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# The Global Financial Crisis and American Wealth Accumulation: The Fed Needs a Bubble Watch

## By John H. Makin

*The global financial crisis destroyed over one-fifth of accumulated American wealth (real net worth of households and nonprofit organizations) in just one year: 2008. That huge loss was on top of a far more modest but still significant 1.62 percent wealth loss in 2007. Both the US stock market bubble burst in 2000 and the housing bubble implosion of 2008 contributed to the current situation, reinforcing the need for a Federal Reserve "bubble watch" program. If we could recognize patterns that lead to these bubbles, we could see them coming and adjust policy to protect wealth accumulation and the economy as a whole.*

A wealth loss of the magnitude of the one in 2008 is unprecedented in post–World War II America. The previous record year was 1974, with a 9.14 percent loss, reflecting the extreme disruptions tied to the "oil shock," when oil prices quadrupled in just a year. The three years from 2000 to 2002 saw a total wealth loss of 9.9 percent, less than half the one-year 2008 loss over a period three times as long.

Americans have enjoyed substantial and persistent wealth accumulation since 1960. Real net worth of American households and nonprofit organizations grew by 3.47 percent per year from 1960 through 2007. The "golden age" was 1991 to 1999, when wealth grew at a remarkable 5.39 percent, some 50 percent faster than in the 47-year span from 1960 through 2007. Little wonder, in view of the unprecedented 2008 wealth loss, that the global financial crisis produced lasting effects on American consumption, saving, and investment, along with record levels of monetary and fiscal stimulus aimed at easing the pain.

This substantial policy stimulus notwithstanding, the post-2008 recovery of American wealth, not to mention the American economy, has been gradual with some setbacks, notably including a 1.26 percent wealth drop in 2011. From the 2008 low through the first quarter of 2013, real net worth grew by 20.5 percent, or at an average annual rate of 4.23 percent. This outcome occurred with the help, especially post-2011, of rising equity markets and a modest recovery in home prices.

The high post-2008 growth rate is a bit misleading since it occurred from a very low 2008

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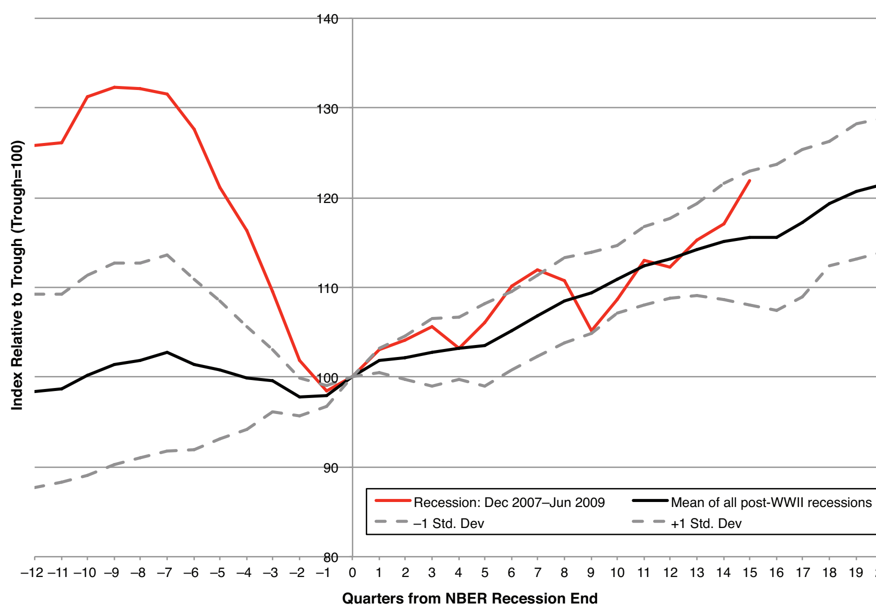
**Key points in this *Outlook*:**

- The 2008 housing bubble burst and the ensuing global financial crisis destroyed an unprecedented 22 percent of accumulated American wealth.
- This massive destruction of wealth has resulted in a tepid recovery marked by below-average recovery levels of saving, consumption, and investment.
- The Federal Reserve needs to create a "bubble watch" program to prevent speculative bubbles from destroying wealth accumulation in the future.

base that followed the 22 percent 2008 wealth collapse. (See figure 1.) By the end of the first quarter of 2013, US wealth still stood 8 percent below its 2006 peak. A longer-term perspective on the devastating impact of the global financial crisis on US wealth arises from the sharply reduced 1.2 percent annual pace of American wealth growth from 2000 Q1 to 2013 Q1. Over the last 13 years, American wealth has risen at a pace just above a third of the 1960–2007 pace and just above a fifth of the 5.39 percent pace during the 1991–99 "golden age." The bursting of the stock bubble in 2000–02 and of the housing bubble in 2008 have taken their toll on American wealth.

Figure 1

**Real Net Worth of Households and Nonprofit Organizations—Comparison of Great Recession to the Mean of All Post-WWII Recessions**




Source: Federal Reserve, Flow of Funds Accounts (Z.1)

## Wealth Losses Weakened the Recovery

In my May 2008 *Economic Outlook*, published just after the Bear Stearns collapse but a few months before the more spectacular Lehman collapse, I identified "the pace at which Americans restrict spending relative to (falling) income, first to arrest the drop in accumulated wealth and subsequently to restore wealth" as a major factor affecting the outlook for the US economy.[1] My prediction later in the piece of "a long recession" was disquieting yet prescient. I continued:

> The US economic crisis resulting from a collapse of the housing bubble and falling stock prices that combine to hammer US household balance sheets is just beginning. Even the Federal Reserve has acknowledged that US growth will probably be negative during the first half of 2008. The Fed's outlook still looks for a rebound in the second half of the year. While tax rebate checks may boost growth slightly in the third quarter, the persistent drag from wealth losses as house prices and stocks fall and households begin saving again—coupled with bank deleveraging—will undercut the Fed's forecast for a sustainable growth rebound. Instead, a prolonged US recession looks like the more probable outcome.

It is useful to note from reading that last paragraph written in May 2008 that the Fed was still in a business-as-usual mode after the Bear Stearns crisis. While acknowledging some slowdown, the central bank was still looking for a second-half recovery as it is doing again, perhaps unwisely, this year.[2] The Lehman crisis and subsequent economic collapse were nowhere to be seen in May 2008.

The recession that followed the Lehman collapse was intense. Although it technically ended in June 2009, the subsequent recovery, as is now well-known, was tepid and disappointing. Understanding the specifics of the actual post-2008 paths of consumption, investment, saving, and policy measures is important to examining both the effect of large wealth losses and the possible direction of future growth five years into the extended post–financial-crisis period of the recovery. There are also lessons for other countries, but we will not delve into those here.

Before the onset of the 2008 financial crisis, the US personal saving rate had been on a long-term downward path since the late 1970s. (See figure 2.) During and after the crisis, in the recession that accompanied its onset and aftermath, the US personal saving rate rose sharply from about 3 percent to more than 6 percent and has held at that level at least until the current year. (See figures 2 and 3.)

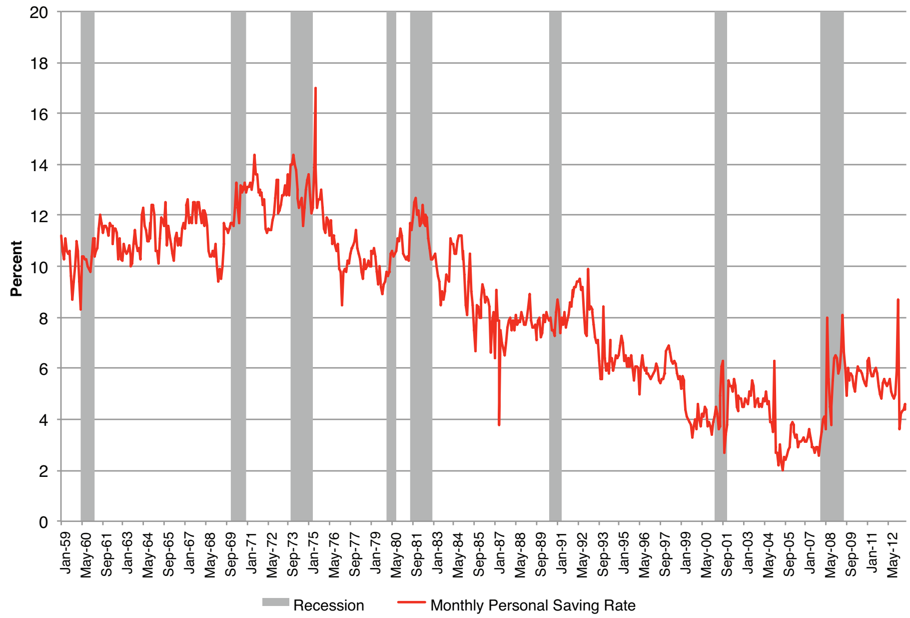
Shocked by wealth losses, American households restricted spending even after the recession technically ended in June 2009. The byproduct was weak growth of aggregate demand, offset in part by aggressive monetary and fiscal measures.

The personal saving rate spiked late in 2012 given the accelerated distribution of dividends in anticipation of higher tax rates on such income that took effect in early 2013. Since then, the personal saving rate has dropped somewhat, back to a level of around 4.5 percent, perhaps because of increasing confidence that rising home prices and equity prices will support future wealth accumulation. Relative to past cycles, the US personal saving rate since 2009 has been low. However, this largely reflects the fact that the personal saving rate was substantially higher in the 1960 through 1980 period, even relative to the elevated levels after the 2008 global financial crisis. (See figure 3.)

A look at the path of personal consumption expenditures explains how US households were able to elevate saving rates even in a period of slow growth. From June 2009 to the present, the path of US consumption has been substantially below that of a typical recovery. (See figure 4.) As consumption continues to lag, the gap between the path of consumption in this tepid recovery and the benchmark of weaker recoveries—a standard deviation below typical recoveries—has grown wider, proving that consumption during the current recovery has been especially weak.

FIGURE 2

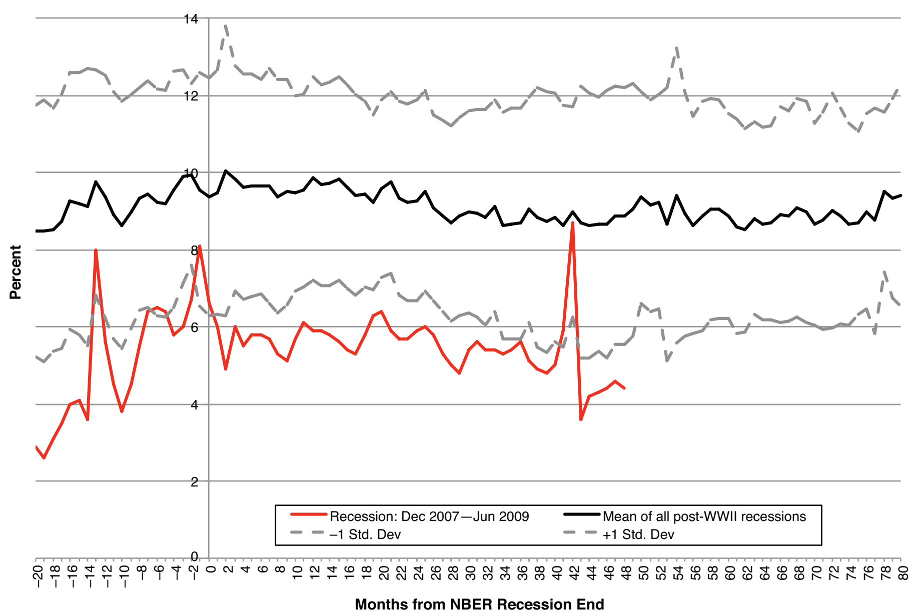
PERSONAL SAVING RATE: JANUARY 1959–JUNE 2013




Source: US Department of Commerce, Bureau of Economic Analysis

FIGURE 3

PERSONAL SAVING RATE—COMPARISON OF GREAT RECESSION TO THE MEAN OF ALL POST-WWII RECESSIONS




Source: US Department of Commerce, Bureau of Economic Analysis

The large wealth losses during 2008 prompted American households to restrict consumption to help restore wealth losses through a higher saving rate. The byproduct of this, of course, has been a slow pace of GDP growth and a subpar recovery. The rationale for high levels of fiscal and monetary stimulus has been that it is necessary to try to replace the lost demand growth, given the restricted spending patterns of American households.

The path of investment before, during, and after the financial crisis is similar to the path of wealth accumulation because investment, in addition to the capital stock, is a form of wealth accumulation. Before and during the crisis, investment fell sharply. (See figure 5.) Thereafter, from a very low base, the recovery of investment, or capital formation, has proceeded along the lines of a normal economic recovery. This reflects the desire of companies conserving on hiring of labor to replace labor with capital. It also reflects the ongoing need to replace depreciated capital as companies aim to increase output to keep up with moderate growth of domestic demand and to help expand exports.

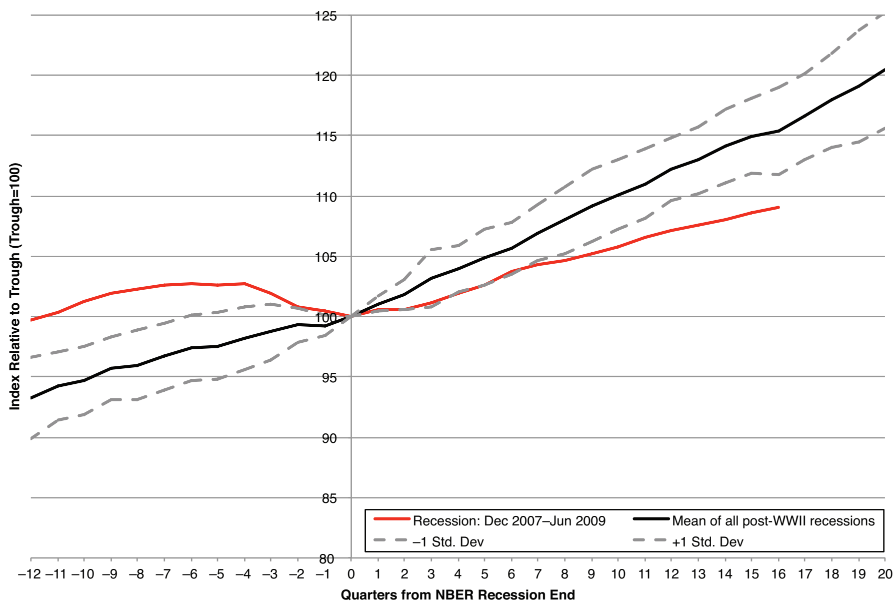
As with wealth accumulation, although the postrecession path of investment has been average, real capital stock is still probably below its level before the global financial crisis, largely because of the sharp drop in investment in the year before and during the crisis. Going forward, sustained growth will require further capital accumulation and some policy measures, such as lower tax rates on capital, that encourage that activity.

Of course, the overall result of reduced levels of consumption and investment growth has been a subpar recovery. (See figure 6.) The growth rate of GDP experienced an unprecedented drop during the crisis in 2008 and has been sharply below the average recovery growth rate. Even now, five years into the recovery, the pace of GDP growth remains below typical levels, and accumulated losses of output are substantial.

Going forward, it will be impossible to sustain higher growth without stronger consumption growth. That, in turn, is made less likely by the fiscal drag introduced early this year and the tapering of monetary stimulus under consideration at the Fed. Indeed, we have reached a

Figure 4

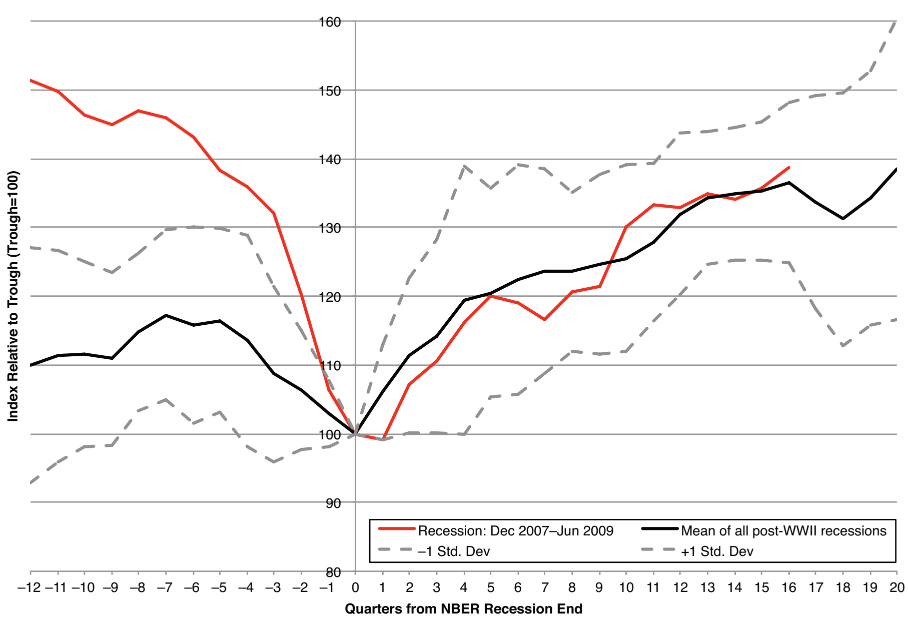
**Real Personal Consumption Expenditures—Comparison of Great Recession to the Mean of All Post-WWII Recessions**




Source: US Department of Commerce, Bureau of Economic Analysis

Figure 5

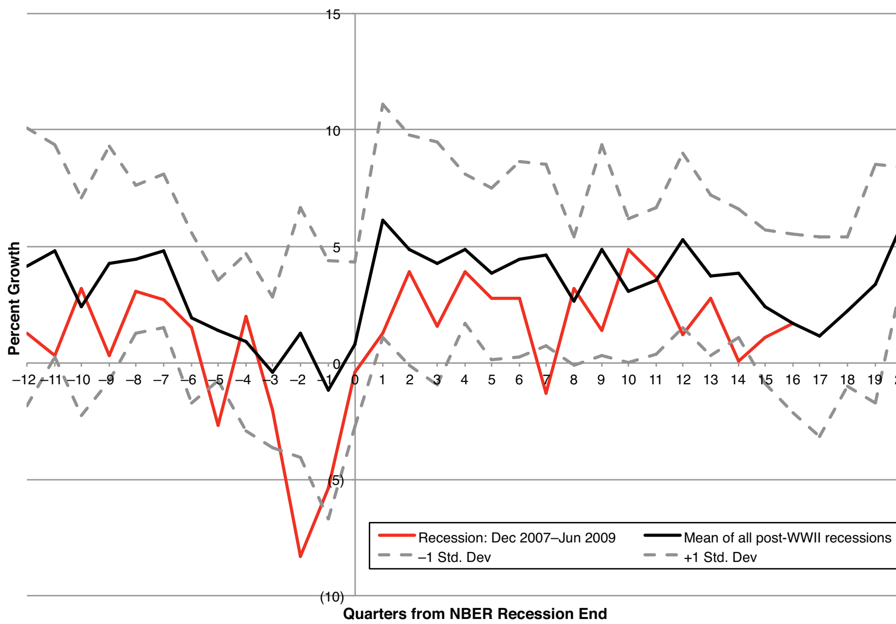
**Real Gross Private Domestic Investment—Comparison of Great Recession to the Mean of All Post-WWII Recessions**




Source: US Department of Commerce, Bureau of Economic Analysis point, 50 months into a recovery, where typical postwar recoveries begin to falter. There is a significant risk of a recession in 2014.[3]

FIGURE 6

REAL GROSS DOMESTIC PRODUCT GROWTH—COMPARISON OF GREAT RECESSION TO THE MEAN OF ALL POST-WWII RECESSIONS




Source: US Department of Commerce, Bureau of Economic Analysis

## We Need a Fed "Bubble Watch"

Notwithstanding the devastation of American wealth and the modest pace of the recovery since 2008, Americans are uniquely blessed with wealth accumulation opportunities. As an excellent place to store wealth, the United States remains a major exporter of wealth storage facilities. Such facilities need to provide liquid, mobile, stable, and long-lived assets, all qualities possessed by a number of American offerings. Between 2006 and 2011, the Chinese availed themselves of wealth storage facilities in the US Treasury market, helping support American consumption in the postcrisis period.

However, the two major avenues of American wealth accumulation, financial assets and owner-occupied housing, have been both a help and harm to American households over the last half-century. The unique convenience of wealth accumulation through homeownership became so compelling after the equity bubble burst in 2000 that the housing bubble developed with considerable government encouragement from tax preferences during the decade after 2000. The bursting of the stock bubble early in 2000 left American households searching for another avenue of wealth accumulation, and with considerable encouragement from banks and brokers, Americans households turned to real estate to accumulate wealth.

As history has shown, the financial asset and housing approaches to wealth accumulation have their drawbacks, particularly manifest in bubbles that, upon bursting, have set wealth accumulation back a long way. Policymakers' sensitivity to financial and housing markets and their desire to support those avenues of wealth accumulation have probably contributed to the bubbles in both sectors during the last half century. It may be better to allow the pace of wealth accumulation in those sectors to slow somewhat to avoid the disruptions that inevitably accompany the bursting of such bubbles.

In any case, the Fed needs to pay more attention to the tricky problem of identifying speculative bubbles before they burst. Any prospective Fed chairman needs to step up to the challenge of creating a viable Fed bubble watch program. Over to you, Larry and Janet.

## Notes

1. John H. Makin, "Wealth Enhancement and Storage," AEI *Economic Outlook* (May 2008), www.aei.org/outlook/economics/financial-services/wealth-enhancement-and-storage/.

2. See John H. Makin, "Third Time Unlucky: Recession in 2014?" AEI *Economic Outlook* (July 2013), www.aei.org/outlook/economics/monetary-policy/third-time-unlucky-recession-in-2014/.

3. Ibid.