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America's Saving Surprise
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CAMBRIDGE – The household saving rate in the United States has tripled in the past three years. Why? And what does it mean for the US economy and the rest of the world?

The rapid rise in saving has reduced consumer spending, slowing the pace of GDP growth in 2009 and in early 2010. If the saving rate continues to rise rapidly, it could push America's fragile economy into another downturn. That would mean lower imports, creating a potential problem for countries that depend for their employment on exporting to the US.

Higher household saving depresses consumption because it is the difference between households' after-tax income and what they spend. The saving may be deposited in bank accounts or used to buy mutual funds or corporate stock. Saving may also take the form of individual contributions to retirement accounts or employer contributions to corporate saving plans. Paying down debt on credit cards or mortgages also counts as saving – but increases in the value of existing assets like stocks or real estate do not, even though they increase the value of household wealth.

In any year, some households are savers and others, especially retirees, are dissavers that use past saving to finance current consumption. The nation's net household saving rate is the difference between the saving of the savers and the dissaving of the dissavers.

The recent rise in the US household saving rate reversed a long-term decline that began 25 years ago. Before that, between 1960 and 1985, American households saved an average of 9% of their after-tax incomes. The saving rate in each of those 25 years was between 7% and 11%.

But, after 1985, a variety of changes caused saving to decline until it reached less than 2% in 2007. One reason was that rising stock markets and higher house prices made individuals wealthier, reducing their need to save for retirement and allowing retirees to dissave more. The general shift from defined-benefit pension plans to defined-contribution plans meant that employees felt the effect of rising share prices directly in their own personal accounts.

Moreover, the increased availability of credit cards gave Americans a greater ability to dissave, buying goods and services now and paying for them later. Mortgages became more widely available. Rising house prices also allowed homeowners to refinance their mortgages, obtaining additional cash to spend on other things. Credit lines secured by home equity provided another new way to finance spending.

All of this changed abruptly when the American economy fell into a deep recession at the end of 2007. The stock market dropped sharply. Home prices fell 40%, completely wiping out the equity of one-third of all homeowners with mortgages. Household wealth is now \$10 trillion dollars less than it was before the recession began.

That fall in wealth means that households must save more to prepare for retirement, and that retirees are not able to dissave as much as they did before. Banks and credit-card companies have become much more cautious about extending credit. And, with unemployment stubbornly high, many households are saving in order to have additional cash if they should lose their job or be put on shorter hours.

There is no way to predict what the saving rate will do next. Households' need to rebuild wealth, and the lack of access to credit, implies that the saving rate could continue to rise from the 6.4% recorded in June (the most recent month for which data are available) to the 9% rate that America averaged in the decades before 1985. If that were to happen quickly, total spending could decline, pushing the economy into a double-dip recession. But if households instead become optimistic about the pace of recovery, they might choose to cut back on their saving in order to maintain consumption, despite weak earnings. Only time will tell.

Household saving is only one part of net national saving. Since after-tax personal income accounts for about 75% of GDP, a household saving rate of 6% translates into just 4.5% of GDP. Corporate retained earnings have averaged about 3% of GDP after allowing for depreciation of existing plant and equipment. The combination of household and corporate saving brings total private saving to 7.5% of GDP. Unfortunately, government borrowing to finance its deficit over the rest of this decade is projected to absorb about 5% of GDP. That would leave a net national saving rate of just 2.5% of GDP.

Such a low national saving rate would not be sufficient to finance the level of new investment in plant, equipment, and housing that the country needs. So, despite the rise in the household saving rate, unless federal government policies change to shrink America's future budget deficits, the US will continue to be dependent on capital inflows from the rest of the world. If that happens, global imbalances will continue to add risk to the global economy.

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