

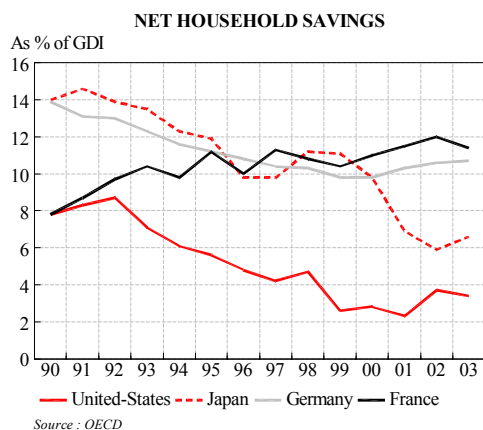
JAPAN'S FALLING SAVINGS RATE OR HOW SAVERS BECOME SPENDERS

Something remarkable has been happening in Japan: the country's traditionally high household savings rate has been in sharp decline since the early 1990s despite the particularly morose economic environment (rising unemployment, falling income, deflation, etc.).

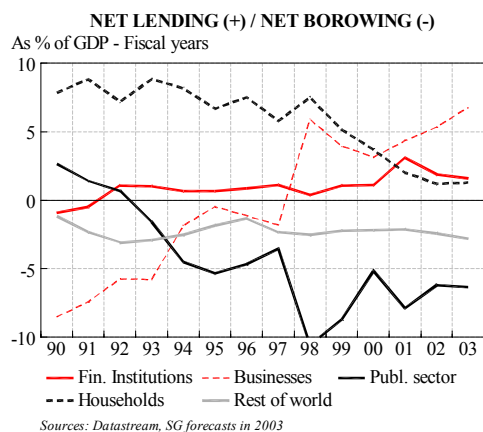
Why have Japanese households altered their savings behaviour? Changes in their financial behaviour may provide the answer. The household net acquisition of financial asset as a percentage of growth disposable income has fallen sharply, much more so than the debt-to-income ratio, although this too has fallen considerably. Various effects have played a part, notably demographics. Above all, however, it seems that consumers have been fully aware of the durability of disinflation and deflation as well as the low nominal returns on their savings.

A sharp decline in the household savings rate

Savings rates have varied widely across OECD countries since the beginning of the 1990s as the chart below illustrates¹. A marked drop in the savings rate has been observed in Japan, particularly since 2000. In principle, this trend is surprising, observers having long referred to the constitution of precautionary savings as a result of the "lost decade" marked by a deterioration in the labour market, by the end to "jobs-for-life" and, ultimately, by deflation (why spend today when products will be cheaper tomorrow?).



As housing investment fell sharply over the period - from 8-9% of gross household income in the early 1990s to 6-6.5% at the beginning of the 2000s - the drop in the savings ratio is moderately offset by financial savings. This can be seen in the household net lending ratio as shown in the Flow of funds statistics.

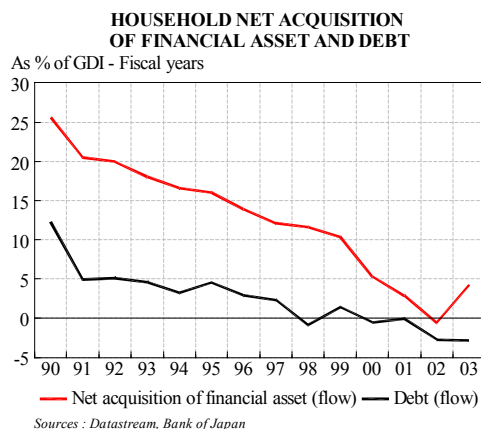


¹ In this case "household savings" refers to the household savings rate net of economic depreciation (capital consumption in national accounting terminology). For example, in the case of France, the net household savings rate comes out at 11.4% of net disposable income in 2003. This level is compatible with a gross savings rate of 16.4% of gross disposable income, which is the standard indicator. Note, also, the atypical movement of France's saving rate, which has risen almost continuously and was particularly high at the end of the period.

The net lending / net borrowing of Japanese economic agents have undergone vast changes since the early 1990s, whereas the nation's net lending as a ratio of GDP have been relatively constant: huge improvement for firms and a strong improvement for financial institutions and a marked deterioration for the government and households. They also reflect the deleveraging undertaken by the business sector -which is now well underway-, and the disposal of non-performing loans by banks. However, Ricardian equivalence does not seem to have come into play and the Japanese have not taken on board the fact that eventually they, or their children, will have to shoulder the burden of reducing the public deficit.

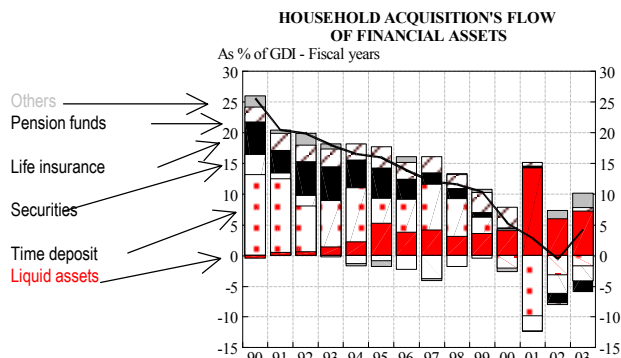
Net acquisition of financial asset is falling much faster than debt

The reduction of household net lending could be explained by the fact that the net acquisition of financial asset as a percentage of GDI is falling extremely fast and at a far quicker pace than the debt-to-income ratio.



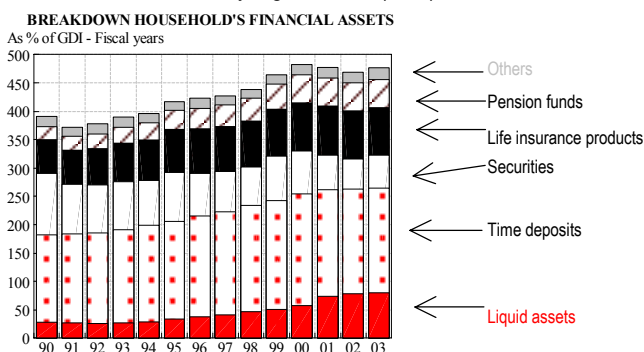
Since the financial and property bubbles burst, Japanese households have reduced their reliance on debt and even started to trim borrowings from 2000 onwards. To a large extent, this trend reflects a decrease in housing investment amid falling property prices (which are now back to early 1980 levels), and extremely low nominal interest rates. Since 2001 and the dismantling of FLIP (Fiscal Loan and Investment Program), the market share of housing loans held by the Housing Loan Corporation (a government bank associated with the system) fell sharply in favour of private financial institutions.

Household net acquisition of financial asset behaviour has undergone a profound transformation. Not only have net acquisition of financial asset slumped, but the structure of investment has also altered significantly. More and more, households tend to prefer short-term, liquid and risk-free assets. Acquisition of life insurance, pension fund and securities products dried up and even turned negative in fiscal years 2002 and 2003.



Time deposits have decreased in favour of liquid assets (coins and notes, sight deposits), and substantial withdrawals have been observed since 2000. The fall in interest rates means that the opportunity cost attached to holding cash is very low, hence the switch to cash accelerated from 2000/2001 ahead of the implementation of the Pay-off system² in April 2002. That said, the substitution phenomenon has abated since the government postponed the removal of the guarantee on all time deposits until 2005. On the whole, however, the assets collected by banks are increasingly liquid, which is heightening transformation risk.

This trend is reflected in the inevitably inert structure of household assets. The share of deposits and cash in household financial assets, which was already high in 1990 (45%), now stands at 55%.



The impact of deflation and lower nominal returns on savings: the Pigou effect at work

How is the drop in the household net acquisition of financial asset as a percentage of the GDI best explained? First of all, it is worth noting that, while the financial savings of Japanese households are considerable, they include very little securities investment. The contrast with the United States is considerable. In other words, the financial wealth of Japanese households is fairly immune to valuation effects, which are in fact absorbed by the financial institutions via their securities portfolios.

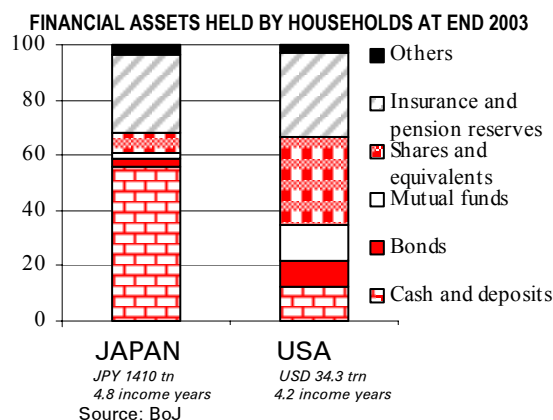
The drop in the savings rate seems to be the result of a number of factors³. The ageing population is one, particularly as the number of pensioners liquidating their savings is increasing (in keeping with the life-cycle theory). Another factor is the high level of spending among

² The Pay off system aims to put an end to unlimited guarantees on deposits set in place to prevent a run on bank deposits. Since early April 2002, the unlimited guarantees on term deposits of more than JPY 10 million have been revoked as planned. However, in September 2002, the removal of the guarantee for other deposits, which was supposed to take place on 1st April 2003, was postponed until 2005 because of the risks to banks, which were still fragile at the time. In addition, this measure will only apply to term deposits of less than JPY 10 million. Current deposits will remain fully guaranteed.

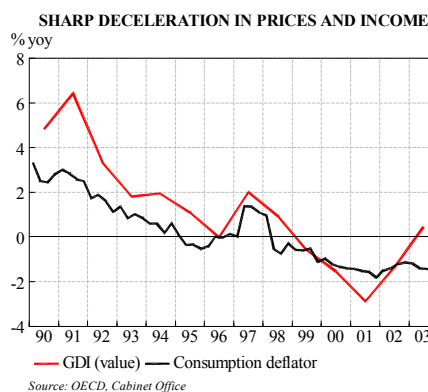
³ See Will Private Consumption Maintain Its Firmness? BoJ Research Division, March 2003.

the 20-29-age bracket, particularly on high tech products and with the aid of intergenerational transfers.

Finally, the slowdown and decline of purchasing power up to 2002 probably led Japanese consumers to scale back their financial asset acquisition and turn to credit in order to maintain their consumption level in keeping with the permanent income theory.



However, the key factor to consider is disinflation followed by deflation and combined with the drop in interest rates that led to the "zero rate" policy. Lower nominal returns have had a significant impact on income. For example, interest income fell from 3.5% of gross disposable income to less than 0.5% in 2002. At the same time, however, the "real balance effect" (or Pigou effect) has doubtless also influenced behaviour: why bother adding to savings that are not being devalued by inflation (and which are in fact increasing in value during deflation)? Apparently, households have been well aware of this phenomenon from 2000 onwards, when deflation became obvious and entrenched.



Despite the drop in the net acquisition of financial asset as a percentage of GDI, the net financial wealth of households has been stable at around 3.5 years of disposable income since 2000. This ratio may be close the appropriate long-term objective for an aging population.

