WACHOVIA
ECONOMICS GROUP

SPECIAL COMMENTARY

April 01, 2009

The Changing Nature of Saving

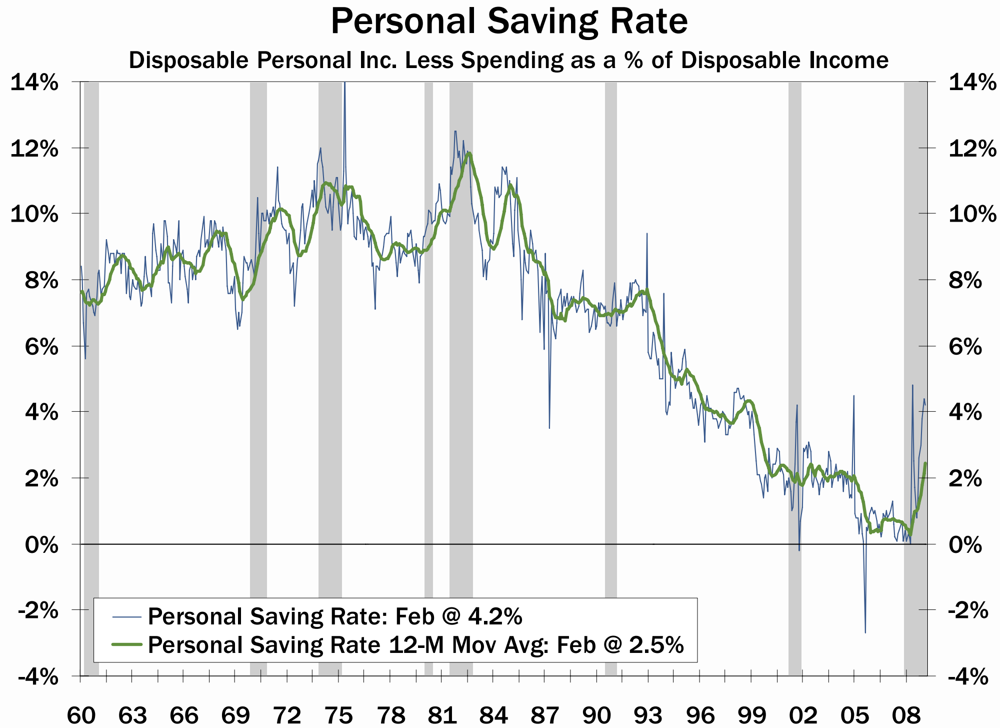
John E. Silvia, Chief Economist
john.silvia@wachovia.com
704-374-7034
Adam G. York, Economist
adam.york@wachovia.com
704-715-9660

The Household Balance Sheet

America's worst economic downturn in a half century has changed the household savings ethos, at least temporarily. The personal saving rate has leapt higher over the past six months to about four percent. While the personal saving rate certainly has its flaws in capturing all the potential aspects of saving and has widely been criticized for many of them, it still gives at least one picture of consumers' current 'cash flows' that is not directly impacted by rapid changes in asset values.

America's worst economic downturn in a half century has changed the household savings ethos, at least temporarily.

Figure 1



Source: U.S. Department of Commerce and Wachovia

The saving rate will likely continue to rise for the next several months driven higher by declines or weak growth in consumption as well as near-term tax relief.

The personal saving rate has not been as high as it was at the start of 2009, on a sustained basis, since the 1990's mid-cycle slowdown.[1] In fact, the saving rate hovered just barely above zero percent from summer 2005 until mid-2008 at the height of the last expansion and into the first part of the downturn (Figure 1). Despite the current increase in the saving rate, our view is that America still roundly has a culture biased towards consumption, as opposed to saving, that will continue to guide us through this cycle and beyond. However, for now, consumers seem suitably spooked by the current state of the economy to increase their own personal reserves. The saving rate will likely continue to rise for the next several months driven higher by declines or weak growth in consumption as well as near-term tax relief. These will at least be partially, but not entirely, offset by weak wage & salary income growth as a result of the turmoil in the nation's labor market.

Figure 2

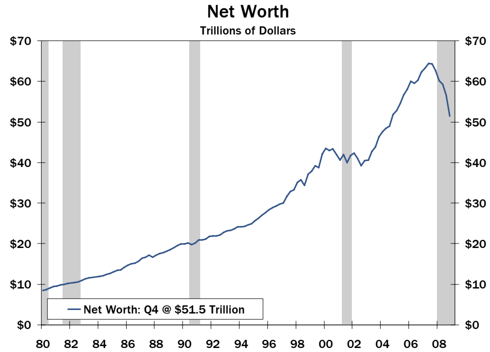
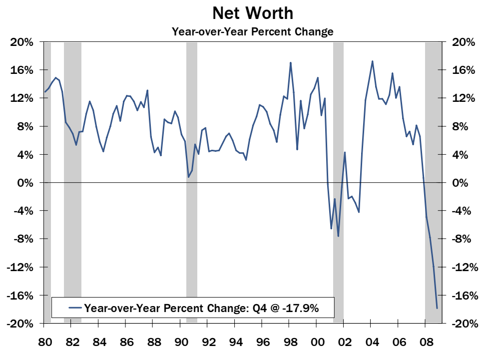


Figure 3



Source: Federal Reserve Board and Wachovia

Household net worth has taken the largest hit it has ever seen in the history of available data (1952). Much of the increased saving will go towards repairing ailing consumer balance sheets that became bloated and over-leveraged along with the rest of the economy during the last expansion. In addition to considerable saving and debt reduction, it will take a major recovery in asset prices on the order of $16 trillion, all else equal, to bring household leverage ratios back to levels seen earlier this decade.

Clearly, we have a long road ahead. In this essay, we will look at how consumers are likely to allocate their income over the next few years, what that will mean for saving and consumption as well as how it may impact the markets, products and vehicles through which consumers manage their wealth.

Assets Have Taken Their Lumps in This Cycle

U.S. households and non-profits held some $65.7 trillion in assets at the end of 2008, distributed roughly 60/40 between tangible and financial assets. Declines in valuations in both real estate and financial assets had plagued consumers for more than a year at this point. Over the last twelve months, households have lost $2.2 trillion in residential real estate holdings and $5.3 trillion in equity, bond and mutual fund holdings combined. By comparison, real estate holdings have never

[1] Personal saving, as defined by the BEA in the NIPA is the portion of disposable income that remains after paying current taxes, outlays for personal consumption, interest payments on non mortgage debt and net transfers to government and the rest of the world are satisfied. To calculate the saving rate, personal saving is divided by personal income less personal current taxes.

declined on an annual basis; the largest previous declines for equity, bond and mutual fund holdings were $3.9 trillion in the wake of the tech-bubble.

Households have clearly been financially and psychologically impacted by the rapid decline in asset values. Even using a conservative estimate of the "wealth effect," all else equal, consumer spending should be lowered by a rate of $400-$600 billion per year. All else equal, a decrease in spending of this magnitude would move the saving rate roughly four to five percentage points higher; clearly some of this impact has already taken place. To phrase the impact another way, the wealth effect on consumer spending would equate to a one-time reduction in GDP of three to four percent.

To phrase the impact another way, the wealth effect on consumer spending would equate to a one-time reduction in GDP of three to four percent.

Despite the declines in wealth that we have already seen to date, we expect that further declines are likely in the coming months. Even with conservative projections, declines could equate to another two trillion dollars over the coming year. Using our current projections for the declines in home values (down 8.5 percent in 2009 and another 3.0 percent in 2010 using the FHFA home price index), residential real estate is likely to lose another $1.3 trillion in value. Equity valuations and financial assets more broadly are more difficult (and largely outside the scope of this piece) to project, but if we assume that the broad Wilshire 5000 is a reasonable proxy for equity assets then just holding at the "current" values would produce further wealth losses since the end of last year of about one trillion dollars. The continued loss of asset values will contribute to an ever more cautious consumer mindset. Consumers are less likely to continue to allocate savings, all else equal, to sectors or products that they perceive to be more risky, especially with financial markets still under extreme stress.

Household real estate is clearly one of the areas that has seen sizeable declines in value, and considering the fact that consumers traditionally purchase the asset with considerable leverage, the declines in real estate equity have been staggering. Consumers have lost $4.6 trillion, or more than 35 percent, of their equity in household real estate since the fourth quarter of 2005 (Figure 5).

Figure 4

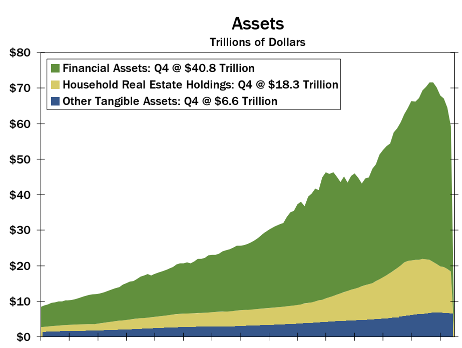
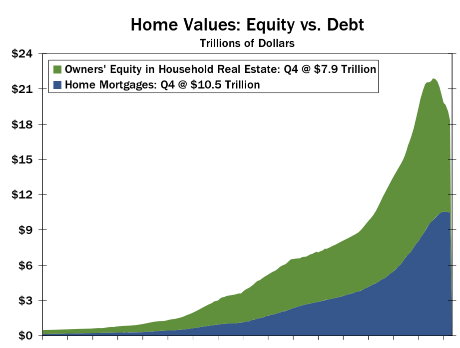


Figure 5



Source: Federal Reserve Board and Wachovia

The advent of subprime lending in the early part of the decade pushed down home owners' equity cushion marginally, but home price appreciation was able to cover much of the increased lending in the boom years that followed. However, by 2006, home value growth could no longer keep pace with the growth in mortgage related debt; consequently homeowners' equity values began to shrink. Homeowners' equity represented just 43 percent of the value of their homes at the end of 2008, while in the late 1990s, this measure hovered near 57 percent.

Consumers may be forced to reconsider the portion of their wealth that they are willing to tie-up in a single asset.

We expect that going forward lenders and borrowers alike will be wary of the leverage that has been allowed in household real estate over the past several years. Underwriting standards on the back side of this crisis may be far more stringent, and rightfully so, than those that we saw at the height of the market bubble. Consumers may be forced to reconsider the portion of their wealth that they are willing to tie-up in a single asset, tax advantages of the asset not withstanding, considering the volatility in prices that has been introduced. Prior to the recent downturn, home values had never declined on a sustained (year-over-year) basis for the history of the data, beginning in 1952.

Figure 6

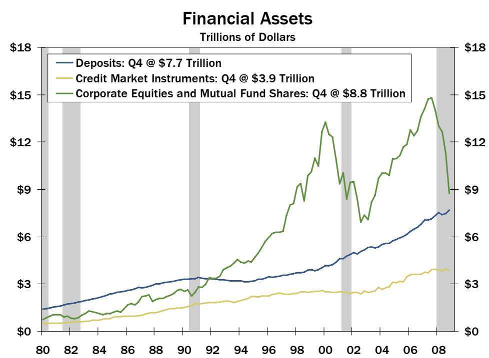
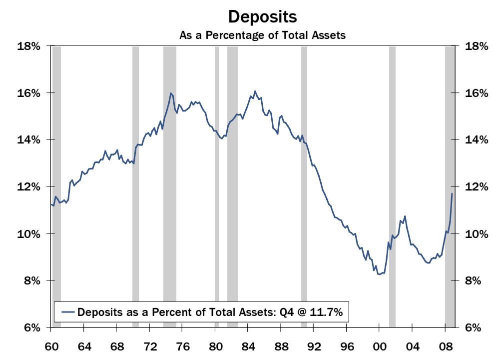


Figure 7



Source: Federal Reserve Board and Wachovia

The promise of U.S. government guarantees has prompted greater holdings in Treasury securities as well as deposits.

The popularity of more stable asset classes, or at least those that are perceived to be more stable in terms of price, will likely continue to rise through the year until the U.S. economy is on more stable footing. Even after the crisis has passed, many of these assets that had fallen out of favor in the 1990s and again this decade may hold onto some of their gains. The promise of U.S. government guarantees has prompted greater holdings in Treasury securities as well as deposits (Figure 7).[2] The two categories combined comprised nearly 12 percent of consumer assets or 15 percent of net worth at the end of 2008. At their trough, the two categories were less than ten percent of consumer assets. Clearly, part of the gain in share is simply the relative stability in the value of these assets as well as the increased issuance of Treasury securities. Both have seen absolute gains in holdings over the past year with Treasuries up 42.9 percent in total while deposits increased 4.9 percent.

Household Liabilities in Decline

On the opposing side of the equation for consumers' balance sheets, one positive is the slowdown, and in fact, decline in outstanding liabilities over the past year. Household and non-profit liabilities slid 0.6 percent over the past year as consumers looked to actively reduce their leverage and shore-up their own finances. Meanwhile, banks and other credit providers tightened standards, reduced access to credit or simply exited the lending marketplace. The combination of these movements led to the first outright decline in household liabilities, at least year over year, since data began in 1952. Home mortgage credit saw a modest decline by year-end and the growth in consumer installment credit has slowed to its weakest rate

[2] Notably the increase in the standard level of FDIC insurance to $250,000 per institution per borrower, as well as the offer of unlimited coverage for certain specific accounts.

since the early 1990s. These reductions coupled with a virtual collapse in security credit (off about fifty percent over the past year) and some smaller movements in other categories, led to the small headline decline in liabilities.

As we discussed earlier, consumers remain extremely levered in their household real estate holdings, more so than they have been at any point in the history of available data, and most likely ever. The demand for additional credit in the mortgage space will remain muted until home values start increasing again or at least level out. We do not see this occurring before next year at the earliest. Even once the market begins to heal in 2011 and beyond, concerns from consumers about the amount of leverage they wish to have on their household balance sheets as well concerns from the credit supply side on how much leverage lenders wish to provide may engender new reasons for saving. Consumers may be expected to put far more equity into future home purchases. Perhaps we are returning to the days when lenders demanded as much as 20 percent in the near-term. Households can certainly expect down payments will be larger than the minimal amounts required at the peak of the housing boom. The negative amortizing mortgage product, which let consumers lever past 100 percent, is likely to remain in the graveyard of bygone financial products. Younger households will likely be forced to save more in coming years in order to purchase their first home, driving up demand for savings products which will allow for the relatively safe and short to medium-term accumulation of funds necessary for a sizable down payment.

The demand for additional credit in the mortgage space will remain muted until home values start increasing again or at least level out.

Figure 8

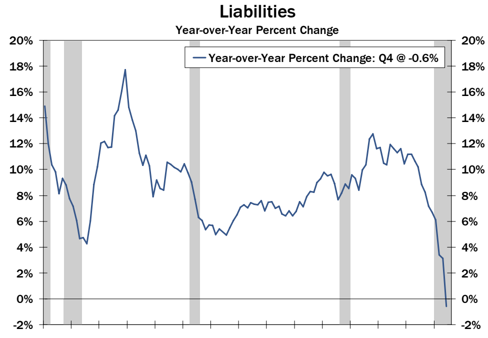
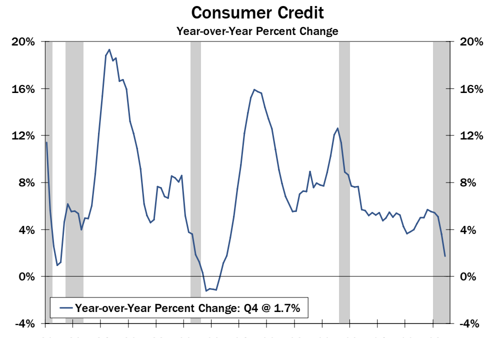


Figure 9



Source: Federal Reserve Board and Wachovia

Lending Standards Will Remain Tight

The supply side of credit will also remain constrained for mortgage lending as lenders attempt to pare back lending and risk exposure with fixed income markets still frozen and potential borrowers facing the worst consumer downturn since World War II.[3] More reluctant lenders will only serve to compound the issues facing the mortgage market. A further tightening of lending standards will serve to discourage or delay potential purchasers, forcing up savings in the near-term as buyers remain on the sideline until they have sufficient equity to enter the new marketplace.

A further tightening of lending standards will serve to discourage or delay potential purchasers, forcing up savings as buyers remain on the sideline until they have sufficient equity to enter the marketplace.

[3] For a more detailed discussion of the supply and demand issues in credit markets specifically please see our recent piece: *Housing & Finance: Still Searching for a New Equilibrium*. February 23, 2009.

While mortgage credit outstanding has declined over the past year, consumer installment credit continued to grow but showed a marked decline of about $20 billion in the fourth quarter. Early data would suggest that the first part of this year showed only modest credit gains.[4] Consumers have certainly been reluctant to purchase any big ticket durable items as the economic downturn intensified. Real consumption of durable goods declined at a more than 20 percent annual rate in the fourth quarter as auto sales—one of the biggest consumer durables—plunged. At the same time, credit providers have been reluctant to supply credit in the current environment across a wide range of product types. The most recent Survey of Senior Loan Officers, conducted by the Federal Reserve, showed (for example) that nearly sixty percent of firms tightened credit card lending standards in the first quarter despite several repeated quarters of tightening in 2008.

Without the same level of access to revolving credit, consumers may face the need to save over the short-run in order to fund even relatively small consumer durable purchases.

Credit card providers have been particularly aggressive in this cycle cutting credit lines for long standing customers that appear to be at risk even if they have yet to become delinquent. In fact, at least one major provider has offered financial incentives to customers who are willing to payoff and close their accounts to reduce exposure. Without the same level of access to revolving credit, consumers may face the need to save over the short-run and keep more liquid savings vehicles in order to fund even relatively small consumer durable purchases whether it is a new big screen TV or a washer & dryer. This pattern of increased saving may further reinforce the move of households into more liquid and safe short-run saving products, such as FDIC insured deposit accounts, as well as short-term Treasury bills and associated funds.

Consumers have quite a dilemma when it comes to demand for revolving and term purchase credit and, therefore increased, liabilities during an economic downturn. On one hand, some consumers may attempt to smooth their spending flow during a temporary decline or lapse in income by using available credit lines and drawing down on saving. Effectively they will spend beyond their means incurring "negative" saving in the hope they will be able to maintain a given standard of living until their income returns to its previous pace. On the other hand, some consumers will seek to improve the stability of their balance sheets and household finances by building up reserves and increasing their own saving rate. Households can choose to solidify their finances and increase their personal saving rate either by demanding saving vehicles, whether they are deposit, debt or equity products or by demanding a negative amount of liabilities—paying down existing debt. Most likely consumers will choose a combination of the two; demanding both more saving vehicles and less credit. This may lead to a considerable cutback in spending, as we have already seen, and a prolonged period of economic weakness as consumers adjust to a lower standard of living.

Will the U.S. Consumer Learn to "Make Do"?

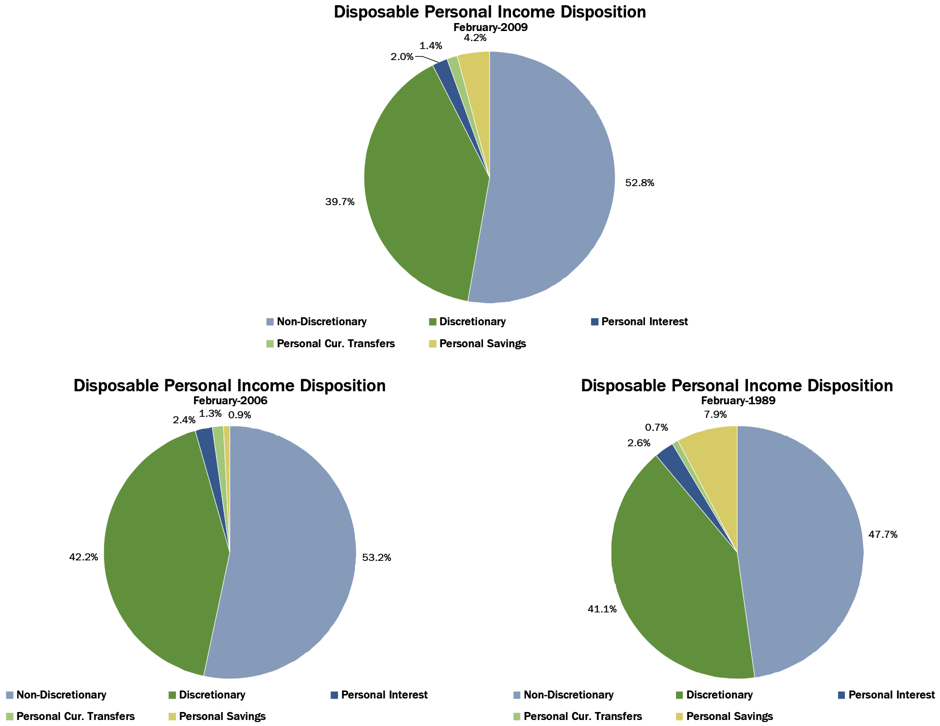
Households across the country have already shown a considerable rebalancing of spending and liabilities over the past six months. We expect some volatility over the rest of the downturn as consumers fight to reconcile lower income with standards of living built on the excesses of the last cycle. Near the height of the last cycle when assets prices were still rising across the board in early 2006, personal saving had dropped to less than one percent of disposable income as households saw less need to add to their existing savings with the capital appreciation that was occurring.

[4] Consumer installment credit, as reported by the Federal Reserve Board, includes "most short- and intermediate-term credit extended to individuals, excluding loans secured by real estate"

Consumers were spending close to all of their available income at that point and relying on unrealized capital gains in both real estate and financial assets to increase the amount of savings that they held for future use.

Consumers were spending close to all of their available income during the boom years and were relying on unrealized capital gains in both real estate and financial assets to increase the amount of savings that they held for future use.

Figure 10



Source: Federal Reserve Board and Wachovia

As the cycle has turned and household balance sheets have taken a considerable hit, the imperative to save from current income has risen considerably. Figure 10, depicts the disposition of consumers' disposable income at three points in time, and while we have not seen the shift return to what we saw in the 1980s when the saving rate was close to eight percent, we have seen a considerable increase versus only a few years ago. We most likely are not going back to the level of saving that we saw in the 1980-82 downturn, at least not on a sustained basis, but consumer balance sheets today are considerably more leveraged and in arguably the worst shape in generations. We believe this will put sustained pressure on consumers to save over the coming quarters.

We most likely are not going back to the level of saving that we saw in the 1980-82 downturn, at least not on a sustained basis.

If we compare the position of consumer balance sheets today to those that we saw in past consumer cycles, the higher degrees of leverage are quite apparent. Much of this can be attributed to secular changes in the nature of consumer credit, whether it is the widespread use of consumer credit cards or the increase in lending to subprime borrowers for everything from mortgages to auto loans.[5] Also consumers have clearly become more comfortable with increased levels of debt over the past few decades, but we expect households will want to reverse some of the extreme levels of leverage and rebuild their net worth relative to income. At the height of the last expansion, households had net worth that was almost 6.5 times their disposable

[5] For example, according to the most recent Survey of Consumer Finance, the percent of families holding credit card balances rose from less than forty percent in 1989 to about 46 percent in 2007.

income. By the end of 2008 that ratio had plunged to just 4.8 times, a level not seen since the early 1990s (Figure 11). At the same time, liabilities as a portion of income had reached nearly 140 percent (Figure 12).

Figure 11

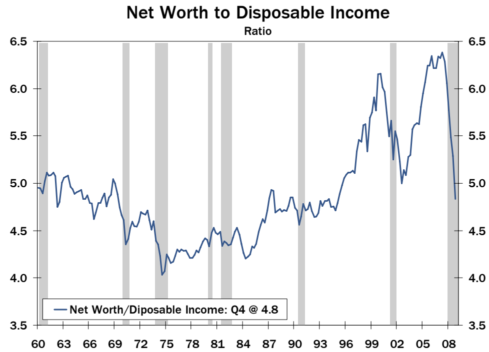
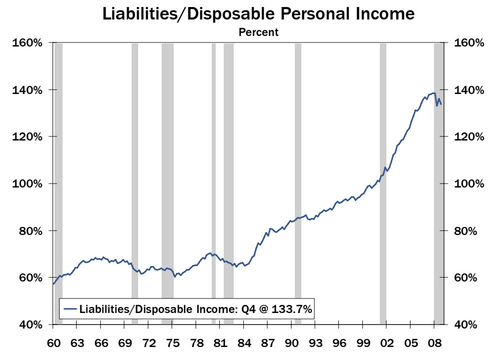


Figure 12



Source: Federal Reserve Board and Wachovia

Conclusions

While the United States will continue to be a society dominated by consumption, we may see a prolonged period of higher saving—at least over the near- or medium-term.

The worst economic downturn in more than a half century has created the biggest impetus for saving in quite some time. Households are attempting to repair balance sheets that have been severely damaged over the past year or two, while at the same time attempting to deal with an extremely challenged labor market. Consumers who have either already lost their jobs and those who are worried about losing them are both cutting back on spending at a rapid pace. While the worst of the outright declines in consumption may be behind us at this point, households may adjust to a new long-term equilibrium that puts a greater emphasis on the need to save until balance sheets are repaired. This should increase the demand over the medium-term for those assets and products that are viewed as more stable and more liquid. Financial firms will also need to adjust to the new reality by providing products that went out of vogue in the booming 1990s and 2000s as household risk tolerance soared. The next few years should see the reemergence of safe and liquid deposit based products. While the United States will continue to be a society dominated by consumption, we may see a prolonged period of higher saving—at least over the near- or medium-term.

Wachovia Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wachovia.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wachovia.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wachovia.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wachovia.com
Sam Bullard	Economist	(704) 383-7372	sam.bullard@wachovia.com
Anika Khan	Economist	(704) 715-0575	anika.khan@wachovia.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wachovia.com
Adam G. York	Economist	(704) 715-9660	adam.york@wachovia.com
Tim Quinlan	Economic Analyst	(704) 374-4407	tim.quinlan@wachovia.com
Kim Whelan	Economic Analyst	(704) 715-8457	kim.whelan@wachovia.com
Yasmine Kamaruddin	Economic Analyst	(704) 374-2992	yasmine.kamaruddin@wachovia.com

WACHOVIA