It's time to 'shift to thrift'

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Economic policy choices these days are fraught with risks because of deep contradictions between near-term efforts to mitigate the recession and the medium-term goal of stable growth.

The Economist magazine argued last week that: “A rapid, global, private sector shift to thrift is exactly what the world economy does not need.” Yet, “it ought to be good news in the long term.”

Last week, governments were loading up fiscal stimulus to support consumer spending, while central banks were driving the cost of money down to zero to overcome the credit freeze. These low rates will not foster the increase in personal saving that is essential to get the North American economy back on a course of stable growth.

As one friend complained last week, “Isn't there a better way to get out of this mess than to promote the spending mania that caused the problem in the first place?”

A recovery in consumer spending will have to wait until Canadians pay down the excess credit card and mortgage debt accumulated in the past decade. Total personal debt nearly doubled between 2002 and the first half of 2008, when it stood at $1.2-trillion. The ratio of debt to disposable income rose from 98 per cent to 130 per cent over that period, while interest payments as a share of available income were virtually unchanged.

Canadians were besieged with advertising messages that promoted borrowing over those years. With credit so cheap and housing prices surging ahead, households took on a lot of risk. Now debt burdens look much too high.

We can take some comfort from the fact that the loans outstanding here are nowhere near as risky as mortgages in the United States. According to the Canadian Housing Observer, Canada has “a negligible subprime mortgage sector; [and] it is characterized by prudent underwriting.” And in Canada, mortgage insurance to protect the lender is mandatory for high-ratio loans.

But there is no insurance to protect the borrower when housing values decline or when someone in the family loses their job. If you ask people living in homeless shelters what sent them on a downward spiral, the common theme is a combination of losing their job, being unable to work because of injury or illness, and then losing their home.

This is a terrible price to pay for doing what was advertised as the smart thing to do.

How then might we foster a thriftier society on the other side of this recession? Over the past two decades, personal savings have declined from about 10 per cent of disposable income to the 2- to 3-per cent range, so we have a long road ahead.

The severe economic shock of 2008 is bound to change human behaviour. In coming years, people will be more risk averse. They will be more reluctant to borrow, more willing to save, and less likely to chase high-risk chances for higher yields. Once people have reduced their debts, expect savings rates to rise – if the incentives are right.

Getting the incentives right calls for prudent policy choices.

The first requirement is to set interest rates so savers can earn a decent rate of return in their savings accounts or in mutual funds, stocks or bonds. While there will be much pressure on governments to get the economy growing again, there is an important tradeoff. In the short run, greater saving will slow the pace of the recovery, even as it provides the investment capital needed for longer-term growth.

Looking back on the past decade, it is clear that the Federal Reserve Board was obsessed with sustaining growth at all costs. This gave the wrong signal to households, but the tipping point for the financial crisis was the bad quality of U.S. mortgage debt.

The second is to ensure the tax system fosters saving. One of the original purposes of Canada's GST was to shift the tax burden from income and savings to consumption. By cutting the GST from 7 per cent to 5 per cent, the Conservatives have so far encouraged spending rather than saving.

Now the government is planning to introduce a pro-saving idea. Their conversion came just in time. Beginning in 2009, the new tax-free savings accounts will enable Canadians to accumulate investment earnings free of tax, although the contributions will not be deductible for tax purposes. Looking across the industrial world, the fiscal and monetary measures announced by governments so far have been ad hoc – with a focus on getting financial markets functioning well enough to support economic activity.

But at some stage, policy makers have to address my friend's question about promoting shopping mania. Canadians reached consensus on appropriate levels for public debt in the 1990s and that stood us in good stead.

What we need now is agreed benchmarks for household debt and personal savings, and then the political will to implement policies to achieve them.

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