THE MINIMAX REVIEW

POINT COUNTERPOINTS

Volume 1 **January 1, 2007** **Number 1**

INTERPRETING THE RECENT ECONOMIC SLOWDOWN
– The Housing "Wealth Effect" and Personal Savings Rate Conundra –

By H.W. Brock, Editor-in-Chief

Both our spring and summer forecasts for GDP growth were below consensus for later 2006 and 2007, and did so for precisely the reasons that became clear when GDP growth came in at a lower-than-expected 1.6% rate. [Adjusting for phantom auto production, GDP growth was in fact about 1%.] What has in fact been happening to the US economy? And what is likely to happen next?

Today's Drivers of the Economy: In most regards, the US economy is in good shape. It is the housing market that merits attention—particularly because the *way* in which the deceleration of house prices will impact the economy has no historical counterpart given structural changes in the way in which Americans now save, spend, and borrow.

There are two "transmission channels" by which the housing market has impacted and will continue to impact Main Street. *First,* there is residential investment spending whereby a reduced level of housing starts depresses GDP growth. *Second,* there is the "consumption wealth effect" whereby a flattening off or drop in house prices allegedly depresses household spending. Let us consider the impact of each.

Residential Investment: This declined by an arresting 17% during the third quarter, the largest decline in more than 15 years. This drop alone depressed GDP by about 1.1%. This should not have been surprising given months of statistics about the drop in production and prices by homebuilders. The good news is that this hit to residential starts should be over by March 2007. Once the *level* of starts has bottomed out (at slightly below today's level of starts), residential investment spending will no longer adversely impact GDP growth.

Wealth Effects and the Role of Home Equity Loans: The wealth effect operates with a significant lag, and will primarily impact the economy in 2007 and 2008, unlike the case of residential investment spending. This is *not* a consensus view about the wealth effect, and frankly, much of what is written about this topic is problematic. The principal purpose of this Client Memo is to shed light upon this admittedly difficult and confusing issue.

The prevalent story is that households have been able to boost their spending on Main Street during the past four years because rising house prices have enabled them to extract equity from their houses *and* to spend a portion of these "withdrawals" on Main Street—thus boosting consumption. By extension, it is assumed that, once house prices fall, households will no longer be willing (or indeed able) to continue this pattern of behavior. The result will be a significant hit to household spending. How much of a hit is unclear. For, while the dollar amount of home equity loans is well-documented, the *share* of such withdrawals that gets spent on Main Street is not known. Estimates vary from 5% to 65%! It is this share that matters to GDP growth.

There are two problems with this consensus view:

- Home equity loans cannot be viewed in isolation from other household balance sheet rearrangements. What matters of course is the *aggregate* balance of spending and borrowing, and the impact of this aggregate on the economy. As we shall see just below, a much bigger story has been taking place in this regard than is generally appreciated—and this story goes back 25 years.

- There is no prima facie reason to assume that the impact on spending of a fall versus a rise in house prices will be symmetrical. Specifically, it is false to assert that households will no longer be *able* to subsidize consumption via home equity loans if house prices decline. For they still retain over $25 trillion of equity in their real estate, and they are perfectly free to draw on this to bolster their spending if they *wish* to do so. Thus what matters is their willingness to go on borrowing to subsidize spending. Frankly, no one knows the extent to which such behavior will continue. Historical data on "wealth effect multipliers" are proving misleading, and this is not surprising given important changes resulting from financial market innovation and deregulation.

The Big Story – One that Puts Home Equity Borrowing into Proper Perspective: As stated above, a problem with focusing on the impact of home equity loans on spending is that such loans are simply *one* of many ways in which households can now reconcile their saving and spending goals. Many families now utilize home equity loans *instead* of other forms of credit to manage their affairs. What matters is how everything washes out—and in particular, the degree to which households choose to subsidize their total spending either by borrowing against their assets, or by reducing their savings rate, or by some combination of both.

To understand the confusion that reigns in this regard, consider the following line of thought advanced by optimists who believe that the impact of home equity borrowing on the economy has been exaggerated in the past, and will thus matter little in the future:

> "Since the official flow-of-funds savings rate is currently running at -0.3% of GDP, or -$40 billion in current dollar terms, households *could* not have been spending on Main Street more than a tiny portion of their $700+ billion in home equity extractions. *For they clearly did not need to do so!* Rather, they used such funds for debt consolidation or other balance sheet rearrangements. In short, home

 ©2007

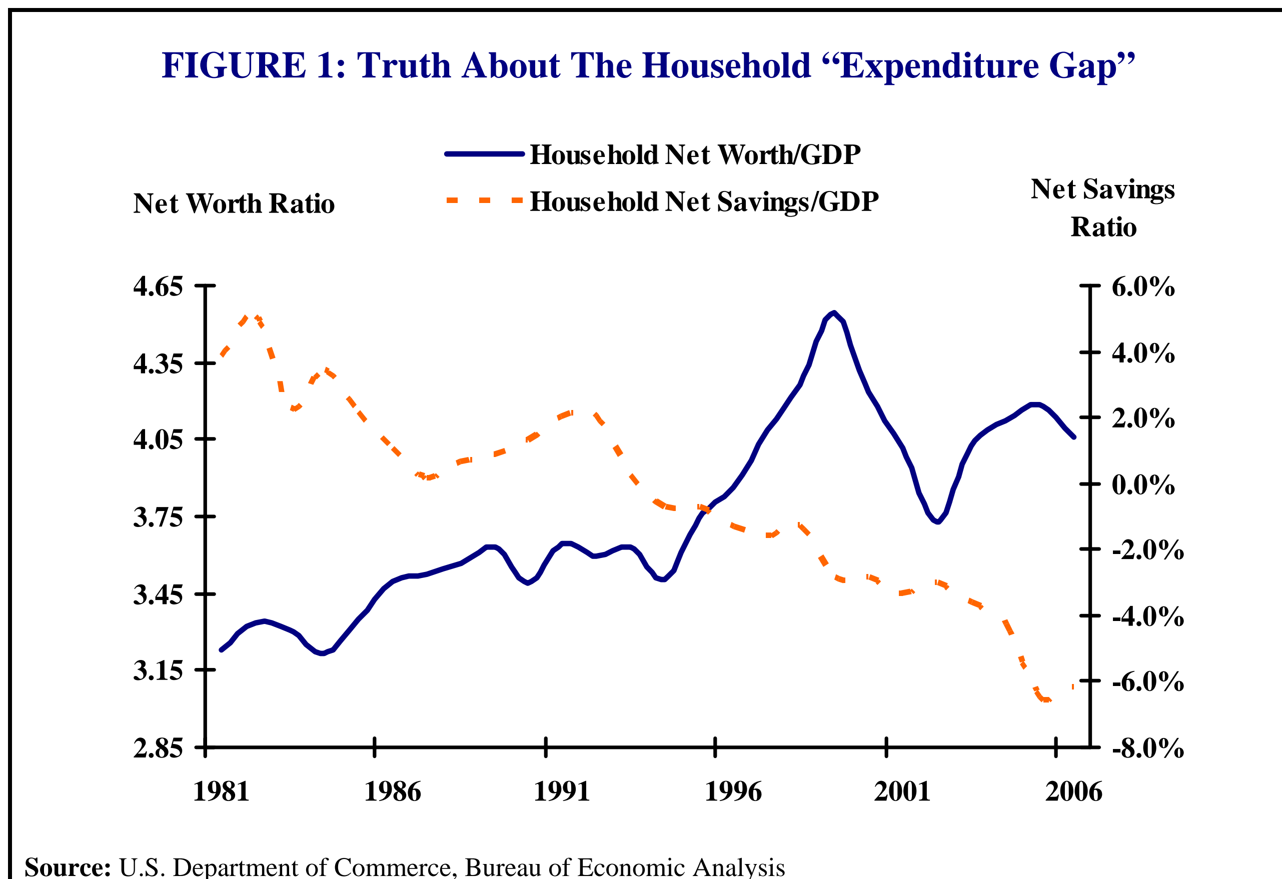
equity loans have not been impacting GDP growth during the period when house prices rose. By extension, should house prices fall and should households no longer extract equity from their homes, there will be no impact on the economy."

This entire story is misleading. The reason it is misleading is that household spending consists *not only* of those "personal consumption outlays" that are subtracted from disposable income to yield the official personal savings rate of -0.3% of GDP cited above, *but also* of personal investment expenditures—particularly gross residential investment spending. When the amount households have spent on gross investment is *added* to personal consumption outlays to yield *total household expenditure,* the resulting number is $10.3 trillion. This is $820 billion *more* than disposable income, or 6.2% of GDP more than income.

This household "expenditure gap" can be interpreted as a negative "Household Net Savings Rate" of -6.2%. *This has to be financed*—whether by borrowing (e.g., home equity lines) or else by asset sales. Thus, the full $750 billion of home equity loans taken out during 2005 was indeed needed to help close the total household expenditure gap of $820 billon. All of it!

Is this spending gap historically unusual? Does this matter? Is it sustainable? What explains it? These are the issues of true importance—not the red herring of how households utilize their home equity loans. The data in Figure 1 below shed light on all these questions.

FIGURE 1: Truth About The Household "Expenditure Gap"



Source: U.S. Department of Commerce, Bureau of Economic Analysis

 ©2007

The dotted line represents the "expenditure gap" cited just above. Specifically, the data represent disposable income *minus* total household expenditures on consumption and investment—as a percentage of GDP. Note that the last data point on this dotted line is the negative 6.2% described above. This "Household Net Savings Rate" has been in constant decline since 1981, and it became *negative* for the first time at the end of 1994. This is when the "expenditure gap" cited above first arose.

Why did this happen? This question is difficult to answer, and all we can do is to sketch a rationale as to what happened. To begin with, note the rising *solid* line in Figure 1 showing the ratio of household net worth to GDP. The story here is as positive as the story with the dotted line is negative. It documents a long period of astonishing wealth growth and hence of rising optimism for Americans. The source of this wealth explosion was **(i)** a recovery of asset prices from their depressed levels in the 1970s, and **(ii)** great new wealth generated by the IT revolution and its "domestication" throughout the US work force during the past decade.

Should the juxtaposition of the rising solid line (wealth) with the falling dotted line (net savings) surprise us? No! Not if we take Franco Modigliani's Lifecycle Savings Hypothesis as a rough guide to how people *should* save over their lifetime in order to be able to retire with the standard of living they seek. According to this theory, when wealth growth is higher-than-expected over a long period, and households become more optimistic about the future, then both their willingness and their need to save out of *income* are reduced. The net savings rate can even become negative, just as it has been since late 1994, as seen in the dotted line of our figure.

But by how much should savings decline? And for how long can this go on? The truth is that no one knows. We are sailing in unchartered waters. *But one thing we do know is that the growth of wealth (net worth) must equal the growth of GDP over the very long run.* This reality is rooted in the theory of economic growth. And drawing upon growth theory, we at SED predicted back in 2001 that US wealth growth would begin to decelerate significantly relative to GDP growth in the decade ahead. And as the behaviour of the solid line in the figure shows, this began to happen during the past five years, just as we expected. Because of this wealth-reversion reality, we also expect via the Modigliani theory that the Household Net Savings Rate (the dotted line) will reverse and begin to rise. *But this will take time.* In doing so, it will serve as a long-term depressant on US GDP growth.

To summarize our entire analysis: The "wealth effect" of falling house prices on GDP growth is just beginning to be felt, and will play out over 2007 and 2008—a view that is not in the market. Conversely, the slowdown in residential investment spending has already adversely impacted the economy, but this impact will have leveled off by spring 2007.

CAVEAT ON MEASURING THE SAVINGS RATE: Many observers criticize the definition of the US household savings rate. They argue that it would be higher than reported if certain expenditures treated by the BEA as "consumption" were reclassified as "investment". While this is true, we have not enjoined this debate herein. Rather, we have focused on a very different aspect of savings, namely the "expenditure gap" between *total* household expenditure (consumption *and* investment jointly) and total disposable income. Thus, our analysis transcends the classification debate.

 ©2007

DISCLAIMER

Content not to be construed as a solicitation or recommendation: This material has been prepared for informational purposes only without regard to any particular user's investment objectives, financial situation, or means, and MINIMAX is not soliciting any action based upon it. This material is not to be construed as a recommendation; or an offer to buy or sell; or the solicitation of an offer to buy or sell any security, financial product, or instrument; or to participate in any particular trading strategy in any jurisdiction in which such an offer or solicitation, or trading strategy would be illegal. Although this material is based upon information that MINIMAX considers reliable and endeavors to keep current, MINIMAX has not verified this information and does not represent that this material is accurate, current, or complete and it should not be relied upon as such.