Remarks to the National Association of Business Economists

by Cathy E. Minehan, President & Chief Executive Officer
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Good morning. Let me welcome you again to Boston. It's a pleasure to have the National Association of Business Economists here in our city. And it was certainly a pleasure to entertain you last night at the Bank. As we recognize the fifth anniversary of 9/11 it seems to me to be important to assess both the state of the U.S. economy and the economic health of the world. In that regard, I know this will be a fruitful and productive conference, as there is no dearth of economic challenges on which to focus.

I want to start my comments this morning with a thumbnail sketch of my thoughts on the current state of the U.S. economy. Following that, I want to spend most of my time on an important challenge facing us in the medium term -- the declining trend in U.S. savings, in particular the savings people need to provide for a financially secure retirement. In discussing this issue, I will draw on work done by the Center for Retirement Research at Boston College headed by Alicia Munnell, who among her many past accomplishments has served as our Bank's research director. I will also talk about what the field of behavioral economics has to say about policies to increase personal savings. Behavioral economics is a new focus of the Boston Fed -- we recently formed a new center to enhance our expertise in this evolving area, and particularly to hone in on what this field has to say about macro policy formation. Finally, I want to share with you some perspectives on financial literacy as that is key to the savings question. And, of course, any thoughts I share with you are mine and not those of the members of the Federal Open Market Committee.

One of the more striking features of the current economic outlook, reflected in the forecast at the Federal Reserve Bank of Boston as well as in other mainstream forecasts, is how relatively benign it is. Against the backdrop of the war in Iraq, the uneasy ceasefire in the Middle East, the looming fiscal deficits driven by demographic change everywhere in the developed world, and sizable international imbalances, the forecast for the next couple of years seems quite optimistic.

Yet, as near as we in Boston can tell, the best baseline forecast is that U.S. growth will moderate from its average of around 4 percent in the first half of 2006 to something slightly below its potential of a bit less than 3 percent over the next year or so. At this pace, the growth of demand will roughly match that of aggregate supply, and lead to little change in unemployment. Moderate growth in jobs and real income is expected to sustain consumer spending, even as cooling housing markets and high energy prices take their toll.

Residential construction has already fallen, and may well slow further. But this seems likely to be offset, at least in part, by increases in non-residential construction as businesses add needed capacity after years of sub-par spending. Solid business profits and reserves of cash also augur well for a pick-up in business fixed investment, and recent data for orders and shipments of capital equipment suggest such a pick-up is occurring. Productivity growth remains solid providing some cushion for resource utilization. Financial conditions in both debt and equity markets remain fairly accommodative, making borrowing relatively affordable and softening the impact of flattening house prices on household wealth. Globally, growth is solid as well. U.S. exports have increased and trade is at least for now marginally supportive of growth. Finally, the baseline forecast also sees inflation subsiding slowly, assuming no further geopolitical or other shocks to oil prices. But more on that later. To summarize — I see growth for the next year or so in the high 2's, approximately full employment, and core inflation subsiding. Not a bad picture, particularly given the challenges I mentioned a moment ago.

The next obvious question concerns risks — where are they and how likely are they to materialize? In my view, risks

have grown over the summer on both sides of this forecast. Growth could be slower or inflation could be higher and more persistent -- or both. I take both of these risks seriously.

On the risks to growth, one obvious concern is the housing market. Trends in housing affordability and sales affect the pace of residential construction, now over 6 percent of GDP and up from its historical average of closer to 4 percent. The Bank's baseline forecast assumes a continued moderate downturn in residential construction. I'm comfortable with that baseline, but recent data on declines in starts and permits, gloomy assessments by builders, the potential for higher mortgage rates, and increased inventories of unsold homes, remind me that this assessment could well be optimistic.

An even larger downside could result if nominal home prices actually decline, rather than flatten out as projected, affecting household wealth and overall spending more than anticipated. Moreover, some have suggested that changes in the ease and terms of mortgage financing spurred more than normal spending during the years of rapidly rising home equity. By that logic, as financing costs rise and equity withdrawals decline, the resulting spending hit could be even greater than that suggested by wealth trends.

These are serious concerns. However, I take a measure of reassurance from a number of factors. First, a fall in nominal home prices nationwide would be quite an unusual event. We have never seen a sustained decline in nationwide home prices in any of the more reliable price measures. Even now, as residential construction wanes, home prices, adjusted for quality, continue to grow, albeit at a much slower pace. Second, the so-called "wealth effect" that links increases and decreases in house prices with rises and falls in consumer spending may not be as strong as some analysts suggest. In our estimation, the run-up in housing values over the past several years did not spur much of a bigger-than-expected increase in consumer spending — if anything, the response was a bit on the low side compared to the historical average. So we wonder about how large a spending effect one should expect to accompany a fall in housing prices, if that were to occur. Clearly mortgage equity withdrawals have been sizable during the housing "boom," but many of these withdrawals were used to reduce other forms of consumer debt and to make one-time improvements in the housing stock. Indeed, as a result, overall household balance sheets today continue to look fairly strong.

That is not to say, however, that rising mortgage interest rates are not negatively affecting borrowers. It also does not mean that new types of mortgages won't contain more than a few nasty surprises. Of particular concern are sub-prime borrowers and perhaps some depository institutions specializing in subprime lending. Thus, there are clear risks to the baseline housing outlook. Overall, however, I continue to think the best guess is that consumption will moderate, not collapse, as the result of cooling housing markets, and that moderate employment growth, and moderately rising income and non-housing financial wealth will buoy household spending.

Another concern is the recent and not very favorable trend in inflation at the headline and the core. Headline CPI and PCE numbers (currently at 4.2 percent and 3.4 percent year over year, and 5.0 percent and 4.1 percent for the most recent quarter) are high and rising over the near term, mostly as the result of energy prices. These energy price increases reflect not only geopolitical shocks but also growing world demand for oil, particularly by the emerging giants, India and China. The feed-through of higher oil prices is likely one reason why core inflation also has increased markedly over the past months, though the breadth and persistence of that increase also suggest a role for pressures related to overall resource utilization. The Bank's baseline forecast assumes that if energy prices stabilize as indicated in the futures market, core inflation will gradually subside. That is my best guess at this point and, based on inflation expectations measured in a variety of ways, private-sector individuals, businesses, and financial markets appear to agree. But, as others have said repeatedly, monetary policy is about risk management. A key risk is that inflation will continue to rise or persist at high levels and embed itself in consumer and business plans. Managing that risk is clearly important, and a matter about which central banks need to be quite vigilant – as I believe the FOMC has been and will continue to be.

While the near term forecast seems benign, though certainly not without risks, the medium-term presents real challenges. One of these involves the dearth of U.S. national savings, more particularly savings by households and the federal government. Let me say a couple of words about the overall numbers, and then turn to the question of personal savings and the retirement of today's workers. Given the demographics, the health and welfare of the consumers in this cohort is a vital aspect of our nation's future.

As many of you no doubt know, U.S. national savings, now about 13 percent of national income, is down about five percentage points since the late 1990s, and is lower in the U.S. than in any other major developed country. National savings includes both private savings by households and firms, plus public savings or the net of government spending and tax receipts. Let's start with public saving, and the federal budget deficit — which reached $318 billion in 2005. Relative to the overall size of GDP, the current budget situation doesn't look all that dire; the deficit was about 2.6 percent of GDP in 2005, a decline from 2004 and relatively low when compared to the 1980s. Indeed, the fiscal deficit as a share of GDP has declined through this year as well. But it would be a mistake, I think, to take a great measure of confidence from this short-term trend.

One must recognize that the deficit would be much larger, 4.1 percent for fiscal 2005, if it were not for a sizable surplus in Social Security — a surplus that is the direct result of payroll tax rates designed to prepare the Social Security system for the surge in benefit payments that will result as baby boomers retire. By 2030, almost one in five U.S. residents will be 65 years or older. Well before then, beginning in about 2018, Social Security will start to pay out more in benefits than it receives from payroll taxes. Even before that, -- in the neighborhood of 2010 -- Social Security will start exerting upward pressure on the unified federal budget deficit as its surplus diminishes, with a consequent reduction in net public saving, absent changes in the program itself, increased taxes, or reduced spending on other government programs.

The situation for Medicare is similar and, potentially even more serious. Payroll taxes to cover Medicare expenditures are currently in surplus. Over time, however, Medicare spending is expected to increase more rapidly than related tax revenues, creating a deficit problem that analysts see as potentially greater in size and more difficult to deal with than that associated with Social Security. Thus, despite the relatively benign federal deficit we currently see, it is clear the situation will worsen dramatically over the next decade. And, unlike the late '80s when deficits became a national concern, there seems to be no political consensus on the nature of this problem or its resolution -- a fact that should be a concern to all of us.

Along with the decline in public saving, the personal savings rate is now in negative territory. In the late 1980s and early 1990s, personal saving in the U.S. was running at about 7 percent of personal income; in 1994, it dropped to 4.8 percent; by 2005 it was actually negative and remains so. A key question here is whether the U.S. consumer is saving enough for retirement, particularly given the nature of the challenges facing Social Security and Medicare. Given the country's demographics, the retiring baby boomers, faced with inadequate retirement income, could impact overall spending and place additional burdens on the government programs and tax rates. The issue is also of concern when one considers the high stakes for low- and moderate-income consumers who face the most difficulty saving and have the smallest margin for error. So for overall macro concerns, and distributional reasons, the question of the adequacy of saving for retirement is key.

Now some have rightly pointed out that the National Income and Product Account's measurement of savings on which the personal savings rate calculation is based may not be well-suited to questions about the sufficiency of household savings for retirement. Measured NIPA savings does not include capital gains, and thus may omit what households consider an important component of their retirement resources.

On the other hand, there are also NIPA accounting rules that tend to overstate saving, such as the fact that interest receipts and payments are included in nominal terms and that pension contributions to saving don't net out the associated future tax liability. In addition, NIPA investment excludes spending on education, which most households surely undertake because they expect it to raise future income and add to retirement resources. So NIPA measures may not tell the whole story about the adequacy of retirement resources, and they certainly do not address distributional issues. But, one should not ignore the headline message -- personal savings need to grow.

Others take a different approach to measurement — one that focuses not on aggregate measures of saving but on the retirement readiness of individual households. The Center for Retirement Research (CRR) has developed a National Retirement Risk Index to measure the share of working-age households that are in danger of being financially unprepared for retirement. Their findings are sobering. They report that almost 45 percent of all such households are "at risk" of falling well short of the amount estimated to be necessary to maintain the household's pre-retirement standard of living. Younger households are particularly vulnerable, as are low-income households and those with

neither a defined benefit pension nor a 401(k) plan. Other studies perform similar exercises and come to similar conclusions. A number of you may have been involved in such efforts in the course of your work.

What accounts for the gloomy retirement picture? Part of the explanation is simply that Social Security will replace a smaller fraction of pre-retirement earnings as the normal retirement age rises from 65 to 67, assuming that people do not delay retirement. Another important part is the shift away from defined benefit pensions to voluntary defined contribution plans, such as 401(k) plans. Since most workers save little outside of employer-sponsored plans, they are an increasingly important part of our nation's retirement readiness. While 401(k)s and IRAs have the potential to work well, they require some expertise and discipline from workers who typically must choose to enroll, decide how much to save, and how their savings will be invested.

Although the projections are worrisome, there are a number of avenues for action. For younger households especially, relatively small changes in savings behavior could substantially reduce the number of households at risk if they occur early enough. Stress tests of the CRR model show that increases in the saving rate of only 3 percent among Generation Xers could reduce the number of households "at risk" substantially. Good news, but this is a fix that is easy to prescribe and much harder to accomplish. How do we encourage people to save more?

Good public policy can help. In that vein there may be some assistance from the Pension Reform Act of 2006 which Congress passed in early August with broad bipartisan support. The bill is more than 900 pages long and contains some very complex provisions, so it may be awhile before its implications are fully understood. Nonetheless, it has a number of provisions that appear likely to increase the flow of savings into both defined benefit and defined contribution plans, and to produce a modest increase in national saving. They include increasing the funding target for most defined benefit pension plans from 90 to 100 percent. And they would allow 401(k) plans to automatically enroll workers; that is, workers would have to "opt out" if they don't want to participate.

This brings me to some encouraging developments from the emerging field of behavioral economics. Behavioral economics attempts to incorporate insights from psychology and other social sciences into the study of economics, and some of its insights have been particularly helpful in studying savings behavior. For example, behavioral economists have focused on the insight that people don't always behave in a consistent fashion over time. In other words, they often have a hard time getting themselves to do in the short-run what they know is best for them in the long-run. This is true when it comes to exercise and to diet — and it is also true for retirement saving. Not surprisingly, people tend to give in to the immediate gratification of spending even though they know they would be better off in the long run if they saved. Households end up saving less than they really intend or want.

Another psychological phenomena addressed by behavioral economists is that people sometimes become overwhelmed when faced with a complicated decision that has many choices and options and they may respond in a counterproductive way by procrastinating or making no decision at all. Retirement planning can be complicated and anxiety-provoking for the person trying to figure out what to do. Some end up putting the decision off, maybe even indefinitely.

Of course many people are well aware of these difficulties and adopt strategies to help them save, such as saving by automatic payroll deduction or using tax withholding to save over the course of a year. In essence, these are pre-commitment devices that make it more likely that a person's short-run impulses do not undermine their long-run goals.

Such insights from behavioral research are already helping design saving programs that deal with complexity and self control issues. One example is adjusting the default option in a savings program — whether people have to "opt out" versus "opt in." People are more likely to join a 401(k) program if they are automatically enrolled and have to actively drop out than if the default is non-enrollment and they have to decide to sign up. The new pension reform bill, by explicitly allowing "automatic opt in" could really help companies in shaping their 401(k) programs.

Taking this a step further are programs that automatically increase 401(k) contributions with salary increases by having staff commit to this in advance. Results from one such program showed a high proportion of those offered the plan enroll, and the majority of those who enroll stay in at least through the fourth pay raise. Average savings rates among participants almost quadrupled, from 3.5 percent to over 13 percent in the first 40 months of the program.

A number of researchers have suggested that simplified portfolio choices might help overcome procrastination and

encourage more people to enroll in 401(k) plans. In one study, allowing people to enroll using a preset contribution rate and asset allocation tripled the number of new employees enrolling in the program and increased enrollment by current employees by more than 10 percentage points. Now, these programs might also have downsides; some may feel that they are too paternalistic or worry that they encourage people to be too conservative in their investment decisions.

But these studies are also promising, as they point the way to more research that will resolve some of the uncertainties and help us devise even better programs in the future. Perhaps some of them will come out of the Boston Fed's new Center for Behavioral Economics and Decision-Making. The Center is an exciting innovation for us, as behavioral research has potential applications to many aspects of monetary policy and bank supervision as well as savings behavior. One new initiative from this Center is an effort by Boston Fed economist Stephan Meier to better understand the credit problems of low-income individuals and specifically study how credit counseling can improve individual credit outcomes. The Center also is co-sponsoring a conference with Boston University and the Research Foundation of the Chartered Financial Analysts Society this fall on the development of new financial products and policy to address consumer savings and investment issues.

This raises an area that is probably already apparent to all of you. That is the importance of financial literacy if workers and households are going to be able to save effectively for retirement. Planning for retirement has always been a complicated undertaking, requiring a fair amount of sophistication and financial skill. But a number of changes in the economic landscape — particularly the introduction of new technology and advances in financial instruments and institutions, along with the increased reliance on 401(k) saving — have really raised the bar on the level of sophistication and financial literacy necessary for effective planning. More than ever, people need to be well informed about the options they face and the potential outcomes that might arise from their decisions.

Unfortunately most assessments of financial literacy only serve to underscore how far we have to go. One 2004 survey found that only a third of adults over 50 years of age surveyed could answer basic questions about interest compounding, inflation, and risk diversification. Fewer than one third had ever tried to devise a retirement plan — and of those who tried, many didn't succeed. In another survey, more than a third of respondents could not even guess at the amount they would need for retirement. Other studies have shown that financial literacy is a particular problem among low-income individuals, people who are especially at risk because of limited resources.

Now again, there is some good news. We have reason to think that financial education works — that it improves knowledge and is associated with better behavior and outcomes. For example, one study suggests that high school curriculum mandates were effective at increasing students' exposure to financial education and were also associated with higher saving rates and net worth in adulthood. Others find that workplace education can increase participation in 401(k) plans and increase wealth, especially in families in the bottom of the distribution and with less education. One study even suggests the possibility that workplace training may have social spillovers to other employees, raising participation in savings programs even among coworkers who did not attend training.

Increasing the general level of financial literacy is also an area of special concern and involvement for the Boston Fed and the Federal Reserve System in general. To this end, the Federal Reserve undertakes a variety of financial education activities focused on increasing access to information about financial products and services, supporting and identifying best practices, and collaborating with educational and community organizations to improve financial literacy. Some of the initiatives focus on students, others on adults, and they cover a wide range of issues.

Many either directly or indirectly try to improve savings and retirement decisions. For example, at a System level, we are active in America Saves, a campaign sponsored by nonprofit, corporate, and government groups targeted at helping low- and moderate-income individuals and families save and build wealth. In Boston, as I mentioned, among our many activities we are trying to better understand the credit problems of low-income people. We have also put a lot of effort into on-line games that make learning the basic concepts of economics fun, and have developed our own "Economic Adventure" at the Bank to teach the concepts behind rising standards of living in a hands-on way. We hope the over 12,000 students and others who visit the Adventure each year come away with an enhanced appreciation of the role their own financial habits can play both in their personal future, and in the health of the overall economy.

U.S. national savings are a major concern. More attention needs to be directed at the potential medium term fiscal

deficit. As the economy slows over the near term, consumers could become more uncertain about the future and save more. Indeed, most forecasts assume this will happen. But more is needed here as well. Individuals must focus more on retirement savings, given the evolving picture of corporate benefits and the challenges facing both Social Security and Medicare. We at the Boston Fed believe there is much that can be done to encourage more savings. Through innovative ideas and research, we continue to learn more about how to devise savings programs in ways that encourage people to participate and help them save more. New and better programs to more effectively reach out to improve economic education and financial literacy can also help. We also encourage you, the country's business economists, to join us and look for ways to participate in this most important endeavor. In that way, we can all look forward to a better economic future for ourselves and our country.

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