

WSJ COMMENTARY
Running on Empty?

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With each hike in interest rates, those predicting a bad ending to the 40-month U.S. expansion look expectantly for consumer spending to flag. One of their main worries is the premise that we will run out of savings, especially if foreigners pull the plug or asset prices fall. The reality is that the U.S. has the world's biggest accumulation of savings and investments. The U.S. household sector, the world's largest net creditor, is favorably positioned for higher rates due to large liquid assets and the generally fixed-rate U.S. mortgage structure.

Of course, more saving would be better especially for those who haven't been able to save, and a reduction in the tax distortions that penalize liquid savings while favoring real estate would add to our growth prospects. However, the bigger harm is not that we expose ourselves to a collapse, but that we allow ourselves and foreigners to underestimate, even mock, our economic system. We apologize for our "low savings rate" and "dependence on foreigners," turn our foreign economic policy over to the International Monetary Fund's economic gurus, and contemplate consumption tax increases, forced saving, protectionism, and a weaker dollar (with the consequent increase in inflation). Instead, while working hard to improve our system, we should encourage others to emulate its freedom, flexibility and prosperity.

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Not only are we not running out of household savings, it is growing fast both in terms of the annual additions and the cumulative buildup of American-owned savings. Household net worth, one good measure of savings, reached \$48.5 trillion in 2004. Time deposits and savings accounts alone total a staggering \$4.3 trillion, versus slow-growing credit-card debt of \$800 billion. True, the U.S. is the world's biggest debtor, but it is building assets faster than debt. Even if household assets took a hard fall, the remaining net worth would still dwarf other countries'. On a per capita basis, counting mortgages but not houses, net financial assets total \$89,800 in the U.S. versus \$76,900 in No. 2 saver, Japan. Of course, some households don't have nearly this average, creating risks for them and burdens on others in the event of a downturn. This is an appropriate policy concern, but the macroeconomic issue is aggregate savings, of which the U.S. has an abundance.

According to the Federal Reserve's flow of funds data, the 2004 additions to household financial assets were a net \$590 billion. This was 6.8% of personal disposable income, providing a meaningful measure of the cash flow going into new financial savings. This increased the household's financial net worth to \$26.1 trillion, way above any other country's savings and plenty to fund profitable domestic investments. If the 2004 appreciation in the value of homes and equities were also counted, the 2004 saving rate was 46% of disposable income. Foreign savings invested in the U.S., the counterpart of the widely criticized current account deficit, is additive to our own large store of savings.

Rather than a "dependence" on foreign savings, the U.S. is an effective user of it, profiting by growing faster than the interest cost of foreign saving. The combination of large domestic and foreign savings allows heavy investment in the U.S. decade after decade, part of the explanation for our fast growth and the world's highest employment levels. Meanwhile, foreigners are actually losing ownership share in the U.S. despite the \$2.6 trillion net debtor position, since U.S. assets are growing faster than foreign savings in the U.S.

How can the U.S. have so much aggregate savings when the government's "personal savings rate" statistic is low and has been falling? The personal savings rate doesn't really measure saving in the real sense. It subtracts a broad measure of consumption, \$8.5 trillion in 2004, from "disposable personal income," a subset of household cash flow, and labels the difference "personal savings." It was recorded at only 1.1% of disposable income in 2004, or \$101 billion. It would have been even worse if not for the \$25 billion Microsoft dividend in December, which counted as income in 2004. Without it, the personal savings rate would have been only 0.9%, nowhere near enough to finance a fast-growing economy if it were a true measure of saving.

Fortunately, the personal savings rate doesn't have much connection to the actual saving taking place in the economy. Basically, the income side of the equation is understated because it doesn't measure gains or cash flows to the consumer, and the consumption side is overstated because it includes many long-lasting purchases, some of which might better be considered investments.

The Microsoft dividend illustrates one of several divergences between the personal savings rate and actual savings. Corporate profits are counted in personal savings only if a dividend is paid, not by owning an appreciating stock or selling it for a capital gain. In general, the reverse was happening in the 1980s and '90s: Companies chose to provide shareholder value through capital gains rather than dividends, depressing the household savings rate even as actual savings went up fast. Since capital gains and stock buybacks are not included in personal income yet provide cash for investment and consumption, the more gains the economy was producing, the more depressed the personal savings rate.

This applies not only to gains in direct holdings of stocks but also to the inside buildup in pension funds and 401(k) plans. While the original cash paid into these plans is counted in income, the later-and-often-much-bigger cash outflow from these plans is not part of personal disposable income even though it is available for consumption and investment. Because pension funds had big compound gains in the '80s and '90s, they caused an increase in consumption without a corresponding increase in personal income. This artificially depressed personal saving as pensions were paid and spent.

A separate problem with the concept that America is running on empty is the definition of consumption, which understates investment and household savings by making no distinction between purchases for immediate consumption and purchases with lasting value. For example, consumption includes education. Even as it has become an increasingly valuable investment in human capital, buying it has pushed the savings rate

lower and lower. The absurd result: Spending less on education would raise the "personal savings rate" even though it would reduce future U.S. growth.

The broader national saving rate (household and corporate saving less government consumption) suffers from some of the same drawbacks as the 1.1% personal savings rate. Consumption is defined broadly, income narrowly. This depresses the national saving rate even though the U.S. ownership of assets net of debt is high and growing at a fast rate. For example, consumption includes personal education plus corporate and government training and R&D expenses, all of which facilitate innovation and future growth. National income doesn't include capital gains, the increasing value of U.S. real estate, or the (rather large) excess of the appreciation of U.S. assets abroad over foreign assets in the U.S. Recognizing these adjustments, the 2004 national saving rate of 13.7% of GDP and investment of 19.7% would both be even higher and the current-account deficit gap narrower (by at least the mark-to-market adjustment to the net international debtor position).

Many economists and politicians have been holding their breath for years waiting for U.S. consumption and investment growth to expire, even though household savings isn't low and is unlikely to limit the expansion. They explain each quarter's fast growth as the last gasp of a nation running on empty. Rather than worrying so much and so publicly about a shortage of savings or foreign withdrawals, we should be working hard to encourage more innovation and engineering, less regulatory, tax and structural drag, more savings for those who haven't been saving, and fewer tax distortions of market-based savings behavior.

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