



RBA/ESA Economics Competition 2013

FIRST PRIZE

Supriya Mehta
University of Wollongong

*Australian Household Savings:
An Economic Saviour*

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In recent years the Australian household saving ratio has increased significantly when compared with the last two decades. The change in saving patterns escalated after the onset of the Global Financial Crisis (GFC), and has since maintained an upward trajectory, reaching levels similar to that of the mid 1980's. Economic reform and increases in personal wealth and capital gains played a significant role in the observed decline of private savings (Hiebert, 2006). Households form an integral part of national saving providing the means for financing domestic investment. In an open market economy, the difference between the level of investment and saving is equal to the current account balance. Traditionally, due to insufficient levels of household saving to fund investment expenditure, Australia has cultivated sizable current account deficits (CAD's), posing concern for vulnerability to external shocks (Belkar, Cockerell and Kent, 2007). The new trend in saving habits is associated with a reduction in aggregate demand, leading to downward pressure on wages, prices and interest rates. As a result, households have assisted in the nation's ability to endure adverse economic conditions.

The decline in savings between the late 1980's and mid 2000's is thought to be a one-off but gradual transitional response to a series of reforms and economic conditions that characterised this period. The deregulation of the financial sector has played an important role in influencing household savings globally, allowing consumers to utilise capital markets to fund investment and expenditure. Prior to deregulation, consumers had limited access to financial intermediation with the result that consumption was defined by endowment levels (Bayoumi, 1993). The large degree of household saving observed before financial deregulation may have been an inefficient response to credit constraints that prevented households to administer their desired expenditure schedules (Garton, Sedgwick and Shirodkhar, 2010). Financial liberalisation has made household savings more sensitive to changes in income, wealth and real interest rates.

In the wake of the deregulation, the household savings ratio underwent a steady decline from a peak of 18.0 per cent in 1975 to a trough of -4.4 per cent in 2002 (Thorne and Cropp, 2008 p.77). The time of the "Great Moderation", characterised by low inflation, low interest rates and positive consumer sentiment, paired with the increased availability of credit

culminated in households becoming highly leveraged (Stevens, 2011). The ratio of private sector wealth to disposable income increased by nearly 200 per cent between 1997 and 2007 alone (Chart 1). The increases in wealth are accounted for due to increases in the real values of housing and financial assets (IMF, 2009). The fall in savings occurred in conjunction with a rise in wealth and capital gains, indicating that increases in wealth have been utilised as substitutes for personal saving (Hiebert, 2006). This trend has been observed in many countries, particularly Europe, the United States and Japan, reflecting how credit availability has satisfied pent-up demand for durables and housing investment (Chart 2).

Higher corporate savings could also be responsible for the decline in international household savings, since households are essentially the owners of corporations and should in theory internalise corporate saving decisions (Poterba, 1987; and Auerbach, 1991). An increase in corporate savings will lower household savings with the proviso that households are able to recognise the link between their equity wealth and future income, and adjust their own saving in response to that of the firms' (Edey and Gower, 2000). The OECD average for the coefficient on corporate saving of 0.4-0.7 indicates that households have partially offset their saving in response to corporates (Callen and Thimann, 1997). This was also the case in Australia, particularly in the early 2000's when corporate saving was at its highest, and households were dissaving (Chart 3).

Declines in savings also coincided with improvements in labour productivity during the late 1990's. When households perceive that the higher incomes associated with the rise in productivity will continue into the future, then their permanent income, or present value of future expected income increases, eliminating the need for additional saving out of current income (Marquis, 2002). This idea is consistent with the trends in Australian labour productivity that peaked when during the early 2000's when saving levels were at substantial lows. (Chart 4). The same movements have been observed in most G7 countries when labour productivity peaked at an average of 2.9% between 1999 and 2000, and household savings declined significantly in the majority of countries (OECD, 2013).

The turnaround in the saving ratio began in the mid 2000's, demonstrating that Australians were returning to a more sustainable saving pattern, after adjusting to previous economic

reforms. Increased savings have been correlated with rising incomes. Australia's terms of trade boom has underpinned the growth in incomes with real net disposable income per capita growing by 2.6% a year between 1998-9 and 2008-9 compared to 1.5% for the previous decade (ABS, 2010). Increases in income have not corresponded with increased consumption, reflecting that a greater proportion of disposable income was saved to maintain smooth consumption profiles (Chart 5).

Post GFC, the financial position of Australian households deteriorated extensively, with assets declining by 500 billion by 2009. Australians heightened their level of saving to compensate for the losses in housing and wealth, building financial buffers against further adverse shocks and potential employment uncertainty. Savings were temporarily boosted by the distribution of the government's economic stimulus payments, where an estimated 60 per cent of the funds were saved by households. Consumption expenditure reduced and households diverted from investing in riskier assets such as shares towards securer bank deposits. Precautionary saving has been at large in those economies, such as the United States, the United Kingdom and Spain, where unemployment was high; consumer confidence was weak as well as the existence of sizable government deficits. These countries also experienced significant falls in house and asset prices during the global downturn, (RBA, 2010). The resulting moderation in capital gains and lower growth in household net worth compared to the strong growth previously witnessed has contributed to higher rates of saving (Thorne and Cropp, 2010).

To address low levels of household saving and reduce dependence on government pensions, the Keating Labor government introduced the compulsory superannuation scheme in the early eighties. As part of this scheme, employers now contribute 9.25 per cent (previously 7 per cent) of employee earnings to super funds. Depending on the extent that compulsory saving substitutes for voluntary saving, influences that of households'. It is estimated in Australia that a 1 percentage point increase in the contribution rate raises household savings by ¼ percentage point, creating an offset of three quarters (Morling and Subbaraman, 1995). The increase in household saving can be attributed to greater awareness about the necessity of saving for retirement as well as the added convenience of being able to make contributions directly in to superannuation accounts. Rising life

expectancies would also encourage higher saving to the extent that households now have to fund longer retirements through superannuation, than they had previously expected.

The impact of increased levels of household saving is well evidenced when reflecting upon its effect on the nation's current account, banking sector, and macro economy. Australia has had persistent current account deficits, generating concerns for insolvency and excessive foreign debt, with the potential for drastic reversals in capital flows and vulnerability to external economic conditions (Belkar, Cockerell and Kent, 2007). Increased levels of household saving post GFC inflated national savings considerably with gross saving increasing from 22.2 per cent of GDP to 24.5 per cent of GDP on average, before and after the GFC respectively (Gittins, 2011). As a result, despite high levels of investment, greater savings subdued the effects of the mining boom and narrowed the CAD. Since 2008-9 Australia's CAD has averaged 3.3 per cent of GDP, which is lower than the pre-mining boom average of 3.7 per cent of GDP and substantially lower than the average during the mining boom prior to the GFC of 5.7 per cent of GDP (Freestone, Gaudry, Obeyesekere and Sedgwick, 2011). Rising household saving combined with improvements in the government's fiscal outlook allowed for greater investment in the resources sector, steadying price and wage pressures, and prevented upward pressure on interest rates (Bishop and Cassidy, 2012)

The main sources of funds for Australian banks are deposits, long and short term wholesale debt as well as equity and securitisation (Deans and Stewart, 2012). High levels of household savings post GFC have manifested the Australian banking sector through increases in deposits, complemented by a fall in short term debt and securitisation allowing banks to move towards a more consistent funding model (Chart 6). The transition in funding setup is a result of banks becoming increasingly risk averse after experiencing the tightening of international funding markets in the midst of the GFC and difficulties encountered in rolling over short-term debt (RBA, 2010). The increased adoption of domestic deposits and long-term wholesale funding is likely to be sustained as banks prepare for the Basel III funding requirements in 2018 that will ultimately improve bank capital requirements and provide greater financial stability (APRA, 2013). Australian banks have competed vigorously

for domestic deposits to fund credit growth, benefiting consumers through competitive interest rates.

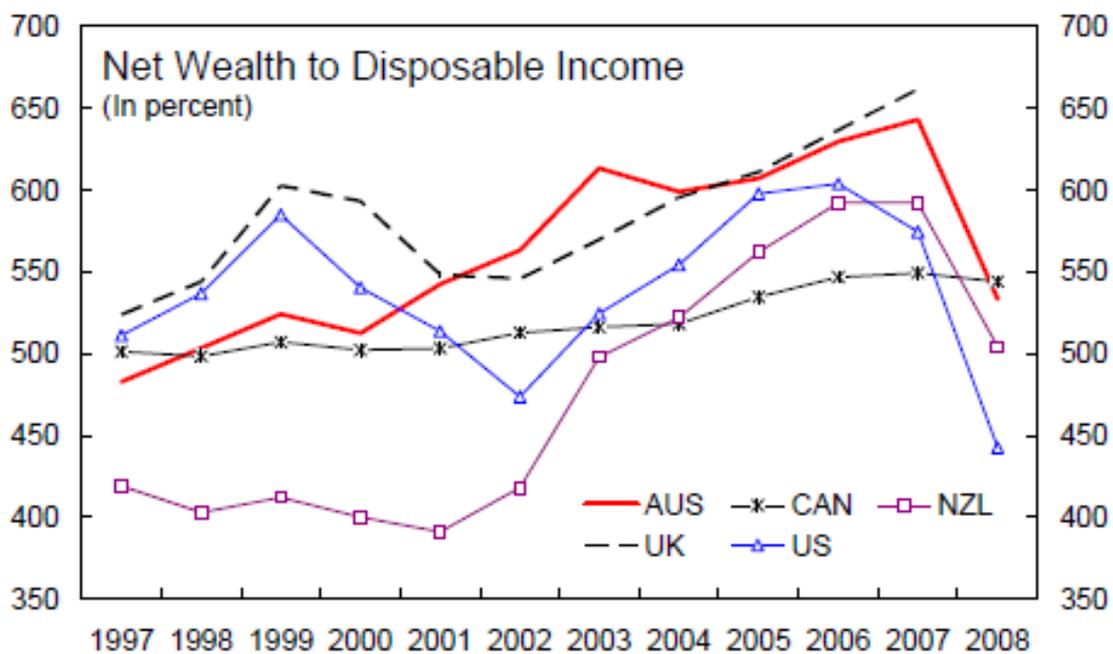
Households have reduced debt levels as a result of increased precautionary saving (Chart 7). Australia's debt to income ratio has remained steady for the last 5 years and sits at 148 per cent compared with a record 153 per cent in late 2006 (Bloomberg, 2013). Highly geared households are sensitive to unfavourable situations such as reduced wages and unemployment. Reductions in debt levels have made households less susceptible to interest rate fluctuations in regard to servicing housing loans. Housing debt accounts for an extensive total of household debt, the majority of which is dependent on varying interest rates. Owner-occupied debt was \$867 billion in March 2013, about twice as much as investor-related debt of \$413 billion (Commonwealth Bank, 2012). Interest rate rises are transferred to consumers quickly in terms of increased costs in debt servicing that can erode disposable incomes. Household savings provide a safety net of funds that can be drawn upon when financial positions become stressed. Increasing savings and restraints on debt has allowed households to reduce their financial vulnerability. While disposable incomes have generally risen, increasing saving, paired with moderation in household consumption has proved to be challenging for many sectors of the economy, particularly retail and construction.

It is expected that the households saving rate will remain around its current level, and consumption expenditure to grow at pace with incomes (Stevens, 2008). If this is the case, the reduced growth in demand would be less detrimental than it has been over recent years when the saving rate was rising (Freestone, Gaudry, Obeyesekere and Sedgwick, 2011, p.75). In the future however, demographic factors will potentially also play greater influential roles on household savings. Most of the baby-boom generation in Australia is now at, or close to, the age of maximum saving, and simple life-cycle theories would therefore predict that demographic trends will soon begin to reduce saving. There will be an increase in old age dependency ratios, as baby boomers move stage of life in which they are saving to a stage of dissaving. (Mody, Ohnsorge, and Sandri, 2012).

There have been a number of factors that have influenced Australian household saving patterns which in turn has had a considerable impact on the economy as a whole. The new levels of saving and the stabilisation of household debt are attributed to households readjusting their levels of gearing after the effects of financial deregulation and other economic reforms that occurred in earlier decades. Weakening of Australia's terms of trade, combined with apprehension regarding future international economic performance is likely to maintain levels of precautionary saving in the short term. Greater household saving has narrowed the CAD, provided the banking system with a more sustainable funding arrangement and reduced upward pressure on interest and exchange rates, thereby improving the nation's financial stability and overall macroeconomic security.

Appendix 1

Chart 1: Net Wealth to Disposable Income



Sources: RBA; RBNZ; Eurostat; OECD; Haver Analytics Database; and Fund staff calculations.

Chart 2: Household Net Saving Rates

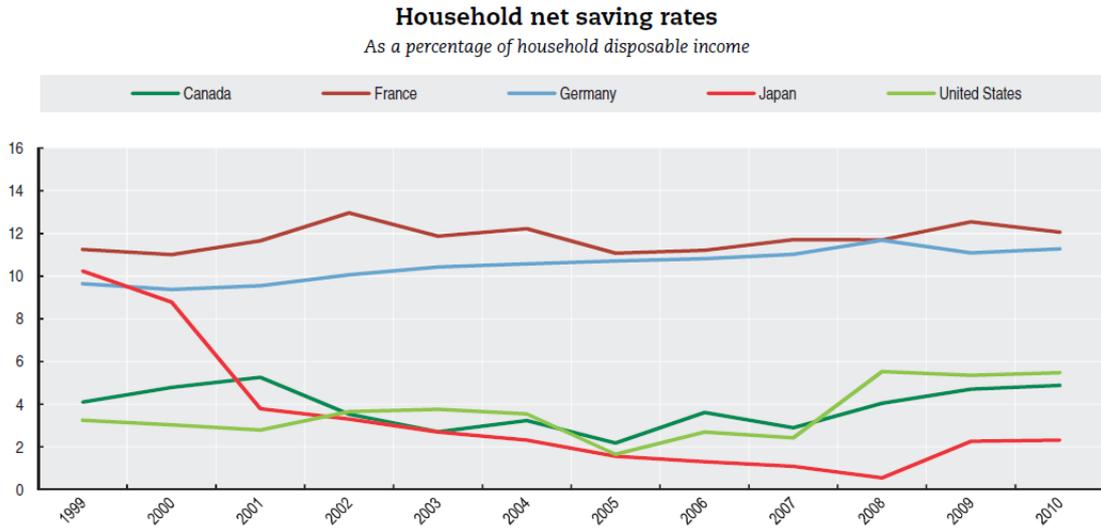
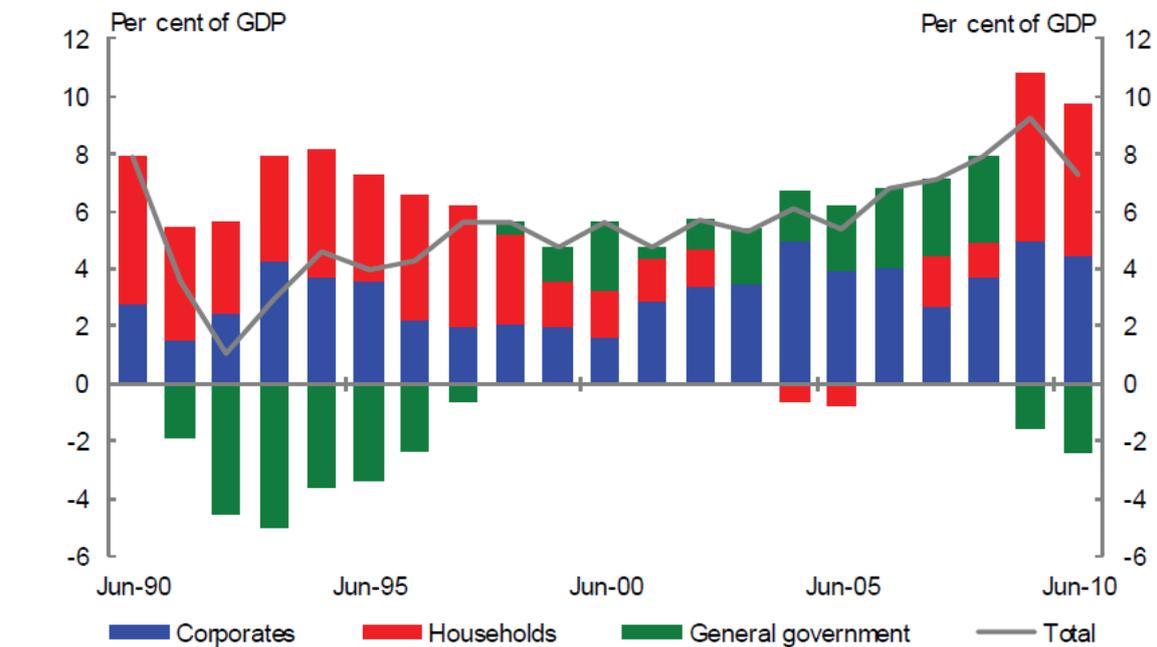


Chart 3: Net Saving by Sector



Source: ABS cat. no. 5204.0.

Chart 4: Australian Productivity

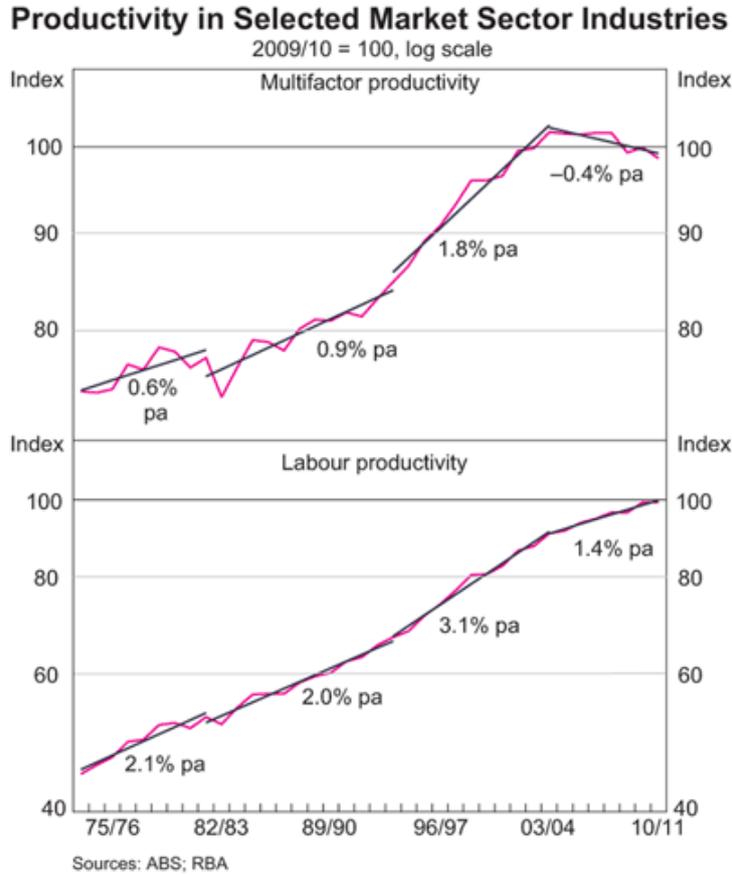


Chart 5: Real Household Income and Consumption

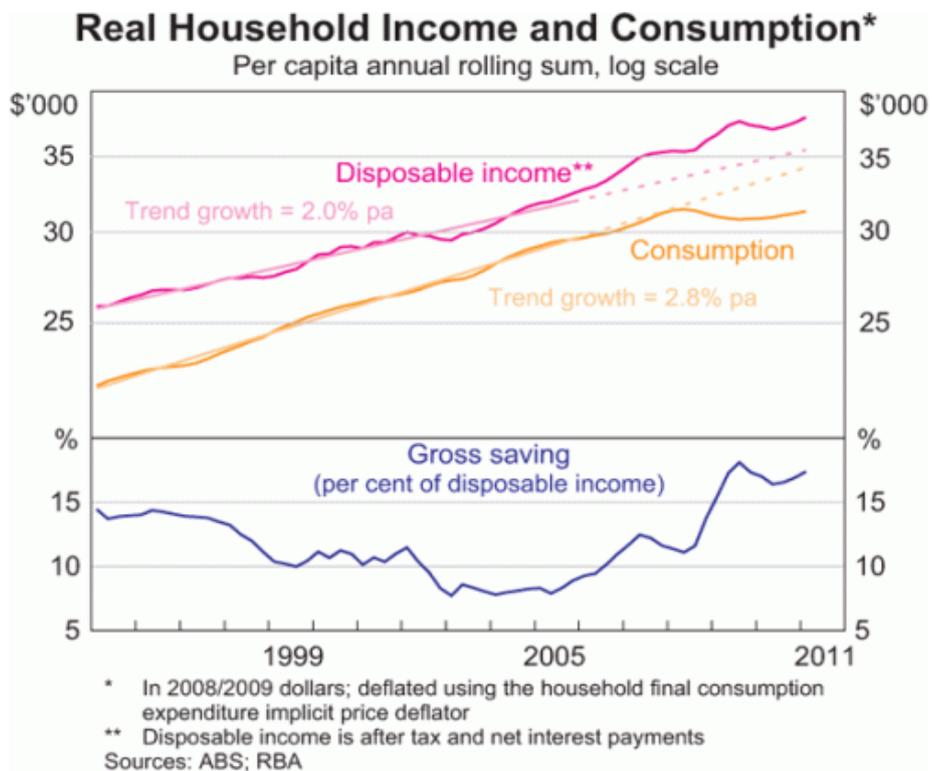


Chart 6: Australian Bank Funding Composition

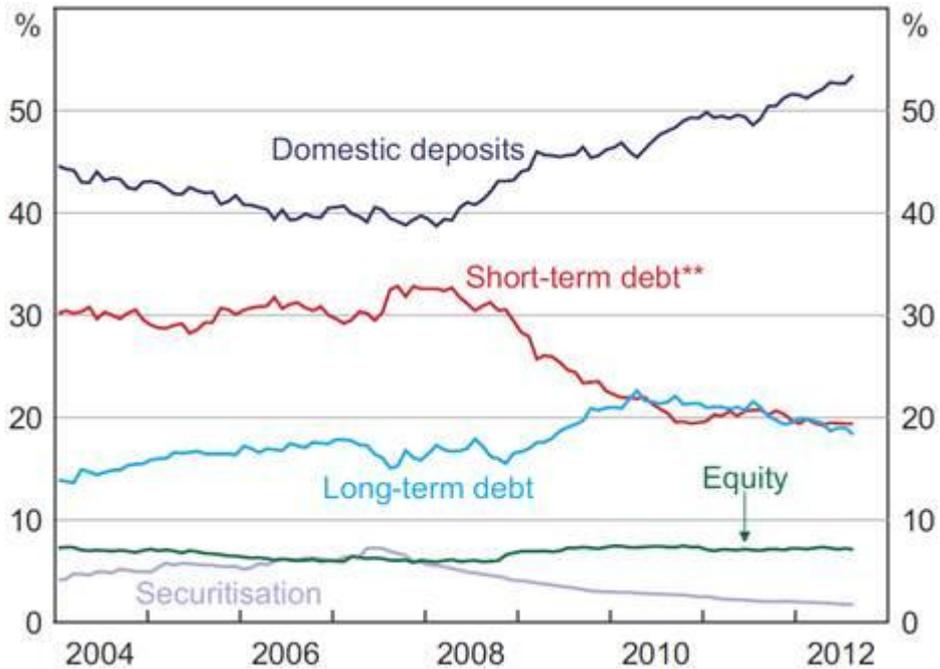
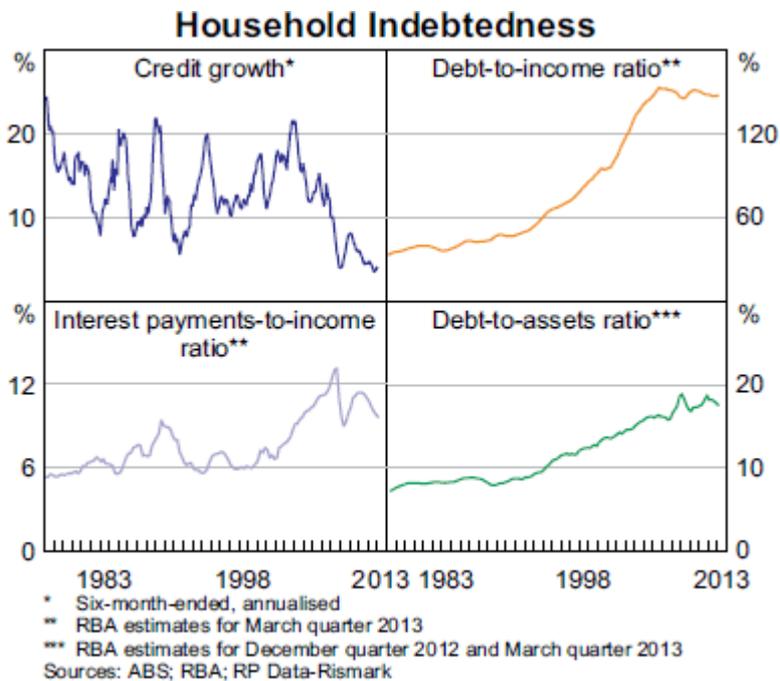


Chart 7: Household Indebtedness



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