Savings As The Stimulus Ends

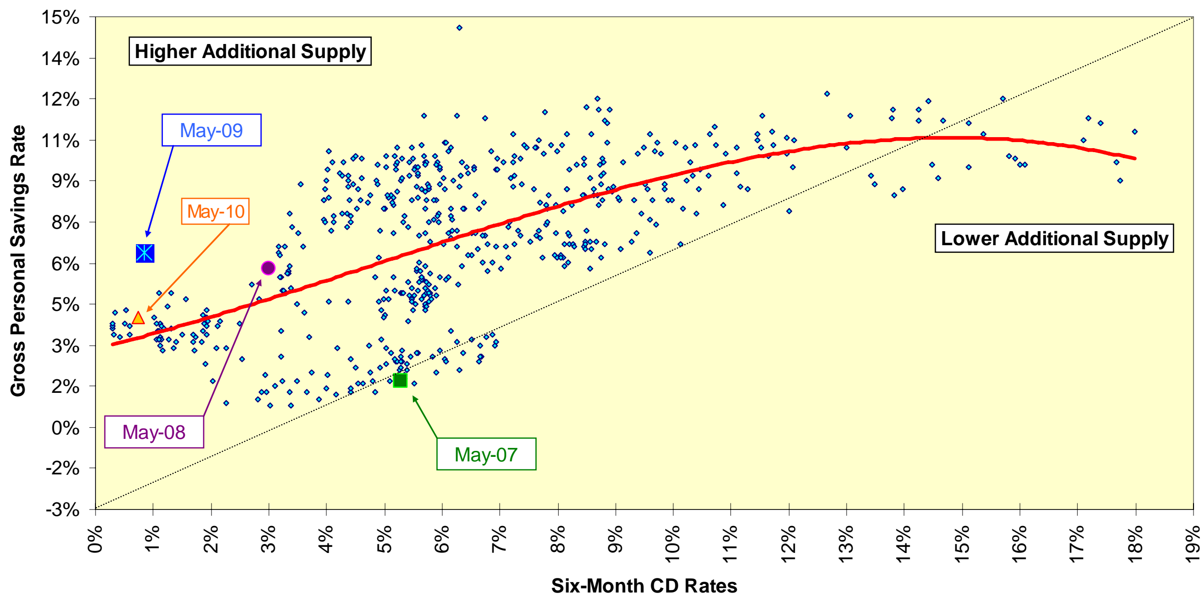
For all of the brow-beating the financial services industry has engaged in over the years extolling people to set aside some small amount of money each week and showing them with the miracle of compound interest and equity market returns that have not existed on a consistent basis since the 1990s, they would become millionaires many times over by the time they were ready to retire. What a knee-slapper; the ugly facts are after the effects of taxes, inflation and various investment costs plus the definite propensity of investors to engage in imperfect market-timing, few ever see this fantasy come to life.

Moreover, savings tend to be a residual in most peoples' lives, not a starting point. You earn X and spend Y, and the difference is something called the gross savings rate. You earn X, pay Z in taxes and spend Y, and the result is something called the savings rate for disposable income.

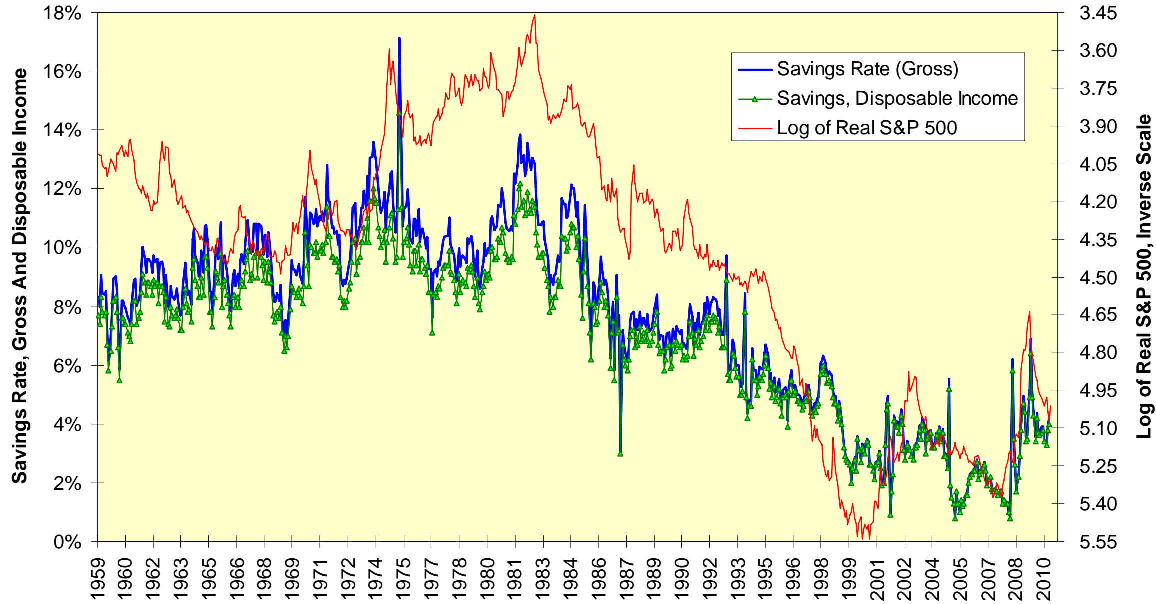
We know a couple of things about the marginal propensity to save. First, people save less when they are confident about the future or when they feel they are the beneficiaries of an asset tailwind, such as a bull market in equities or rising residential real estate prices. Lower savings rates, the very thing Americans were castigated for, are actually a sign of economic confidence in this regard. Second, the demand for investable funds is indifferent to their source; if China wants to lend us a few hundred billion dollars to tide us over until the next payday, anyone looking to invest those funds really does not care about their origin.

The third is a more exotic concept, and that is the supply curve of savings often is backward-bending. This is a fancy way of saying savers have an income goal in mind and will increase their savings not in response to higher interest rates, but paradoxically to lower interest rates: Pay me half the rate and I have to save twice as much. We can illustrate this backward-bending supply curve by mapping the gross savings rate against six-month CD rates. Please note how the supply of funds has been relatively high during the low-rate era, and vice-versa.

The Backward Bending Supply Of Savings



Now please note the data points for the past four Mays: As CD rates fell between May 2007 and May 2009, savings rates rose as expected, but the rate has shifted lower between May 2009 and May 2010. Two explanations come to mind immediately. First, the stock market rally – the link between real equity valuations and savings rates is depicted below – that ended at the end of April lowered the supply of savings as household balance sheets rose. Second, the low rates prevailing have led to a sense of despair: How can I ever increase my actual principal saved enough to offset the puny rates offered without taking on inordinate risk?



All of this glosses over the massive distortions to savings created by increased transfer payments, tax credits and all of the other folderol of both the Bush and Obama administrations. Future economic historians are going to have a hard time deciding what worked and what was useless as Washington was engaged in its own version of too fast, too furious.

As the rest of the world tells us to knock it off with the deficit spending, Keynesians such as Summers and Geithner fret demand will fall. This may be the case; a lower deficit will reduce capital inflows into the U.S. to finance that deficit and neither businesses nor households are ready to pick up the spending slack. We will know if this is happening if we start seeing savings rates, particularly gross savings, rise as the economy slows.