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OPINION

Rainy-day blues

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Households in most rich economies are saving a declining slice of their income. Does this matter?

THE growth in America's third-quarter GDP was revised downwards this week to an annual rate of 2.4%, a sharp fall from the 5% growth recorded in the first half of the year. Yet American consumers continue to spend furiously. In the third quarter, and maybe in the fourth, their spending will have exceeded their income for the first time since the 1930s. In other words, they had a negative saving rate. Nobody is storing up for a rainy day. In the early 1990s, American households were saving around 9% of their disposable income.



That Americans now prefer consuming to saving is a familiar story. Less widely appreciated is the fact that saving is also going out of fashion in many other developed economies. Germany's personal-saving rate has fallen by half, to some 8% over the past decade; Canada's has plunged from 12% to 1%; and Italy's from 19% to 13%. The main exception is Japan, where households still save 12% of their income, exactly the same as they did in 1990.

Some of the decline in saving around the world reflects liberalisation of financial markets over the past two decades. This has made it easier for people to borrow and so reduced their need to save in order to make big purchases. A lower saving rate is not necessarily, therefore, a bad thing. But there are two reasons why low saving might be a cause for concern: if consumers become financially overstretched, and if low saving constrains investment.

Some economists argue that the official figures understate the true level of saving. Household saving is measured in the national accounts as the gap between personal disposable income and expenditure. It ignores changes in the value of financial assets, such as shares. Yet, from an individual's point of view, an increase in financial wealth thanks to rising share prices means that less needs to be saved out of current income to build up a desired nest-egg.

A recent paper by Richard Peach and Charles Steindel, two economists at the New York Fed, calculates that if realised capital gains were added to personal disposable income, the saving rate in 1999 would have been over 9%, not 2%. And, instead of plunging during the 1990s, the rate would have fallen only a little. If unrealised capital gains were also included, then saving would actually have increased over the decade.

The two Fed economists also reckon that worries about consumer borrowing are overdone. Although household debt has increased relative to disposable income, it has fallen in relation to household assets. They conclude that American consumers are not financially overstretched.

Moreover, consumers are only part of the picture. At the same time that households have been on a spending spree, the American government has become more prudent, moving from a budget deficit of 5% of GDP in the early 1990s to an estimated surplus of 2% of GDP this year.

Adding up all its components, America's total domestic saving (by households, firms and the government) actually rose slightly as a share of GDP in the 1990s. This paints a more reassuring picture of America's financial health. Private borrowing has been substituted for public borrowing, but overall saving has held up.

A saving disgrace

To many, however, this view seems too complacent. Ed McKelvey, an economist at Goldman Sachs, points out that the historically flat personal saving rate (once realised capital gains are included) means that households are, in essence, treating such gains as a perfect substitute for disposable income. Yet capital gains are much more volatile than wages, and cannot be guaranteed in future. If share prices plunge, a low personal saving rate provides less of a cushion than a high one.

Nor does the fact that overall domestic saving has risen mean that we can all sleep soundly. The problem is that investment by American firms has risen by even more than domestic saving, leaving a large gap to be filled by foreign capital. America's infamous current-account deficit (the gap between domestic saving and investment) has widened to a record level of around 4.5% of GDP. This is the best evidence that America is living beyond its means. So far, capital has been easily lured to the United States by its firms' high profitability. But as America's economy (and so its corporate-profit growth) slows, that money could dry up.

As well as America's external current account, the IMF has focused on yet another measure of net saving: the private-sector financial deficit. This is the difference between the saving of households and firms, and their investment. Over the four decades to 1996, net private saving was consistently positive—ie, the saving by American households was more than adequate to meet the financial needs of business. But America's private sector now has a net financial deficit of almost 7% of GDP.

In the euro area, too, the net financial position of the private sector has deteriorated sharply. But there is a striking difference between Europe and America: in the euro area, the private sector is still in rough balance. This is partly because rising share prices have less impact on households' wealth—and hence on their borrowing—in Europe. Indeed, a report by Dresdner Kleinwort Benson finds that the euro area displays an extraordinary degree of balance at present: all three sectors—the government, the private sector and the current account—are in broad financial balance (see chart). This suggests that Europe's expansion is better balanced and therefore more sustainable than America's.

History argues that the unusually large financial deficit of America's private sector should be a cause for concern. Booming asset prices caused net private saving to plummet in Britain, Japan and Sweden in the late 1980s. Just as in America today, it was argued that this did not matter, because all three governments had moved into budget surplus. It was also pointed out that if capital gains on property and shares were included, personal saving rates looked more stable. But when markets went sharply into reverse, private saving rebounded as households were forced to correct their previous over-borrowing. And this pushed the three economies into recession.

Most economists and policymakers still expect that America's high-flying economy will have a soft landing. But a gentle slowdown will not do much to reduce the economy's financial imbalances. If growth slows to around 3% over the next couple of years (down from an average of 4.5% over the past four years), as consensus forecasts suggest, that might be enough to keep inflation in check. But the current-account and private-sector deficits would remain at alarming levels. This, in turn, implies that the debt burden for households and firms, and America's net foreign debt, will continue to mount. A case of soft tomorrow, hard the day after?

