The National Savings Crisis Worsens

As a consequence of regularly occurring recessions, which wrecked havoc in western capitalist nations, the new economists of the early 20th century beginning with John Maynard Keynes were led to define the problem as the result of sporadic periods of insufficient aggregate demand which could not automatically correct itself through adjustments in prices. In other words, national economies could get stuck in a depressed state because the consumer was saving too much (consuming too little) and this weakness in demand (spending) inevitably results in contractions in the aggregate economy with all of its consequences of unemployment and financial market failures.

The Great Depression of the 1930s, which devastated America and most of the rest of the world, was the ultimate evidence that this flaw in laissez-faire capitalist economies to self correct and reverse the imbalance by naturally inducing more spending required governmental intervention. To the "Keynesians", the solution was to mop up the excessive savings with government spending beyond its revenues. If savings exceeded private investment (common during times of fear for the future), then government would tap the excesses through government borrowing and spend the proceeds back into the economy.

The observation by Keynes and others was correct for its time, a time when, without the social security blankets of the latter part of the century and without today's excessive ease of credit, savings was a critical element to family survival. However, as the decades have passed, this national obsession with aggregate spending as the driving force for economic growth and prosperity came to dominate that national view regarding the path to stability and prosperity for the rest of the 20th century, a view that continues today. With the consumer responsible for around three-quarters of all spending, Wall Street analysts and government officials constantly worry about such things as falling consumer sentiment and declining retail sales. This, of course, is picked up by the media who magnify the significance of monthly variations in such statistics. Each winter the news is full of statistics and forecasts regarding the strength of Christmas sales and what that might portend for the macro-economy.

But, while the fear and obsession regarding consumer spending continues, the fact is that the beginning of the 21st century has not been troubled with excessive savings, but by a serious dearth in savings. During the near recession years of 2001-02, not a single quarter went by with even a modest decline in spending. Spending simply spiraled upward while savings declined further and further. During the past two years the national savings rate for the U.S. economy was actually negative. That meant that collectively Americans spent more than they earned. From a national accounting perspective, that can only occur when we allow our national stock of capital to deteriorate through net depreciation or when we buy significantly more foreign goods than we sell abroad. These past two years are the first time in modern post-agrarian American history in which the national savings rate was negative during a period of economic recovery and expansion.

From a Keynesian perspective, this might sound good. Aggregate spending is strong. But the Keynesian preoccupation with demand, which was a greater concern 75 years ago, leaves out the essential need for supply to grow if Americans are to remain prosperous and continue to see improvement in their standard of living. More than ever, we need to remind ourselves that economic growth is dependent upon both expanding demand and increased supply. After all, it is what we produce that makes us prosperous, not just how much we spend. Growth in our potential to produce requires national investment in capital (machines, equipment, buildings, technology, and even education).[1] The nation's collective ownership in all those elements of capital provides the means to produce the goods and services necessary for our high standard of living. Economic growth thus requires annual increases in the stock of this capital, which requires positive net national investment (gross investment over and above capital depreciation). But, American owned net national investment can't occur without net national savings. The stock of national capital could also increase by borrowing abroad or by letting foreigners invest in America, but then most of the returns to these investments will be captured by those other than Americans.[2]

So, what are the consequences of a negative national savings rate? The answer is that there are many. The problem is that they are subtle and not easily linked to the root cause of anemic savings. The most immediate impact is that a negative national savings rate by definition implies a negative trade balance. The more we borrow abroad to maintain our high level of spending (the public, the government, and businesses), the fewer dollars foreigners will have left to spend on American produced goods and services. Thus, the savings deficit guarantees a trade deficit that can't be corrected by any other policies. Indeed, the serious risk is that we as a nation will try to "correct" the trade deficit problem with a return to protectionism and economic isolationism. That would be a mistake detrimental to the national welfare and it wouldn't work anyway, not as long as we continue to borrow from abroad. As shown in previous IRF symposia, there is a close link between the U.S. trade deficit and the U.S. savings deficit. Before we exert excessive efforts in getting the Chinese to float the Yuan, the Japanese to more fully open markets to U.S. goods, or the Europeans to stop protecting domestic agricultural products, we need to first get our own act together. But can the public and their politicians recognize that getting our act together will require a re-stimulation of domestic savings? That will be a challenge since the link between trade and savings is not intuitively obvious.

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[1]Investment from an economics perspective is not simply buying stocks, bonds or real estate. Such activity is merely a transfer of one type of financial asset (perhaps money) for another. Investment is when new capital is created resulting in more improved real estate, more machinery, etc.

[2]An increase in the capital stock in the U.S. which is owned by foreigners provides significantly reduced benefits for Americans. More capital which increases labor productivity can increase wages, but the returns to capital themselves will be syphoned abroad.

There are other consequences to the current negative savings rate. It means that American households are whittling down their wealth. In an environment where asset prices were rising rapidly, the paper gains in stocks and real estate appeared to compensate for reductions in savings or increases in consumer debt. However, the real estate cushion is gone, not likely to return for some time. Right now stock market gains are helping to alleviate the pains of lost capital gains in the housing market, but were there to be a stock market correction in tandem with continued home value weakness, the consumer would find themselves in quite a bind.[3] Thus, it is likely that the consumer will be considerably constrained for the rest of this decade by the burdens of debt that can no longer be easily refinanced from excess home equities.

But the most serious problem with a negative national savings rate is that it means that the nation is not accumulating capital (the source of productivity gains for the nation) sufficient to meet the consumption needs of a large retiring segment of the population over the next 2 decades. Congress is going to continue to wring their hands over issues of Social Security solvency and Medicare and Medicaid payments as though they were purely accounting problems, when the root cause of the impending crisis is that for the past couple of decades, Americans simply haven't been saving enough. Because of it, the nation's production capacity will not be great enough to support the large retirement population without a substantial increase in taxes upon the working generation. The significant increase in transfers of income from workers to non-workers over the next 2 decades will be terribly burdensome to workers unless overall national income rises substantially. But, that won't happen without a significant increase in net national investment (which Americans can lay claim to). This, in turn, will be impossible without a significant increase in savings.

Thus, recent media stories that the national savings rate for the entire year of 2006 was negative for the second year in a row, have, in fact, been understatements of the seriousness of the problem this country faces, not their typical overblown declaration of some crisis. In addition to all of the national agendas being talked about today, such as defining a serious energy policy, this country desperately needs to put in place a viable savings policy which pushes national savings back up to at least the average of other developed nations throughout the world.

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[3] Home price appreciation is always better than stock market appreciation because stock ownership is restricted to a much smaller segment of society except for the highly illiquid portion tied up in retirement accounts.