 2007.

As a result, inflation should remain moderate through 2007. I expect that core CPI inflation will be around 2 ¼ percent this year and 2 to 2 ¼ percent in 2007.

Policymakers believe inflation must not become embedded in long-term expectations. In the 1970s, high inflation expectations became ingrained in wage and price setting and distorted business decisions. Getting rid of this inflation was costly and took many years. Fortunately, long-term inflation expectations now appear contained. Although 5-10 year inflation expectations from the Michigan survey rose because of higher energy prices last year, long-term inflation expectations recently fell back below 3 percent.

There are, of course, many risks to the outlook. With the economy at full resource utilization and energy supplies uncertain, one risk is higher inflationary pressures. Another is greater weakness in housing, which could contribute to the third risk, a rise in the personal saving rate and weaker consumption growth.

Saving and net worth

I will say more on the risk of a sharp rise in the saving rate shortly. As I noted earlier, personal saving and household net worth have been behaving very differently! The saving rate was 8 percent or higher in the mid-1980s, but has declined in the last two decades. The saving rate dropped from 1.8 percent of disposable income in 2004 to -0.4 percent last year.

Yet household net worth as a share of disposable income has climbed sharply. Households had assets of $64 trillion at the end of 2005. Real estate holdings were the largest asset, but households also had substantial assets in stocks, mutual funds, pension funds, and noncorporate businesses. Liabilities were $12 trillion, consisting mostly of mortgage debt. As a result, households' net worth was $52 trillion, or 564 percent of disposable income.

Many observers are concerned about the low saving rate. One reason is households might suddenly decide to save more of their income. Lower consumption would hurt GDP growth and business profits, and might cause a recession. We might fear this outcome if consumers have been on an extended spending spree and must finally come back to reality. I don't want to come across as Pollyanna, but we should remember that more optimistic interpretations of the low saving rate are possible.

Many economists believe consumers are forward-looking and base their spending on expected future income as well as current income and assets. If households expect faster income gains—perhaps because of rapid productivity growth—they might boost their consumption even before income growth picks up. As a result, the personal saving rate would decline even though expected lifetime resources are higher. The improved outlook might raise the demand for housing, boosting home prices, and stock prices might rise because faster productivity growth would increase corporate profits.

If this sounds familiar, it is basically the "new economy" story. Although this story lost some of its appeal after technology stocks crashed—and I hesitated to mention it because I know it doesn't help my credibility—it's not totally crazy. Productivity is growing, information technology is advancing, and globalization is pressuring businesses to become more efficient. Stock prices are much higher than they were 10 years ago despite the stock market correction. In short, favorable long-term trends may have lowered saving and boosted household net worth at the same time. I do not want to claim this for sure, but at least there are more upbeat interpretations of the low saving rate than you read in the newspapers. If this view is correct, the saving rate may rise in the future because of faster *income* growth rather than a drop in consumption.

Historically, low personal saving has not been a good predictor of recessions. Sometimes, the saving rate increased sharply right before or during a recession—for example, in the 1970s. But other times, the saving rate did not increase near recessions—for example, the saving rate was flat around the last two recessions.

Personal saving has also not been very reliable for real-time forecasting. The saving rate gets revised for years after it is first released. In fact, the saving rate has tended to be revised *upward* after it is first reported. The saving rate appeared to be declining when the statistics were initially released in the 1970s, but subsequent revisions raised estimated saving until the saving rate now looks relatively high in the 1970s. Because of such large revisions, the numbers released in real-time may be far from the mark and are questionable for forecasting.

Long-term saving needs

But there are reasons to be concerned about the low saving rate. Our nation faces some major long-term challenges that could be met more readily with higher saving. To meet these long-term needs, *national* saving is what matters. National saving is the sum of personal, corporate, and government saving. National saving has also declined as a share of gross national income.

You can't blame low national saving just on consumers. Corporate saving was positive in 2005, but personal and government saving were negative. Corporate saving has not had a downward trend, and in fact, corporate saving was relatively strong at 3.7 percent of gross national income in 2005. But the government usually runs a deficit, and that has substantially lowered national saving. Combining these rates, the national saving rate was 0.9 percent in 2005, down from 8.3 percent in 1970.

Higher national saving could help meet important long-term needs. The U.S. population is aging and medical costs are climbing. Over the next 75 years, the share of the population aged 65 and older will rise to 23 percent from about 12 percent today. As a result, Social Security and Medicare face huge unfunded liabilities, which may put higher tax burdens on future workers. More national saving could reduce these burdens by raising the capital stock and increasing output per worker. More productive workers would earn higher wages, and they would find it easier to pay higher taxes, if needed.

Increased saving could also help to improve U.S. competitiveness in the global economy and to close the large current account deficit. National saving and the current account balance are closely related. If we can't finance domestic investment out of savings, we must borrow abroad. The inflow of foreign capital raises the foreign exchange value of the dollar and make U.S. products less competitive in foreign markets. As a result, the trade deficit tends to worsen.

How do we encourage saving?

We do not have time to explore policy options in detail, but various actions could help to raise the national saving rate. Reducing the federal deficit would directly raise national saving. Changes in tax policy might encourage personal saving—for example, Congress might expand availability of tax-advantaged accounts like IRAs. The complexity of the tax code also may discourage personal saving. Faced with a complex choice between different savings accounts, people may become so confused that they do nothing. Thus, simplifying the tax code or providing financial education might help.

Monetary policy's role in promoting saving is important, but limited. Monetary policy can encourage higher saving by maintaining price stability and financial soundness. People are more likely to save if they know the purchasing power of their assets will not be eroded by high inflation. Likewise, sound financial markets and institutions build confidence that funds put aside now will be available for future needs.

Summary

In summary, the near-term outlook for the economy is favorable. Growth will likely slow toward trend, while core consumer price inflation should remain moderate. The negative personal saving rate in 2005 does not contradict this because the personal saving rate has not reliably predicted economic slowdowns in the past, and a low saving rate might even foreshadow stronger income growth in the future. But it would be prudent to gradually raise our saving rate so that the nation can deal more effectively with the large current account deficit and the long-term pressures from population aging.