Higher Return for Savers and a Path toward Higher Investment

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Abstract

The rise in personal saving rate following the Great Recession was an unexpected development in light of Federal Reserve's effort to foster stronger consumer spending via ultra-accommodative monetary policies. From the perspective of some policymakers, higher saving rate exerts downward pressure on the neutral interest rate (short-term real rate r* where monetary policy is neither contractionary nor expansionary) and increases the risk of secular stagnation.

Concerned over prolonged low growth and below-target inflation despite years of policy stimulus, recent proposals have advocated aggressive measures to boost demand, such as raising Fed's inflation objective above 2%, or to discourage saving via fiscal measures.

However, there are growing signs that higher saving is not an economic anomaly but a product of the very policies designed to spur growth and inflation – the public's response to an arduous path toward saving goals with rates near the zero lower bound. From this perspective, future policies should be mindful of low rates' diminishing returns. Instead of forcing a reluctant public to spend on the premise of substitution effect, a more normal rates regime would likely be effective to induce higher investment by aligning policy with the public's interest to meet future obligations.

Savers in policy crosshairs

In his article "The Age of Secular Stagnation," Larry Summers argued that excess of saving over investment is acting as a drag on demand to weigh on growth and inflation, and current monetary stimulus should be expanded to accelerate investments and pull demand forward, such as raising the inflation target or to conduct nominal GDP targeting.

On one hand, Mr. Summer emphasized that the neutral rate interest rate cannot be increased through monetary policy, and that "primary responsibility for addressing secular stagnation should rest with fiscal policy," thereby preferring a fiscal approach to combat risks of secular stagnation, such as infrastructural investments and increases in Social Security to reduce the saving rate and raise the neutral interest rate, but fiscal policies are outside of Federal Reserve's purview, and Mr. Summers called for continued monetary easing as the best course of action for the Federal Reserve.

The Federal Reserve does not officially endorse the secular stagnation thesis, but Chair Yellen's recent focus on policy tools' asymmetric efficacy under low r* would nevertheless signal a view on the imbalance between saving and investment demands in-line with Mr. Summers. Under both Fed's focus on r* and Mr. Summers' secular stagnation thesis, policies would work to discourage saving in hopes to spur spending and investment.

Substitution and income effects on saving decisions

Efficacy of current monetary policy to induce greater demand (and discourage saving) hinges on the question "why do savers persist when low rates have greatly reduced the returns on saving?" Conventional economic thinking argues that low rates should disincentivise saving and induce borrowing, spending, and investment, but as then-RBI Governor Rajan explains, low rates does not always lead to lower saving:

> Second point is that a number of people have started raising the question: if I cut interest rates, the theory says you should go out and spend, because you say "why save? I am getting peanuts for saving. Instead, let me go out and enjoy the new iPod or that new car."

> That is the theory. Turns out that we don't seem to have been encouraging consumption through lower and lower interest rates. In fact, saving rates are pretty much where they were before the crisis, or even a little higher. So what is going on? One possibility that people argue for is that it could be that beyond a certain point in cutting rates, income effects begin to outweigh substitution effects. Essentially what happens is that I say I'm 50 years old, I need to save twice what I have by the time I am 60. Unfortunately, if I'm to do that at these low interest rates, I need to actually save more rather than save less. So I stopped going out, I cut back on dinners. So you cut interest rates, I cut consumption instead.
>
> So the argument is that one can tell a story where at low interest rates, cutting interest rates further especially for people who rely on fixed income investments, doesn't actually enhance consumption. It enhances savings, because in this case I find my overall income is falling and therefore to preserve that income in order to meet my end of life retirement goals - I actually save more rather than save less.

Mr. Rajan added that the public may choose to look through current "unnatural" asset price inflation induced by unconventional monetary policies and instead exercise prudence in risk management on concerns of future volatility. He was not alone to focus on the starting point in rates to gauge rate cuts' impact on consumption, for hedge fund manager Eric Lonergan also outlined a case which substitution effect of a fall in the opportunity cost of consumption has diminished in the developed world, and saving preferences of those who save may be very resistant to further declines in real rates:

> If interest rates rise, the "substitution effect" has a negative sign on consumption: the opportunity cost of consumption in period one has risen, this encourages us to save more and consume less.
>
> The magnitude of this effect is likely to vary significantly depending on the starting point level of real interest rates. A consumer who has been credit-constrained and experiences a fall in real interest rates will borrow more for consumption. If interest rates are very high and there is pent-up demand for consumer durables and housing, interest rate cuts may well spur consumption booms. We have seen this in recent years across many emerging economies as global real interest rates have fallen.
>
> But the prevailing conditions in the developed world are the opposite. The US economy is in part recovering from a boom in lending to people on low incomes. The availability of credit – particularly in housing – is not favorable for those with the highest propensity to consume. It is likely that the substitution effect of a fall in the opportunity cost of consumption has diminished. It may be close to zero. [3]
>
> What about the income effect? I suspect this is where Einhorn has a really powerful case. The marginal utility of consumption is important – if current consumption is already high, the marginal utility in period 1 will be low – and if people are worried about longevity and the rising costs of healthcare in old age, marginal utility in period 2 will be high. The savings preferences of those on middle- to high-incomes may be very resistant to further declines in real interest rates.

Other market participants such as Amit Sinha are cognizant of their divergence from Fed models' expected behaviors due to future uncertainties and obligations:

> Instead, the opposite is happening. I am saving more of my income than before, and am looking at ways to downsize our lifestyle. Some of it may be philosophical, in trying to be a minimalist consumer family by choice. However, a large part of saving is driven by uncertainty about the future.
>
> - Low rates demand higher saving (without moving up the risk spectrum) to meet future obligations
> - Education and health-care costs are growing at a pace higher than the CPI (which Social Security is indexed)
> - Individual savings make up the shortfall as defined-benefit pension plans give way to defined-contribution plans

- Defined-contribution plans and investment volatility warrant higher saving
- The public defers asset purchases on concerns of asset price correction from policy-induced levels

Central banks are doing their part by keeping rates low, even taking them negative. However, they are unable to bring about a sense of stability that can foster long-term planning to steer people's expectations in the right direction. For that, more than negative rates are needed.

The above concerns corroborate with the following economic theories on saving:

- "Life-cycle hypothesis" pioneered by Franco Modigliani: people try to smooth consumption over the lifetime, with higher saving in their middle years and lower saving in later years
- "Precautionary reasons" to save for a rainy day, prepare for future uncertainty or perceptions of instability

Under both theories, effects of ultra-low rates further compressed returns on saving, thus making the path to prepare for future obligations more arduous. A perceived decline in future financial security would in-turn raise public anxiety and perception of instability, and individuals would increase saving as a hedge to dampen spending and investment.

Indeed, the correlation coefficient between front-end interest rates and saving rate have turned negative in recent years (-0.31 between 1995 and 2016). The orange line in the following chart represents the change in personal interest income (YoY change), and it highlights the decline in interest income in response to lower rates, as well as the unorthodox rise in personal saving rate as a mean to compensate for the income loss:

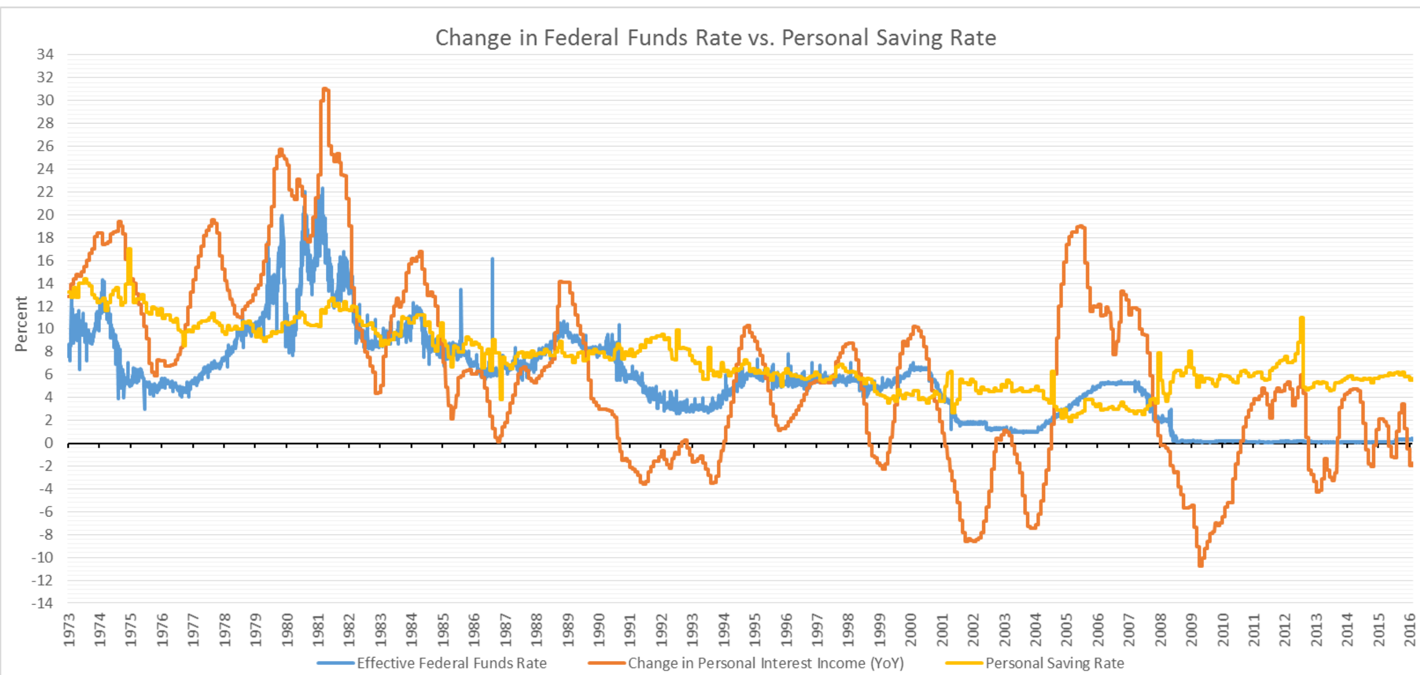

Figure 1 sources: BEA, Federal Reserve Board of Governors

Fed's monetary policy transmission mechanism vs. public's reaction function

Former Fed Governor Stein highlighted that Federal Reserve's monetary policy transmission mechanism works through the "recruitment channel," in such way that investors are "enlisted" to achieve central bank objectives by taking higher credit risks, or to rebalance portfolio by buying longer-term bonds (thus taking on higher duration risk) to seek higher yield when faced with diminished returns from safe assets. This understanding allowed policymakers to project changes in financial conditions (short-term borrowing cost, long-term credit spreads, equity valuation, and exchange rate), which would elicit reactions from the real economy. In other words, central bank policymakers have a good grasp on investment community's reaction function, for they often share a common intellectual lineage.

However, investors and savers' reaction functions are different – the former seeks yield to achieve higher returns (or oneself or clients), the latter seeks safe returns to ensure future obligations are met, and to mitigate risks. When one is concerned about low interest returns and a longer path to saving goals, the allure of a low borrowing cost to finance asset purchases would lose its luster, and effectiveness of the wealth effect would be diminished.

Conclusion

In recognizing the catalysts behind the public's persistence to save and reluctance to spend, additional analysis by policymakers should focus on the efficacy of further rate cuts on spending and investment, as well as potential "roundabout" benefits of a more normal rates regime to affirm support toward the public's saving objectives, with the end goal of boosting public's risk sentiment and perceptions of future economic stability. Ultimately, easing concerns by savers will likely foster stronger economic growth to help achieve the Federal Reserve's dual mandate of maximum employment and stable prices.

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