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Two Long-Run Issues for the U.S. Economy

I'd like to take this opportunity to talk about two longer-term issues that we must address in order to maintain a healthy economy and continued improvement in our standard of living in the future—the importance of financial education and our substantial and still growing current account deficits.

But first, a brief description of what we do at the Chicago Fed. We're one of the twelve district reserve banks across the country that, together with the Board of Governors in Washington, D.C., serve as the nation's central bank. The Chicago Fed covers a region that includes most of Illinois, Indiana, Iowa, Michigan, and Wisconsin. Our mission is to help maintain a sound U.S. financial system and to promote maximum sustainable economic growth and price stability.

We carry out our mission with three main activities. First, we conduct monetary policy, which involves controlling how much money and credit flows through the economy. Second, we supervise and regulate banks to make sure they are safe and sound while complying with government rules and regulations. And third, we are involved in the payments system through processing electronic funds transfers and paper checks.

Of course, there are other activities that we pursue to help support our mission. One is financial education and community outreach. It's especially important for consumers to have as much knowledge as they can when making financial decisions. These decisions can have important effects on how credit gets allocated and used, which can impact the economy and monetary policy. And financial decision making is so much more complex and challenging today than it used to be. For instance:

- Many retirement and savings plans now require people to take more responsibility for their personal investments. With 401k plans, employees will sometimes have 20 or more options on where to invest. And employers often offer little help in determining the best investment mix.

- Credit is more broadly available, particularly to young adults, seniors, and low- and moderate-income people. Ten years ago, it was college students who were increasingly being solicited for credit cards—now it's high school students. A recent poll of teenagers reported that about 10 percent of 17-year-olds had a credit card, and almost 20 percent of 18- and 19-year-olds had one.

- But this credit can also be more costly, too: The highest penalty rate charged to consumers with a major credit card jumped from just over 20 percent in the early 90s to over 40 percent now on some cards issued to risky borrowers. And many credit card agreements are now written so that the company can raise your rate if you are late on any of your bills, not just their credit card.

- Finally, technology makes it possible to offer more complex and customized financial products, playing a role in the conduct of virtually every traditional financial transaction. Several companies, including PayPal, are now offering people the ability to send money to each other, purchase items from select companies, or donate money to charity by using text messaging on their cell phones!

And data from the recently released JumpStart report, which surveyed high school seniors from around the country, show that knowledge of basic and important financial concepts is lacking. A sample question from the survey asked about what type of credit card user would pay the most in finance charges per year, holding constant the amount purchased on the card. The correct answer was someone who only pays the minimum amount each month. This question was missed by about 30 percent of the respondents.

In addition, few understood how the risk and returns from investing in stocks differed from putting money in checking or saving accounts. Perhaps this reflects the survey response that fewer than 20 percent had taken any kind of money management or personal finance course. And don't think that this is just an issue of family background: students from families with incomes of $80,000 or more only answered about 55 percent of the questions correctly, not much more than those with family incomes of less than $20,000.

The importance of this information and knowledge becomes more acute when you examine the investing and saving behavior of the average family. The 2004 Fed Survey of Consumer Finances reveals that over half of U.S. households have no retirement savings beyond Social Security—and we all know the concerns about the sustainability of our current level of Social Security benefits if the method of funding those benefits remains unchanged. Also, almost half of U.S. households carry a credit card balance, with the average amount of that balance over $5000.

Given these facts, we need to focus more on the importance of financial education and literacy. At the Chicago Fed, a big part of our effort in this area is our fifth-annual Money Smart WeekSM, which is going on this week. More than 150 organizations are participating in this year's events, with over 250 free educational activities being held throughout the Chicago metropolitan area. Our goal is to achieve greater awareness of programs and services being provided in the Chicago area that are designed to help consumers learn how to make sound financial decisions. To accomplish this task, we work with our Money Smart Advisory Council and partners, which include schools, libraries, nonprofits, banks, media, businesses, and city and state government agencies. We've even arranged for several landmark Chicago buildings to display green lights this week to bring more visibility to this important campaign.

A great deal of the need for financial education arises because many people today are spending more than they earn and face difficulty financing their borrowing. The fact that we spend more than we earn is also true on a national scale, as evidenced by our large and growing current account deficits. But the issues regarding the financing of our current account deficit are much more complex.

A current account deficit, as you know, means that a country is spending more than it is earning. To be more precise, the consumers, firms, and government of a country are collectively spending more than the total income that they are earning from domestic production and earnings on net investment returns from abroad. The current account deficit can also be thought of as the extent to which national investment exceeds national saving. The changes in the current account deficit over the past 10 years largely reflect a steady decline in the national saving rate; the investment share of GDP has fluctuated quite a bit, but on net it has risen only a couple of percentage points.

How big are these deficits, and how fast have they been growing? In 2005, the U.S. current account deficit reached $805 billion, or 6.4 percent of GDP. This deficit has been growing rapidly since 1997, when it stood at just 1.7 percent of GDP. These persistent and widening deficits have translated into a large increase in the U.S. net foreign debt position. Prior to 1986, the U.S. was a net creditor to the rest of the world. During the early 1990s, net foreign debt stayed in a narrow range of 5 to 6 percent of GDP. Since then, however, it has widened steadily and is currently estimated at over $3 trillion, or 25 percent of GDP.

So what are those fundamental economic factors in the U.S. economy that have affected our desired saving and investment? To answer this, it helps to identify the three sources of national saving: households, businesses, and governments. An obvious candidate to explain the falling U.S. saving rate would be the large shift in the U.S. fiscal balance. From 1998 to 2001, U.S. governments—federal, state and local—ran fiscal surpluses of 1 to 2½ percent of GDP. Since 2002, however, they have been running fiscal deficits in the range of 2¾ to 3¾ percent of GDP. But research by economists at the Fed suggests that the growing fiscal imbalances explain less than 20 percent and certainly not the bulk of the change in U.S. net saving or the current account.

Of course, that doesn't lessen the importance from the point of view of U.S. public policy of reducing these large fiscal deficits. Growing medical costs and rapidly changing demographics will soon put an enormous strain on our ability to fund our entitlement programs. A large and growing public debt could also eventually put upward pressure on interest rates and crowd out private investment.

Another factor that may help explain the drop in net saving in the U.S. is the persistent rise in productivity growth rates that began in the mid-1990s. Higher productivity has three related effects, all of which serve to widen the gap between saving and investment. First, it raises the demand for investment because it increases the rate of return on capital. Second, higher productivity also increases households' permanent income. This means that households are willing to temporarily reduce saving out of current income in order to consume more today. Indeed, they know they can afford to do so because the higher return from a dollar's worth of investment will boost income in the future. And third, higher productivity attracts foreign saving. The increased GDP growth and higher risk-adjusted rates of return on capital enhance the attractiveness of investment opportunities in U.S. markets relative to those in slower-growing industrial countries, such as Europe and Japan. Furthermore, with the persistence of solid productivity growth and its relatively younger labor force, the U.S. could continue to experience relatively higher GDP growth and thus continue to attract foreign capital and retain domestic capital for some years to come.

Over time, however, as higher productivity and capital accumulation boost income, the saving rate will move back up. And because of the higher income growth, this increased saving rate can be achieved while maintaining the higher levels of consumption. So how far along are we in this process? Well, it's not clear. The U.S. national saving rate has been constant over the last 4 years, so perhaps we are at the turning point, and the saving rate is about to start to rise back up to its long-term level. But it's too early to tell.

It's important to realize that U.S. GDP growth and overall economic conditions generally have been good over the past decade despite the large U.S. current account deficit. And right now, our debt service is low: The rates of return that foreign investors earn in the U.S. are low relative to the rates of return that we earn on our investments abroad. So with our relatively high pace of GDP growth, we have been able to service our debt largely from the growth of the economy, rather than by a substantial reduction in the level of consumption. In addition, the open capital markets that make such current account deficits possible have obvious economic benefits. Without them, it would have been much harder for the U.S. to accumulate the additional capital needed to exploit the increase in productivity. Instead of borrowing cheaply from abroad, the U.S. would have had to sacrifice a significant amount of current consumption in order to finance the necessary investment.

Still, an economy the size of the U.S. cannot run large current account deficits indefinitely. For it to do so, the rest of the world would have to run persistently high net saving rates. Eventually, these countries will want to consume or invest more in their own countries. With fewer funds available, the U.S. current account deficit would fall.

No one can say when this adjustment away from such high current account deficits will begin. But I expect that when it does, the adjustment will be gradual, without a major disruption to U.S. economic performance. One reason is that many of the forces driving investment and saving in the U.S. and the rest of the world are long-lived developments driven by fundamental economic factors. Also, our large creditors likely would prefer a gradual adjustment of the U.S. external debt because they would undoubtedly suffer large capital losses in the event that there was a rapid unwinding of portfolio positions.

Conclusion

Though seemingly unrelated, financial education and the current account deficit are two long-term issues that we must focus on if we want to ensure that the economy remains strong in the future. Both topics at their core deal with understanding how current spending—by the individual or by the nation—must be balanced against future income prospects and future needs. The key is that we recognize the costs and trade-offs that we incur when we make these consumption decisions. A little more financial education would certainly help in this regard.