Spent:

Why Americans Are Saving More…
…and Why It Makes a Difference

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Editor

Once upon a time, Americans saved more than 10 percent of their incomes. Then the saving rate went south — fast. By 2005, it had dipped to nearly zero. Borrowing followed the opposite path: Total U.S. consumer credit outstanding clocked in at around $60 billion in 1960, jumped to $400 billion by 1980, then soared beyond $2.5 trillion by the early 2000s.[1]

Now, in the wake of the recession, the saving rate has ticked up again to around 5 percent. Debt levels, by contrast, have edged lower. The question of whether this is the "new normal" has large implications for the economy.

According to what's known as the *Solow economic growth model* — and depending on the saving rates of other economic sectors, such as business — just bumping the personal saving rate from 5 percent to 6 percent could increase income levels by 2 to 3 percent in the long run. "A difference in the saving rate of one or two percentage points is very important," says Filippo Occhino, a senior research economist with the Federal Reserve Bank of Cleveland.

But the recession was so deep, and climbing out of it is taking so long, that there are more questions than answers about where Americans' saving behaviors will go from here. The variables abound.

People don't save because it's fun; they do it to ensure their ability to consume later. At root, the amount that people save or borrow is nothing more than a manifestation of countless other factors: Do they feel wealthy or poor? How confident are they about their future income? How sanguine about the economy?

An example: During this season of debt-ceiling discontent, Americans may be quite skeptical about government's ability to provide safety nets in the future. Social Security,

1. Consumer credit outstanding includes most short- and medium-term debt less mortgage and other longer-term debt.

Medicare, unemployment insurance — the viability of each has been cast into serious doubt. This factor — how people view government — may impel them to sock away more than they otherwise would have.

So if people mistrust the government safety net, our saving rate could rise. Great, right? Yes, though in the short run, when people save more and borrow less, they consume less, which theoretically shrinks aggregate demand and slows growth. That's one of the paradoxes of the recession's aftermath. People's balance sheet decisions seem to work at cross-purposes with the recovery.

Personal Saving Rate

Sources: U.S. Department Commerce, Bureau of Economic Analysis; Federal Reserve Bank of St. Louis.

The Fundamentals of Saving and Borrowing

But beyond the short run, high saving rates tend to promote growth and improve standards of living. Savings usually get turned into investments—not so much in stocks and bonds, but in durables like factories and equipment. Higher investment levels lead to higher productivity levels (think computers). Standard economic models will tell you that higher productivity means higher incomes. In the medium term (between five and 20 years), higher saving rates encourage investment and growth. Over the longer term, they boost productivity and per capita income.

How much Generation Recession will save or borrow going forward boils down to the basics of consumer finance. Fundamentally, individuals save so they can consume more in the future, such as in retirement. Likewise, they may go into debt early in their careers in anticipation of higher future wealth. In each case, the amount depends on a wide range of factors, touching on everything from government policy to personal preferences to demographics.

Occhino zeroes in on several factors that are most closely tied to saving rates:

Expected income growth is important; a medical school graduate may save less early on, knowing that he will be earning more in the future. For him, taking on some debt is a useful and rational way to smooth consumption.

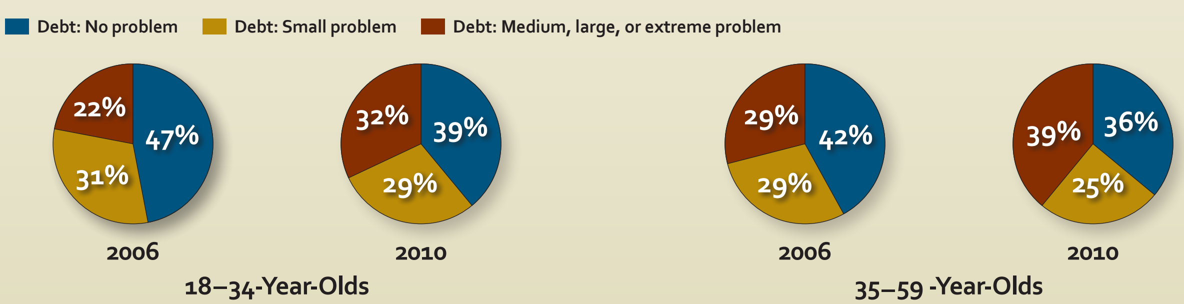
Recession Adds to Debt Stress

Americans — especially those under 60 — have amped up their stress levels about debt since the recession began.

The Ohio State University's *Consumer Finance Monthly* survey neatly encapsulates the nation's rising anxiety over debt.

For starters, the fraction of young people who believed debt was "no problem" shrank by 8 percentage points between 2006 and 2010. Meanwhile, the combined percentage of those who felt debt was some sort of problem rose 8 percentage points.

That trend was similar among middle-aged households, whose debt stress (those who said debt was a small, medium, large, or extreme problem) grew by 6 percentage points.



Sources: Center for Human Resource Research at the Ohio State University; Federal Reserve Bank of Cleveland.

Snip: More Americans Cutting Their Cards

One piece of early evidence that sheds light on Americans' reduced appetite for taking on debt comes from an analysis of recent figures from Equifax, one of the three main consumer credit reporting agencies. The Cleveland Fed's Yuliya Demyanyk, a senior research economist, has pored over millions of credit bureau files.

What her research may suggest is that the reduction in overall debt levels hasn't been driven from the supply side—that is, from creditors burned by reckless lending habits leading up to the financial crisis. The real driver appears to be a pulling back from the demand side, or in other words, from the increasingly debt-averse American consumer. Of course, what we don't know is whether this change in behavior is temporary or generational.

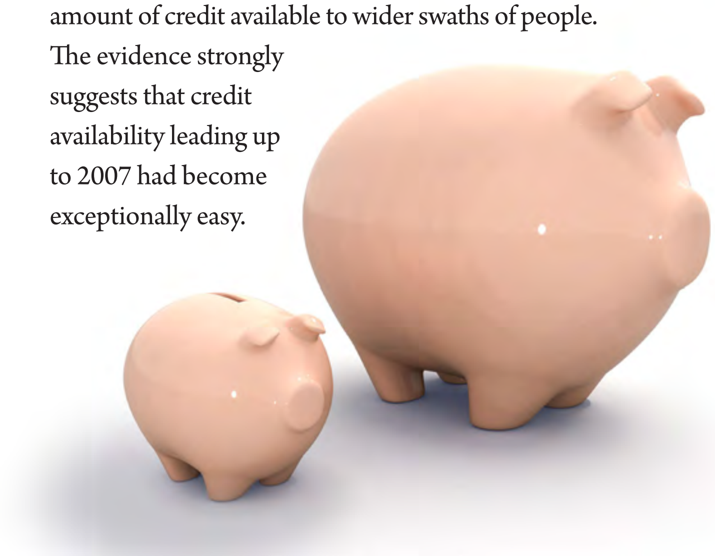
Wealth is essential; when people have less of it, they are likely to build it up by saving more. Of course, lack of wealth can also constrain borrowing. Alternatively, if people feel richer, they are liable to save less. As home values rise, for example, people see their newfound paper wealth as a substitute for savings. And when people pull money out of their homes instead of the bank, it drives down the saving rate.

Also important is **uncertainty**. In volatile economic times, it's natural for people to set aside money against the possibility of job loss, medical emergencies, and so forth.

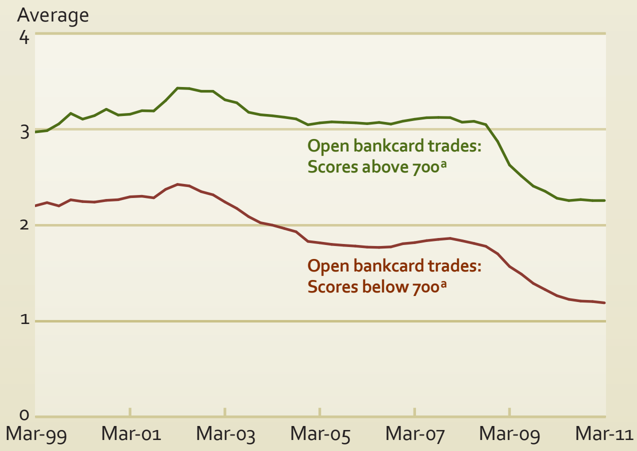
To these evergreen drivers of saving rates, two more must be added to explain what happened in the United States starting in the late 1990s. The first is what Federal Reserve Chairman Ben Bernanke termed the global "**savings glut.**" Foreign countries, especially China, amassed large amounts of U.S. Treasury bills. Part of the effect was downward pressure on U.S. interest rates, which discouraged saving by lowering its payoff.

Yet *investment* was actually encouraged, because investors could borrow at low rates to finance their projects. Thus, traditional saving went down but credit went up. All the houses that were sold during this period—which buyers confused with saving because they were confident that they could sell their homes at a profit come retirement—are a case in point (though regulatory gaps certainly played a role as well). One might argue that the construction boom proved that investment is not always good for the economy, since overbuilding contributed to the housing bubble. Investment is good—until it isn't.

A final factor, which is particularly relevant to any discussion about the cause of the financial crisis, is credit availability. Not coincidentally, the U.S. personal saving rate began to decline in 1980, just as consumer credit took off. With new information technology and innovation, financial institutions developed programs that expanded the amount of credit available to wider swaths of people. The evidence strongly suggests that credit availability leading up to 2007 had become exceptionally easy.

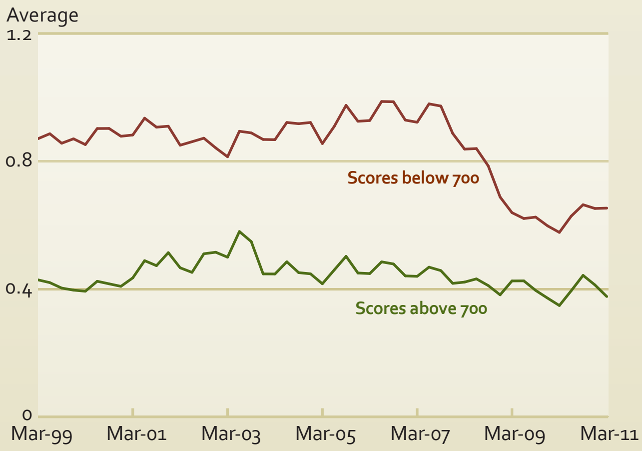


Average Number of Bankcards by Credit Score



Both high-and low-quality borrowers have consolidated debt and shrunk their numbers of credit cards. Since the end of the recession, the average consumer has closed one credit card account.

Number of Credit Inquiries, Last Three Months by Credit Score



High-risk borrowers have sharply cut back on their applications for new credit since the recession began. Meanwhile, credit applications by low-risk borrowers—who presumably could obtain credit if they wanted it—have been flat.

Notes: Primary borrowers only, excludes bankruptcies; score is Equifax Risk Score; both consumers and lenders have contributed to the decline in open bankcard accounts, but the simultaneous decline in credit inquiries suggests that it's consumers who have driven it.
a. Bankcard trades are revolving credit loans originated by banks.
Sources: Equifax; New York Consumer Credit Panel.

Apart from technology, credit may have been expanded for basically bad reasons. Banks didn't maintain solid underwriting standards. Some products grew so complicated that it became difficult to judge their risk.

These exceptional factors — the savings glut and slipshod lending that led to things like the housing bubble — help explain why saving rates plunged in the 2000s. It is not surprising that since the financial crisis, saving rates have risen again: Creditors have tightened lending standards and shored up their risk management practices, and households have been rebuilding their balance sheets.

Adding up these factors, it's unlikely that we will soon see the 10 percent saving rates that prevailed decades ago. That's largely because the technology that widened credit availability in the first place still exists and, indeed, is getting smarter. With more credit permanently accessible, savings may be naturally lower.

Perhaps the saving rate is stabilizing around 5 percent. It's difficult to know whether this is a good number, but it is probably reasonable to say that the rate is currently driven by sounder fundamentals than before. For example, credit card borrowing is moving lower as consumers tighten their belts. Yet nonrevolving credit, for items like student loans and cars, is holding firm. This suggests that consumers have shifted away from using debt to finance consumption in nondurables and services and are now investing in education and longer-lived consumption goods — a positive trend.

A fairy tale ending? We simply don't know yet. While it's categorically true that a zero percent saving rate is unsustainable, an occasional dip is not necessarily cause for alarm. It may just mean that people are more certain about their future prospects, or that they believe government backstops won't go away. In the end, Americans will save or borrow at levels that depend on outside events. And those events may only be at the first stages of shaking out. ■

Recommended reading

To see how inflows of asset-backed securities drove the global savings glut, see "ABS Inflows to the United States and the Global Financial Crisis," Federal Reserve Board of Governors, *International Finance Discussion Paper* 1028, August 2011.
www.federalreserve.gov/pubs/ifdp/2011/1028/default.htm

Filippo Occhino and Timothy Bianco. 2011. "Household Balance Sheets and the Recovery." Federal Reserve Bank of Cleveland, *Economic Commentary* (March).
www.clevelandfed.org/research/commentary/2011/2011-05.cfm