

SAVING: "FOREIGN" BEHAVIOR FOR THE U.S.?

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Today, we all recognize that economic events and related policy actions have a powerful influence on what happens in our communities, our businesses and, of course, our own lives. Thus, while we can take comfort that, at the present moment, the economy is in reasonably good shape, we are naturally concerned about what the future holds. As a result, widespread public attention is focused on announcements of the latest inflation, output and employment numbers, the most recent federal deficit figures, and the current trade deficit calculations. We wonder whether the next announcement will bring good news or bad; and what, if anything, we can do to prevent some of our potential problems from becoming actual ones.

It is certainly true that the causes of our current and prospective economic problems are many and varied. However, there is one factor that is related in a fundamental way to many of the prospective problems we face--the extremely low rate of personal saving in this country. Today, I would like to say a few words about the general importance of saving; why we, as a nation, need to save more; and what the Federal Reserve can do to encourage saving.

Throughout history, saving has been characterized as truly virtuous behavior. In recent years, I am sorry to say, savings behavior in the U.S. has not been all that virtuous. Since 1982, as individuals, we have saved, on average, about 2.3 percent of our income each year. Our personal savings rate is not only down sharply from its 6.6 percent

average rate in the late 1970s; it is also abysmally low when compared to personal savings rates in other industrial countries. For example, in 1987, the personal savings rate in Japan was about 11 percent, and in Germany, almost 8 percent. While these rates may be a bit overstated due to differences in measurement, there is still a whopping imbalance.

Now, it might be easy to say "so what?" when confronted with comparisons showing how low this nation ranks in terms of its savings. After all, we are well into the sixth year of the current expansion. Since 1982, more than 15 million new jobs have been created; and over this period, our real output growth has averaged better than 4 percent per year. However, such a quick-and-easy dismissal of our failure to save more would be a serious mistake. Our lack of saving in this decade has come to be viewed with alarm by many people for reasons that relate closely to our national self-interest.

The problem we face is simple to state, but difficult to solve as long as our savings rate remains low. Our problem is where to find the funds to provide for private investment, on the one hand, and to cover our federal deficit, on the other.

As you well know, investment is vital to maintaining economic growth and, thereby, providing for continued expansion of jobs and income in this country. The record of continuing growth since 1982 could not have been achieved if, in recent years, we had not spent about 16 percent of our GNP on gross private domestic investment. Last year, for example, gross investment totalled nearly \$720 billion. This year and next, we will need to spend even more if our expansion is to continue into the future.

Another activity that absorbs funds is our federal deficit. When government spending exceeds its tax receipts and other revenues, the additional funds must come from someone. During the 1980s, federal deficits have grown to substantial proportions. Last year, for example, the federal deficit exceeded \$150 billion--the sixth triple-digit deficit in a row; and this year it will again reach \$150 billion or more. Thus, despite all our good intentions, it appears that large federal deficits will be with us for some time to come.

Whether federal deficits are "good" or "bad" per se is not important to what I am saying. My point is simply that someone is going to have to provide the funds to cover them--someone is going to have to buy those government bonds. And given the sheer size of our federal deficit, a shortfall in funding could "squeeze out" private investment to a significant extent.

Now, "the \$870 billion dollar question," to use last year's total gross investment and federal deficit figure, is who is going to provide the funds necessary to finance these requirements? There are only three potential sources of funds available for this purpose: our own domestic savings, the savings of foreigners, and government bond purchases by the Federal Reserve System. Does it matter to us who provides these funds? The only way to answer this is to look at the consequences of each of these sources of financing.

Let's start with our own domestic savings. People save by spending less on consumption goods than they earn in income. We save for a variety of reasons: to provide for retirement, to insure against those nasty "rainy days," to purchase big-ticket items like cars and houses, and to leave bequests. Saving is a conscious effort to spend less now so that we can spend more in the future.

Last year, our personal savings totalled \$120 billion, about 2.7 percent of our GNP. This is less than 14 percent of the funds that were spent on investment and the federal deficit. Thankfully, there are other sources of domestic savings in addition to our personal savings. Gross business savings contributed more than \$550 billion; state and local government surpluses added another \$45 billion. Thus, in total, we saved about \$720 billion of the \$870 billion that was spent to fund U.S. investment and the federal deficit last year.

Now, where in the world did the other \$150 billion come from? Where in the world indeed! It came from the rest of the world. When people in one nation save more than their own current investment spending and government deficits, these additional savings will flow to wherever the demand for them is the greatest. Because we do not save enough to fund our own investment and government deficits, we have had to rely on the savings of our friends abroad. Last year, foreigners bought, on net, about \$150 billion of U.S. bonds, equities and other assets.

But the process of attracting foreign savings is not costless; nor, can it last forever. To purchase dollar-denominated assets, foreigners first had to acquire these dollars. In the process, they bid up its value. The increased value of the dollar encourages more imports and discourages exports--the trade deficit that ensues provides the necessary dollars for foreign investment in the U.S.

Thus, for every dollar of foreign savings we attracted, our trade deficit increased by one dollar. Last year alone, our trade deficit reached approximately \$150 billion. This figure is no coincidence. It represents precisely the \$150 billion worth of our investment and government deficit that was financed by foreigners.

Now, should we worry if foreigners want to channel their savings into the U.S.? Perhaps, as long as this flow of foreign savings continues unabated, we don't have to be overly concerned. It's true, of course, that import-competing and export industries suffer a reduction in output and employment, but other industries pick up the slack. Certainly, this is what has happened since 1982; despite our large trade deficits in recent years, our output and employment have grown at historic rates and our unemployment rate has declined substantially.

So why worry? Well, like all borrowing, our foreign debt eventually must be repaid. Currently, we owe foreigners, on net, around \$450 billion, and this amount is rising rapidly. When it comes time to repay our debt, we as a nation, like all debtors, will have to tighten our belts; we'll have to consume less in order to repay.

This means, as we repay our foreign debt, that our standard of living will be significantly lower than it would have been otherwise. Whether our economy will be forced to undergo a period of very low growth to repay these debts depends on how productively we have used these foreign borrowings. One thing, however, is certain; repayment will not be painless. And, unless we can start to reduce the pace of growth of our foreign indebtedness, the pain will be all the more severe.

A third possible source of financing is the Federal Reserve. The Fed, in the normal course of conducting monetary policy, purchases and sells government securities. This process is called open market operations. It represents the day-in and day-out manner by which the Federal Reserve adjusts the nation's bank reserves and the money stock.

Occasionally, someone or other suggests that the Federal Reserve should buy even larger amounts of government debt and thus reduce the amount of domestic and foreign saving that is necessary. The chief problem with this "solution" is that, when the Fed buys government securities, it pays for these securities with newly-created money. If this "monetizing the deficit" were done on the scale necessary to influence our need for savings meaningfully, the result would be both perfectly predictable and catastrophic in the extreme. In no time at all, we would have high inflation, high interest rates and a general collapse of domestic financial markets. "Chaotic" would be a mild description of the consequence of such actions.

Now, I'm not trying to scare us into saving more by threatening financial ruin if we don't raise our savings rate. All available evidence suggests that the Federal Reserve has not followed a policy of monetizing the deficit in the past, and we are certainly not going to do so in the future--for the very reasons that I've just mentioned.

My purpose for listing the potential options is to convince you how important it is for us, as a nation, to save more and to start to do so now. Let us review the possibilities. We can allow our investment to decline drastically and forego economic growth far into the future. Clearly, this is not desirable--something to be avoided at all costs. We can reduce the government deficit. But that does not seem probable given our experience of the past several years. Thus, it seems that we have to assume that the rate of investment and the deficit are given, and our real options are to finance it through domestic or foreign savings.

Financing these expenditures through foreign savings implies continuing trade deficits for now, but ultimately a major adjustment problem when we have to repay our foreign indebtedness. Indeed, it seems to me that the process of adjustment may have already begun. Foreigners have become more reluctant to lend to us. This reluctance is clearly demonstrated by the decline in the dollar exchange rate since 1985 and by the decline of private foreign investment in the U.S. In the past year, a quarter of our trade deficit was financed by foreign central banks in their attempt to prevent the dollar from declining even further.

What if even the central banks become reluctant? The dollar would fall more precipitously and real interest rates would have to rise. The rise in interest rates would ultimately increase savings, but it would also reduce investment and add to the volatility of financial markets. There is no doubt that market forces will eventually solve the savings and investment problem, and there is no doubt that eventually the savings disparity and the international balance will be resolved. But at what cost?

On the other hand, if we were to save more at current interest rates, much of the adjustment pain could be alleviated. The dollar would stabilize, interest rates would not have to rise, and investment would not have to be curtailed. Thus, while we have always looked upon saving as an individual virtue, at this time it has become a national priority.

You may recall, at the beginning of this talk, I promised to say something about what the Federal Reserve can do to encourage Americans to save more. Directly, of course, the Fed can do nothing; you and I are the ones who save and we make our savings decision based on our own circumstances and opportunities. The Federal Reserve cannot save for us;

we have already discussed the adverse consequences that would occur if the Federal Reserve were to monetize the federal deficit.

However, the Federal Reserve can play a crucial--though indirect--role by pursuing policy actions that foster a stable economic environment, primarily one in which we have stable prices and reasonable long-run economic growth. I believe that the Federal Reserve can accomplish this role, and I have proposed certain policy procedures that will help it to do so. I am convinced that, with the appropriate policy actions in place to provide the necessary economic backdrop, we, as a nation, will save more. And, while the increase in savings will certainly not solve all our prospective problems, it would represent a major step toward reducing the risks that we face in the coming years.