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The Saving Shortfall

During the first three quarters of 1987 the United States had a deficit in its international payments of $152 billion (at an annual rate), or 4 percent of the net national product (NNP). The continuing imbalance between our imports and exports, which has resulted in a cumulative deficit of more than a half trillion dollars since the beginning of 1983, reflects an excess of domestic spending on goods and services over what our economy produces.

This excess spending has been made possible by the net inflow of funds from abroad that is the financial counterpart of the foreign payments deficit. As a result of this inflow, our total liabilities to foreigners are now estimated to exceed the value of our assets held abroad. In the third quarter of 1987, payments to foreigners on their investments in the U.S. exceeded receipts of income on U.S. assets abroad for the first time since before World War I. To release the funds required to service these additional foreign liabilities, the U.S. must either reduce the quantity of goods and services it imports, or export a larger portion of its current production.

Some economists contend that foreign investors have been willing to invest in the U.S. because the expected returns have increased in recent years and thus that the capital inflow is a reflection of the dynamism of the U.S. economy. According to this view, future generations of Americans will benefit from the increase in our foreign debts because the resources obtained from abroad have been used to increase domestic capital formation and to add to our economy's capacity to produce goods and services. Although some of the income flowing from this additional capacity will accrue to foreigners, our citizens will benefit too.

Unfortunately, the facts seem to be at odds with this optimistic interpretation. If the capital inflow had resulted from a rise in the rate of return to productive investment in the U.S., one should have observed both a rising share of our national resources being devoted to capital formation and an increase in domestic saving.

In fact, the proportion of available resources devoted to net capital formation has been trending downward, while that used for private consumption has been rising, since the late 1960s. The share of the nation's net resources, including the net national product plus the inflow of foreign funds, used for net capital formation declined from an average of 8.5 percent between 1966 and 1969 to 5.5 percent between 1983 and 1986. Between these same periods, the share of our resources devoted to personal consumption increased from 68 percent to 72 percent. There is little evidence that the inflow of foreign capital in the 1980s has led to a reversal of the downward trend in capital formation, or to a shift of resources away from private consumption toward greater saving.

Saving and the federal deficit

The appearance of a significant imbalance in our overseas payments has coincided with the emergence of huge federal budget deficits totaling more than a trillion dollars since 1982. These federal deficits are not a result of faster growth in federal spending on goods and services. The budget deficit primarily has been the result of slower growth in federal tax revenues, due to significant reductions in tax rates, and of an increase in federal payments of interest and other transfers to the private sector of the economy. In effect, the federal government, while continuing to spend about the same proportion of the nation's resources on goods and services, has borrowed in order to add to the spendable income of the private sector of the economy. As a result, the share of NNP accruing to the private sector (including both households and private businesses) has increased from an average of 80 percent during the 1975-80 business-cycle expansion to 82 percent since 1982.

In turn, the private sector has used this two-percent increase in its share of the national product to finance additional consumption. Indeed, the nation's households have added to the saving shortfall by increasing their expenditures on consumption by considerably *more* than the increase in their spendable incomes.

Between 1982 and 1986, private saving averaged only 10.3 percent of private income compared to 12.2 percent between 1975 and 1980. This brought the private saving rate to its lowest level since the late 1940s.

This two-percentage-points decline in the private saving rate, combined with the two-percentage-points increase in the share of the nation's product accruing to the private sector, meant that the proportion of the nation's net output devoted to current consumption rose from 70 percent in the late 1970s to almost 74 percent between 1982 and 1986. Most of this increased consumption has been indirectly financed by the inflow of foreign resources, which amounted to almost 4 percent of NNP last year.

Sources of private savings
Most discussions of the dearth of private saving focus on the *personal saving rate*, which is the proportion of household disposable income that is not spent on consumer goods and services. The personal saving rate averaged a meager 3.4 percent in the first three quarters of 1987, compared to an average of around 6-7 percent over most of the postwar period.

Personal saving, however, is only one source of saving by the private sector. A second important source is the undistributed profits of corporations. Since corporations are privately owned, their undistributed profits ultimately belong to their stockholders, and thus are a form of private saving. Retained corporate profits fluctuate widely over the business cycle, but have been declining as a proportion of NNP over the past twenty years.

A third source of private saving that has become increasingly important in recent years, and that is not included in the official measure of personal saving in the national income accounts, is the accumulation of funds in the pension funds of government employees. In the official accounts, contributions to these funds are not included in personal income or saving.

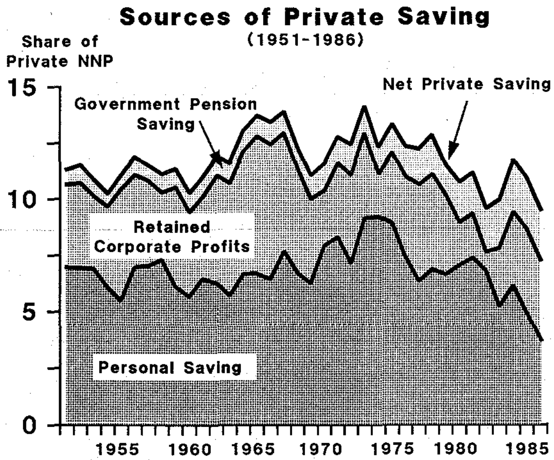
If contributions to government pension funds were treated in the same way as those to private pension funds, this would add to measured private saving and reduce government saving. In 1986, about $47 billion of the $63 billion surplus of state and local governments represented additions to the reserves of their employee pension funds, and so should be treated as private rather than government saving. Thus, state and local governments make only a modest contribution ($16 billion last year) to the nation's saving. Similarly, if the $20 billion of contributions to federal employee pension funds were included in private saving, the measured federal deficit would be that much larger.

The chart shows these three sources of private saving since 1951, with each category of saving presented as a proportion of private NNP. Although the steady rise in the amount of saving through government pension funds has partly offset the downward trend in personal and corporate saving, total private saving in all forms has been trending downward since the mid-1970s.

Saving and the foreign deficit
The imbalance between the supply of domestic savings and demand for funds to finance capital formation and the federal deficit has been caused not only by the increase in that deficit but also by the steady downward trend in the supply of private saving. As a result of this imbalance, almost one-third of the total demand for savings in 1986 was met by the inflow of funds from abroad.

The depreciation of the dollar since 1985 should cause the deficit in our foreign payments, and thus the inflow of foreign funds, to decline. This means that domestic demand must be slowed to match the growth in domestic production. To maintain the future growth of the economy, it is important that this slowing of demand occur in consumption or government spending rather than in capital formation. Otherwise, there is a danger that rising interest rates will cause a cutback in capital formation and a slowdown in economic growth over the long haul.

A reduction in the federal deficit achieved through a decrease in federal expenditures on goods and services would accomplish the required slowing in domestic demand. But government outlays on goods and services have not risen much as a proportion of the national product in recent years, suggesting that it may be dif-



ficult to reduce this component of spending significantly.

Alternatively, an increase in taxes or some cutback in federal transfers would reverse the rise in the share of the national income accruing to the private sector. The impact of these tax and transfer changes on domestic saving would be even greater if they were designed to fall more heavily on consumption than on saving. Several economists have suggested that this emphasis could be achieved through the imposition of a national sales tax.

Implications

Much of the debate surrounding the savings imbalance has centered on the foreign payments deficit, and its implications for the U.S. economy. On balance, the short-run implications have surely been positive. Without the inflow of foreign funds, interest rates in the U.S. would have been higher and capital investment severely crowded out. But even in the short run, some parts of the economy have been hurt by the increased competition of foreign imports, leading to sentiments in Congress for protectionist legislation.

In the longer run, the foreign payments deficit implies more serious problems since it means larger interest and other income payments sent abroad. Unfortunately, the inflow of foreign funds that has given rise to these payments has been used for current consumption rather than to add to the nation's productive capacity.

A more intangible result of the saving imbalance and resulting payments deficit is that the U.S. economy has become more vulnerable to foreign economic shocks and policies, because of the necessity to continue to attract foreign capital. Policymakers now must consider the effects of their actions on foreign expectations of the future of the U.S. economy, providing an added incentive for reducing the foreign deficit.

To reduce the foreign deficit, a significant slowing in the growth of living standards will be required. In 1986, the deficit amounted to almost four percent of the national product while personal consumption was 74 percent. Even if the NNP continues to grow at its recent rate of around two-and-a-half percent, eliminating the imbalance within five years by a corresponding reduction in personal consumption would require cutting the growth of household spending to an annual rate of one-and-a-half percent, from the four percent annual growth rate over the five years ending in 1986. This slowing in consumption growth is the price that we must now pay for the excessive spending of the past.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/9/87	Change from 12/2/87	Change from 12/10/86 Dollar	Percent[7]
Loans, Leases and Investments[1 2]	207,122	– 510	1,178	0.5
Loans and Leases[1 6]	183,229	– 499	– 2,199	– 1.1
Commercial and Industrial	51,526	318	– 694	– 1.3
Real estate	72,445	– 159	5,469	8.1
Loans to Individuals	36,958	– 172	– 4,443	– 10.7
Leases	5,421	– 2	– 180	– 3.2
U.S. Treasury and Agency Securities[2]	16,548	– 26	3,523	27.0
Other Securities[2]	7,345	14	– 147	– 1.9
Total Deposits	207,114	– 2,228	– 3,518	– 1.6
Demand Deposits	51,866	– 2,033	– 4,827	– 8.5
Demand Deposits Adjusted[3]	36,832	188	– 2,578	– 6.5
Other Transaction Balances[4]	20,467	– 45	1,561	8.2
Total Non-Transaction Balances[6]	134,782	– 149	– 252	– 0.1
Money Market Deposit Accounts—Total	44,145	– 227	– 2,701	– 5.7
Time Deposits in Amounts of $100,000 or more	31,614	215	– 1,079	– 3.3
Other Liabilities for Borrowed Money[5]	20,612	– 3,993	– 5,953	– 22.4

Two Week Averages of Daily Figures	Period ended 11/30/87	Period ended 11/16/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	105	18
Borrowings	9	6
Net free reserves (+)/Net borrowed(–)	96	12

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change