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America's Saving Rate and the Dollar's Future

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CAMBRIDGE – The saving rate of American households has risen sharply since the beginning of the year, reaching 6.9% of after-tax personal income in May, the highest rate since 1992. In today's economy, that is equivalent to annual savings of $750 billion.

While a 6.9% saving rate is not high in comparison to that of many other countries, it is a dramatic shift from the household-saving rate of less than 1% that the United States experienced in 2005, 2006, and 2007.

Before it began rising last year, the US household saving rate had been declining for more than 20 years in response to the increasing level of household wealth. The rising stock market and the higher value of homes induced individuals to consume more of their incomes and to save less. As a result, most working individuals reduced the amount that they saved for their retirement, and retirees were able to increase their spending. The net saving rate fell to near zero.

The sharp drop in household wealth over the past two years, however, put an end to that. Dramatically lower share prices and a 35% fall in home prices reduced household wealth by $14 trillion, a loss equal to 140% of annual disposable income. Individuals now have to save more to prepare for retirement, and retirees have less wealth to spend. Looking ahead, the saving rate may rise even further, and will, in any case, remain high for many years.

The increase in the household saving rate reduces America's need for foreign funds to finance its business investment and residential construction. Taken by itself, today's $750 billion annual rate of household saving could replace that amount in capital inflows from the rest of the world. Since the peak annual rate of capital inflow was $803 billion (in 2006), the increased household saving has the potential to eliminate almost all of America's dependence on foreign capital.

The annual capital inflow is equal each year to the US current-account deficit – the sum of the trade deficit plus the net interest and dividends that America's government and businesses owe to the rest of the world. The fall in the capital inflow would therefore bring with it a fall in the trade deficit. Since reducing the trade deficit requires increasing exports and shrinking imports, the international value of the dollar must decline to make US products more attractive to foreign buyers and US goods and services more attractive to American consumers.

Without a fall in the dollar and the resulting rise in net exports, a higher saving rate and reduced consumer spending could push the US economy into a deep recession. By contrast, the lower

dollar makes reduced consumption consistent with full employment by shifting consumer spending from imports to domestic goods and services, and by supplementing this rise in domestic demand with increased exports.

But this direct link between higher household saving and a lower dollar will only be forged if higher household saving is not outweighed by a rise in government dis-saving, i.e., by a larger government deficit. A large fiscal deficit increases the need for foreign funds to avoid crowding out private investment. Put differently, the value of the dollar reflects total national saving, not just savings in the household sector.

Unfortunately, the US fiscal deficit is projected to remain high for many years. The Congressional Budget Office projects that the US government's budget deficit will average 5.2% of GDP over the next decade, and be 5.5% of GDP a decade from now. If that high level of government borrowing occurs, it will absorb all of the available household savings even at the current elevated level. That would mean that the US would continue to need substantial inflows of foreign capital to fund business investment and housing construction. So the dollar would have to stay at its current level to continue to create the large trade deficit and resulting capital inflow.

It is, of course, possible – I would say likely – that China and other foreign lenders will not be willing to continue to provide the current volume of lending to the US. Their reduced demand for dollars will cause the dollar to decline and the trade deficit to shrink. That reduced trade deficit and the resulting decline in capital inflows will lead to higher real interest rates in the US. The higher interest rate will reduce the level of business investment and residential construction until they can be financed with the smaller volume of national saving plus the reduced capital inflows.

Although the higher level of household saving will limit the rise in US interest rates, it will not change the fact that the combination of large future fiscal deficits and foreign lenders' reduced willingness to buy US securities will lead to both a lower dollar and higher US interest rates.

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