A Saving Grace

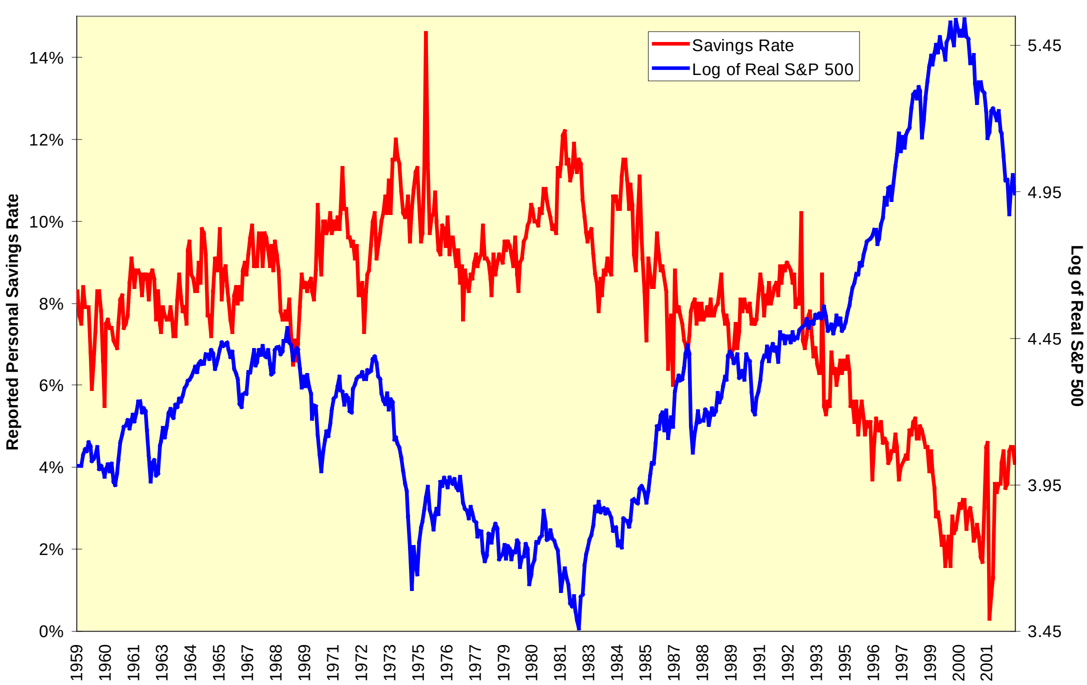
Americans should:

1. Eat more spinach
2. Not wear dark socks with sneakers and Bermuda shorts
3. Enjoy soccer as much as the rest of the world does, especially those lovely British fans
4. Save more

Since this is a financial Website, let's focus on the last point, especially why it may not be the right cure for what ails us. The definition of what does and does not constitute saving is knottier than it may appear at first blush. The Commerce Department defines it as the difference between personal income and personal outlays. The former does not include unrealized capital gains on real estate or financial assets. The latter includes taxes, some of which go toward public investment in capital projects (the rest, he quipped, are just wasted).

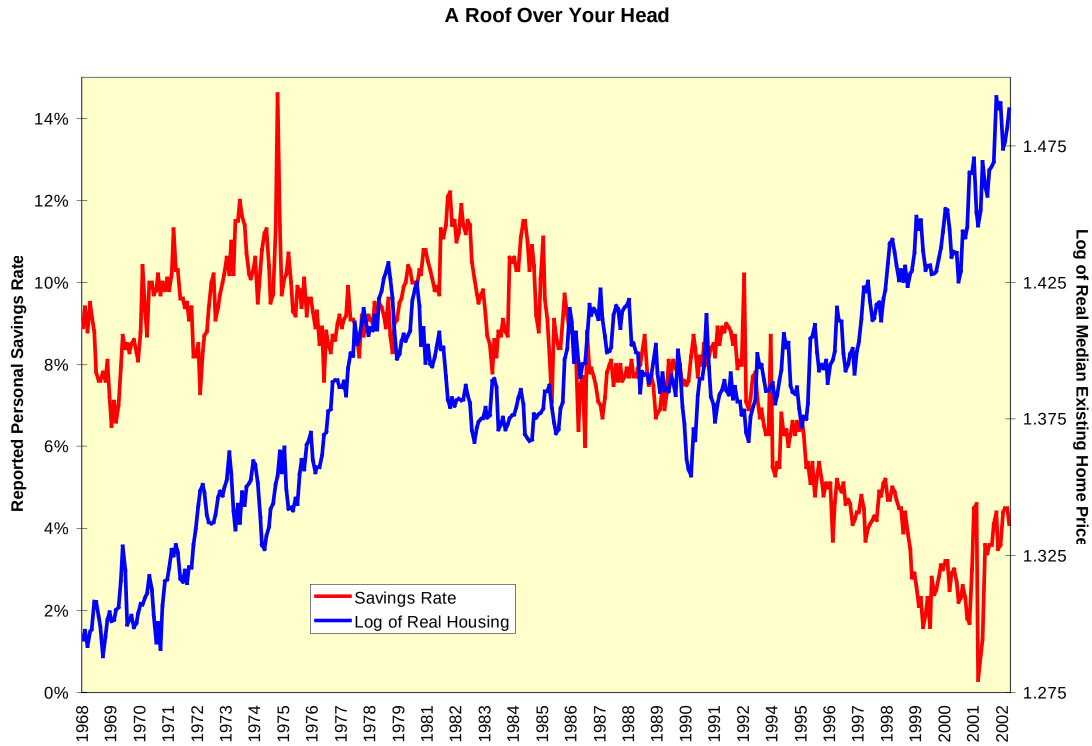
The failure to include unrealized capital gains in the personal savings rate ignores actual economic behavior. If we compare the reported savings rate to the deflated S&P 500 presented on a logarithmic scale, we find that personal saving is almost a mirror image of the stock market.

Saving For A Rainy Day



This inverse relationship should surprise no one. Households have a demand for savings, and when one portion of their total portfolio surges, the need to maintain a certain growth rate to meet definite life-cycle targets such as education, housing or retirement falls.

The relationship between the savings rate and real estate, here represented by the logarithm of non-seasonally adjusted median sale prices for existing homes as reported by the National Association of Realtors, is not quite as direct. After all, several million new homes are built each year, and real estate markets are by definition local in nature. In addition, the demand for real estate is far more stable than for equities: You don't have to own stocks, but you do have to live somewhere (please, no e-mails telling me that homelessness is a viable housing alternative).



A couple of relationships stand out in the chart above. First, real estate prices spent close to 16 years going nowhere after their 1970s boom. This 16-year wandering in the wilderness is consistent with stocks' 16-year era of frustration between 1966 and 1982; real fans of market history can chime in about 1906-1921 if they so choose. Second, the real prices of both stocks and real estate shot higher in the late 1990s, the very period when, unsurprisingly, the savings rate fell. The third observation - and this is just an observation, not a forecast - is that real housing prices probably have a few good years ahead of them on a cyclical basis.

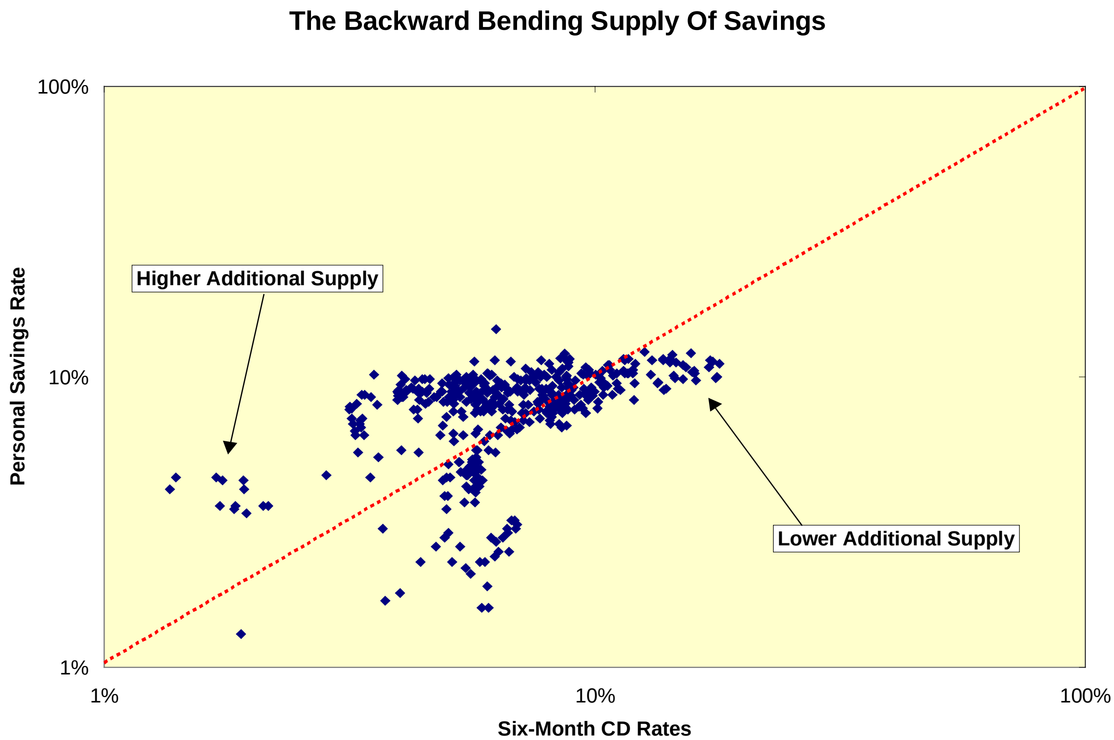
The Role of Rates

The FOMC meeting came and went last week with as much fanfare as a tree falling in the forest; Alan Greenspan may yet wear the mantle of, in homage to Otto Von Bismarck's dismissal of Napoleon III, being a sphinx without a riddle. The question arose prior to the meeting of whether the Fed would need to lower rates once again in an effort to stimulate the economy.

My opinion was no; we have entered a zone where further rate reductions paradoxically may encourage increased saving as opposed to increased consumption. How can this be if, in classical financial theory, interest rates equilibrate the relative demands between current consumption and deferred consumption (save now, spend later)?

The answer lies in the demand for household saving: Most of our portfolios have taken a few bumps and bruises over the past three years, and while the value of our houses have risen, you still have to live somewhere. The returns on bonds and other fixed income vehicles have plummeted. So, in order to meet your savings goals you have to save more as rates fall. This is what is called a "backward bending" curve, a savings supply curve where the quantity starts to increase as the price of money falls.

The savings supply curve can have a backward bend at very high rates, too: If you are meeting your savings goals by virtue of high returns, then you do not have to save as much. This is evident in the chart below where savings remain higher than a linear trend at low rates and lower than a linear trend at high rates; the rate chosen is the average 6-month certificate of deposit rate as reported by the Federal Reserve Board.



Much has been made, correctly, of the role behavior plays in investment. It plays a role in savings, too, especially in what are termed monetary illusions. Illusions are a way of saying we do get fooled again: It took us a long time to adjust to the inflation of the 1970s and to the disinflation that began in the early 1980s and continues to this day. For this reason the nominal six-month CD rate, not the real rate, was chosen to illustrate the backward bending supply.

Policy Implications

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.