RBC Financial Group

Financial Industry Monitoring Service

In-depth analysis of developments in the Canadian and U.S. financial services industries

Why the personal savings rate might remain negative

June 2005

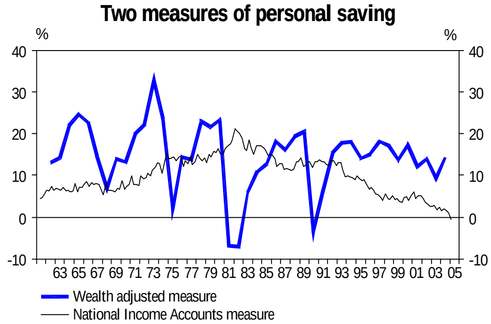
The traditionally defined personal savings rate pushed marginally into negative territory in the first quarter of 2005. This measure is derived from Statistics Canada's National Income Accounts and simply measures the fraction of personal disposable income that is not spent in a particular quarter. Though data revisions are a notorious possibility, it is still quite possible that this measure will push deeper into negative territory or at best remain near-zero for some time yet. Why this is the case, and whether or not it matters, are bound to become matters of growing debate going forward.

Does a negative personal savings rate matter?

This open-ended question clearly depends on the context in which it is posed. A negative personal savings rate matters little as a measure of either the health of household finances or economy-wide finances, but matters a lot to those with an eye on the total flow of new dollars into household saving products. From a macroeconomic standpoint, there are plenty of other measures of the health of household finances that count far more than the narrowly defined traditional measure of the personal savings rate when it comes to determining the outlook for consumer spending and evaluating whether long-term saving goals are being addressed.

Chart 1

Two measures of personal saving



Sources: Statistics Canada, RBC Financial Group Economics Department

A key criticism of the traditional measure of the personal savings rate is that it is not at all linked to what is happening on household balance sheets. Most people, however, think of saving as not only what they tuck away from their paycheques, but also in terms of what is happening to the value of their assets net of their debts. Rapid growth in net worth — the difference between the market value of assets, like housing and portfolio investments, and debt, like mortgages and consumer loans — is one reason why households have moved their narrowly defined personal savings rate downward. To include wealth gains in a broader measure of saving behaviour requires one to consider the wealth-adjusted personal savings rate. This is shown as the thick line in chart 1 and points to a much healthier but trendless picture of household saving behaviour than the narrowly defined traditional measure which is shown as a thin line.

Even from an economy-wide standpoint, a low or negative personal savings rate matters little. This is because Canada's overall financial health is stellar. The ratio of net foreign debt to GDP has been trending down for years and is well below the United States. This, in turn, is because governments have shifted away from big deficits, corporations are saving through retained earnings and have pushed their debt-to-equity ratios lower over the past decade, and Canada still maintains a trade surplus. As such, despite a low traditional measure of the personal savings rate, Canada requires less in foreign credit than we used to need to add to domestic savings in order to fund the economy.

For the financial industry, however, the negative personal savings rate is of relevance because it suggests that room for growth in household saving products is likely to be entirely driven by portfolio shifts and valuation effects rather than inflows of new saving dollars from household paycheques. Indeed, for financial institutions, the counter-cyclicality of personal deposit and

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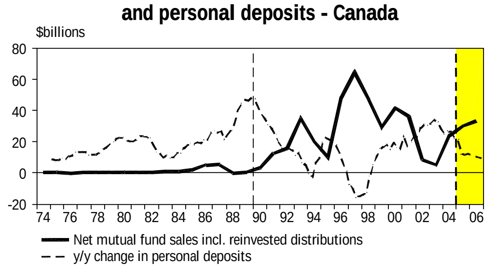
Chart 2

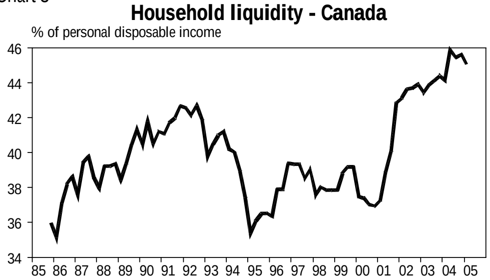
Mutual fund sales and personal deposits - Canada



Source: Investment Funds Institute of Canada, Statistics Canada, RBC Economics Department

Chart 3

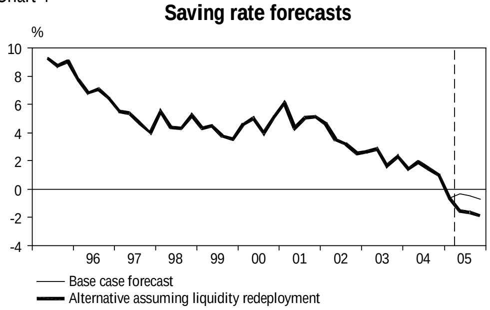
Household liquidity - Canada



Note: Saving & chequing accounts at banks, trusts & credit unions plus money market fund assets plus currency holdings
Source: Bank of Canada, IFIC, Statistics Canada

Chart 4

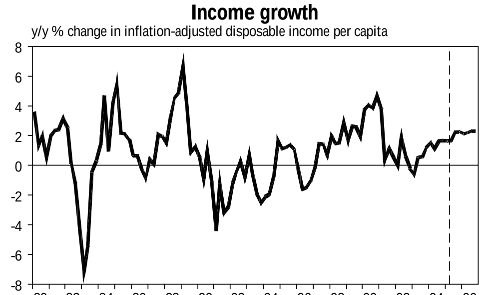
Saving rate forecasts



Sources: Statistics Canada, RBC Financial Group Economics Department

Chart 5

Income growth



Source: Statistics Canada, RBC Financial Group

mutual fund purchases has been well documented during the past decade (chart 2) and will likely continue such that market share gains and losses through portfolio shifts will dominate overall net new saving product purchases. Valuation effects will also remain important to growth in fee revenues.

Cyclical drivers

A key reason why the personal savings rate may remain negative for some time yet is the redeployment of record levels of household liquidity that exist because households have dramatically changed their investment behaviour in recent years. At present, the amounts invested in personal saving and chequing accounts, direct holdings of money market instruments and indirect holdings through money market mutual funds, plus outright holdings of cash equal almost one-half of total after-tax personal incomes in Canada (chart 3).

This reflects a portfolio realignment away from longer-term portfolio investments that has occurred in recent years. The popping of an equity market bubble that was particularly concentrated in hi-tech companies shocked retail investor confidence and the result was a flight to safety. Concerns about the economic outlook only served to dramatically ramp up the precautionary demand for savings in a manner that reflects liquidity-hoarding behaviour.

It is likely that liquidity levels in the household sector are unsustainably high given a more stable economic and market environment than a few years ago and a high opportunity cost of maintaining large balances in relatively low yielding financial instruments. This means that households are likely to shift towards redeploying liquidity either to fund consumer spending, or long-term portfolio investments in equity and/or bond markets, or in housing markets. As this liquidity is redeployed, it may well bolster higher growth in spending than in incomes. If, for instance, the liquidity ratio plotted in chart 3 were to return to its historical average of about 40% by the end of this year with the liquid balances being spent, that would be enough to drop the personal savings rate by more than one percentage point more than we are already forecasting (chart 4).

There are other cyclical reasons that are of secondary importance in explaining why the personal savings rate is so low. A low inflation rate means that the purchasing power of assets and incomes is not being rapidly eroded, so households don't need to replace as much eroded principal by saving more. Low interest rates also mean that the incentive to save for investors focused on fixed-income products is weak. Strong employment markets and a low unemployment rate also mean that, on average, households may not perceive themselves as having as much of a need to save for a rainy day. Indeed, it is not for a lack of income growth that households are not saving by the traditional measure since inflation-adjusted per capita income growth is currently fairly strong and expected to remain that way (chart 5).

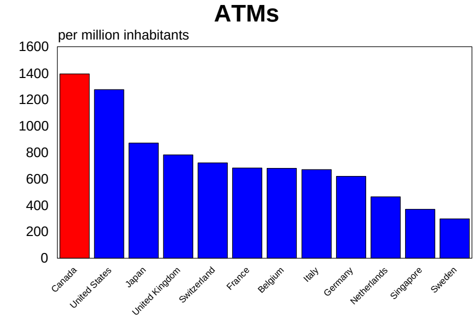
There are also measurement problems with the personal savings rate that are related to the challenges associated with measuring economic activity but also the challenges of measuring true saving behaviour in different inflation environments over time. On that note, Statistics Canada was reporting a negative personal savings rate for a brief period in the late 1990s, and then data revisions and changes in estimation methodologies fully swept away negative readings. There have also been more recent problems with estimating the personal savings rate that have led to sizeable revisions. We're not sure if that may be a renewed source of challenge in the present data, but at present, one can say that the negative reading in the personal savings rate is occurring for the first time since the Great Depression of the 1930s but for very different reasons.

Structural factors

Aside from the aforementioned cyclical factors, there are important structural changes that have been unfolding in recent years that are historic in proportion, somewhat unique to Canada, and may well be fundamentally altering the manner in which households conduct their financial affairs. As well as cyclical developments in inflation and interest rates, there have also been secular downward shifts in both measures that have pushed the traditional measure of the personal savings rate downward.

Some economists also subscribe to the view that households are saving less today in anticipation of the transference of federal and, in some cases provincial, surpluses to households in the form of either higher expected program spending or a lower tax burden. This is the opposite argument from the early- and mid-1990s when households may have been saving more in part because they believed that large fiscal deficits meant a higher coming tax burden and lower program spending.

Chart 6



Source: Bank for International Settlements

Further, attempts to model the inflation of cyclical drivers on the personal savings rate have fallen short in recent years partly due to the difficulty in predicting shocks to saving behaviour, but perhaps also because of the speed of financial innovation that is not something that models based on historical data would be picking up.

Changing technology and financial innovation are at the heart of such structural shifts. The proliferation in the availability and the more widespread adoption of electronic payment options has led to dramatic improvements in the ease, speed and cost of access to liquid balances. Growth in ATMs, debit and credit cards, on-line banking and personal credit lines have all served to reduce the transactions and precautionary demand for liquidity. Indeed, Canada is a world leader in terms of the availability and adoption of electronic payment and cash management options and ranks number-one in the world on debit cards per capita, third in the world on Internet connectivity behind Denmark and Norway, and first in the world in terms of ATMs per capita (chart 6). As well, on-line banking and payment options such as automated pre-payments are among the most developed in the world.

This may make Canada's experience with a very low and now negative traditionally defined personal savings rate a lesson on what other countries can expect as they develop their own electronic channels further. Easier access to funds in liquid saving accounts and easier access to bridge financing through lines of credit to meet liquidity pressures mean that households have less of a need to save as much for a rainy day or to keep as much on reserve to fund spending. Of course, this may seem at odds with why households have run up liquid holdings so far, but it is presented as a factor that explains why high liquidity is not being complemented by a high savings rate and why high liquidity may be redeployed going forward.