THE INTERNATIONAL ECONOMY
THE MAGAZINE OF
INTERNATIONAL ECONOMIC POLICY
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Washington, D.C. 20006
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A SYMPOSIUM OF VIEWS

The Jobs-Stock Market Connection

Imagine you were told two years ago that the US stock market would soon begin declining in value such that by late 2002 (a) more than six trillion dollars in wealth would have vanished; but (b) the unemployment rate would be not that far from where it was at the beginning of the process. Would you have been surprised, expecting the decline in stock market wealth to have had a greater effect on employment? To what extent is there today a disconnect between the market and job creation? Or are lag times simply much longer in today's economy where consumers enjoy the comfort of a strong housing market?

The complexity occurs because the richest 10 percent of households own a vastly disproportionate share of all equities.

BARTON M. BIGGS
Barton M. Biggs is a Managing Director of Morgan Stanley and Chief Global Strategist.

The only real danger to employment: A synchronized stock and real estate market collapse.

I don't believe there is a disconnect between the stock market and job creation, but the intensity of the hook up is overestimated. And lag times are much longer (and weaker, for that matter) in today's economy where house prices are rising 5-6 percent per year in real terms.

I have long been skeptical of simple analysis of the so-called "wealth effect" of the stock market on both consumer spending patterns and job creation. There is no question that the rise in the stock market in the second half of the 1990s caused Americans to feel richer and save less. However, the long-term relationship between the saving rate and net worth as a percent of disposable income suggests these trends take years to play out and are gradual, not cataclysmic, happenings. The saving rate fell gradually from 7–8 percent in the early 1990s until 2001, eventually touching zero, and consumer spending was clearly above its long-term, normalized trend.

A superficial analysis would suggest that the $6-trillion decline in the stock market in the past few years would devastate consumer spending because equities amount to 60 percent of the aggregate net worth of all households. Thus, many argued that inevitably consumer spending is another bubble waiting to be popped which will trigger a recession and rising unemployment. The complexity occurs because the richest 10 percent of households own a vastly disproportionate share of all equities. A much higher percentage of their net worth is in equities and an even higher percentage of their equity in private businesses. They are the big spenders on luxury goods but to what extent will they curtail spending because of a stock market decline? Are the likes of Bill Gates or Warren Buffet going to diminish their lifestyles because of the stock market decline? Obviously these two billionaires are a ridiculous example but perhaps it helps to prove the point.

By contrast, the middle 70 percent of households have 60 percent of their net worth in their home and only 12 percent in equities and 12 percent in pension accounts of which only half are defined contribution. Thus, the steady rise in residential real estate values has offset much of the vanishing wealth effect from the stock market collapse. Furthermore, declining long-term interest rates have triggered massive amounts of refinancing, about half of which has been used for consumption of one form or another.

My conclusion: Unless both the stock market and the real estate markets have a synchronized collapse which (although it happened in Japan) I do not anticipate, the growth of consumer spending will slow to below trend over the next few years but not decline and tip the U.S. economy into a severe recession with high unemployment.

By the end of 2001, the two agencies together had $1.8 trillion of mortgage- backed securities and $1.3 trillion of outstanding debt. There was rising criticism that the agencies were becoming too big.

CHARLES P. KINDELBERGER
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Spending and housing saved the day. But will it last?

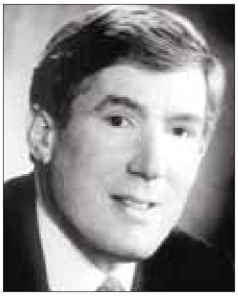
Collapse in a stock-market bubble is expected as a rule to be followed by reduced consumer spending, falling prices of other assets, especially real estate, and rising unemployment. The situation in 2000–2001 proved different. Consumer spending rose, residential house prices rose—though not those of commercial building—and employment held more or less steady, buttressed by consumer spending in general and spending on residences in particular.

The usual explanation is that the eleven steps taken to reduce the Federal Reserve's overnight interest rate, though t failing to raise industrial and commercial investment, encouraged consumers to refinance their debt, especially existing mortgages, and to expand borrowing on credit cards and so-called "equity mortgages," or second mortgages, as rising home values increased their equity. The proceeds were used for consumption in general but especially for improved shelter—moving to a bigger place, enlarging an existing one, acquiring a summer, or even a winter place.

The boom in housing and employment for residential work was supported by two government pponsored enterprises—dedicated to promoting moderate and lower-income housing, Fannie Mae and Freddie Mac, who acquired mortgages by borrowing in the capital market and buying mortgages from issuing banks. Their readiness to buy encouraged the banks to accept low down payments and high appraisal values. By the end of 2001, the two agencies together had $1.8 trillion of mortgage-backed securities and $1.3 trillion of outstanding debt. There was rising criticism that the agencies were becoming too big. Along with consumer debt in general, and U.S. indebtedness to the rest of the world, this posed the threat of the collapse of a housing bubble and a double dip in the economy.

Financial opinion on the question of a bubble and its collapse is sharply divided. Alan Greenspan, chairman of the Federal Reserve Board, insisted in May that there would not be a housing bubble. William Poole, president of the Federal Reserve Bank of St. Louis, in a speech in August, expressed doubt about future financial stability, especially concern over the heavy debt load carried by Fannie Mae and Freddie Mac. Financial analysts also put forward differing opinions. One think-tank, the ISI Group, pushed "Good-bye NASDAQ, Hello Homes." Stephen Roach, the Morgan Stanley economist, was optimistic in a May analysis, but his usual pessimistic self returned in July when he said, "The housing cycle is extended and increasingly vulnerable to downturn." One can even see the typical herd-behavior signs of booms that crash: A story in the *New York Times* in August states that investment clubs are abandoning stocks and "zeroing in on real estate."

The stock-market crash of 2000–2001 produced large-scale job losses in finance and industry, made up for, however, to a considerable extent by spending for consumption in general and house maintenance and building. But will it last?



A weak jobs market will add to the frustration and the trauma felt by many Americans.

ROBERT HORMATS

Robert Hormats is Vice Chairman of Goldman Sachs (International) and Managing Director of Goldman Sachs & Co.

The real danger: a rise in the saving rate.

If the stock market remains weak, a rise in unemployment is highly likely. The main question would be how much. Even if the market picks up somewhat in the future, most corporations are likely to be cautious about hiring, and a weak jobs market is likely.

Prolonged weakness in the equity market would continue to deplete the saving nest eggs of American households. If more and more Americans become convinced that a quick recovery in equity prices is unlikely, they will save a larger portion of their net incomes. That will slow the growth of consumer spending and, in time, of job creation. Mortgage refinancing can help, but it cannot continue at a high rate indefinitely; by itself, it will not prevent this slowdown from occurring.

In the post-World War II period, stocks have always risen in value in the 12-month period surrounding the month marking end of a recession—until now. The previous weakest performance for the S&P 500 index during such a 12-month period was +20 percent. Rising equity values during such transition periods have boosted consumer confidence, spending and, business investment—thus giving a lift to the recovery. The current unprecedented drop in equity values in the period surrounding the present recovery (which appears to have begun in December 2001) deprives the economy of a needed boost. It means that consumption is likely to remain weak as households (50 percent of which are exposed to the market) struggle to rebuild their retirement funds or college savings; this rise in the savings rate is already beginning to occur.

On one hand a higher saving rate is highly desirable, because the average family's saving rate in the United States is very low. On the other, by slowing consumer demand it will make businesses more cautious—reluctant to hire, more inclined to fire, and slow to engage in new capital spending.

All told, this portends rising unemployment. The rise is not likely to be sharp—if the economy continues to grow modestly. However, if the economy weakens significantly, unemployment is likely to become considerably higher. In any case, a weak jobs market will add to the frustration and the trauma felt by many Americans, large numbers of whom have already seen their hard-earned savings plummet in value.

Firms will probably revert to relying on internal cash flow to finance investment and thus make the upturn itself dependent on their success in reviving profitability.

DAVID HALE

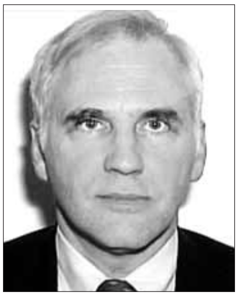
David Hale is Chief Global Economist with Zurich Financial Services and its investment affiliates.

Yes, it is surprising that such large wealth losses haven't had a more dramatic impact.

The decline in the value of U.S. stock market capitalization during the past two years now exceeds the losses during 1929–1932. Since March 2000, the value of America's stock market capitalization has slumped from 182 percent of GDP to about 110 percent. During the period after the 1929 crash, the country's stock market capitalization slumped from 82 percent of GDP to about 20 percent.

It is surprising that such large wealth losses have not had a more dramatic impact on the economy, but several factors have probably helped to cushion the impact. First, the wealth gains during the period 1998–2000 occurred so quickly that many people probably did not have time to build them into their long-term consumption habits. There was broad awareness by 2000 that the market had become highly speculative, so everyone assumed that a correction would occur at some point. Second, the Federal Reserve eased interest rates quickly and dramatically during 2001 when it became apparent that the stock market decline was setting the stage for a major slump in capital spending. The Fed easing helped to sustain a robust housing market and encouraged over $1.1 trillion of mortgage refinancing. As a result, the recent business cycle was the first in which investment rather than homebuilding and construction led the economy into a downturn. Third, the appreciation in home prices resulting from accommodative monetary policy has helped to produce wealth gains which partly offset the losses in equity values. The mortgage refinancing boom also allowed households to convert those capital gains into increased consumer spending.

The slump in capital spending during 2001 was the primary side effect of the stock market slump. As the market declined, telecom and information technology companies lost access to the cheap equity financing which had permitted large spending gains during 1998, 1999, and early 2000. As cheap equity capital is unlikely to be available again for a long time, there will be only a subdued upturn in capital spending during the next several quarters. In fact, firms will probably revert to relying on internal cash flow to finance investment and thus make the upturn itself dependent upon their success in reviving profitability.



The effects of renewed budget deficits are salutary in the short term.

PROFESSOR DANIEL K. TARULLO

Daniel K. Tarullo, formerly Assistant to the President for International Economics, is Professor of Law at Georgetown University.

The negative wealth effects have been partially offset.

Surprises have become unsurprising in recent turns of the business cycle. It has been quite some time since the U.S. economy has produced and then popped asset bubbles, except for real estate prices in some local markets. Further surprises may thus await us. And, of course, a snapshot of the economy in the fall of 2002 cannot capture the whole picture. Still, a few observations are worth making.

First, while unemployment may not have increased as many "basis points" as in prior recessions, it has increased by half, from about 4 percent to about 6 percent. This is not trivial. Second, substantial further layoffs are certainly possible, particularly among middle management. Third, as with all statistical series these days, one wonders how accurate the numbers actually are.

Fourth, while wealth held in equities has been reduced by $6 trillion, real estate and some other asset classes have seen continued wealth gains. Thus, negative wealth effects working their way through the economy have been partially offset. Fifth, the u-turn in U.S. fiscal policy has had significant stimulative effects. Though a problem in the medium-term, the effects of renewed budget deficits are salutary in the short-term, also offsetting part of the negative wealth effect. Finally, one effect of the equity decline may be lagged—an increase in personal saving rates, if and as consumers become convinced that equity values will not renew sustained appreciation for the foreseeable future. If so, then we could see medium-term impacts on the consumer spending which has been keeping the economy afloat and holding down unemployment.

The stock market is not necessarily the exogenous influence here to which unemployment reacts.

IVO WELCH

Professor of Finance and Economics at Yale University.

The link is more complicated and long term.

The question on the jobs-stock market connection is unanswerable. If the question were "would I be surprised if the market dropped by 50 percent and the unemployment rate would remain within +/- 1 percent," it would be easier to answer.

First, I would be shocked if the stock market dropped another 50 percent. I think that another 10–25 percent could be possible, but 50 percent is beyond my imagination. Second, I believe that a large drop in the stock market would go hand-in-hand with declining growths of companies, especially publicly traded companies. So yes, I do believe that a large stock market drop eventually leads to a significant increase in unemployment, albeit not necessarily over a time span of just a couple of months. I think the connection is more long-term and noisy, and has always been such. As to the housing market, it can indeed moderate the stock market, as can any other large asset base not counted in the stock market.

One should also consider that the stock market is not necessarily the exogenous influence here to which unemployment reacts. On the contrary, the stock market itself may estimate future growth and future unemployment. The question could have been posed as whether estimates of future unemployment increases (from lower economic earnings/growth) might have caused some of today's stock market declines. Here, too, I believe that the answer is yes, but again, the stock market/unemployment link is complex and long-term. ◆