



## RBA/ESA Economics Competition 2013

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# BEST 1ST YEAR ESSAY

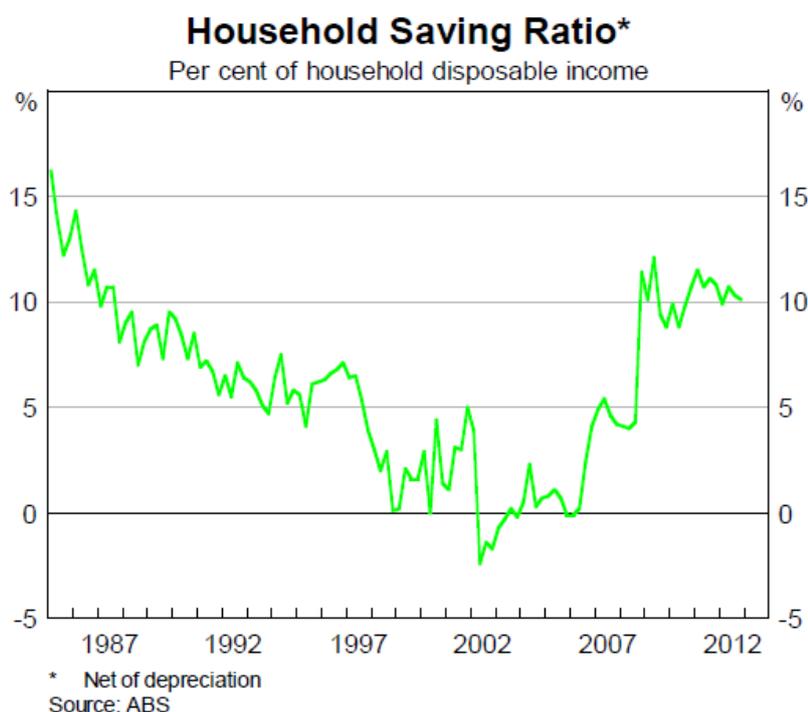
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*Australian Household Savings*

## Australian Household Savings

Trends in Australian household savings reflect the greater changes in the national and global economy. Household savings, as measured by the Australian Bureau of Statistics, is calculated as the residual of household disposable income and household final consumption expenditure (Thorne & Cropp 2008, pg 77). As such, trends in income, consumption and borrowing, which are affected by economic conditions, have been central to the two key trends in household savings: the decline from the 1980s to mid-2000s and the return to more 'normal' levels near 10% of disposable income (Figure 1). The decline in household savings and growing household debt occurred against the backdrop of financial deregulation, falling interest rates and rising household wealth, but has since increased rapidly following the Global Financial Crisis. This essay will examine the two major trends in the Australian household savings ratio and consider them in an international context. It will also examine the implications of these trends for macroeconomic policy, both monetary and fiscal, as well as the improvement in financial stability.

Figure 1



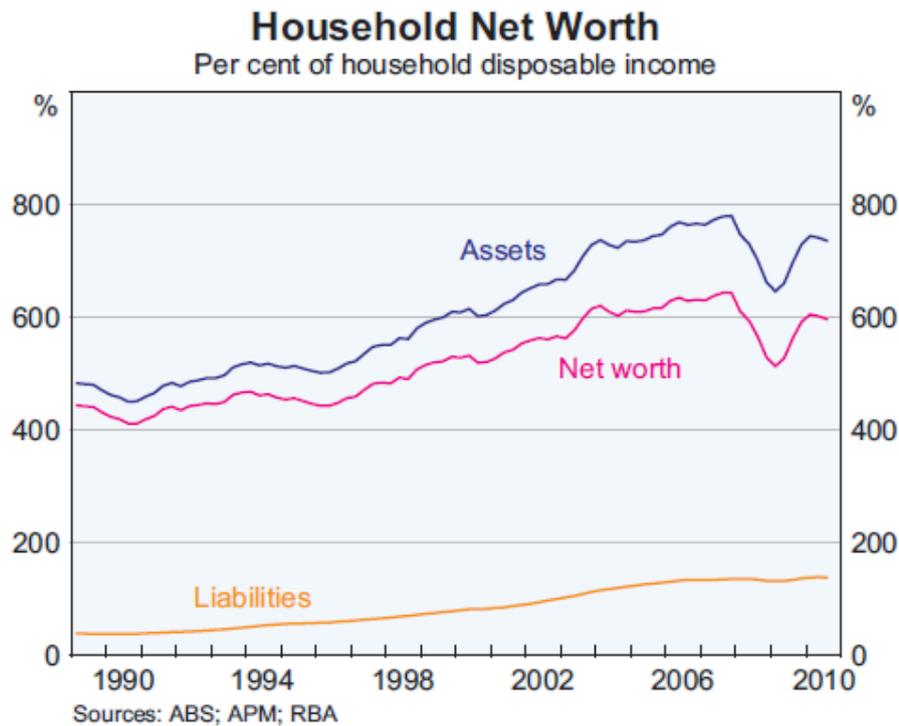
## **The Decline in Household Savings**

Through the 1980s and 90s, household saving levels trended downwards. In 2002, the household saving ratio reached a trough of -2% (Figure 1), reflecting that the sector's debt was greater than its total income. This trend was observed in various OECD countries, but was most evident in English speaking countries with comparable institutions, specifically the United States, Canada and the United Kingdom (Hiebert 2006, pg 1).

The decline in savings occurred in the context of financial deregulation and technological innovation. These significant developments provided households with considerably easier access to credit, creating the opportunity for higher levels of debt than was previously possible (RBA 2011, pg 42). Additionally, borrowing became more affordable as the liberalisation of financial markets coincided with the decline in nominal interest rates from an all-time high of 17.5% in 1990 to 4.25% by 2002. Combined with generally positive economic conditions, these factors encouraged higher levels of household leverage and consumption and saw a decline in household savings. This is evidenced by the debt-to-income ratio which has trebled since the early 1990s, peaking at 153% in 2006 (RBA 2013, pg 45).

Another key reason for the decline in the household saving ratio was the rise in household wealth. This rise mainly resulted from capital gains in household prices as well as shares held increasingly through superannuation funds. As Figure 2 demonstrates, the increase in household assets to nearly 800% of disposable income saw household net worth continue to rise despite increasing debt. Hiebert (2006) argues that as households transitioned to higher levels of debt they relied on realised and unrealised capital gains to accumulate wealth rather than traditional means of saving. As capital gains are not included in the income component of the household savings ratio but encourage greater consumption, this has seen a marked decline in the household saving ratio (Thorne & Cropp 2008, pg 77). Hiebert also attributes the 'wealth effect' to the downward trend in household savings observed in other English speaking OECD countries.

Figure 2



(Source: RBA *Statement on Monetary Policy*, Box C, February 2011)

### The Turnaround in Household Savings

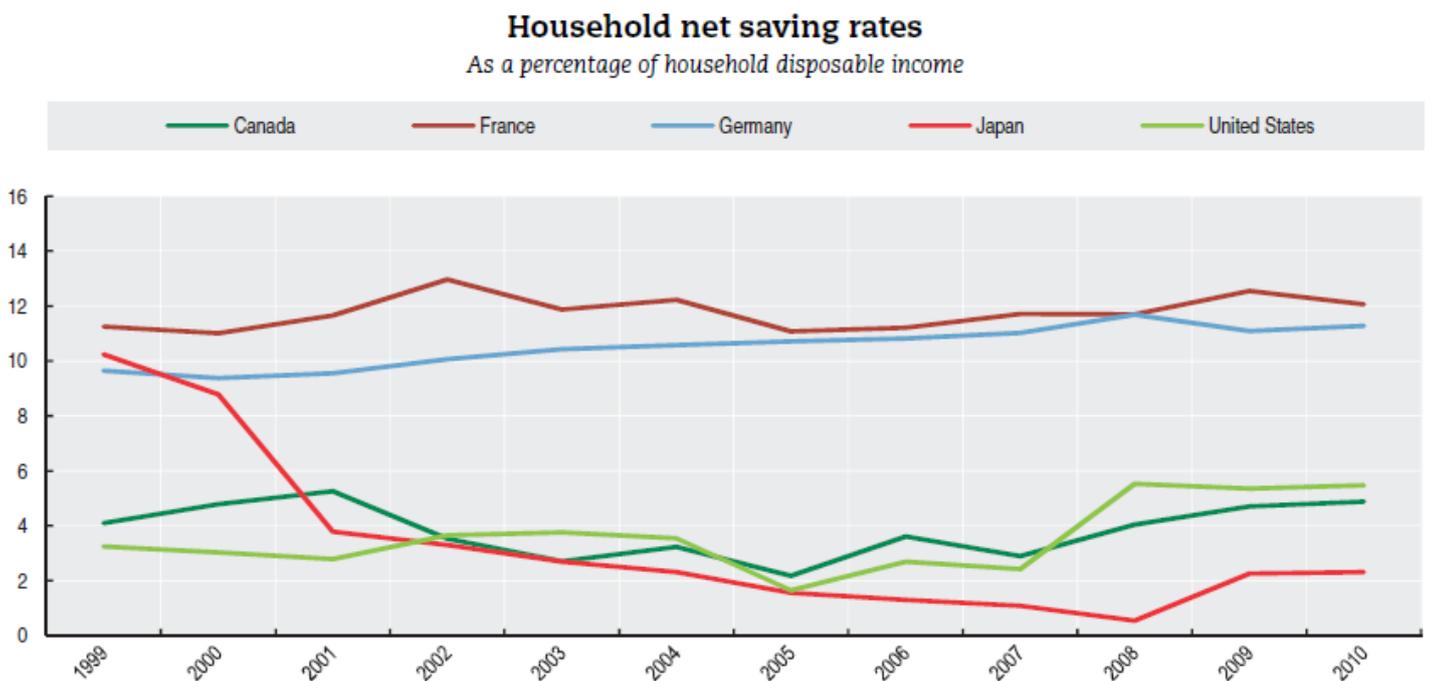
As seen in Figure 1, the household saving ratio began a new upward trend during the mid-2000s and dramatically accelerated following the Global Financial Crisis. Trends in consumption and income growth explain this turnaround. From 1995 to 2005 as household savings declined, consumption growth was faster than income growth (Stevens 2011, pg 79). But since the mid-2000s, nominal household income has grown strongly at an annual rate of 7.3% on average. This has outpaced nominal household consumption of 5.4% on average each year between 2004 and 2008, and lower consumption growth since (RBA 2011, pg 43).

The growth in disposable income reflects the boom in the terms of trade, a measure of export prices relative to import prices. Between 2003 and 2008 it increased by nearly 10% on average each year (Thorne & Cropp 2008, pg 80), and reached record high levels during 2011, largely due to the mining boom and soaring mineral prices. Thorne and Cropp (2008)

suggest that the increase in the terms of trade was perceived to be temporary and so in response, households increased savings to allow for a smoothing of consumption. The notion of achieving a smooth level of consumption over a lifetime to maintain living standards is widely accepted as a key motivation for saving and explains why household saving patterns change with transitory fluctuations in income.

Concurrently, the decrease in consumption in recent years has occurred against the backdrop of the Global Financial Crisis and heightened consumer uncertainty. A large increase in precautionary saving is most evident from 2008-2009 in Australia (Figure 1) as well as countries including the United States, United Kingdom and Spain where unemployment and government debt have significantly increased while household wealth has declined (RBA 2010, pg 14). This trend has been observed in some but not all OECD countries and to different degrees (Figure 3). Comparability between nations is undermined by the significant estimation errors involved in determining household disposable income and consumption expenditure, as well as institutional differences in how old-age pensions and other social safety nets are funded (OECD 2013, pg 64).

**Figure 3**



(Source: OECD Factbook 2013)

Like much of the developed world, household wealth in Australia briefly fell following the financial crisis as a result of a drop in asset prices (Figure 2). Continued consumer uncertainty has motivated households to build up larger financial buffers as a precautionary measure against future unexpected setbacks (Lowe 2011). Additionally, household attitudes towards debt have changed as observed by the moderation in borrowing. From 2007 household credit growth has been at its slowest in 20 years, averaging 5.5% annually (RBA 2013, pg 44).

Since the household saving ratio has returned to its highest point in 20 years, it has stabilised around 10% to be more in line with historic averages. This reflects a return to 'normal' savings levels after years of households transitioning to higher levels of debt following financial deregulation and falling interest rates. As Governor of the Reserve Bank Glenn Stevens (2011) suggests, the period of consumption growth outpacing income growth was atypical and unsustainable. It started to end in 2006 as the household savings ratio began to increase with the cooling off of the housing boom (RBA 2011, pg 43), but was brought to a rapid end with the Global Financial Crisis. This suggestion of Australia returning to 'normal' levels of saving is further evidenced by the recovery in asset prices and the continued stabilisation of the household saving ratio.

### **Implications of Changing Household Savings for Macroeconomic Policy**

As the household sector is a significant component on the demand side of the economy, subdued levels of household consumption and rising household savings have had implications for both monetary policy and the government's fiscal policy. Household consumption is one of several key factors that affect the level of inflation and therefore the Reserve Bank's stance of monetary policy. In the wake of the Global Financial Crisis precautionary saving by households eased the upward pressure on prices. In September 2008 the headline inflation rate was 5%, but by September 2009 it had fallen to 1.2% (RBA 2013). This factor as well as international trends prompted aggressive cuts to the cash rate by 100 basis points at a time in 2008 and 2009. Recent cuts to the cash rate over the past 18

months largely relate to global growth trends and the slowing levels of mining investment. But, as noted in the recent July 2 Monetary Policy Decision, it also reflects an effort to support “interest-sensitive spending and asset values” as household borrowing has moderated and savings have increased.

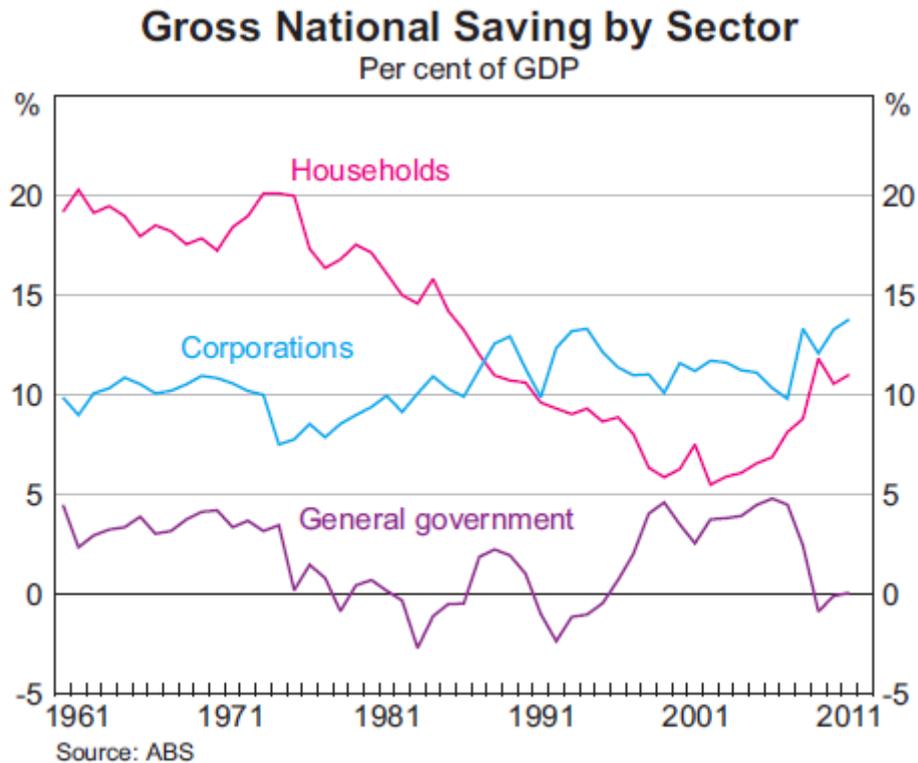
Recent events also demonstrate the implications for fiscal policy. During Australia’s period of declining household savings, high levels of household consumption and leveraging were particularly significant forces driving economic growth (Stevens 2011, pg 80). This economic growth was an important factor elevating government income, which in turn assisted to facilitate successive budget surpluses of approximately 1% of GDP (Bishop & Cassidy 2012, pg 16). In contrast, the immediate aftermath of the Global Financial Crisis saw the sharp acceleration of household savings and decline in consumption which prompted a fiscal stimulus programme involving cash transfers to households to encourage spending and avoid an economic downturn. The fiscal stimulus as well as automatic stabilisers led to an immediate change in the government’s fiscal policy stance (Freestone et.al. 2011, pg 70). The increase in household savings continues to impact fiscal policy through lower revenues generated by the GST, which have not returned to their pre-2008 levels and are 0.5% of GDP below the 2000 to 2010 average (Daley et.al. 2013, pg 25). However, other factors, particularly declining mineral prices and mining investment, have had greater implications for lower than expected tax revenues and continued budget deficits.

### **Implications of Changing Household Savings for Financial Stability**

The recent increase and stabilisation in household savings has positive implications from the perspective of financial stability. Since the financial crisis, the rise in household savings, and to a lesser extent the rise in corporate savings, has compensated for recent budget deficits (Figure 4). Despite the end of successive budget surpluses, gross national savings as a percentage of GDP has continued its upward trend and is currently around 25%, its highest level since the late 1980s (Bishop & Cassidy 2012, pg 10). These higher levels of national saving, mainly due to the household sector, have funded significant levels of domestic

investment during the mining-boom, reducing Australia's reliance on overseas funds and international credit markets.

Figure 4



(Source: Bishop & Cassidy, 2012)

Furthermore, recent behavioural trends in the household sector have provided greater financial stability by facilitating a more dependable funding stream for banks (Freestone et.al. 2011, pg 71). Households have moderated borrowing, thereby easing funding pressures, and have also moved towards making safer investments in bank deposits. In 2008 deposits represented 40% of total liabilities for banks, but now represent 53% (IMF 2012, pg 12). However, despite the greater domestic source of funds, banks still strongly rely on offshore funds, and continue to manage this risk to financial stability.

Another risk to financial intermediaries, as suggested in the IMF financial stability assessment of Australia (2012), is the occurrence of an economic shock resulting in accelerating unemployment while current household debt is still high and household prices remain elevated. But this particular risk has become less of a concern as higher household

savings provide a financial buffer for households to draw on should they need to. Additionally, households have focused on repaying debt and are estimated to be approximately 20 months worth of repayments ahead of schedule (RBA 2013, pg 45). As seen in Figure 2, household liabilities as a percentage of disposable income have barely changed since 2007. This moderation of debt-to-income is explained in the most recent HILDA (Household Income and Labour Dynamics in Australia) survey by the slower borrowing and households taking advantage of lower interest rates to repay debt (RBA 2012 pg 53). These factors in the housing sector are a key reason behind expectations of continuing financial stability.

## **Conclusion**

The abrupt return of household savings to historically normal levels reflects a reassessment of finances by households after a period of transitioning to higher indebtedness in the context of financial deregulation, falling interest rates and reasonably strong economic fundamentals. Trends in household savings and consumption continue to have implications for macroeconomic policy, both monetary and fiscal. But as economic growth has increasingly focussed on mining resources rather than household consumption, macroeconomic policy decisions have been more dependent on the export sector of the economy. Finally, as borrowing has moderated, increased household savings have been central to providing a greater source of funds for domestic investment, thereby improving Australia's overall financial stability.

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