

Tuesday, February 17, 2004

Running on Empty

By Frank Shostak

[Posted February 17, 2004]

In his testimony before the Congressional Committee on Financial Services the Chairman of the Federal Reserve Board, Alan Greenspan, said that he could see good chances for a sustainable expansion of the U.S. economy.

According to Greenspan:

The household sector's financial condition is stronger, and the business sector has made substantial strides in bolstering balance sheets. Narrowing credit risk spreads and a considerable rally in equity prices have reduced financing costs and increased household wealth, which should provide substantial support for spending by businesses and households. With short-term real interest rates close to zero, monetary policy remains highly accommodative. And it appears that the impetus from fiscal policy will stay expansionary, on net, through this year. [1]



In short, Greenspan has informed us that his low interest rate policy since January 2001 is finally starting to produce good results. But is it factually correct that the financial condition of consumers and businesses has improved to such an extent that economic expansion is likely to be sustainable?

According to Greenspan, it seems that we must be grateful to the Fed for its loose interest rate policy. Without this policy we would probably be suffering a terrible economic slump by now. In short, according to Greenspan the low interest rate policy of the U.S. central bank has strengthened consumers' and businesses' financial conditions. Our analysis, however, disagrees with this. Rather than showing strengthening in financial conditions the data demonstrates that the exact opposite took place.

Thus the household liabilities-to-assets ratio climbed to a new record high in Q3 of 0.185 from 0.183 in the previous quarter. Furthermore, the outstanding consumer credit-to-personal income ratio stood at a record of 0.214 in December. This record high ratio indicates that the pace of consumption by far exceeds the pace of wealth generation. This is likely to force consumers to curtail their borrowing and in turn curtail their expenditure in the months ahead.

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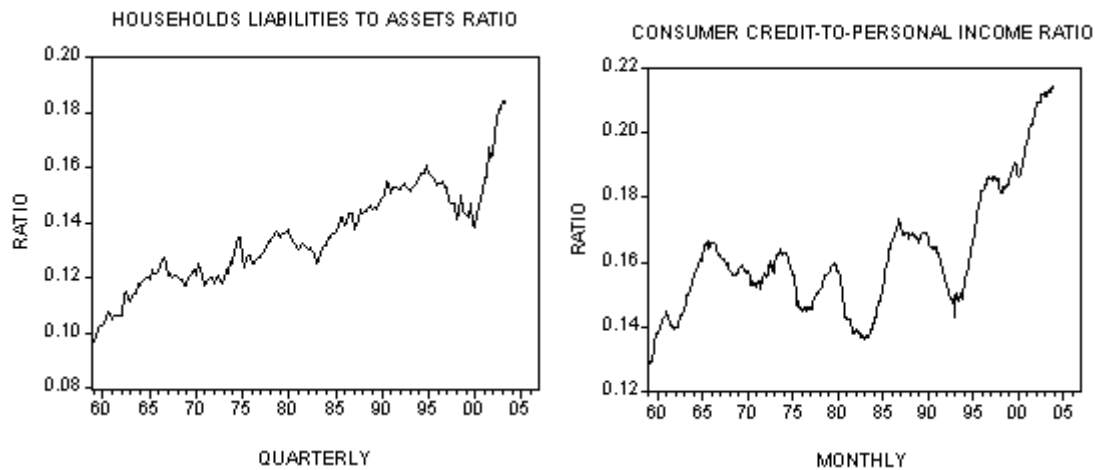
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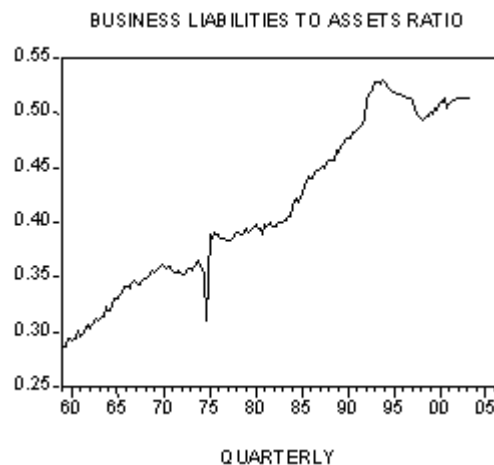
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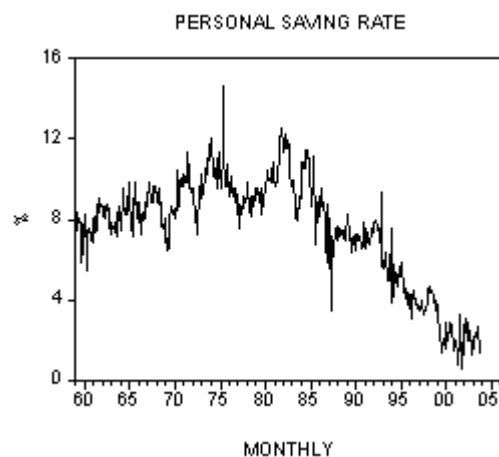


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Also, the business liabilities-to-assets ratio remains at a lofty level. The ratio stood at 0.513 in Q3 against a similar figure in Q2.



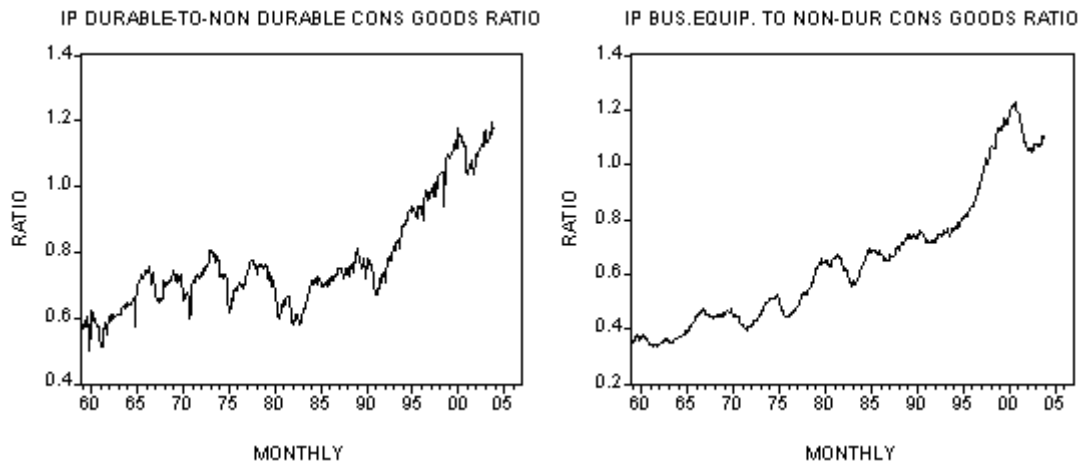
Shrinking consumer savings also underline the fact that the pace of consumption continues to exceed the pace of wealth generation. Latest personal income data indicates that personal savings remain in free fall. The personal savings rate fell to 1.3% in December from 1.5% in November.



The prolonged low interest rate policy of the Fed has significantly arrested the pace of liquidations of past excesses. This in turn continues to maintain pressure on the pool of funding. In short, the existence of non-productive activities constitutes a drain on the pool. Thus the production of durable consumer goods to nondurable consumer goods ratio rose to 1.19 in December from 1.18 in the previous month. This must be

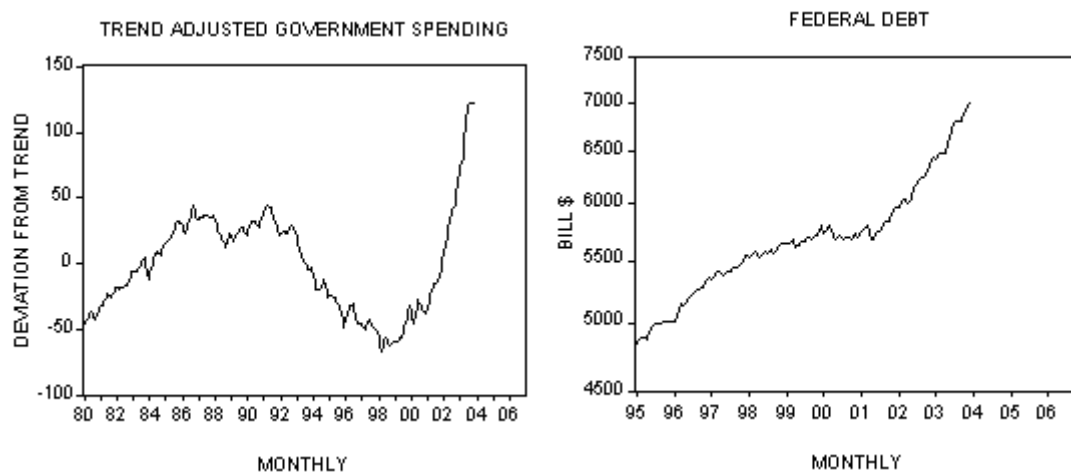
contrasted with an historical average of around 0.7.

A renewed build-up of excesses is also seen in the production of business equipment in relation to nondurable consumer goods production. This ratio stood at 1.1 in December—the same figure as in November. The historical average of this ratio stood at 0.6. It follows then that contrary to what Alan Greenspan has said the facts of reality indicate that the liquidation of past excesses has barely begun. This, coupled with the shaky state of the pool of funding, casts doubt on the feasibility of a sustained economic expansion.



Furthermore, increasing pressure on the pool of investable resources is coming from ever growing government outlays. Between December 2000 and December 2003 government expenditure increased by 33%. Moreover, government spending stood above its long-term trend by \$122 billion in December 2003. In December 2000 spending was \$37 billion below the trend.

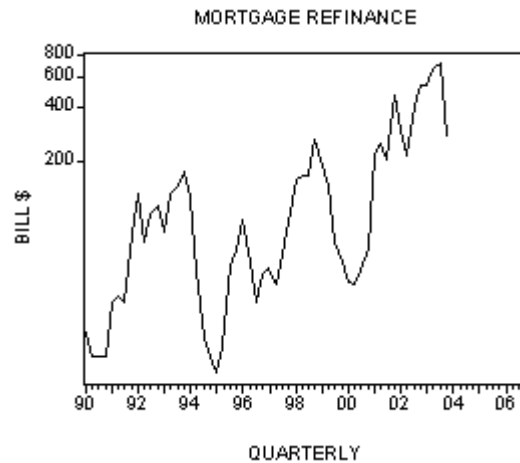
In the meantime, the Federal debt stood above \$7 trillion in December last year. Note that since 2001 the pace of the Federal debt has been accelerating.



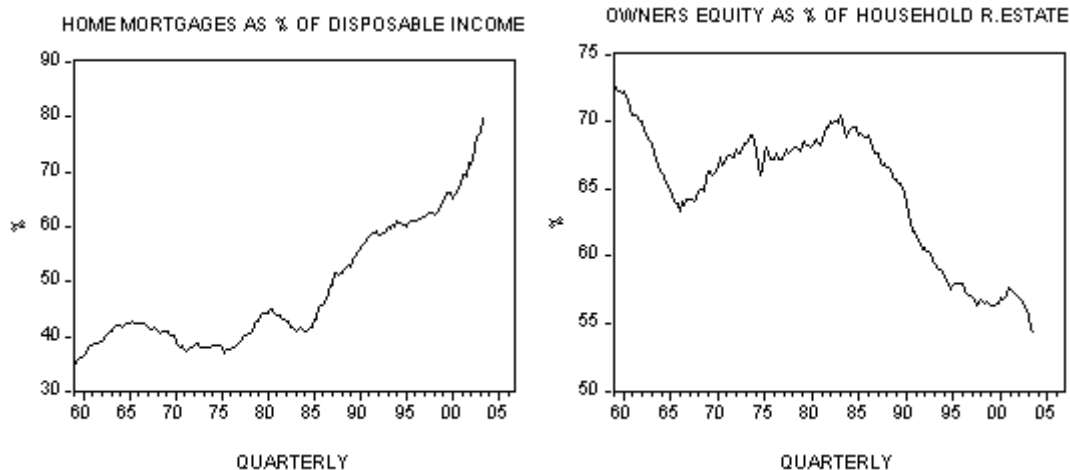
Now, according to Greenspan mortgage refinancing played an important role in last year's buoyant economic growth. (How in the world can credit, which is not backed-up by real savings, generate economic growth?) Mortgage refinancing on account of the Fed's low interest rate policy, according to Greenspan, permitted consumers to boost their expenditures and thus the pace of GDP. (Note that this increase in consumption has led to the depletion of the pool of investable resources).

However, there are currently strong indications that this source of "funding" is fading rather rapidly. After climbing to a record high of \$723 billion in Q3 mortgage

refinancing plunged to \$276 billion in Q4. Note that this fall took place despite low mortgage interest rates.

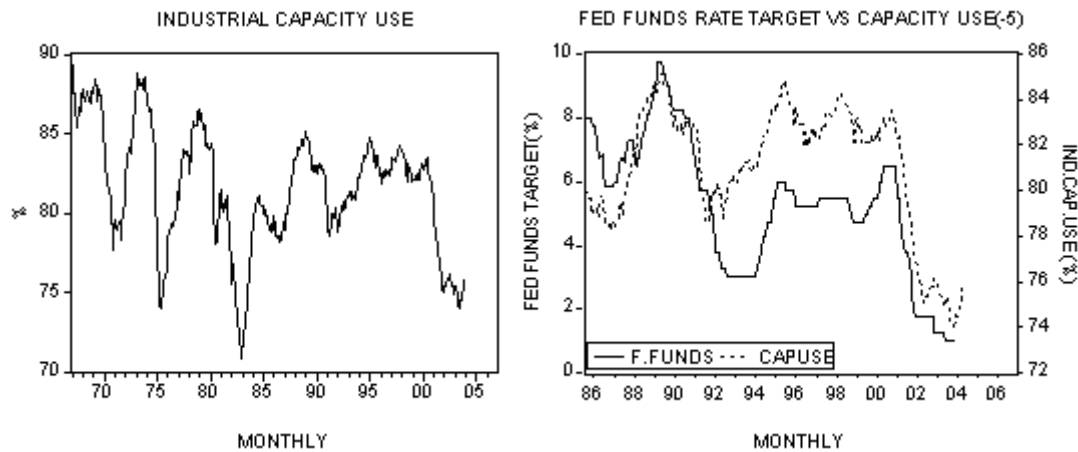


Given the fact that the mortgage debt-to-income ratio remains at a record level it wouldn't surprise us if mortgage refinancing continues to weaken further. Home mortgages as a percentage of disposable income rose to a new record high of 80.1% in Q3 from 79.2% in Q2. Also, households' home equity as a percentage of real estate fell to 54.3% in Q3 from 54.8% in the previous quarter and 55.7% in Q1. In other words, even in terms of Greenspan's own analysis economic activity is likely to weaken and not strengthen in terms of GDP.



If the economy were to weaken in the months ahead in terms of GDP, it is most likely that the Fed will continue to maintain its current easy interest rate stance.

In addition to the employment factor, another important economic indicator in the Fed's monetary policy deliberation is industrial capacity use. In December capacity use stood at 75.8%. In short, there is still 24.2% of spare capacity in the industrial sector. This in turn raises the likelihood that as long as the capacity use remains low the U.S. central bank policy makers are likely to maintain their loose interest rate stance for some months to come.



Furthermore, a visible softening in the growth momentum of the personal consumption price deflator (a favorable price inflation indicator of Greenspan) is another factor that will deter the Fed from tightening its stance. In December the yearly rate of growth of the price deflator stood at 1.3% (see chart). (Note that the Fed holds that price deflation is still a possibility.) We suspect that the Fed will continue to further undermine the process of wealth generation and thereby delay any prospects for a sustainable economic recovery.



Frank Shostak is an adjunct scholar of the Mises Institute and a frequent contributor to Mises.org. He maintains weekly data on the AMS for subscribers through [Man Financial, Australia](#). Send him [MAIL](#) and see his outstanding Mises.org [Daily Articles Archive](#).

[1] [Testimony of Chairman Alan Greenspan before the Committee on Financial Services, US House of Representatives February 11, 2004.](#)

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