



The Northern Trust Company
Economic Research Department
Positive Economic Commentary

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October 22, 2004

Wealth Illusion

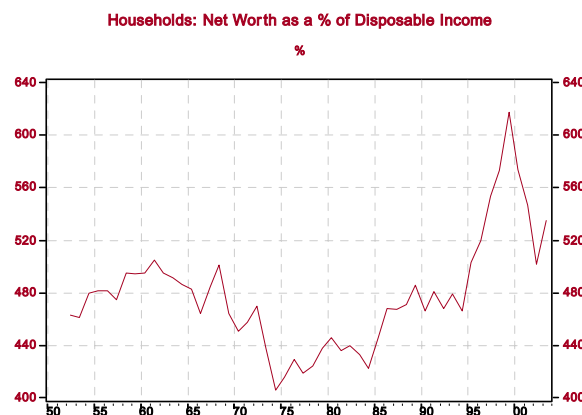
The rise in household net worth in recent years has largely resulted from inflating prices of corporate equities in the late 1990s, and residential real estate in the past four years. But this rise in household wealth is illusory. The true measure of an increase in the wealth of a nation is the growth in its capital stock. In recent years, growth in our capital stock has slowed and the composition of the slower growth has moved in favor of McMansions and SUVs, which do little to increase the productive capacity of our economy.

In his remarks about household indebtedness to a community bankers convention on October 19, Fed Chairman Greenspan was in his usual Panglossian mood – not to worry. What especially caught my eye was the following sentence in his prepared text:

Despite the recent high debt-to-income ratios, at least some of which is more statistical than real, the ratio of households' net worth to income has risen to a multiple of more than five after hovering around four and one-half for most of the postwar period.

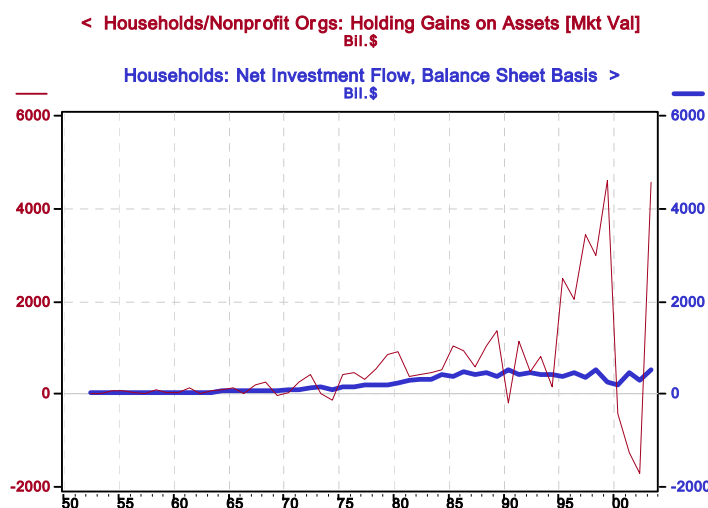
Chart 1 is a graphical representation of the net worth/disposable personal income ratio to which Greenspan referred. And, indeed, since the mid 1990s, there appears to be a "new era" for the ratio of household net worth relative to after-tax income – a new era even after the end of the new era in U.S. equities.

Chart 1



But let's examine how this elevated ratio of household net worth came about. There are two ways that a household can increase its net worth – by spending less than its after-tax income, otherwise known as saving, or through an increase in the value of its assets acquired through *past* saving. Saving in this context is defined as the net acquisition of financial assets (i.e., stocks, bonds, deposits) and tangible assets (real estate, consumer durables) less borrowing. Chart 2 shows the behavior of these means of increasing – or *decreasing* -- household net worth from 1952 through 2003. **Starting in the mid 1990s, holding gains on assets as an influence on changes in household net worth began to outstrip saving (or net investment) by a wide margin.** From 1995 through 1999, the run-up in the value of corporate equities was the principal driver of household net worth. In the past couple of years, increases in real estate values have played a big role in accounting for increases in net worth. From 1952 through 1994, holding gains were, on average, 1.7 times as big as household net investment. From 1995 through 2003, holding gains averaged 4.4 times household investment, or saving.

Chart 2

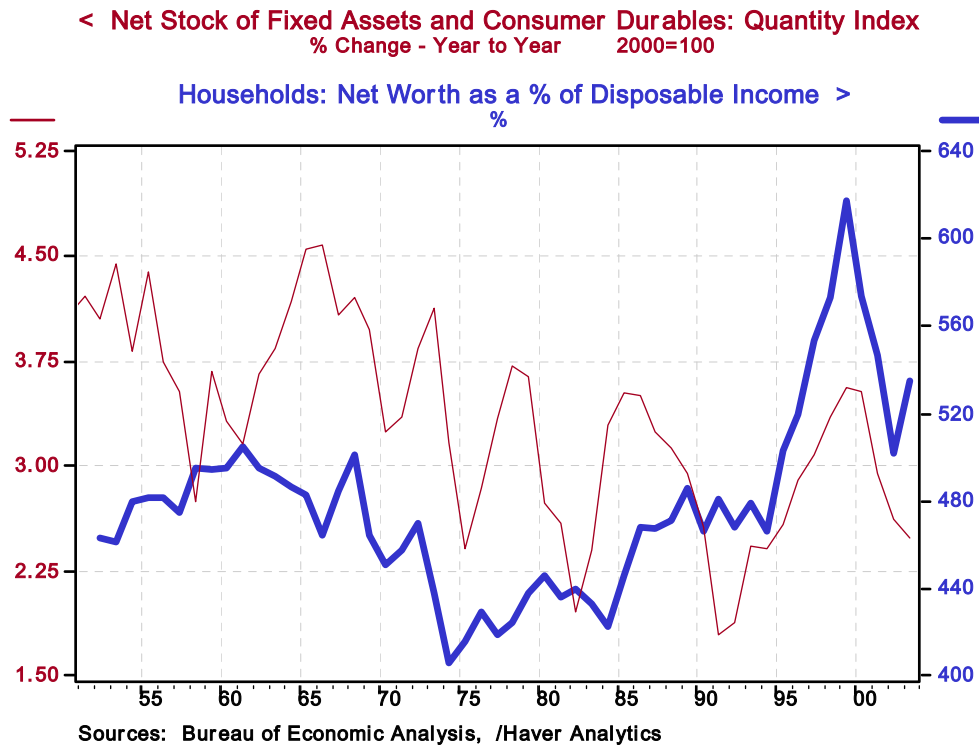


Just because an existing house goes up in value does not necessarily mean that the more expensive house “produces” more actual housing *services*. Does a rise in the price of the house enable more people to live in it? Does the increase in the price of an existing drill press necessarily mean that the drill press is now capable of drilling more holes in an hour? The *economic* wealth of a nation is related to an increase in the *number* of drill presses, not the nominal value of the existing stock of drill presses. The more drill presses an economy has, the more holes can be drilled in the production of other goods. The greater the capital stock of an economy, the more productive is its labor force to be. In short, the greater the capital stock of an economy, the more goods and services that economy is likely to be able to produce.

Let's look at what has been happening to the total capital stock – drill presses, houses, SUVs, B-2 bombers – of America in recent years and the behavior of some of the components of that capital stock. Chart 3 shows the year-over-year percent change in the nation's real, or price-adjusted, capital stock along with the ratio of household net worth to after-tax income. The surge in household net worth resulting from the surge in stock market holding gains in the late 1990s was accompanied by faster growth in the nation's real

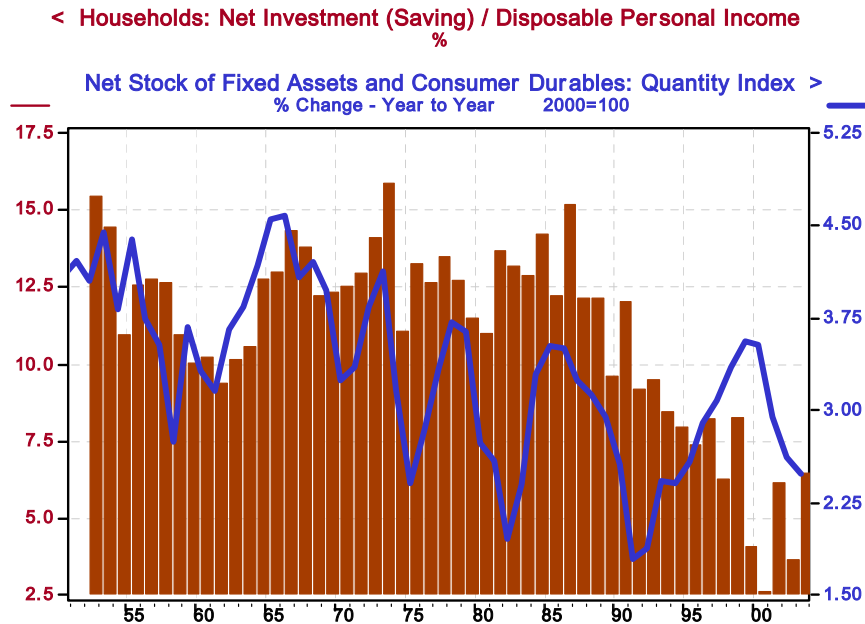
capital stock. But notice that this faster growth in the capital stock was no more than what occurred in the first half of the 1980s and was actually less than what occurred in prior cycles of accelerating capital stock growth. Moreover, prior periods of faster capital stock growth were accompanied by much more subdued growth in household net worth relative to after-tax income. But these prior periods of stronger capital stock growth were accompanied by much slower growth in household net worth relative to after-tax income.

Chart 3



In these prior periods of stronger growth in the capital stock and weaker growth in household net worth relative to after-tax income, the composition of the increases in net worth was more skewed toward net household investment (saving) than holding period gains, as implied in Chart 2. Another way to illustrate this point is to directly compare household net investment to after-tax income. This is what is shown in Chart 4 along with the year-to-year growth in the nation's capital stock. **So, the composition of increases in household net worth may be more important in determining growth in the capital stock than the increase in household net worth itself.** *All else the same*, the more net investment (saving) households do, the faster the growth in the capital stock. In the late 1990s, of course, all else was *not* the same. This was a time of tremendous foreign *direct* investment in the U.S., which augmented weak saving on the part of households. This is why growth in the capital stock in the late 1990s, although not a record setter, would have been much slower.

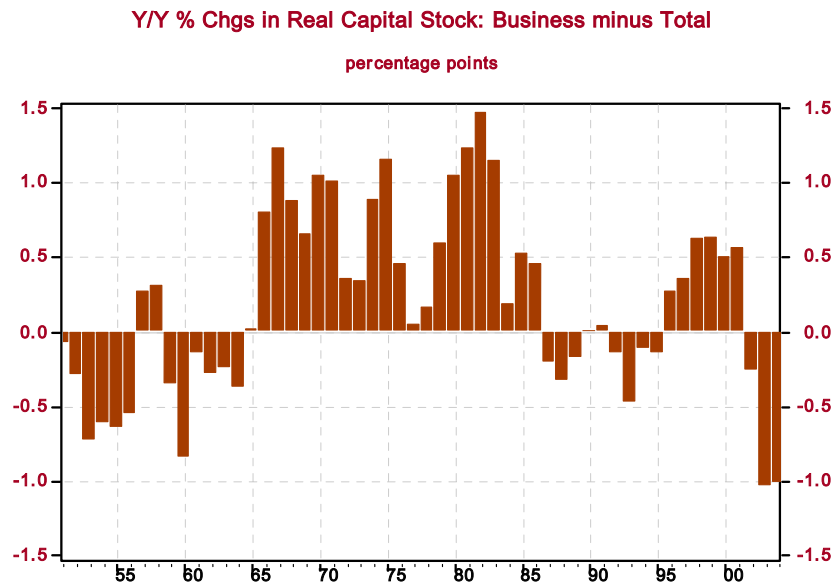
Chart 4



Now, just as the composition of increases in household net worth has implications about an economy's true wealth, so does the composition of its capital stock. That is, some forms of capital imply faster future economic growth than others. For example, housing is part of the capital stock. But does a physically bigger house (more square footage) with granite kitchen countertops enable the occupants to produce more widgets? Does massive SUV driven by the suburban soccer mom make her or anyone else to produce more widgets? Bigger houses and bigger household vehicles add to the nation's capital stock. But I would submit to you that increases in business equipment and business structures are more reflective of a nation's wealth than increases in consumer durables and houses.

So, let's see how the composition of the capital stock has been behaving since the mid 1990s, a period when household net worth has been elevated relative to after-tax income. **As a guide to the following discussion: Capital stock is a sum of business capital spending including structures, private residential housing, consumer durables, and government assets.** Chart 5 shows the difference between the year-over-year percent changes in the real capital stock of businesses vs. the total capital stock. If the difference is positive, then the business capital stock is becoming a greater share of the total capital stock. A negative difference means that the business capital stock is becoming a smaller share of the total capital stock. Chart 5 shows that although the share of the business capital stock to the total was rising in the second half of the 1990s, the rise trailed that of previous periods. Moreover, starting in 2001, the business capital stock started losing share and in 2002/2003 it was losing share at the fastest pace since the early 1950s.

Chart 5



If the share of the business capital stock is falling relative to the total since the stock market and business investment bust of 2000, what shares are rising? You guessed it. As shown in Charts 6 and 7, McMansions and SUVs are gaining as a share of the total capital stock.

Chart 6

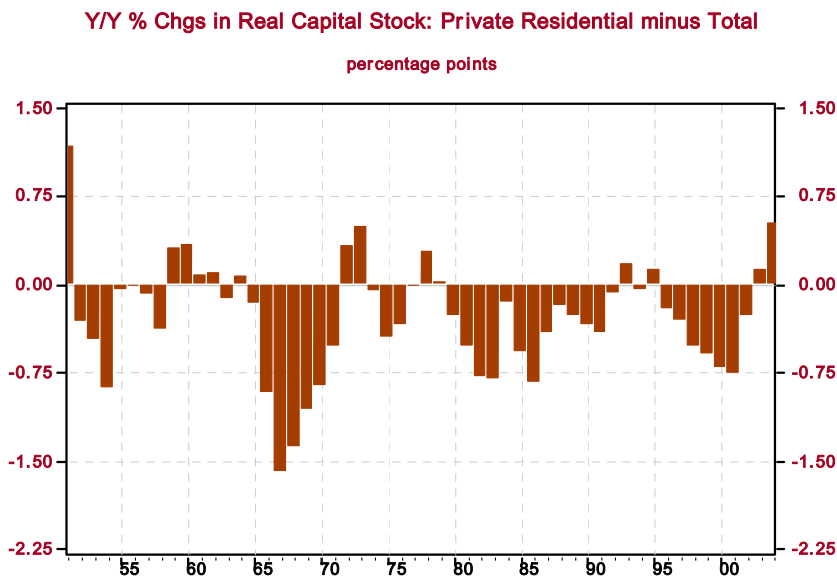
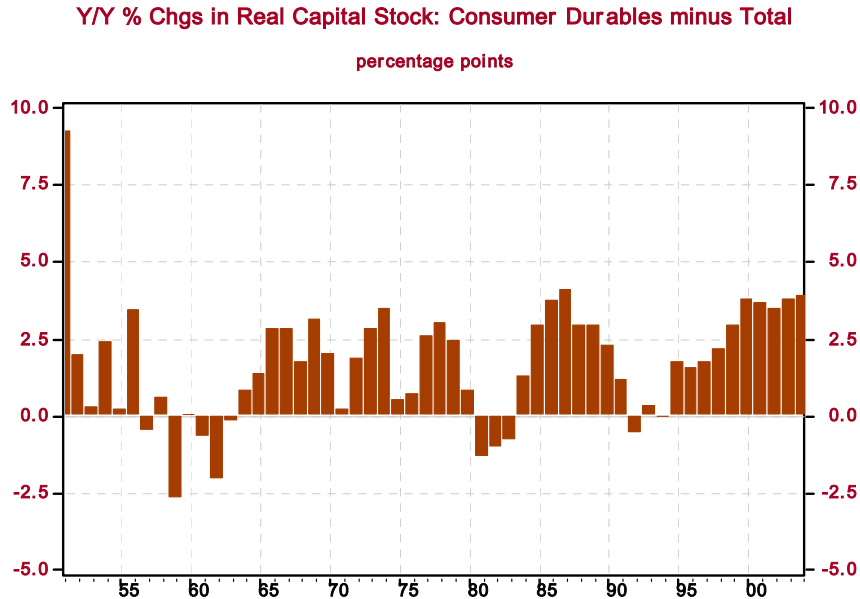


Chart 7



So, in the past four years, not only has the growth in the nation's capital stock slowed, but the growth in the truly productive part of that capital stock -- the business capital stock -- has slowed even more. Fed Chairman Greenspan can crow about the continued rise in household net worth as percent of after-tax income if he wants. And, indeed, he has helped bring about an increase in household net worth through his easy money policies, first inflating the value of corporate equities, and then the value of residential real estate. But his measure of wealth is illusory. The growth in the true wealth of this nation is slowing, Chairman Greenspan, despite your best efforts to "paper" over it.

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