Debt Deflation in America

What the Jump in the U.S. Savings Rate Really Means

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Happy-face media reporting of economic news is providing the usual upbeat spin on Friday's debt-deflation statistics. The Commerce Department's National Income and Product Accounts (NIPA) for May show that U.S. "savings" are now absorbing 6.9 percent of income.

I put the word "savings" in quotation marks because this 6.9% is not what most people think of as savings. It is not money in the bank to draw out on the "rainy day" when one is laid off as unemployment rates rise. The statistic means that 6.9% of national income is being earmarked to pay down debt – the highest saving rate in 15 years, up from actually negative rates (living on borrowed credit) just a few years ago. The only way in which these savings are "money in the bank" is that they are being paid *by* consumers *to* their banks and credit card companies.

Income paid to reduce debt is not available for spending on goods and services. It therefore shrinks the economy, aggravating the depression. So why is the jump in "saving" good news?

It certainly is a good idea for consumers to get out of debt. But the media are treating this diversion of income as if it were a sign of confidence that the recession may be ending and Mr. Obama's "stimulus" plan working. The *Wall Street Journal* reported that Social Security recipients of one-time government payments "seem unwilling to spend right away," 1 while *The New York Times* wrote that "many people were putting that money away instead of spending it."2 It is as if people can afford to save more.

The reality is that most consumers have little real choice but to pay. Unable to borrow more as banks cut back credit lines, their "choice" is either to pay their mortgage and credit card bill each month, or lose their homes and see their credit ratings slashed, pushing up penalty interest rates near 20%! To avoid this fate, families are shifting to cheaper (and less nutritious) foods, eating out less (or at fast food restaurants), and cutting back vacation spending. It therefore seems contradictory to applaud these "saving" (that is, debt-repayment) statistics as an indication that the economy may emerge from depression in the next few months. While unemployment approaches the 10% rate and new layoffs are being announced every week, isn't the Obama administration taking a big risk in telling voters that its stimulus plan is working? What will people think this winter when markets continue to shrink? How thick is Mr. Obama's Teflon?

We are living in the wreckage of the Greenspan bubble

As recently as two years ago consumers were buying so many goods on credit that the domestic savings rate was zero. (Financing the U.S. Government's budget deficit with foreign central bank recycling of the dollar's balance-of-payments deficit actually produced a *negative* 2% savings rate.) During these Bubble Years savings by the wealthiest 10% of the population found their counterpart in the debt that the bottom 90% were running up. In effect, the wealthy were lending their surplus revenue to an increasingly indebted economy at large.

Today, homeowners no longer can re-finance their mortgages and compensate for their wage squeeze by borrowing against rising prices for their homes. Payback time has arrived – paying back bank loans, whose volume has been augmented to include accrued interest charges and penalties. New bank lending has hit a wall as banks are limiting their activity to raking in amortization and interest on existing mortgages, credit cards and personal loans.

Many families are able to remain financially afloat by running down their savings and cutting back their spending to try and avoid bankruptcy. This diversion of income to pay creditors explains why retail sales figures, auto sales and other commercial statistics are plunging vertically downward in almost a straight line, while unemployment rates soar toward the 10% level. The ability of most people to spend at past rates has hit a wall. The same income cannot be used for two purposes. It cannot be used to pay down debt and also for spending on goods and services. Something must give. So more stores and shopping malls are becoming vacant each month. And unlike homeowners, absentee property investors have little compunction about walking away from negative equity situations – owing creditors more than the property is worth.

Over two-thirds of the U.S. population are homeowners, and real estate economists estimate that about a quarter of U.S. homes are now in a state of negative equity as market prices plunges below the mortgages attached to them. This is the condition in which Citigroup and AIG found themselves last year, along with many other Wall Street institutions. But whereas the government absorbed their losses "to get the economy moving again" (or at least to help Congress's major campaign contributors to recover), personal debtors are in no such favored position. Their designated role is to help make the banks whole by paying off the debts they have been running up in an attempt to maintain living standards that their take-home pay no longer is supporting.

Banks for their part are slashing credit-card debt limits and jacking up interest and penalty charges. (I see little chance that Congress will approve the Consumer Financial Products Agency that Mr. Obama promoted as a flashy balloon for his recent bank giveaway program. The agency is to be dreamed about, not enacted.) The problem is that default rates are rising rapidly. This has prompted many banks to strike deals with their most overstretched customers to settle outstanding balances for as little as half the face amount (much of which is accrued interest and penalties, to be sure). Banks are now competing not to gain customers but to shed them. The plan is to offer steep enough payment discounts to prompt bad risks to settle by sticking rival banks with ultimate default when they finally give up their struggle to maintain solvency. (The idea is that strapped debtors will max out on one bank's card to pay off another bank at half-price.)

The trillions of dollars that the Bush and Obama administration have given away to Wall Street would have been enough to buy a great bulk of the mortgages now in default – mortgages beyond the ability of many debtors to pay in the first place. The government could have enacted a Clean Slate for these debtors – financed by re-introducing progressive taxation, restoring the full capital gains tax to the same rate as that levied on earned income (wages and profits), and closing the tax loopholes that effectively free finance, insurance and real estate (FIRE) sector from income taxation. Instead, the government has made Wall Street virtually tax exempt, and swapped Treasury bonds for trillions of dollars of junk mortgages and bad debts. The "real" economy's growth prospects are being sacrificed in an attempt to carry its financial overhead.

Banks and credit-card companies are girding for economic shrinkage. It was in anticipation of this state of affairs, after all, that they pushed so hard from 1998 onward to make what finally became the 2005 bankruptcy laws so pro-creditor, so cruel to debtors by making personal bankruptcy an economic and legal hell.

It is to avoid this hell that families are cutting their spending so as to keep current on their debts, against all odds that they can avoid default in today's shrinking economy.

Working off debt = "saving," but not in liquid form

People are putting more money away, but not into savings accounts. They are indeed putting it into banks, but in the form of paying down debt. To accountants looking at balance sheets, savings represent the increase in net worth. In times past this was indeed the result mainly of a buildup of liquid funds. But today's money being saved is not available for spending. It merely reduces the debt burden being carried by individuals. Unlike Citibank, AIG and other Wall Street institutions, they are not having their debts conveniently wiped off the books. The government is not nice enough to buy back their investments that had lost up to half their value in the past year. Such bailouts are for creditors and money managers, not their debtors.

The story that the media should be telling is how today's post-bubble economy has turned the concept of saving on its head. The accounting concept underlying balance sheets is that a negation of a negation is positive. Paying down debt liabilities is counted as "saving" because one owes less.

This is not what people expected a half-century ago. Economists wrote about how technology would raise productivity levels, people would be living in near utopian conditions by the time the year 2000 arrived. They expected a life of leisure and prosperity. Needless to say, this is far from materializing. The textbooks need to be rewritten – and in fact, are being rewritten.3

Keynesian economics turned inside-out

Most individuals and companies emerged from World War II in 1945 nearly debt-free, and with progressive income taxes. Economists anticipated – indeed, even feared – that rising incomes would lead to higher saving rates. The most influential view was that of John Maynard Keynes. Addressing the problems of the Great Depression in 1936, his *General Theory of Employment, Interest, and Money* warned that people would save relatively more as their incomes rose. Spending on consumer goods would tail off, slowing the growth of markets, and hence new investment and employment.

This view of the saving function – the propensity to save out of wages and profits –viewed saving as breaking the circular flow of payments between producers and consumers. The main cloud on the horizon, Keynesians worried, was that people would be so prosperous that they would not spend their money. The indicated policy to deter under-consumption was for economies to indulge in more leisure and more equitable income distribution.

The modern dynamics of saving – and the increasingly top-heavy indebtedness in which savings are invested – are quite different from (and worse than) what Keynes explained. Most financial savings are lent out, not plowed into tangible capital formation and industry. Most new investment in tangible capital goods and buildings comes from retained business earnings, not from savings that pass through financial intermediaries. Under these conditions, higher personal saving rates are reflected in higher indebtedness. That is why the saving rate has fallen to a zero or "wash" level. A rising proportion of savings find their counterpart more in other peoples' debts rather than being used to finance new direct investment.

Each business recovery since World War II has started with a higher debt ratio. Saving is indeed interfering with consumption, but it is not the result of rising incomes and prosperity. A rising savings rate merely reflects the degree to which the economy is working off its debt overhead. It is "saving" in the form of debt repayment in a shrinking economy. The result is financial dystopia, not the technological utopia that seemed so attainable back in 1945, just sixty-five years ago. Instead of a consumer-friendly leisure economy, we have debt peonage.

To get an idea of how oppressive the debt burden really is, I should note that the 6.9% savings rate does not even reflect the 16% of the economy that the NIPA report for interest payments to carry this debt, or the penalty fees that now yield as much as interest yields to credit-card companies – or the trillions of dollars of government bailouts to try and keep this unsustainable system afloat. How an economy can hope to compete in global markets as an industrial producer with so high a financial overhead factored into the cost of living and doing business must remain for a future article to address.

Notes

1 Kelly Evans, "Americans Save More, Amid Rising Confidence," *Wall Street Journal*, June 27, 2009.

2 Jack Healy, "As Incomes Rebound, Saving Hits Highest Rate in 15 Years," *The New York Times*, June 27, 2009.

3 Four years ago at a post-Keynesian "heterodox economics" conference at the University of Missouri at Kansas City (on whose faculty I have been for some years now), I outlined the shift from over-saving to debt deflation. Michael Hudson, "Saving, Asset-Price Inflation, and Debt-Induced Deflation," in L. Randall Wray and Matthew Forstater, eds., *Money, Financial Instability and Stabilization Policy* (Edward Elgar, 2006):104-24.

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