

Question for Team Obama:

**Can U.S. personal
consumption fully recover
without the value of
real estate and other
assets rising?**

The views of some prominent experts.

"INTERNATIONAL
ECONOMY

THE MAGAZINE OF
INTERNATIONAL ECONOMIC POLICY

888 16th Street, N.W.
Suite 740

Washington, D.C. 20006

Phone: 202-861-0791

Fax: 202-861-0790

www.international-economy.com



Both personal saving and consumption will increase slowly over the next few quarters.

RUDOLPH G. PENNER

Institute Fellow, Urban Institute, and former Director, Congressional Budget Office

As the conventionally measured saving rate hovered near zero from 2005 through 2007, it was tempting to conclude that Americans were incurable spendthrifts. But the conventional measure does not include capital gains and losses. Saving measures that do are quite erratic, but it is hard to discern a distinct trend over the past fifty years. In other words, households show a tendency to spend a portion of capital gains and become more frugal when they experience losses.

During 2008, household net wealth declined by an unprecedented \$11 trillion. Predictably, conventional saving rose toward the end of 2008 and in the advance National Income Accounts report for early 2009. But even if saving rates continue to soar, it is implausible to imagine households making up for an \$11 trillion loss unless asset and real estate values recover mightily from end-of-2008 values. (Despite a substantial increase in the saving rate to 4.2 percent, personal saving was only \$453 billion in the advance report for the first quarter.)

Does that mean that saving will continue to rise rapidly and consumption will remain stagnant absent a very large increase in asset prices? Not necessarily. The stimulus package may have been poorly designed, but you cannot throw that much money at a problem without bolstering incomes. Moreover, safety net programs and the fall in income tax revenues are also adding to disposable income.

My guess is that a positive income effect will offset the negative impact of the fall in wealth and that both personal saving and consumption will increase slowly over the next few quarters, much as they did in the first quarter of 2009. However, it will take a substantial recovery in the housing and stock markets to set off a real consumption boom.



Yes, but the recovery will be unusually slow.

DAVID M. JONES

President and CEO, DMJ Advisors, Professor of Economics and Finance, Florida Gulf Coast University, and Chairman of the Board, Investors' Security Trust Company

My view is that U.S. personal consumption can recover even without the value of real estate and other assets rising but, in light of a new element of crisis-induced caution, the recovery in consumer spending will be unusually slow and uneven compared with earlier post-World War II recoveries.

On the plus side, massive monetary and fiscal stimulus should result in a step-up in previously depressed employment and income before the end of 2009 and growth in these dominant influences on personal consumption expenditures should accelerate further in 2010. Moreover, consumer confidence turned higher in April after hitting record lows, with the rebound likely reflecting in part fiscal stimulus in the form of the lowering of withholding rates on payroll taxes as of April 1, 2009.

In contrast, on the negative side, the new watchword for consumers is frugality as they face unusually severe strains on their balance sheets. Households have seen their wealth (net worth) hard hit, with prices of both real estate and equities plunging on the asset side of their balance sheets, while they are burdened by heavy indebtedness on the liability side. The ratio of household indebtedness to GDP stood at 48 percent in 1981, but by 2007 this ratio had soared to 100 percent. Households are desperately trying to repay debt. The wealth (net worth) effect on consumer spending, though not as powerful as that exerted by employment and income, has nevertheless been decidedly negative.

The upshot is that consumers have sought to curtail spending while increasing savings out of their income. The individual savings rate has promptly jumped to a present range of 4–5 percent from zero during the earlier housing boom, and this savings rate should climb still higher to perhaps 7–8 percent. The average saving rate for the post-World War II period is 6.9 percent.

Regarding the overall economic outlook, the expected slow and uneven pick up in consumer spending (which accounts for 70 percent of GDP) is likely to be reflected in a slower and more prolonged recovery in general economic activity. Helping to bolster prospects for economic recovery in the second half of this year and next, however, is an expected acceleration in government spending as the impact of the Obama fiscal stimulus plan gradually increases. Also, we are the midst of a precipitous decline in the U.S. trade deficit as imports fall faster than exports. The decline in imports mostly reflects restrained consumer spending. Hopefully, once the U.S. recovery takes hold and subsequently spreads to the rest of the world, the United States can make a further dent in its chronic trade deficit by placing much greater emphasis on export-led growth, while China, as a chronic trade surplus country, focuses increasingly on consumer-led increases in domestic demand, thereby boosting its imports.



MARTIN NEIL BAILY
Senior Fellow, Brookings Institution, and



SUSAN LUND
Senior Fellow, McKinsey Global Institute

No, personal consumption cannot recover.

No, U.S. personal consumption cannot recover without the value of real estate and other assets rising. Many economists believe there will be a short-term burst of spending at the start of the recovery as businesses replenish inventories and consumers make purchases they have been postponing. But beyond that, U.S. consumption growth is likely to be slower in the years ahead for three reasons: over-indebted households, lost wealth, and tighter credit standards.

Between 2000 and 2007, U.S. household debt as a percent of disposable income grew from around 100 percent to nearly 140 percent—well outside the bounds of

historic experience. This figure has begun to decline as households begin the slow process of reducing their debt (some unfortunate ones through foreclosure). At the same time, U.S. households have lost \$14 trillion of wealth due to equity market declines and falling property values, and when households are less wealthy they choose to consume less. Many households approaching retirement see the need to rebuild their assets. A sign of this is that the personal saving rate has already risen to around 5 percent and is likely to remain much higher than the near-zero levels we saw prior to the crisis. Finally, credit will be harder to get, which will crimp many big-ticket purchases. We know from past banking crises that it will take years for banks to work through their losses and recapitalize their balance sheets. During this process, consumer credit will be less available and more expensive. Banks had encouraged families to open large home equity credit lines based on inflated housing prices, but these have now been scaled back or shut down.

The bottom line: U.S. personal consumption growth will be slower in the years ahead as households save more. In the long run this will produce a healthier economy—but in the short term it could hinder the recovery.



Consumption is likely to stay subdued.

MICHAEL J. BOSKIN
T.M. Friedman Professor of Economics and Hoover Institution Senior Fellow, Stanford University, and former Chair, President's Council of Economic Advisors

U.S. personal consumption growth on balance is likely to stay subdued as households struggle to strengthen their balance sheets by positive saving and debt reduction. While consumption could grow without much of a rebound in real asset prices (consider the 1970s when the stock market fell even more in real terms than the recent debacle, yet consumption grew solidly), I do not expect that to happen. Rather, consumption and equity values more likely will both eventually grow to reflect the fact and expectation of rising

income and improving job prospects. But consumption recovering does not mean returning to the days of \$600–\$800 billion a year of home equity withdrawals, plus generally easy credit, financing a spending binge. Home prices are likely to fall further and the large excess inventory of empty homes must be worked through before home prices appreciate much. Finally, President Obama’s large explicit and even larger implicit tax hikes (to pay the interest on his exploding debt, energy cap-and-trade, and other regulatory costs) will weigh on consumption.



*Yes, with a
qualifier.*

SUSAN M. PHILLIPS

Dean and Professor of Finance, George Washington University School of Business, and former member, Board of Governors of the Federal Reserve

The short answer is “yes.” But as always, with economic questions, there are qualifiers. Personal consumption will eventually recover when the job market starts to improve whether or not the values of real estate and other assets rise. As consumers develop confidence in their ability to get, maintain, or change jobs, they will risk-adjust their personal balance sheets and expectations and resume spending. That may take some time and not be at the same rate as in the “good old days” when houses and investment accounts were over-valued. Such assets provided an additional source of income or served as the household savings account. Lower asset values will likely prompt consumers to adjust their spending appetites, live in smaller houses, work longer, and become savers. From a macro perspective, increased personal saving in the United States would be a good thing for the economy, providing a domestic source of investment.

Personal consumption is already starting to show signs of life without improvement in housing prices, but some recovery in financial asset prices. That process will continue, but is unlikely to recover to pre-bubble rates. Some permanent realignment of prices in those sectors

will limit their future use as savings accounts. Consumption rates will be lower than experienced in pre-bubble days. But in the long term, we will eventually grow our way back to pre-crisis levels.

As always, economic adjustments are not smooth or even. Housing price adjustments will vary across geographic regions and financial asset values will reflect ever-changing fortunes of individual industries and companies. The path of personal consumption back to recovery will be bumpy with different regional patterns, but the resilience of the U.S. consumer is a good long-term bet.



*What’s needed are
steps to boost
investment.*

BOB MCTEER

Distinguished Fellow, National Center for Policy Analysis, and former President and CEO, Federal Reserve Bank of Dallas

Personal consumption can recover without the value of real estate rising, but it would be difficult and would likely prolong the recession and weaken the recovery. Most economists I know avoid discussing Keynes’ “Paradox of Thrift” lest they be labeled Keynesians. So, let’s call it a fallacy of composition.

For years, consumers have saved next to nothing out of their disposable income because they regarded gains in their 401(k)s and rising home prices as saving. That may work for individual consumers since they can sell those assets for cash to purchase other things. Capital gains, however, don’t represent real saving for the aggregate economy, since resources aren’t freed up for real investment. What’s true for the individual consumer is not true for the economy as a whole.

Since those capital gains have now turned into capital losses, consumers, who still need to save more than ever, can only do so the old fashioned way: by reducing consumption out of disposable income. But, as what’s his name pointed out, large-scale attempts to save more with investment not rising can be self-defeating by reduc-

ing aggregate demand. This dilemma will likely contribute significantly to prolonging the recession and dampening the recovery unless steps are taken to boost investment.



***Recover, yes.
But not a
robust recovery.***

ROBERT J. SHAPIRO

Chairman Sonecon, LLC, and former U.S. Under Secretary of Commerce for Economic Affairs

Personal consumption can and will recover, but not along the robust path of recent years, when Americans spent virtually everything they earned after taxes. The rising value of people's assets—houses for 70 percent of American households, and stocks for the big-consuming, top 10 percent—supported this high consumption in two ways. First, it gave people the illusion of increasing their saving without having to put away much of their current incomes. Second, tens of millions of American households used their rising home values to directly support their consumption, by pulling out their equity and spending it through mortgage refinancing and home equity loans. These dynamics all have reversed. Now, falling home values have taken a significant piece out of almost everyone's wealth—20 to 25 percent so far—with one-quarter of Americans now holding mortgages larger than the market value of their houses. For the next several years, few Americans will be able or inclined to use the value of their homes to support their personal spending. Moreover, most Americans are now significantly poorer than they used to be—and well know it—producing a negative “wealth effect” that will further dampen personal spending and raise the saving rate. Finally, consumption gains generally track income progress; and for a number of reasons, incomes are not likely to increase much over the next several years.

The very well-to-do may behave differently—which is to say, consume in the future much like everyone used to. One reason is that they have more assets, so recent losses are less likely to constrain their plans to

buy a new car or meet tuition payments. Moreover, larger shares of their assets are held in stocks, which are likely to recover more quickly than housing. Finally, their incomes are more likely to rise at healthy rates than everyone else's, since they often have the advanced skills in high global demand. But since there are not enough of them to drive overall spending levels, total consumption is likely to grow at substandard rates for some time. That leaves government as the main spur to higher spending over the next year or two, and the administration and Congress are thankfully determined to run enormous deficits.



***The prospects for
consumption
growth are dim.***

DESMOND LACHMAN

Resident Fellow, American Enterprise Institute

In the absence of renewed asset price appreciation, U.S. personal consumption can still very well increase on a sustained basis as it reverts to be mainly driven by household income and employment growth. However, there are three considerations that would strongly suggest that U.S. personal consumption growth over the next decade will be decidedly slower than it was over the previous ten years.

First, the household de-leveraging process that is presently underway is almost certain to continue to be a major drag on U.S. consumption for a number of years as households seek to repair their seriously damaged balance sheets. During the boom years, U.S. households increased their debt levels to around 140 percent of their incomes, while since the end of 2007 declining home and equity prices have destroyed around \$14 trillion, or around 100 percent of GDP, in U.S. household wealth.

Second, one has to expect that the markedly expanded public sector spending proposed by the Obama Administration will considerably crowd out the room for private investment and consumption and will meaningfully reduce potential output growth. The Congressional Budget Office is presently estimating that the Obama budget will result in budget deficits averaging

more than \$1 trillion per year over the next ten years and will boost the public debt-to-GDP ratio to around 80 percent by 2019.

Third, one similarly has to expect that the long-overdue correction in the U.S. payment imbalance will provide less room for domestic consumption and investment.

The dim prospects for U.S. consumption growth in coming years heighten the need for policy measures in the Asian countries in general and in China in particular to increase domestic consumption and to be less reliant on exports as their main engine for growth.



Real personal consumption expenditures will post modest growth.

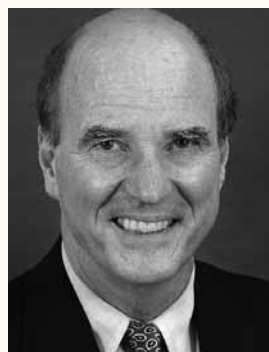
ROGER KUBARYCH

Chief U.S. Economist, UniCredit Research, and Henry Kaufman Adjunct Senior Fellow for International Economics and Finance, Council on Foreign Relations

Wealth destruction has been unprecedented. Average home prices are down 30 percent or more from their peaks. The stock market is still off 40 percent from theirs. If consumption spending was largely driven by changes in household net worth, the slide in personal outlays would have been far worse than it has. So consumers are clearly shrugging off the worst of the collapse of asset prices. Yes, they have increased their savings a little. But a personal savings rate of 4 percent, up from 1 percent or lower before the recession started in December 2007, is still well below the long-term average. Restoring wealth to former levels will take years, not months. That will be all the more difficult because millions will remain unemployed during the transition—and for longer periods of time than in the past.

That said, the recent irregular rally in the stock market is helpful, not least in boosting consumer confidence. Tax cuts provide some relief as well, letting families decide whether to sustain consumption levels or, more likely, pay down debt.

We expect that house prices will barely increase in the medium term. The stock market will rise in fits and starts but not return to the past peak for three or four years. Even so, real personal consumption expenditures will be able to post modest growth, though at a slower rate than real GDP. That will allow some increase in the savings rate.



Customers will only come back now if they have a paycheck in their pocket.

JEFF FAUX

Distinguished Fellow, Economic Policy Institute

Consumption can only recover the old-fashioned way—through rising real incomes based on production of competitive goods and services.

The subprime mortgage crash teaches us once again the folly of running an economy based on using cheap and easy consumer credit to compensate for stagnant wages. Returning to balanced growth will require more public investment in human development and infrastructure that can generate jobs now and improve competitiveness in the future, along with tax and trade policies to reduce the current account deficit, and strengthening the weakened bargaining position of workers.

The President correctly tells us that we cannot go back to the old profligate ways. But his policymakers don't appear to get the message. Instead, they seem committed to preserving the bloated financial sector whose purpose has become the provision of credit to its own asset-bubbling activities rather than to the country's long term re-development. Thus, the Treasury handles Citigroup, AIG, Merrill-Lynch, and others with kid gloves, while forcing General Motors and Chrysler to radically downsize, bankrupt their suppliers, and off-shore more production for the U.S. market. It continues to support an overvalued dollar that helps Wall Street buy foreign assets but disadvantages Main Street producers and discourages domestic investment.

This misguided effort to return to the pre-crash world is doomed. Washington may be able to pump up

the balance sheets of those too-big-to-fail banks, but the balance sheet of the American household sector is still under water, and—given widespread distrust of get-rich-quick schemes—there are no new potential asset bubbles big enough to reflate it. Customers will only come back now if they have a paycheck in their pocket.



Yes, but at a lower pace.

ALLEN SINAI
*Chief Global Economist and President,
Decision Economics, Inc.*

The basic prospect for U.S. consumption is far less of it, on average, and far more saving, on average, than in decades. But consumption spending can recover without the values of real estate and other assets rising—just at a much lower pace than historically.

A seismic shift away from consumption, credit, and debt, and toward saving, using much less credit and taking on much less debt, has been in place now nearly three years, gathering force over the past year as a stressed and fragile consumer has been battered by lost jobs, lost income, lost wealth, lost confidence, and no easy means of funding because of falling stock and real estate prices.

U.S. aggregate consumption cannot recover to anywhere near the past historical trend growth rate of 3.5 percent annually, inflation-adjusted, that went on for forty-five years to 2007, not just because of \$15 to \$20 trillion of lost wealth in real terms but from much reduced growth in real disposable income, a realization that the good and easy times for credit, debt, and spending are over, and retirement needs.

Real consumption can grow again, with or without rising stock and real estate prices, but only on a new lower trend growth path that has to reflect the negative consumer fundamentals, including an unemployment rate near 10 percent and slow re-absorption of the unemployed; weak real income growth and higher price inflation; tight credit and no easy funding from rising values of household assets; and the most deteriorated household financial conditions since the Great Depression.

Household balance sheets must be reliquified, rebalanced, and readjusted to more normal dimensions before an aggressive pace of consumer spending can be restored.

In the meantime, real consumption can grow by 1 to 2 percent annually, on average, with the personal savings rate moving higher, perhaps to a range of 8 to 10 percent before returning to a new normal level, something like 6 to 7 percent.



The very question echoes the “roller coaster school of macroeconomic management.”

HANNES ANDROSCH
*Former Finance Minister and
Vice-Chancellor of Austria*

The very question echoes what I call the “roller-coaster school of macroeconomic management.” We have seen it all before; the spine-tingling ascent to a new record high, followed by a heart-stopping plunge into the abyss. No sooner do you believe the worst is over than the next amplified cycle starts off again. These consumption-driven cycles have not served us well, precisely because they have been based to a significant extent upon asset-market wealth effects, combined with easy credit market conditions. Indeed, the unwinding of the credit market—asset market loop, along with the hangover from the related consumption excess, is a major component of what we now refer to as the global financial crisis.

The accumulation of assets, which represents investment, is the mechanism whereby current consumption is sacrificed in the interest of future consumption. This process was severely distorted by low interest rates and lax lending conditions. Credit market developments, which enabled us to acquire assets at little or no cost and to boost current consumption on the strength of rising asset values, created a situation of “having your cake and eating it too.” Indeed, it seemed to resolve the paradox of making two incompatibles compatible.

For too long, the U.S. consumer has been regarded as “the consumer of last resort,” hardly an accolade to be

proud of. Countries, like households, have also construed a virtue-vice dichotomy; surplus countries see themselves as virtuous while deficit countries are not. The reality is that persistent imbalances, in either direction, are a vice and inflict enormous costs on the international community. Countries, just like households, must revert to the old fundamentals of linking consumption to productivity and economic performance, and it is as important to avoid excessive saving as excessive consumption. This applies with special force at present to China, with its domestic savings rate about 50 percent, encouraged via government policy and stimulated by an absence of social security networks. Domestic demand will now have to rise to offset the drop in exports, caused by a recession which China helped to induce.



Yes, personal consumption can recover.

MURRAY WEIDENBAUM

Mallinckrodt Distinguished University Professor, Washington University in St. Louis

Yes, U.S. personal consumption can recover without the value of real estate and other assets rising. However, that combination of events is unlikely, because a general upturn in the economy will generate rising consumer spending as well as additional construction of new housing and more buyers for existing housing stock.

Nevertheless, the economic future of the United States would be enhanced by a substantial shift of new investment away from residential housing and toward business capital formation—and even to some governmental investments in selected energy and environmental projects. Compared to alternative forms of capital investment, housing is the least productive in terms of any contribution to economic efficiency and international competitiveness.

The present is a good time to recognize that, over the years, the United States has devoted a much larger proportion of national output to the construction of new

residential housing than any other advanced industrial nation. Contrary to political oratory, the very thought of living in rental housing is not sinful (I grew up in rented apartments and witnessed the great flexibility that short-term rentals give people in times of economic distress). Public policy needs to be re-oriented away from the preoccupation with maximizing individual home ownership as a fundamental national goal, especially large structures filled with expensive, resource-intensive gadgetry.



Consumption and assets will probably both rise together from a lower base.

DAVID MALPASS

President, Encima Global, and former Deputy Assistant Treasury Secretary for Developing Nations and Deputy Assistant Secretary of State

Consumption and assets will probably both rise together from a lower base, but the relationship isn't causal.

Personal consumption depends heavily on lifetime earnings expectations. Input factors include expectations for employment and for earnings growth. The current crisis is hitting employment probabilities, the level of current earnings, and expectations for earnings growth, arguing that consumption will start growing again but from a lower base and at a slower rate than expectations a year ago.

I attribute this decline in U.S. current and expected living standards to the deterioration in the labor and profit environment more than the decline in asset prices.

While the common perception is that mortgage equity withdrawals, house price gains, and stock market appreciation earlier in the decade funded excessive growth in consumption, the data doesn't support this perception. Real consumption grew more slowly in this decade than in the 1990s even though population was probably growing faster. The three-year annualized real consumption growth rate hit 5 percent in the late 1990s, versus a 3.4 percent peak in the 2000s. Net additions to financial assets by U.S. households—the actual new

money flows not counting market gains—were very strong earlier in the decade. This more than absorbed the increase in mortgage equity withdrawals. In effect, people had more cash but put a lot into financial assets, not just consumption and houses.

From a policy standpoint, there are two lessons. First, avoid the super-low Fed interest rates that fueled the 2003–06 global bubble in house prices and construction. To help judge the appropriateness of monetary policy, the Fed should pay more attention to changes in the absolute value of the dollar (not trade-weighted, since it also measures changes in the value of foreign currencies). Second, reduce large tax and regulatory distortions like the deductibility of mortgage interest and the broad Washington policy pressure for ever-higher home ownership rates regardless of loan quality.



The American consumer will not be the next engine of growth.

ROBERT JOHNSON

Former Managing Director, Soros Funds Management, and former Chief Economist, Senate Banking Committee

The logical answer is yes, personal consumption can recover without a boost from real estate. But we are a long way from there now. If real estate and other assets were steady and income gains were inspired by productivity growth, we could see a rising standard of living and consumption. Both private fixed investment and public infrastructure investment, as well as human capital investment and improvements in health-care, could increase the productivity of the American workforce and set the stage for rising compensation and consumption. These sustainable compensation gains might also be reflected in a demand for real estate and other assets rising. They are the basis of rising living standards in healthy economies.

Right now, we are adjusting to a violent decline in stock market values and real estate prices, though many bond prices have risen with the fall in interest rates. Sta-

bilizing or steady prices would be a welcome dream, but still might leave many households with a hole in their balance sheets and curtailed consumption along the lines of the balance sheet recession that has been presented most elegantly in the work of Richard Koo of Nomura Securities.

At present, I do not see a strong move afoot to build public infrastructure and I do not see large scale private fixed investment in process. As the asset markets equilibrate to a lower level of leverage in the financial system, it is difficult to imagine that the world will be able to rely upon the United States consumer as the buyer of last resort in world markets. Alternatively berated and yearned for, the American consumer will not be the next engine of growth.



Consumption will continue to fall until private sector balance sheets are repaired.

RICHARD C. KOO

Chief Economist, Nomura Research Institute

The dramatic drop in consumption last autumn was triggered by the Lehman shock, which in turn was caused by utter incompetence on the part of U.S. monetary authorities. If they had intervened as they did with Bear Stearns in March or with the Merrill Lynch merger with Bank of America in December last year, the drop would have been much more moderate than what actually happened. The subsequent damage control actions by the authorities, including massive capital and liquidity injections, offers of government guarantees, and asset purchases by the central banks, finally arrested the collapse. That in turn gave reasons for those consumers who were not directly affected by the Lehman debacle to return to their normal lives, resulting in some recovery in economic activity.

On the other hand, the bursting of the debt-financed housing bubble, which has been the root cause of economic weakness long before Lehman, is still with us. The resulting destruction of millions of household and financial sector balance sheets will take years to repair.

With a large part of the private sector minimizing debt instead of maximizing profits, the economy will remain weak for years in what may be called balance-sheet recession. This means consumption may return to the level where it might have been in the absence of the Lehman shock, but that level is still falling and will continue to fall until private-sector balance sheets are repaired. With the private sector minimizing debt even with zero interest rates, the only way to keep the economy from shrinking further is for the government to take up the excess savings and debt repayment in the private sector and put them back into the income stream through its fiscal stimulus.



If the capital and credit markets can regain a semblance of equilibrium, consumption will contribute to growth.

PAUL DEROSA

Principal, Mt. Lucas Management

Real consumer spending in the United States has fallen from its crest by just under 2 percent, while houses are down by more than 20 percent. I am reasonably sure personal consumption expenditure will return to its best levels well before real estate values see their former highs. Its subsequent growth could be somewhat slower than it might have been because many people will be poorer than they were. If the capital and credit markets can regain a semblance of equilibrium and stock prices appreciate, I expect consumption will be strong enough to contribute to growth. This expansion, however, will probably be subject to numerous fits and starts, as balance sheet disruptions of the magnitude we have just experienced are not easily remedied.