August 12, 2002

THE OUTLOOK

Forget the Wealth Effect: Income Drives Spending

By BERNARD WYSOCKI JR.
Staff Reporter of THE WALL STREET JOURNAL

It's time to stop paying so much attention to the "wealth effect."

Monitoring the wealth effect became a popular practice for economists during the high-flying 1990s as they sought to quantify how much of the trillions of dollars in new stock-market wealth consumers were spending. The conventional wisdom was that they spent about 4% of their gains. That is, for every new $1 of equity wealth that consumers rack up, they will spend about four cents over time.

COMPANIES

Dow Jones, Reuters

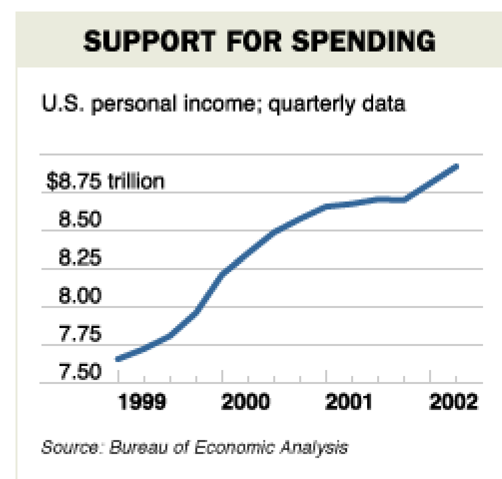
Wells Fargo & Co. (WFC)

PRICE	50.55
CHANGE	-1.25
U.S. dollars	11:24 a.m.

* At Market Close

And ever since stock prices began to decline two years ago, economists have been looking for the "negative" wealth effect to kick in as trillions of dollars in stock-market losses trigger some untold cutbacks in spending.

Funny thing is, spending has continued to grow despite the market's weakness. So, why hasn't the negative wealth effect destroyed consumer spending? The answer is that the wealth effect -- in which spending is partly driven by a psychological sense of well-being -- pales next to real fundamentals that drive most U.S. households to spend, which is their ongoing flow of income.



By far the biggest driver of consumer spending is personal income, the $9 trillion a year flowing to U.S. households in the form of wages, salaries, interest, dividends and government pension payments. This is what really determines how much the U.S. consumer will spend in the months ahead.

At **Wells Fargo** & Co., Sung Won Sohn's economic model attributes 75% of consumer spending to income, and 25% to wealth effects, whether positive from rising asset prices or negative from falling prices. At the Conference Board, Gail Fosler puts the income weight even higher, at 90%, compared with 10% for the wealth effect. Other economists use similar weightings.

Further blunting the impact of the "negative wealth effect" from the stock market is a "positive wealth effect" from housing. An International Monetary Fund study concluded that between January 2000 and October 2001, the downturn in equities lowered consumer spending by 1.9 percentage points. However, this was almost offset by a 1.6 point gain from spending by homeowners out of the building in the value of their homes.

But the important point is that wealth effects, even if they are growing because of gyrations in asset prices, are far outweighed by income effects in determining what drives consumer spending. And incomes have been strong. In the 12-month period ended in June, personal income was up 3.4%.

Looking at these numbers, there is no mystery why the consumer has been the standout of an otherwise lackluster U.S. economy. Even in a lackluster job market, overall wages and salaries grew moderately. Moreover, pension income and other government transfer payments soared nearly 10%. And one subcategory, inflation-adjusted disposable income, has been increasing. It rose at a 9.1% annualized pace in the first half of 2002, which Richard Berner of Morgan Stanley calls the fastest growth rate in two decades.

These big gains in real purchasing power owe their strength to low inflation, low interest rates that cut mortgage payments, and lower tax burdens on Americans.

It is far from certain, of course, that personal income, and thus spending, will hold up as well in the months ahead. Last week, some big retailers reported that sales were softer than expected in July, although it is too early to know if this marks a trend.

And with continued weakness in the U.S. business sector, some economists are bracing for a new round of job cuts in the months ahead. William Dudley, economist at Goldman Sachs Group, believes that a weakening job market "implies sharp deceleration" in income growth.

The sharp declines in the stock market have prompted people to save more, driving the personal savings rate to greater than 4% of income. By definition, money saved isn't money spent on consumer goods and services.

Other possible threats include an oil shock, another terrorist attack, or higher interest rates that add to Americans' debt burdens.

But there are signs of a more positive outlook. If the worst of the cyclical economic downturn is over, then the employment picture should stabilize and maybe even improve. There is some evidence of this already. Thursday, the government announced a sharp drop in jobless claims, putting the four-week moving average at 379,000, the lowest level since February 2001.

It could mean that the worst of the corporate payroll slashing is ending, as companies are made lean enough to weather the current economy. If demand picks up, the profit and productivity gains will be great, and some portion of those gains will be shared with employees in the form of higher wages and benefits. It would mean that today's strong gains in personal income aren't a fluke, but part of a solid platform for building a U.S. recovery.

Whether personal income strengthens or weakens over coming months, focusing on income is the correct thing to do. For most Americans, it is the continuing cash flow into their pockets -- not the rise or fall in the value of their assets -- that plays spending's biggest role.

Write to Bernard Wysocki Jr. at bernie.wysocki@wsj.com[1]

URL for this article:
http://online.wsj.com/article/0,,SB1029102547978812195.djm,00.html

Hyperlinks in this Article:
(1) mailto:bernie.wysocki@wsj.com

Updated August 12, 2002

Copyright 2002 Dow Jones & Company, Inc. All Rights Reserved

Printing, distribution, and use of this material is governed by your Subscription agreement and Copyright laws.

For information about subscribing go to http://www.wsj.com