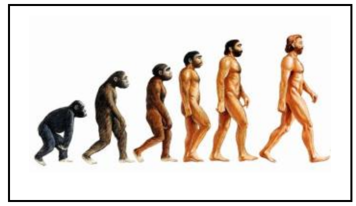
Mitchell's Musings 12-9-13: The Missing Link

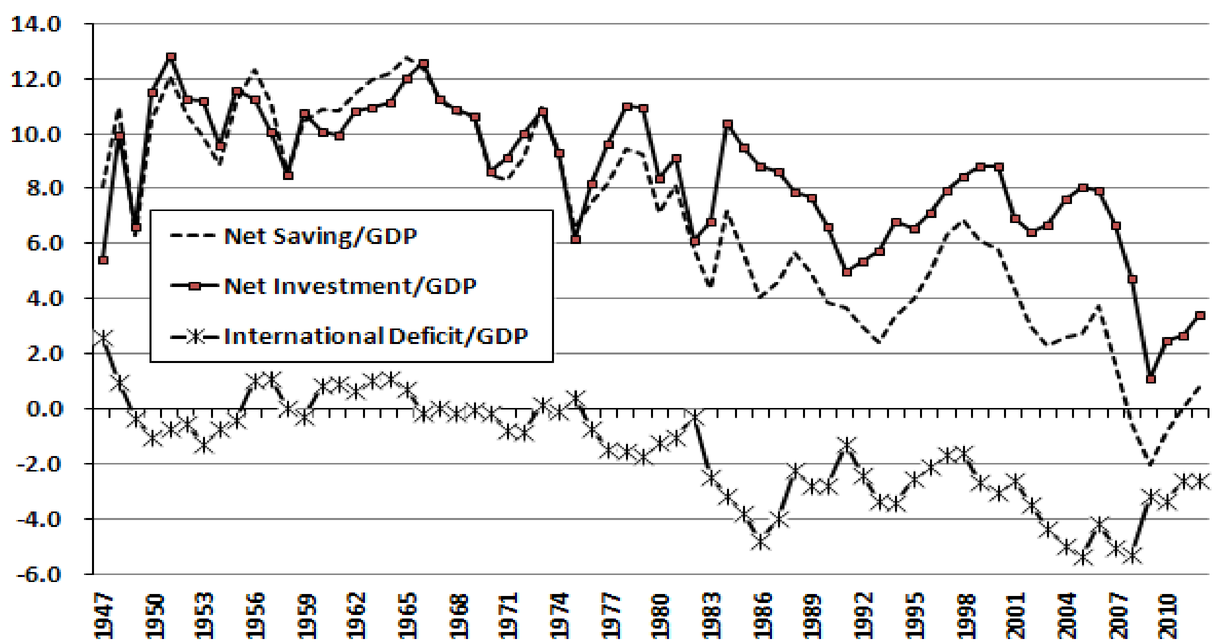


Daniel J.B. Mitchell

I attended the quarterly UCLA Anderson Forecast conference last week which dealt with the economic outlook for the U.S. and California, as it always does. However, the Forecast usually contains an additional theme and this time that theme was the inadequacy of U.S. saving rates as the baby boomers retire. The discussion was familiar. Boomers did not save enough. They have created *de facto* and *de jure* liabilities for their children and grandchildren as a result. Much of the discussion revolved around Social Security, Medicare (a more dramatic issue), and state and local pension systems (against the background of the Detroit bankruptcy and possible cuts in city worker pensions there).

There was reference to stagnant real wages over the past decades which mean that the burden for younger cohorts of caring for "grandma" will be greater than it would have been had real wages advanced. ("Grandma" was the appellation used at the conference, presumably since women outlive men.) Prominently featured in the discussion was a chart - similar to the one below but showing only the top two lines. Essentially, the take-away message from the chart was that to a large degree net investment (gross investment minus depreciation) follows net saving (gross saving from all sectors – households, businesses, and government – minus depreciation). The move to more-or-less zero net saving means that the U.S. will have a smaller capital stock (via reduced investment) so that the economic base for caring for grandma will be smaller than it would have been under a high saving/high investment scenario.

Net Saving, Net Investment, and Internatiional Deficit Needed to Finance Insufficient Saving as Percent of GDP

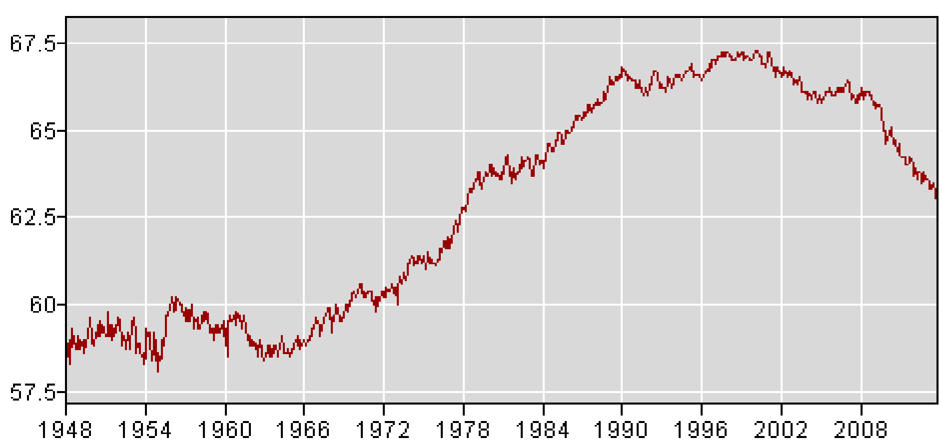


All of these concerns are legitimate but there is a missing element that links them all together.   Let's start with the question as to why saving rates seem to be inadequate in a search for a missing link. And let's note that in a closed economy (no international trade possible), the saving rate and the investment rate would be the same. Saving is the putting aside of a portion of income not used for immediate consumption. Investment goods are therefore what you get when some of national income is not immediately consumed. But the U.S. is not a closed economy and so, as the chart shows, it is possible for saving and investment to diverge (even though they tend to exhibit similar trends and fluctuations) because you can also get goods from abroad, goods that are not produced domestically.

In crude and not entirely accurate terminology, you can finance more investment than your national saving would provide by buying more from abroad (importing) than you sell (exporting). Of course, to do so, you have to run down (spend) claims on the world that have previously accumulated and/or borrow from the world to finance your international deficit. And we know, as discussed in prior musings, that the U.S. has been doing just that to varying degrees since the early 1980s. The end result is that the U.S. is the world's biggest (net) debtor. The third line down on the chart shows the international deficit that the U.S. has been running to finance the gap between investment and saving as a percent of GDP.

That observation opens up two questions. First, why has the U.S. had inadequate saving? Second, why has the world permitted such borrowing? As indicated, real wage stagnation was mentioned in the conference. Note, however, that households could maintain consumption standards and even improve them by working more. In fact, labor force participation until the early 2000s had been rising during the baby boom era as indicated on the chart below. The increase was the net of female participation rising and some fall in the male rate. However, the capacity to increase overall participation lost steam in the 1990s, and the soft labor market following the Great Recession clearly reversed the trend.

Labor Force Participation Rate



In short, labor force participation increases provided a partial route to keeping up consumption which has now evaporated. The other route to keeping up consumption is borrowing which from a national perspective means borrowing from the rest of the world (and concomitantly importing more than we export). So we are back to our second question of why the world permits such ongoing borrowing.

Part of the answer, as we have noted in prior musings, is that certain other countries for varying domestic reasons keep their exchange rates low to run export surpluses with the U.S. Such policies mean that they have to accumulate claims on the U.S. (i.e., lend to the U.S.). Part of the answer is that the U.S. dollar became the principal world currency after World War II and that even with the end of the postwar Bretton Woods international monetary system in 1971, the dollar and dollar-based assets are still seen as advantageous to hold.

Note also that it is likely that the continuous U.S. trade deficit has tended especially to displace manufacturing jobs in the U.S. which at one time were the source of relatively high and rising real wages, particularly for workers with less than a college education. So real wage stagnation, international trade, and too-low saving rates are really not one-by-one developments. They are all part of a larger system which provides the missing link(s) we are seeking.

As at the Forecast conference, the popular tendency has been to blame baby-boomer "grandma" for being selfish and for not saving enough. But as the discussion above suggests, in fact grandma did what she could to offset wage stagnation and the decline in (often-male) manufacturing jobs by increasing her labor force participation. As the U.S. became a borrowing society, boomers (male and female) were facilitated in their debt accumulation by innovations such as credit cards, payday loans, and other financial devices. They were offered artificially cheap foreign goods to consume. Foreign lending to the U.S. helped hold down interest rates, also facilitating household borrowing and borrowing by other sectors. The U.S. *could* have followed policies that didn't lead to its ongoing borrowing from the world, but it didn't. Had it done so, perhaps real wages wouldn't have been quite so stagnant. Perhaps the boomers would have saved more.

Grandma didn't make those policy choices. She probably wasn't even aware of them. So if you are looking for someone to blame, look elsewhere. And when you do so, try focusing on policies that would reverse the U.S. trade deficit.