

# Message from the President

For many Americans, 2007 was a difficult year. Housing markets were considerably weaker than most economists expected at the beginning of the year. Residential construction and home prices declined steadily, and the resulting erosion in home equity contributed to rising delinquencies and foreclosures, particularly on more recent mortgage vintages. Financial markets were



rattled as losses mounted on securities backed by pools of home mortgages. The loss of housing-related jobs dragged down overall employment growth in the second half of the year. Real household income gains moderated, held down as well by rising food and energy prices. Consumer spending held up fairly well through the year, but then flattened out in the last few months.

Inflation was disappointing as well last year. The price index for personal consumption expenditures rose by 3.6 percent during 2007, compared to 2.3 percent the year before. Rapid increases in food and energy prices were the obvious culprits, but that provides little comfort to this central banker. The Federal Reserve is responsible for keeping *total* inflation low and stable—including food and energy prices. While the effects of unexpected commodity price increases are difficult to offset rapidly, an appropriate monetary policy would ensure that such shocks even out over time and do not impart

a persistent inflation bias—either up or down.

Amid all the talk of a near-term downturn, it's important not to lose sight of the long-term economic challenges we will face when growth resumes, as it inevitably will. For example, the movement of the baby boomers into retirement raises a host of complex, inter-related issues. Historically, Social Security and Medicare have served as important backstops

average across the entire population. The aggregate saving rate doesn't tell us much about the saving habits of individual U.S. households. Nor does it fully capture changes in the financial assets that families commonly count among their wealth holdings, such as housing equity, pensions, and their expected Social Security benefits. To worry about saving behavior based solely on the drop in

for retirees. But the solvency of these programs is threatened, and fixing them will require either reduced benefits, or increased taxes or debt. Meanwhile, many of today's workers no longer can count on defined-benefit pensions to provide annuities that they can't outlive. Instead, they are learning to finance their own retirement eggs with defined-contribution pensions, most commonly 401(k) plans. And though we have evidence that most Americans are saving reasonably well given their incomes, we also know that some people aren't. Financial literacy programs can help in this regard, but with limits.

We address these issues in this year's Annual Report essay. Our main intent is to explain what the data tell us about Americans' saving habits, and what that may portend as the population ages. It is true that the personal saving rate in the United States has declined to historical lows, even dropping into negative territory during 2005. But that measure of personal savings is an

the saving rate would be a mistake.

The economics of how households allocate spending over their life cycle is instructive in this discussion. People tend to smooth their consumption throughout their lifetimes based on how much they expect to earn. To look at a young worker's assets, one might get the impression that his savings are inadequate. But it's natural for young people to borrow in their early working years. Many are anticipating making more money as they get older. In middle age, the peak earning years, people save at a more rapid rate to accumulate assets to draw on in retirement. This life-cycle theory of consumption and saving behavior has held up quite well in studies that match it against the data.

Through the lens of life-cycle theory, one way to think about savings is how well households are saving given their present and expected income levels. An optimal savings pattern would provide a household with a stream of retirement spending that is close



to pre-retirement spending when adjusted for work-related expenses. Careful research reveals two important things. First, most households nearing retirement appear to have saved reasonably well; the wealth that they can draw on is enough to provide them with a smooth spending transition upon retirement. Second, the largest concentration of “undersavers” is at the bottom tail of the income distribution. In other words, poor people are most likely to also not be saving enough to provide for adequate consumption spending in retirement. This suggests that our approach to “undersaving” problems should best be thought of as part of a broader approach to problems associated with poverty.

These estimates of the adequacy of retirement savings depend critically on the assumption that Social Security and Medicare benefits remain at their current statutory levels. The aging of the baby boom generation challenges those assumptions, because it means a larger share of old people in the population and a smaller share of young. Add to that the fact that Americans are living longer and having fewer children.

With most baby boomers still in the labor force at present, we have five working-age adults for every person aged 65 and above. Twenty years from now, there will be three working-age adults for every elderly person. This means that our economy will produce fewer goods and services, per person, than it would if these demographic shifts did not occur. There will be a relatively smaller consumption pie, resulting in smaller consumption possibilities per person than would otherwise be possible.

This perspective is the key to understand-

ing the pros and cons of various proposals to “fix” the federal retirement benefit programs. The projected insolvency of the Social Security and Medicare funds implies an additional burden for some segment of the population. Cutting benefits when the funds are depleted would reduce the consumption of the generation now retiring. Raising taxes would reduce the consumption of the next working-age generation. Issuing debt would likely mean higher taxes and reduced consumption for the generations beyond today’s young. Whether we raise taxes, cut benefits, or issue debt to cover future deficits, someone will need to consume less than they otherwise would.

Reasonable people can disagree about which solution to our federal retirement problems is best. By itself, economics has little to say about the advisability, as opposed to the costs, of redistributing resources among different population segments and different generations, and we make no recommendations here. But economists are unanimous that the sooner we settle on a solution and begin preparing for it, the better off we are likely to be. The more lead time people have to adjust their retirement saving plans, the more they will be able to smooth the adjustment costs over their lifetime.

Long after the current slowdown has past, the fundamental macroeconomic problems surrounding retirement savings will remain. We hope our essay helps you think it through.



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President