Have US consumers become too frugal?

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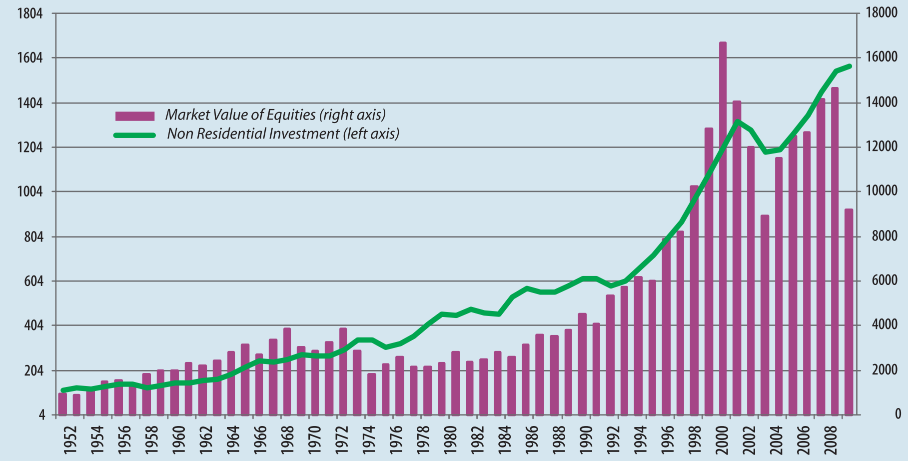
In response to the financial crisis, US consumers now save more. Many observers are concerned that they have become too frugal, insofar as their higher savings may mean weaker demand and lower economic growth. In a recently released IMF working paper, Yasser Abdih and I suggest that this is an incomplete diagnosis of savings, wealth, and economic activity.[1]

We stress that the beneficial effects of additional new savings will be cumulative. By saving more, households and firms replenish their net worth. This will be critical for restarting capital investment. Historically, there has been a close link between net worth and capital expenditures (Figure 1). Ben Bernanke and others describe such a link metaphorically as a "financial accelerator." Extending the metaphor, we believe new savings flows are needed to refill the gas tank propelling our "financial accelerator."

We find a fundamental feedback mechanism between savings and wealth: By definition, the net wealth of households is simply their accumulated savings. Thus, in the current "great unwinding," US households will rebuild their wealth. This is already beginning to happen:

Fig. 1 – United States: Market Value of Corporate Equities and Non Residential Investment

(Billions of Constant 2005 US Dollars)



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after declining steadily though gradually in 2007 and then plummeting in the fall of 2008, the net worth of US households increased in the second quarter of 2009. We can credit this to both a market recuperation and to more "out-of-paycheck" saving by households — disposable *labor* income minus consumption.

In the other direction, as households become wealthier, they begin to save less and consume more out of each paycheck. Historically, we find, households make such an offsetting adjustment to their savings in response to positive changes in their income (Figure 2). This offsetting adjustment is gradual, but over the long run it approaches one-to-one.

Our forecasts of savings and wealth are anchored to the dynamic feedback between these two variables. Most of our scenarios suggest that out-of-paycheck savings will rise only modestly and temporarily, peaking in or about 2011. The forecast takes on a hump shape precisely because, as household savings accumulate, consumers gradually become less frugal.

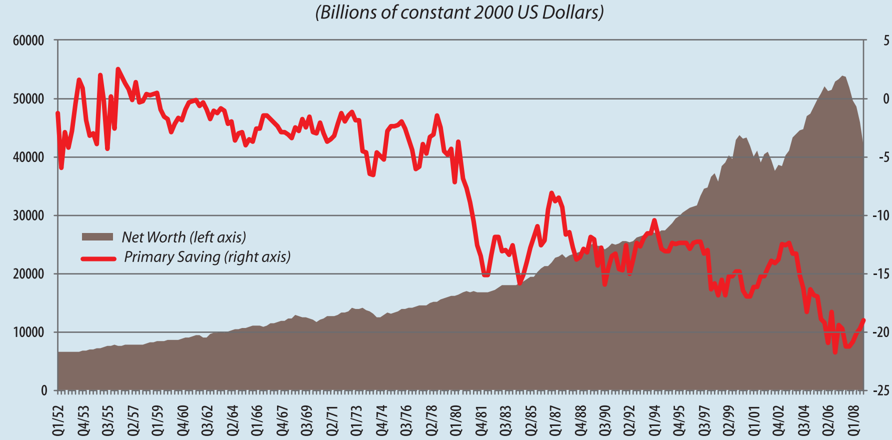
In our baseline scenario, household net worth and capital investment remain well below their pre-crisis levels for years. For net worth and investment to return to their pre-crisis levels soon, the future path of savings would have to be higher than the baseline; savings would have to be more closely aligned with one of our "new frugality" scenarios. And unless that extra saving starts today, both net worth and investment may stagnate for years to come. Thus, our projections suggest that we may be too spendthrift — not too frugal.

By saving more, households and firms replenish their net worth. This will be critical for restarting capital investment.

The paper, "Frugality: Are We Fretting Too Much? Household Saving and Assets in the United States" (IMF WP/09/0197), is available at http://www.imf.org/external/pubs/cat/longres.cfm?sk=23259.0.

Fig. 2 – United States: Primary Saving and Net Worth of Households

(Billions of constant 2000 US Dollars)



Source: Federal Reserve Bank.