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The role of savings in the economy

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Savings play an important role in any economy and its role is important at different levels.

To understand the role of savings one must consider who all the savers are and how it can affect the overall performance of the economy.

- **Who saves and why?**

Savings are done by three 'entities' in the economy: households, companies and government.

Households save essentially for two reasons: to cover future expenses (children's education, buying big-ticket durable goods, eg a car) and for retirement.

Company savings are simply that part of their profits that they do not pay out to shareholders as dividends, but retain it to finance future investment in the business (expansion of existing facilities and the replacement of outdated equipment).

Government saves when its tax revenues exceed its expenditures on recurring items (such as wages, social security payments, fuel, schoolbooks, medical supplies for hospitals, etc). If its tax revenues exceed these current expenses, it has money left to spend on the building of new roads, bridges, hospitals, schools, etc.

- **Implications to each entity, and to all of us combined, of not saving enough**

If *households* fail to save sufficiently to cover future expenses, the outcome is very simple: they will not have sufficient funds to cover planned future big expenses and/or they will struggle financially during retirement. They will eventually become dependent on others or the government. This is unfortunately a very common occurrence in South Africa.

If *companies* do not, or can not, save sufficiently, they will not have the capital available to finance replacement or expansionary investment. This will put a dampener on the company's efficiency and growth potential, as well as its ability to employ more people.

If *government* does not save, it simply means it will have no money available for fixed investment in social infrastructure (schools, hospitals, low cost housing, etc) or physical infrastructure (roads, bridges, harbours, airports, etc). The implications of underinvestment in people and infrastructure are easy to understand and need no further explanation.

What happens in practice, of course, is that entities in need of capital (eg businesses or government) will access available savings (from households or other companies saving for future investment) through financial intermediaries (banks, capital market) by borrowing or issuing paper to investors. *The trouble starts if we as a nation do not save enough to meet the country's financing (and therefore investment) needs.*

If we save too little, the answer is simple: for households it will mean that they will eventually struggle financially and for the broader economy it will mean that there will be insufficient funds available to finance investment in physical and social infrastructure. *Any student of economics will very quickly tell you that insufficient investment in an economy also means sub-optimal economic growth, sub-optimal job creation and inferior overall living standards relative to nations with a better savings performance.* Indeed, South Africa today suffers from decades of underinvestment in social and physical capital.

To make matters worse, these three entities' respective savings behaviour is not independent of each other. On the contrary, they are closely interlinked. For example, low saving households will eventually increase the burden on government to provide social services, limiting government's ability to rather spend money on social and physical infrastructure (ports, roads, bridges, schools, hospitals, etc). Government could, of course, raise taxes to generate additional revenue to cover the additional social expenditure, but this will further limit households' ability to save and spend, and, if the additional tax burden falls on companies, it will reduce their profitability and limit their ability and willingness to invest (as overall demand prospects worsen owing to the higher tax burden).

So, there is unfortunately no easy answer other than South Africans at all levels need to develop a much stronger culture of savings. This goes for all three entities: households, companies and government.

- **What about capital inflows from abroad?**

Relying on the savings of foreigners in the form of capital inflows can provide us with a limited solution, but the key word is limited. We have indeed enjoyed strong capital inflows over the past decade or so and it has played a key role in providing capital for much required investment in the economy.

However, we can not indefinitely rely on a large volume of foreign capital as a key source of financing local investment. Foreign investors tend to be fickle and any bit of bad news or concern over the health of the economy or worries about future policy direction can result in a sudden withdrawal of these funds. This typically causes a currency slump, higher inflation, higher interest rates and an economic downturn. What typically suffers the most in such an outcome is new investment and employment – the two things we can least afford.

- **SA simply has to save more**

Over the very long term the only real solution to our capital needs is to provide it ourselves through a higher level of savings.

Indeed, experience elsewhere around the world, especially in Asia, has shown that high savings rates typically tend to be associated with higher economic growth and employment and less cyclical economic volatility.

It is, however, also important to note that while sufficient savings is a prerequisite for higher economic growth over time, it is not a sufficient condition, i.e. high savings ratios alone do not guarantee higher economic growth. All the other conditions for healthy growth must also be in place, including business friendly economic policies, political stability, rule of law and property rights. On the other hand, even if the latter are all in place, a dearth of domestic savings may yet seriously strain the growth potential of the economy. This, unfortunately, is where SA finds itself today.

- **A word on households**

South African households save way too little. Most assume their pension funds will provide sufficient retirement capital, but few ever bother to check whether this is true. In an environment where many South African employees are nowadays on defined contribution pension funds, the onus is entirely on them to ensure that they will one day have sufficient capital to be able to retire comfortably.

Unfortunately many discover far too late that they are underprovided and they then find themselves having to work way past normal retirement age or they eventually struggle badly during their supposed 'golden years' or, in a worst case, become dependent on others for survival.

* Here are a few simple, but vital, pieces of advice:

- Make sure you *fully* understand your future financial needs (including your pension provisions)
- Start saving early – time is your best friend
- Beware of ‘quick-rich’ schemes as much money has been lost on these over the years – if it sounds too good to be true, it most likely is
- Entrust your money to reliable financial institutions with proven track records

The recent global panic around huge and growing government debt levels around the world has, in effect, highlighted the need for individuals to save more. With many governments around the world needing to focus heavily on reducing their budget shortfalls and containing their outstanding debt levels, an early casualty of fiscal tightening has been social security cutbacks (cutting pension benefits, raising retirement age, etc). With government budgets under heavy pressure, people worldwide will have to accept that governments will not be able to lend much support during their retirement years. People will have to care for themselves and this will likely require much higher savings during their working years. South Africa, while less constrained fiscally, will be no different.

- **So, how much should we save?**

This is a very common question with a not-so-easy answer as the answer is dependent on a number of factors.

The factors that need to be considered when determining how much a household must save will depend on the length of time over which savings will be made (the longer the better), the expected investment returns before and during retirement (the higher the better) and the ‘targeted amount’ of capital that will be needed to retire comfortably.

While the answers differ widely using different assumptions, the only conclusion one can draw with available information is that most South Africans save way too little and most probably do not even realise this.

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