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FINANCIAL FAQs

WHAT SAVINGS RATE?

There is a tremendous debate on whether Americans have any personal savings. It is an important debate, because investment in new plant and equipment has to come from someone's savings—whether in the form of capital from stock, or loans. And when the savings rate falls, less is available for the expansion of businesses, and hence jobs.

The so-called personal savings rate— disposable (after tax) personal income less personal expenditures—was negative in 2005 for the first time since the 1933 Depression. But some economists maintain that it is not a true picture of our savings rate, since it does not measure the value of assets we own. Stock and real estate values have been climbing—total stock valuations are now above $11 trillion and the value of real estate is closing in on $17 trillion, with $9 trillion in mortgage debt.

So why shouldn't assets be treated as savings? Primarily because assets can fluctuate wildly in value, whereas income (i.e., cash) that is not spent becomes savings. An asset only has value in relation to the net income stream that it generates, in other words.

Stocks currently 'earn' less than 2 percent annually, for instance, in both capital gains and dividends. This is mainly because S&P 500 stock prices are at 18 times earnings. Stocks' price-to-earnings ratio has been 15 to 1 historically, and earned 7 percent per annum. What good is an asset, in other words, if it has no earnings? Stocks were earning less than 1 percent during the 2000 stock market bubble, thus hinting at the bubble about to burst and illustrating Alan Greenspan's warnings of irrational exuberance.

Real estate has also been earning less as prices have risen. Properties earn from rents—as well as capital gains on a sale, of course. In California, prices are so high that an investor cannot earn much more than 2 percent per annum, even when paying all cash! This is because rents have not increased at the same rate as property prices. They have increased very little, in fact, since rents are tied to disposable personal incomes. Incomes have been rising at no more than the rate of inflation since 2000, which means average incomes haven't risen at all!

Business Week in a recent article makes the case that investing in education should not be treated as consumption but as an investment, therefore a form of savings. This is on the theory that investments are written off over their lifetime, thus improving the bottom line, whereas consumption is deducted from income when it is spent. America spends more than 7 percent of GDP on education, compared to 4.6 percent in Japan, according to Business Week. If education were counted as savings, then the 2005 savings rate would be 2 percent instead of minus the 0.5 percent published by the Commerce Dept.

That is a good, but not valid point. Most investments do generate future income, but first have to be funded from someone's savings or borrowings, as we said. Education does generate higher future incomes. And the 2005 unemployment rate of college graduates was just 2.1 percent, vs. 4.4 percent for high school grads, vs. 7 percent for those with no diploma. But remember student loans? It takes years to pay them off if the monies were not saved in advance, thus cutting into personal incomes.

One can neither escape paying the piper nor paying for assets which may or may not result in a bubble that can burst. Education is a very valuable asset, as are real estate, stocks and bonds. But all are only as valuable as what they earn.