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The Negative Personal Savings Rate: Is It Just A Statistical Mirage?

Benjamin Tal

"A penny saved is a penny earned." Benjamin Franklin, who coined this phrase, must be turning in his grave now, as the personal savings rate in both the US and Canada is hovering around zero. Is the dismal North American savings rate a cause for concern or is it only a statistical mirage?

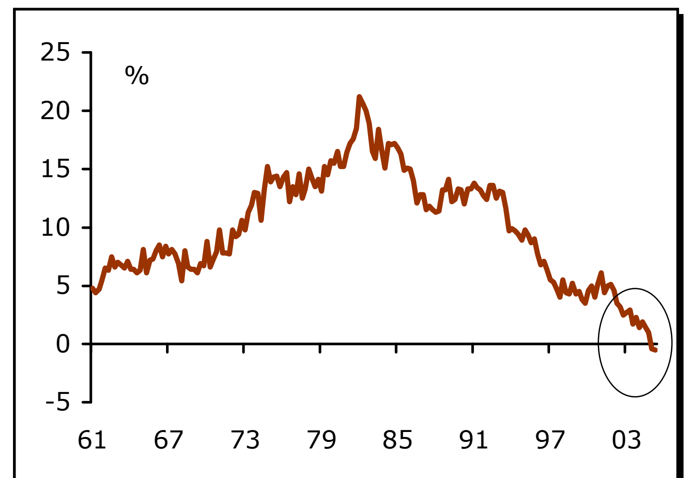
It's true that the widely quoted "personal savings rate" is a poor indicator of the true saving behaviour of households. But changes in net worth, the alternative measure of savings, reflects mostly "passive" savings through asset appreciation, since its relative stability over the past few years mirrors mainly the higher value of real estate assets, as opposed to "active" savings, by way of money put aside. Once the flaws in the existing measures of the savings rate are examined, the next logical question is who is doing the saving? The national numbers tell us nothing about the distribution of savings among income and age groups. Do Canadians start saving at a young enough age to ensure adequate growth in their savings in today's low-yield environment?

The Savings Rate: A Bad Statistic

The Canadian personal savings rate is now in negative territory (-0.5% in the second quarter of 2005) — its lowest level since the 1920s (Chart 1). This means that, in aggregate, Canadians spend more than they earn. But is it truly the case? A closer look at the way the savings rate is calculated suggests that the picture is not so bleak. The savings rate is constructed by formulating the ratio of personal savings to disposable income. The latter is defined as total personal income minus tax and non-tax payments to the government. Personal savings is calculated by subtracting total personal outlays (mostly personal consumption) from disposable income. As a result, savings here is simply a residual — it's what is left from household disposable income after all spending is deducted.

This sounds reasonable, but it's not so simple. Since savings are calculated as a residual, they are subject to significant measurement errors, as reflected in the frequent revisions to the figures. More importantly,

Chart 1
The Canadian Savings Rate Is Negative — But Should We Care?



the savings rate focuses on the flow data associated with current production, so it gives an incomplete picture of household saving behaviour. For example, the measurement of the savings rate excludes the sale, or change in the market value of existing assets. For financial assets, personal income does include dividends and interest income paid to an individual, but excludes capital gains and losses. For real estate assets, the measure of savings includes service flows from housing as consumption, but also treats expenditures (for example, renovations) as consumption. Similarly, personal expenditures on education and training are treated as consumption.

These accounting practices tend to overstate consumption and understate savings. The ramification of this is that developments in equity and/or real estate markets are not reflected as changes in personal income and would not be included in the savings rate. But one does not have to be an economist to realize that these considerations play an important role in the household financial decision-making process.

It's Not Really A Demographic Story

Before we dismiss the savings rate altogether, one has to remember that the savings rate was similarly flawed 10 and 20 years ago — when it stood at 10% and 20% respectively. So, the fact that the savings rate has been in free fall over the past two decades must have some significance.

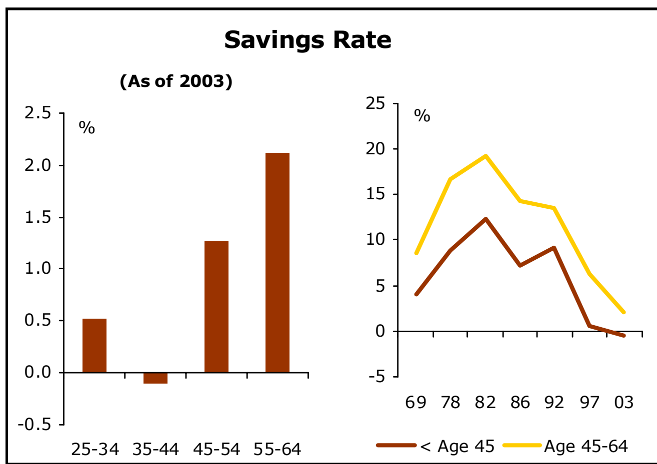
Some argue that the savings rate will rise soon, since baby boomers are now at their peak-earning age, and thus are expected to increase their active savings. Indeed, the savings rate among the age group 45-65 is the highest among all groups (Chart 2, left). But, even this group has seen a dramatic decline in its savings rate. In the early 1980s, the savings rate among Canadians aged 45-65 was over 20%, while as of 2003 it was only 3.6%.[1] Consequently, the decline in the savings rate over the past two decades is not really a demographic story, since it was evident in all age groups, including the important age group of 45-65 year olds (Chart 2, right). Put differently, shifts in the age structure of the population have been secondary in explaining changes in the savings rate. More important are changes in the saving behaviour *within* a given age group. The fact that all age groups have seen a drop in their savings rate suggests that something more fundamental has impacted all Canadians uniformly, and is responsible for the drop in the savings rate.

Home Made Savings

Many point to the ascent in the housing market as the main reason for the current dissaving by Canadians. After all, with the average house price in Canada rising by almost 50% since 1997, many households have been saving indirectly via the increase in their home equity, and thus feel less pressured to save from their current income. Another factor here is the housing "wealth effect", whereby increases in the

Chart 2

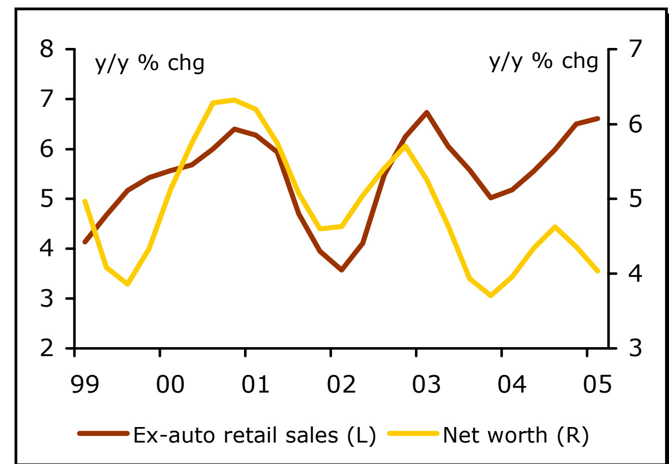
The Decline In Savings Was Among All Age Groups



Source: Family/Household Expenditure Survey, Statistics Canada

Chart 3

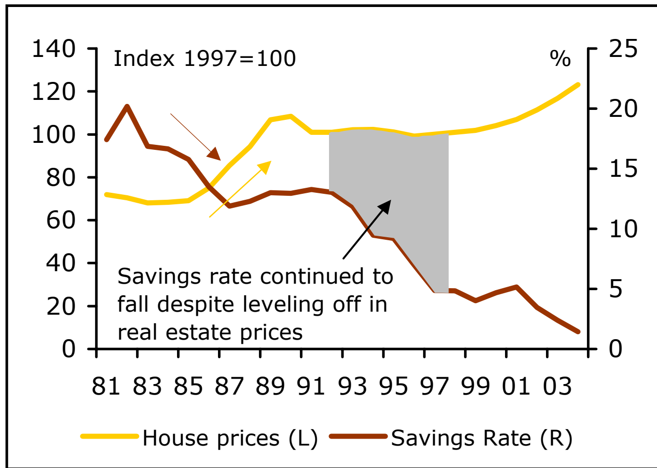
Housing Wealth vs. Spending



value of real estate assets stimulate consumption, and reduce savings (Chart 3). As indicated in our previous issue of Consumer Watch *Loonie Boom: How The Soaring Dollar Is Sustaining The Canadian Housing Market*, the housing wealth effect is estimated to have generated no less than $20 billion in extra consumer spending since 2002. But the housing wealth effect cannot be the sole driver of the declining savings rate. Note that during the early part of the previous housing market boom, the savings rate indeed fell measurably. However, during the 1992 to 1998 period, when the housing market was in neutral, the savings rate continued its descent (Chart 4).

Chart 4

Savings Rate Fell During The Last Housing Boom... And After



Other factors which probably have contributed to the decline in the savings rate over the past two decades are: lower inflation expectations (that is, the inflation rate is expected to remain relatively low, and consequently savings do not need to compensate as heavily for inflation); an extended period of low interest rates (since there is less incentive to save when borrowing is less expensive and financial assets generate lower interest); a softening in the pace of growth in personal income; the cohort effect (for example, the changing financial attitudes and behaviours of a 40 year-old person today compared to a 40 year-old person 10-20 years ago); and innovation and deregulation in financial markets (which has increased access to credit through relaxed liquidity constraints).

Change In Net Worth: Passive Savings

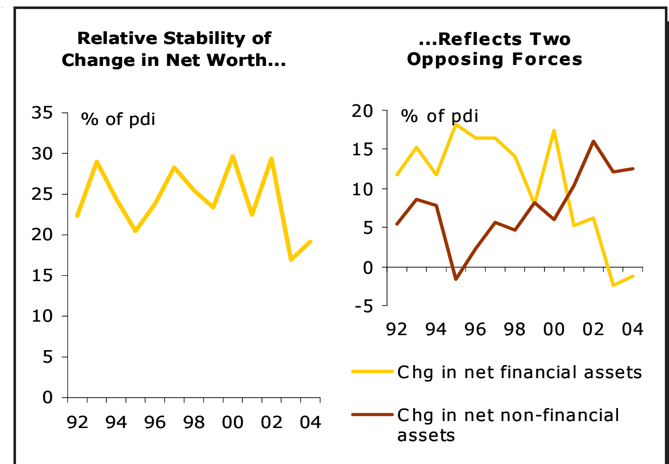
Despite the shortcomings of the savings rate as a measure of the overall saving behaviour of Canadians, the message is clear. Fewer Canadians are *active savers* today. That is, a typical household now puts aside less money as a percentage of their income compared to a typical household 10 or 20 years ago.

But saving is not only about putting money aside. It's also about capital appreciation. After all, if the existing investment pie is growing nicely, one is less motivated to compromise his/her current standard of living in order to save. Indeed, as illustrated in Chart 5 (left), the ratio of the change in net worth to disposable income has been relatively stable in recent years — a completely different picture than the free falling savings rate.

This type of *passive savings* currently dominates the saving behaviour of Canadians. As indicated earlier, the increase in real estate values in recent years has played an important role here. In fact, the relative stability of the ratio of net worth to income reflects the net impact of two opposing forces: a strong increase in the value of real estate assets, and slow growth in the value of financial assets (Chart 5, right).

Chart 5

Little Change In Net Worth



So, passive savings, as reflected in the changes in net worth in general, and real estate values in particular, are working to compensate for the lack of active savings, as approximated by the savings rate. But is it a healthy equilibrium? While we do not foresee a major correction, the real estate boom

is already in its eighth inning, and a leveling off in house prices will strip households of one of their most important means of savings. Furthermore, real estate is hardly a perfect substitute for old-fashioned savings. After all, real estate-based savings are highly illiquid and selling a home is often an inconvenient and expensive transaction.

Increased Liquidity Not Enjoyed By All

Since real estate savings are illiquid and should not be relied upon as a person's sole vehicle for savings, we now turn our attention to household *financial* net worth. That is, total financial assets (chequing and savings accounts, GICs, stocks, bonds, mutual funds etc.) minus liabilities (mortgages and consumer debt). As discussed earlier, the change in net financial assets as a share of disposable income has been trending downward in recent years (Chart 5, right). But, behind the scenes, household holdings of liquid assets[2] have risen measurably over the past five years, likely reflecting a desire for safety. The process started in late 2000 and has accelerated significantly after September 11, 2001. Measured in both nominal and real terms, the current value of personal liquid assets is currently at a record-high (Chart 6, left). On the surface, this is good news. Increased household liquidity might not only compensate for the lack of liquidity in real estate holdings, but it can also be seen as a buffer against the growing indebtedness of Canadians.

Unfortunately, things are not so simple. Digging a bit deeper reveals that the increase in household liquidity has not been distributed uniformly. More than 80% of the dramatic increase in balances in personal saving and chequing accounts since 2001 was made by Canadians aged 50 and over (Chart 6, right). Since the excess liquidity is concentrated among a relatively narrow group with little outstanding debt, increased household liquidity, in fact, serves neither as a real buffer against growing debt nor as a counter to illiquid savings via the housing market. The picture is even less balanced when one examines total financial savings, as Canadians under age 50 account for only 10% of the increase in total financial savings since 2001 (Table 1). Furthermore, at least 40% of Canadian households have no financial savings outside of their personal savings and chequing accounts (Chart 7). Note that even among older Canadians, the number is surprisingly high (approximately 30%).

Table 1
Contribution to Growth in Financial Assets Dec 2001-Dec 2004

	Age					
	18-24	25-34	35-49	50-64	65+	
Chequing & Savings	-2.7%	3.6%	17.3%	24.8%	57.0%	100%
GICs	-1.0%	9.0%	13.7%	23.9%	54.4%	100%
Direct holdings of Bonds & Stocks	0.2%	-4.4%	7.9%	16.6%	79.6%	100%
Mutual Funds	-0.3%	-5.3%	-6.5%	10.7%	101.3%	100%
TOTAL	-1.0%	1.6%	9.9%	20.0%	69.5%	100%

Chart 6
Liquidity Is Rising But Only Among Older Canadians

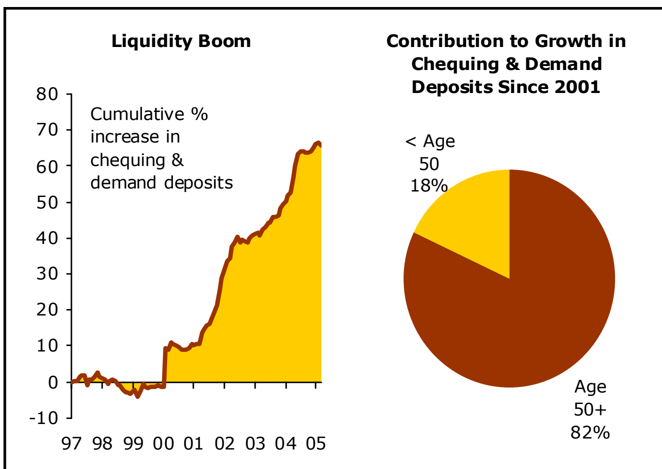


Chart 7
Distribution of Financial Assets

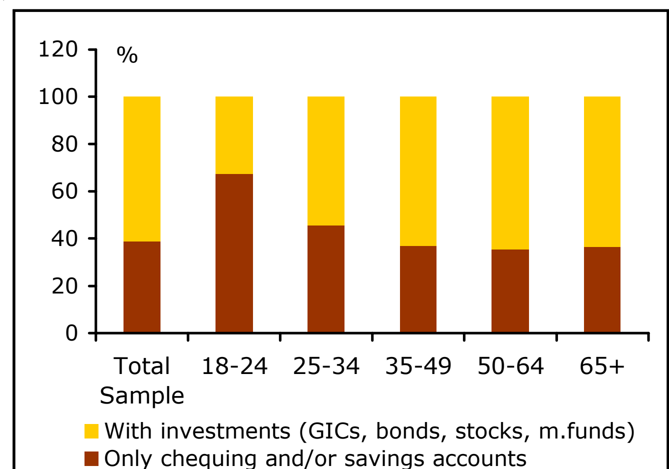
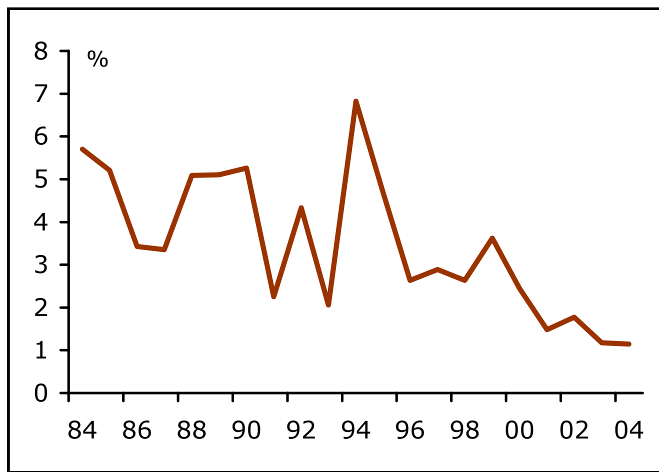


Chart 8
Inflation Adjusted 5-Year GIC Rate



The picture that emerges from this analysis is the following: Canadians of all age groups are not saving enough *actively* by putting money aside for a rainy day. How much savings is enough is a matter for debate, but most Canadian households would likely benefit from building a little nest egg. And while *passive* savings are still relatively healthy, it's primarily due to the appreciation in real estate prices. The illiquid aspect of real estate savings and the heavy reliance on debt are not being offset by increased household holdings of financial assets in general, and liquid assets in particular, since the vast majority of the increase in household financial assets in recent years has been among the age group of 50+.

Outside real estate holdings, why are young and even middle-aged Canadians not saving enough, neither actively nor passively? One can point to low interest rates as the main factor here, since they discourage investment in interest bearing assets and encourage borrowing (Chart 8). But what if interest rates remain low in the coming years? The globalization and the Wal-Martization of the North American economy suggest that the low inflation/ low interest rate environment is here to stay.[3] And even after the Bank of Canada's current tightening cycle is over, Canadian rates would still be miles below their previous cyclical peaks. Given today's low interest rates, money invested in 5-year GICs would take twice as long to achieve the same inflation-adjusted return than in the mid-1980s. The practical implication of this environment is that young Canadians today must start saving very early in their life compared to previous generations. Our findings, as presented in this article, suggest that this is not happening.

Notes:

(1) Based on unpublished data from Statistics Canada's family/household expenditure survey, wherein the savings rate is calculated as after-tax income minus total expenditures as a share of after-tax income.

(2) Liquid assets: chequing and demand deposits, money market mutual funds and cash positions in brokerage accounts.

(3) A full discussion of these factors is beyond the scope of this article.

Data sources used in this study:
CIBC World Markets
Statistics Canada published and unpublished tabulations
*Canadian Financial Monitor (CFM), conducted by Ipsos-Reid**

* CFM is a continuous syndicated research study. Data is gathered from Ipsos-Reid's panel of Canadian households via a mail survey. The sample is distributed proportionally by region to match Statistics Canada targets. Unless otherwise stated, the data in the CFM report are presented on a rolling 6 month basis based on the following time frame: Q4 (May-October) 2004. 3,000 households complete the questionnaire per quarter. Based on the rolling 6-month period, with a national sample of 6,000 respondents, the margin of error is approximately ±1.3%, 19 times out of 20. For analysis of specific product categories, some base sizes decrease considerably, and hence the margin of error increases.

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