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The Health of Personal Saving

Rates are low, but might not be as dire as predicted

After Janel Ward starts collecting her salary as a doctor, she'll still drive her '98 Buick with its cracked windshield. Her family will still live in their modest townhouse in Denver. And for years to come, those big paychecks won't go toward vacations or nights out, but paying bills—still.

When Ward graduates from the University of Colorado's School of Medicine this year, she will have accumulated more than $200,000 in student loans.

"It's pretty scary," she says. "But, if I want this career, I have to have this debt."

For Ward, and many of her fellow med students, this means costs have to be cut. Life's luxuries are out of reach. Building a nest egg must wait.

But they hope not for long.

Their anticipated annual salary, usually in the hundreds of thousands, makes the debt incurred early in life an easier pill to swallow, they say.

It's this behavior—when households rationally plan spending based on expected income and assets—that illustrates why the decline in the country's personal saving rate may not be as alarming as is often portrayed, says Alan Garner, an assistant vice president and economist at the Federal Reserve Bank of Kansas City.

Data show for the last two decades, Americans' personal saving has been steadily dwindling and has dropped to a negative rate. While Garner acknowledges many Americans aren't saving adequately for long-term needs, he says this current-spending-based-on-future-income theory suggests the low saving rate may not be as dire as initially stated.

Additionally, there may have been various measurement problems with the most recent saving rate calculations. Recognizing these factors can reduce concern about Americans' well-being and the nation's economy.

"The low personal saving rate may not foreshadow wrenching future adjustments in consumer spending," Garner says.

A penny saved

The most commonly cited measure of personal saving is calculated from the national income and product accounts, or NIPA, from the U.S. Department of Commerce. It measures the funds taken out of current household income (after taxes) and saved, not including capital gains or losses on existing assets.

Personal saving has plummeted from about 10 percent of disposable income in the 1980s to 2 percent in 2004. But by 2005, the saving rate turned negative for the first time since the Great Depression, falling to -0.4 percent.

"The downward trend in the personal saving rate has prompted expressions of concern by economists and other observers," Garner says. "Underlying these and virtually every other discussion of saving trends is one point of agreement: Saving for the future is important."

Much of the concern about the low saving rate stems from the aging population's burden on health care and retirement systems. Projected population aging during the next 25 years creates unfunded Social Security and Medicare liabilities. Adding to the health care burden, medical costs are climbing faster than inflation.

Additionally, the decline in saving eventually might prompt a sudden increase in saving, effectively reducing growth of consumer spending, and in turn, real output and employment.

The purpose of saving is to increase resources for future use, Garner says, whether it's for vacations, retirement or unexpected loss, such as an illness or job layoff. Typically, savings are invested in financial assets—bank accounts, mutual funds or real estate.

"Today's saving influences future consumption because investments in financial assets are channeled into productive investments in factories, industrial

Personal Saving as Percent of Disposable Personal Income

machinery, computers and other kinds of capital," Garner says.

Increased saving could help reduce these burdens by raising the domestic capital stock and increasing workers' output. This would lead to higher earnings and make it easier to pay higher social insurance taxes if needed in the future to support Social Security and Medicare, he says.

Explaining the drop

Many explanations for the saving decline have been suggested, such as overspending and increased access to credit. However, Garner says much of the debate considers wealth effects on spending.

"Modern economic thought suggests saving and consumption depend on expectations about the future—expected future income or expected returns on stocks, bonds and other investments," Garner says. "Thus, economists assume current consumption and saving depend on expected future resources as well as current resources."

Right or wrong, this is the way Americans live, agrees Eric Seff, of Seff Investments Inc. in Albuquerque, N.M.

Seff is a long-time financial planner, specializing in spending- and investment-program development for his clients, who most often come to him for help tackling their debt, whether it's from student loans or spending beyond their means.

This concept of spending now because you will earn later has at least one major risk: "Emergencies do come up," Seff says, "whether it's a broken furnace or something medical. There's no cushion. There's nothing there at all."

However, economists traditionally have believed permanent-income and life-cycle views of consumption imply a dependable relationship between wealth and consumption for the economy as a whole.

Estimated life-cycle consumption implies a $1 increase in household net worth raises consumption by about 3 cents. Recent increases in

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JANEL WARD says rather than focusing on the debt she's accumlated from student loans, she thinks about her future career. "This is what I want to do in my heart," she says.

the stock market and home equity may have raised consumption relative to current disposable income and lowered the measured saving rate. Some argue that the overall decline in the personal saving rate since the mid-1980s is the result of capital gains on corporate stocks.

Estimates of the wealth effect on consumption are difficult to pin down empirically, Garner says.

Should we worry?

Although the personal saving rate may be revised upward in the coming years as data are further analyzed, the revisions would have to be exceptionally large to eliminate this downward trend, Garner says.

One factor in assessing the severity of the situation is the rising net worth of U.S. households, which is a sharp contrast to declining saving. Recent data estimate assets of households and nonprofit organizations totaled about $64 trillion in 2005. Liabilities, which were mostly home mortgages and consumer credit, were about $12.2 trillion.

The growth of household wealth relative to income has been quite high. From 1980 to 2004, the average household net worth rose by about 34 percent of disposable income annually. Growth was volatile from year to year, ranging from almost a 72 percent gain in 1999 to a 22 percent decline in 2002.

"Weighing the long-run concerns may be more difficult than assessing the short-term risks to economic performance," Garner says.

Projected aging during the next several decades is unprecedented in our nation's history and may pose unexpected challenges. The best way to meet these challenges: more personal saving, say most economists and policymakers.

If you are in debt, Seff says, "The best strategy is to try to avoid more debt." He adds that developing good saving habits means first developing good spending habits. It's this simple approach that can raise the country's saving rate one person at a time.

Seff's advice: "Pay yourself first." Factors specific to the individual, such as age, income, debt and expenses, including children and their education, determine how much should be saved, he says.

Not so bleak

Sam Ceridon has lived a financially disciplined life, always budgeting and religiously saving for his golden years. Until now.

In fact, he's spent all the money—plus some—that he'd put away during his three most-frugal years working as an engineer, and has even cashed in his retirement fund.

As in Janel Ward's case, it's all gone toward tuition, but it's barely made a dent. Ceridon, only halfway through medical school at the University of Colorado, estimates his debt at $180,000. For someone who never carries a credit card balance, it's "terrifying," he says.

Rather than think of his debt as a

Crunching the numbers

There are several issues in measuring the rate of Americans' personal saving that may alter its current–and negative–estimate, says Alan Garner, assistant vice president and economist at the Federal Reserve Bank of Kansas City. Coupled with rising net worth and expected income, revised calculations might mean the rate isn't as alarming as initially thought.

However, alternative measures of the national income and product accounts, or NIPA, saving rate generally do not eliminate the downward trend, Garner cautions.

For example, counting purchases of consumer durables as a form of saving raises the personal saving rate but it doesn't eliminate the downward trend. Neither does adding federal taxes on capital gains back into disposable income.

But possible future revisions, even if they are small, may gradually raise the saving rate. This has happened in the past, often decades later, and the revision can be substantial.

Published estimates from 1965 to 1999 were revised upward by about 2.8 percent. For the fourth quarter of 1981, the upward revision was 7.3 percent; the average revision for 1980-84 was 5.1 percent.

Garner says there is some evidence the NIPA revision may raise the personal saving rate. It is possible personal consumption expenditures may have been overstated, or income understated, which could return the personal saving rate to a positive–but still low–value.


PHOTO BY JOSHUA LAWTON

MED STUDENT SAM CERIDON is willing to go into debt now and assumes his future salary as a physician will pay it off quickly.

liability, Ceridon considers it an investment in his future. He predicts his salary as an orthopedic surgeon will have him not only living debt free again in about 15 to 30 years, but also saving again.

Although they are incurring large debts, Ward and Ceridon also are building specialized knowledge that raises their future earning power. If such growth of the knowledge economy was fully incorporated in saving measures, the personal saving rate would likely rise and current high asset values would appear more sustainable. These assets could provide financial resources to meet future needs, and associated growth in productivity of firms and workers would create more output.

Meanwhile, short-term concerns are focusing on the possible decline in consumer spending, reducing demand and economic growth.

The personal saving rate could adjust upward gradually if consumption grows at a longer-term average rate while the growth rate of disposable income increases. This is consistent with a permanent-income or life-cycle theory of consumer behavior.

"If new information were to become available that disposable income is likely to increase faster in the future, households might immediately boost their estimates of permanent income, and would increase consumption accordingly," Garner says. "But if the income increases materialize as expected, consumption need not be adjusted further, and more rapid gains in disposable income would raise the measured saving rate."

Med students Janel Ward and Sam Ceridon know this to be true.

"A low personal saving rate," Garner says, "does not necessarily imply painful economic adjustments in the future."

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BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

SHOULD THE DECLINE IN THE PERSONAL SAVING RATE BE A CAUSE FOR CONCERN?
By C. Alan Garner
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