A Threat From Savings?

The idea Americans might start to save too much might strike you as halfway between ridiculous and absurd. After all, we have been scolded from birth about how profligate we are and, verily, how this will lead us to ruin.

But the threat is real. John Maynard Keynes influenced two generations of economists for better or worse by advocating an increase in government expenditures when individuals and businesses shift their preferences from spending to saving.

I last wrote about the issue in February 2003 and concluded:

> *If you want people to save more - and in an economy wrestling with deflationary pressures, that in itself is something of a debatable proposition - you have to provide them with a return. Lower rates are counterproductive. Raising the real return on capital, however, may be effective. For this reason, the Bush administration's proposals to eliminate the double tax on dividends, to effectively cut capital gains rates by adding retained earnings to the cost basis of stocks and to expand retirement account contribution limits deserve a full and complete hearing.*

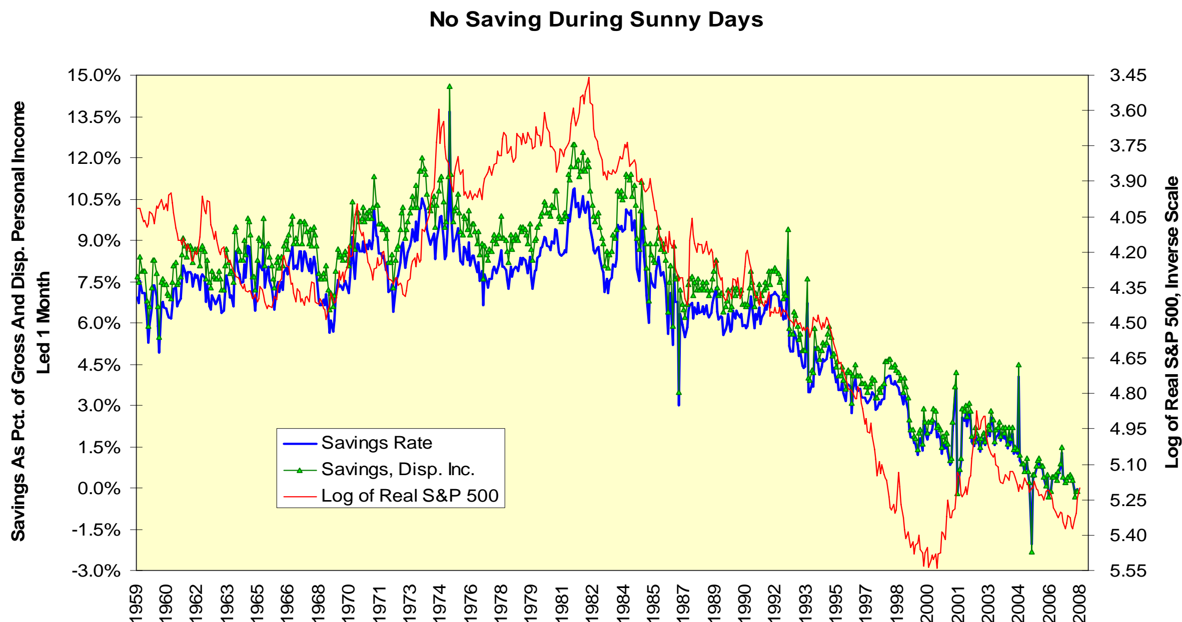
If the concern then was price deflation, the concern today is asset deflation. And if the tax cuts worked then as a form of fiscal stimulus is such a prescription warranted today? Let's update the analysis with a few modifications.

Savings From Thin Air

Milton Friedman once joked he could create a three-line Form 1040: 1) How much did you make last year? 2) How much do you have left? 3) Send it. This is more or less the approach the Commerce Department takes toward counting savings. Consumption is deducted from income, and savings are the residual. If it sounds good enough for government work, it is government work.

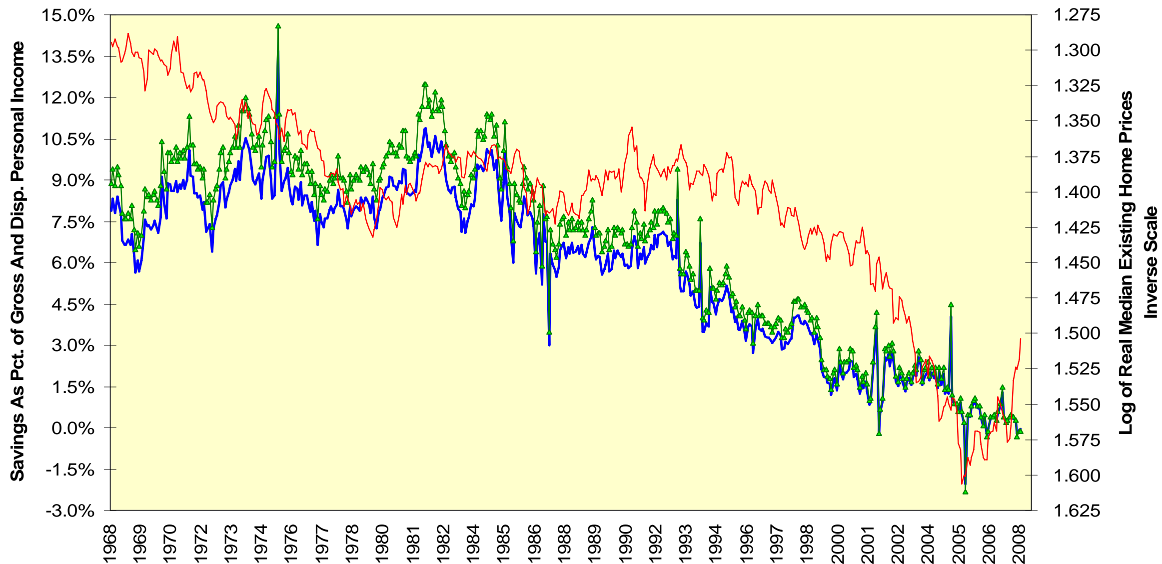
We can modify the number somewhat by using disposable income, which nets out tax expenses. As an aside, my state and local taxes here in Cook County, Illinois, seem to be rising in price as if they were food and energy. If we divide savings by disposable income, we get a higher savings ratio in the charts below.

If we map these savings rate with a one-month lead against the logarithm of the constant-dollar S&P 500 plotted inversely, we find people really do, in John Kenneth Galbraith's words (name-dropping economists today, aren't we, Howard?) believe they have created wealth out of thin air. With the very prominent exception of the late 1990s bubble, savings rates have tracked the fortunes of the stock market closely.



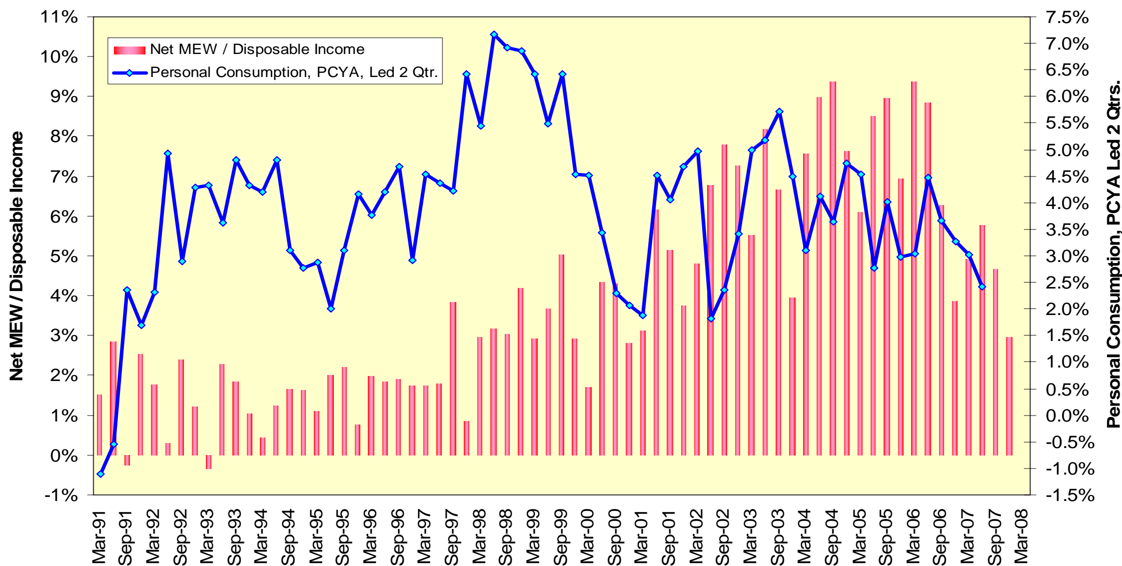
What about that other large asset class on household balance sheets, real estate? This is always more difficult to measure as the old saw about location, location, location makes national data somewhat meaningless. And, as noted in the previous column, no one has to own stocks but all of us believe we have to live somewhere.

If we measure trends in real estate by the logarithm of constant-dollar existing home sales, we find a general tracking relationship. We should not expect a tight one as homeowners are slow to realize changes in their property's value and it was not until quite recently did the tools for "mortgage equity withdrawal" (MEW) exist on a wide scale.



MEWs You Can Use

How have homeowners converted their free savings into consumption using MEW? Prior to 2001, the relationship was weak. After 2001, changes in MEW as a percentage of disposable income have led changes in consumption by two quarters on average. As excess equity in the nation's housing stock disappears, downward pressure will be placed on spending.

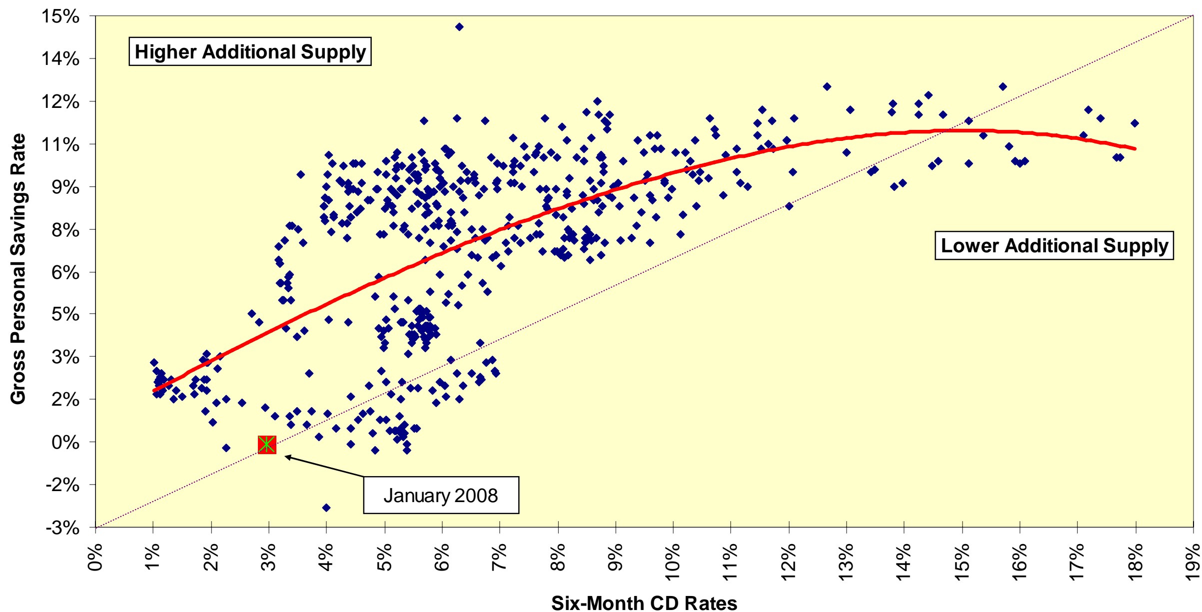


The Role Of Interest Rates

If households see their wealth shrinking and rationally decide to start saving more and spending less in response, what role will interest rates play in the supply side of the equation? The answer is counterintuitive at first as it

involves a "backward-bending" supply curve. The key is to view households as having income goals from their savings. When those goals are reached, either by asset gains as noted above or by higher interest income, saving slows.

Let's map the savings rate against the six-month certificate of deposit rate. At first, higher CD rates new funds into savings. Once they rise, income goals can be met with a lower principal, and the savings rate stagnates or falls. The opposite occurs as investment income falls; here savers must add funds to their accounts to generate their desired income.



Macroeconomic Implications
Lower interest rates and risk-averse investors will combine to increase the demand for savings regardless of the returns involved; there is a reason why real returns on TIPS maturing in five years or less have been negative this month.

If we add all of these together, we have the same situation Keynes addressed in the 1930s, declining aggregate demand. How should this be addressed? The classic Keynesian response was to increase government spending. Japan has been doing this for more than ten years and now has a national debt on the order of 160% of its GDP. The U.S. is fiscally conservative in comparison.

Given our exorbitant absolute debt levels and our misguided spending policies, a better course of action might be to do what we did in 2001 and later in 2003, which is to cut taxes further. We could achieve two goals here, allowing taxpayers to keep more of their money while financing the federal maw via borrowing rather than taxation. Remember, creditors finance the government voluntarily while taxpayers finance the government under penalty of law.

Either way, we are facing a period of constricting consumer spending and increased household incentives to save. This suggests underweighting sectors such as consumer discretionary and health care and overweighting international exposure.