TEN TALK: Episode 6 - Why are Americans saving so much of their income?

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Research and Policy Advisor Lee Smith examines savings rates during the pandemic and finds Americans saved more than ever.

Audio File: Ten Talk Episode 6

Rick Babson: Hi, and welcome to TEN Talk, a podcast by the Kansas City Fed. I'm Rick Babson, and I'm the managing editor in the Bank's Public Affairs department, and I'll be your host today for this episode. With me today is Lee Smith from the Bank's Economic Research department. Lee is a research and policy advisor, also known as an economist. Lee, thanks for taking time to visit with us today.

Lee Smith: Thanks, Rick. I appreciate the invitation. I'm glad to have this chance to connect with listeners and share some of the research that's being done here at the Kansas City Fed.

Babson: You're welcome, Lee. During your tenure at the KC Fed, why don't you tell us what some of the topics and areas of interest that you've been focused on?

Smith: I've been at the KC Fed for about seven years now. One of the things I enjoy most about my job is really the wide range of issues we analyze and cover as a research team. So, most of my research has been done with colleagues of mine in the research department. And a lot of that work has focused on better understanding how Federal Reserve actions and communication shapes expectations and economic outcomes. But I've also done a number of projects looking at recent economic developments, ranging from inflation to oil markets, to money markets.

Babson: And most recently, I know you've looked at savings rates of Americans. Generally, we define this as a percentage of the disposable income that people save after accounting for their spending and taxes. How does this fit into your interests and your previous research?

Smith: A lot of times in economic research, you don't really pick the topics, but rather they kind of pick you. So, this recent analysis on the savings rate is an example of that, as discussions around spending and saving have really come into the forefront during this pandemic. I thought a deeper analysis could better inform some of our discussions on the topic.

Babson: Thanks. And to get into some specifics, your recent *Economic Bulletin*, titled, "Why Are Americans Saving so Much of Their Income," looked at saving rates during the COVID-19 recession and found that Americans, especially in 2020, were saving significantly more than ever.

Smith: Yes. So, to motivate the analysis for listeners, it might be helpful just to frame the magnitude of the movements we've seen in the savings rate recently. In December of 2019, prior to the pandemic, the savings rate was around 7%. What that means is that for every $100 of disposable income, consumers were saving about $7. Then the savings rates started to rapidly increase during the pandemic. And by April, it had reached about 34%, meaning that now for every $100 of disposable income, consumers were saving almost $34. It has since come down a bit, but remains elevated at about 14%, or nearly twice as high as it was prior to the pandemic.

Babson: That's certainly an interesting observation. I'm just curious; why is it important for the Fed to study and understand personal savings rates?

Smith: Well, economists have long been preoccupied with the relationship between savings and future spending. In fact, not to take us too far from the current situation, but if you look back to the 1930s amid the Great Depression, the famous economist, John Maynard Keynes speculated on the consequences for the economy when everyone tries to save more. In particular, he speculated that if everyone all at once decides to save, rather than spend their incomes say because they became worried about their future economic prospects, future savings and future spending would actually fall. And the logic here is really just the simple fact that one person's spending is another person's income. So, when we look at the recent rise in the savings rate, it's really just reviving an old question, and that is simply what does all this savings mean for future spending once the economy reopens.

Babson: I believe your research showed that these types of increases in the overall savings rate of Americans have occurred a number of times in the past related to other economic damage.

Smith: Yes, that's right. We typically see consumers become more reluctant to spend during recessions. Instead they choose to save more when the economy is not doing well. The desire to save during recessions reflects really a natural response to the fact that employment opportunities are scarcer in recessions and the value of investments like stocks and housing tend to fall in recessions as well. And this leads households to desire, greater savings, buffers to lean against, should they find themselves among the unemployed.

Babson: So, what makes was happened in the last year different? Is all of the gain attributable to the COVID-19 pandemic?

Smith: Certainly one thing that stands out is simply the magnitude of the increase. It's really historic. So, the recorded savings rate, if you go back to the early 1960s, had never crossed 20% prior to this pandemic, much less crossed 30%. The key question is really why are consumers saving so much? And I look at two primary factors that could be driving the savings rate higher. One of the first things that comes to mind, and to think about, is the large fiscal transfers, including stimulus checks and unemployment benefits, which have really boosted incomes at a time that much of the economy was closed. A second factor though, that is also likely responsible for the savings increase that I examine, is an increase in precautionary motives. As consumers have become more reticent to spend amid heightened uncertainty

Babson: Broadly, what constitutes a precautionary motive and what are some of the likely outcomes if savers mostly were motivated by these precautionary motives?

Smith: Precautionary savings refers to an increased desire to save today, to guard against a future risk or uncertainty. In the present context, it's not hard to imagine what risk and uncertainties might be prompting this type of savings. There's a great deal of uncertainty surrounding the economic outlook due to the many unknowns around the evolution of the virus. Moreover, the imposition of economic restrictions last spring exposed many households to a level of income risk that was previously unimaginable, as many workplaces were literally closed. Also, the duration of this pandemic may have led consumers to believe that having just three months of income and savings is not enough. That was a typical rule of thumb, but now they might be thinking they need six or even 12 months of income and savings. In the face of this unsettling situation, saving more seems a perfectly reasonable response in many ways.

Babson: So, maybe you could expand on the fiscal response, please. While there's little doubt that the economic prospects of millions of Americans have dimmed during this crisis, there's also been aggressive fiscal support to insulate many households from the full effects of this virus.

Smith: That's right. The large fiscal transfers are surely another factor contributing to the rise in savings. While many Americans haven't been able to work during the pandemic, the government has enhanced unemployment benefits and extended these benefits to many more workers than ever before. The generosity that benefits means that for some unemployed, the benefits are actually greater than their typical incomes. The government has also issued stimulus checks to many households.

Babson: And I know you didn't specifically look at demographics of savers, but is it fair to assume that not all Americans benefited equally from the fiscal transfers or the stimulus payments?

Smith: Yes. These fiscal transfers have allowed many households, particularly those who are experiencing a loss of income because of a job loss, to meet their basic necessities during this crisis. But for other households who have maybe been fortunate enough to remain employed, the transfers have facilitated their desire to build a savings buffer. The sheer generosity of the transfers has been such that some households have been able to both spend a bit more and save a bit more than they otherwise might absent this fiscal support. What's important to keep in mind as we have this discussion today is really that my analysis is looking at aggregate numbers for the entire population. So, over the course of 2020 excess savings, or savings above what might be normal, amounts to nearly $2 trillion. This money is surely not divided equally among the population. While many Americans may want to save more these days only those who are fortunate enough to maintain their livelihoods have actually been able to save more.

Babson: And I think another interesting aspect of your recent research is that there are a number of indicators that show that despite this buildup of savings, Americans may not be as willing to part with that money when things do finally loosen up.

Smith: I think what happens with the savings, that's really the $2 trillion question. What's going to happen to all of this money once the virus is behind us and the economy fully reopens. To the extent that precautionary motives led to the increase in savings, then consumers may be reluctant to draw down the savings in the future to support spending. Instead, the savings may be earmarked for a rainy day. However, households who have been fortunate enough to keep working during the pandemic, they may have had no choice but to save more of their income since so many parts of the economy remain closed. Therefore, some of the savings we have seen over the past year could essentially be what you might call forced savings that households are earmarking for perhaps future vacations. Any estimate of the motives behind what is driving the savings behavior is imperfect, certainly, but my analysis suggests that based on historical patterns between government transfers, savings and consumption, much of the recent increase in savings is driven by precautionary motives. And therefore this kind of leads me to conclude that we should probably be cautious when considering the possibility that the savings will be drawn down and fuel spending once the pandemic ends. Instead, consumers may hold onto the savings for some time.

Babson: And I'm just curious does the Federal Reserve have a role in trying to encourage consumers to spend as we come out of this downturn?

Smith: Well, in recessions, the Federal Reserve tends to lower interest rates, which creates the incentive to spend rather than save. This crisis has proven no different with the Federal Reserve setting rates to essentially zero since March of 2020. On the margin, these low rates may nudge consumers to spend a bit more than they otherwise might, especially on purchases that need to be financed like cars and houses. And we have actually seen those parts of the economy do really well in this pandemic. However, the types of spending that have yet to recover are in sectors like travel and leisure/hospitality, and how strongly those sectors bounce back will really depend, I think, more on the course of the virus and progress on vaccinations.

Babson: I know you looked at a number of past recessions, but I think perhaps the one most fresh in everyone's mind is the Great Recession that came out of the global financial crisis. How is what's occurring in this pandemic recession that's different?

Smith: The lasting effects of this pandemic on consumer behavior remain a large unknown at this point. But if we look back to the global financial crisis, we saw some pretty significant scarring. Savings rates moved persistently higher after 2008. And I think while there is some potential for scarring this time around, there's also a reason for optimism. In the global financial crisis and the Great Recession that ensued large amounts of household wealth were destroyed amid the crash in house prices. However, in that regard, this pandemic has been very different as household wealth has actually increased. So, that's one reason to be optimistic that even if the stock of accumulated savings isn't drawn down, the savings rate will likely move back to pre-pandemic levels once this crisis ends just given how strong household balance sheets look right now.

Babson: One final question, Lee. The Biden the administration has delivered another round of fiscal support, including stimulus checks of about $1,400 a person. Given the large amounts of past savings, in a healthy economy aren't households likely to just save the money again?

Smith: They might well end up saving some of that stimulus. In fact, based on what we saw from these prior rounds of stimulus, a good portion of the money was saved. I think some may look at that and really conclude that the stimulus wasn't actually all that stimulatory at all. However, I'd kind of caution against that interpretation. If precautionary motives have increased desired savings buffers, then fiscal support could speed the accumulation of those buffers. For instance, if households now want to hold six months of income and savings for a rainy day fund, whereas before they held three months of income and savings, the government transfers may help consumers achieve those desired buffers. Without the stimulus it may take years to build those buffers, keeping the savings rate persistently elevated. Along these lines, even saved, government transfers may be stimulatory if they give consumers greater confidence to go out and spend, once this pandemic is finally behind us.

Babson: And that's the key right there, finally behind us. Lee, I want to thank you for your time and your insight today on why Americans are saving more money than ever, even a pandemic. You can find more of Lee Smith's research on our public website. The views expressed today as always are those of the host and the guest, and don't necessarily represent the Kansas City Fed or the Federal Reserve System. You can find more of our TEN Talk podcasts at KansasCityFed.org. Thanks for listening.

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