



**The Northern Trust Company**  
**Economic Research Department**  
**Positive Economic Commentary**

*"The economics of what is, rather than what you might like it to be."*

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November 15, 2005

### **Greenspan's Legacy Of Debt**

On the day that Ben Bernanke, the nominee for the next Fed chairman, appears before the Senate Banking Committee for his confirmation hearing, it is only fitting that his predecessor's legacy be reviewed. Although it is true that under Alan Greenspan's command of the Fed the U.S. economy has experienced unusually low volatility, this low volatility may turn out to have been a Faustian bargain. That is, the low volatility was achieved by increasing the indebtedness of the U.S. economy, especially the household sector, to record levels. And increasingly, the debt is owed to foreign entities, not ourselves. The final chapter on Greenspan's legacy will not be written until we see how this indebtedness issue is resolved.

Greenspan's predecessor, Paul Volcker, provided us some insights on these issues in an article he wrote for the April 10, 2005 edition of the *Washington Post* entitled "An Economy On Thin Ice," (<http://www.washingtonpost.com/wp-dyn/articles/A38725-2005Apr8.html>) excerpts of which are quoted below.

"[U]nder the placid surface, there are disturbing trends: huge imbalances, disequilibria, risks -- call them what you will. Altogether the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot."

"We are buying a lot of housing at rising prices, but home ownership has become a vehicle for borrowing as much as a source of financial security. As a nation we are consuming and investing about 6 percent more than we are producing."

"What holds it all together is a massive and growing flow of capital from abroad, running to more than \$2 billion every working day, and growing."

"The difficulty is that this seemingly comfortable pattern can't go on indefinitely. I don't know of any country that has managed to consume and invest 6 percent more than it produces for long. The United States is absorbing about 80 percent of the net flow of international capital. And at some point, both central banks and private institutions will have their fill of dollars."

"I don't know whether change will come with a bang or a whimper, whether sooner or later. But as things stand, it is more likely than not that it will be financial crises rather than policy foresight that will force the change."

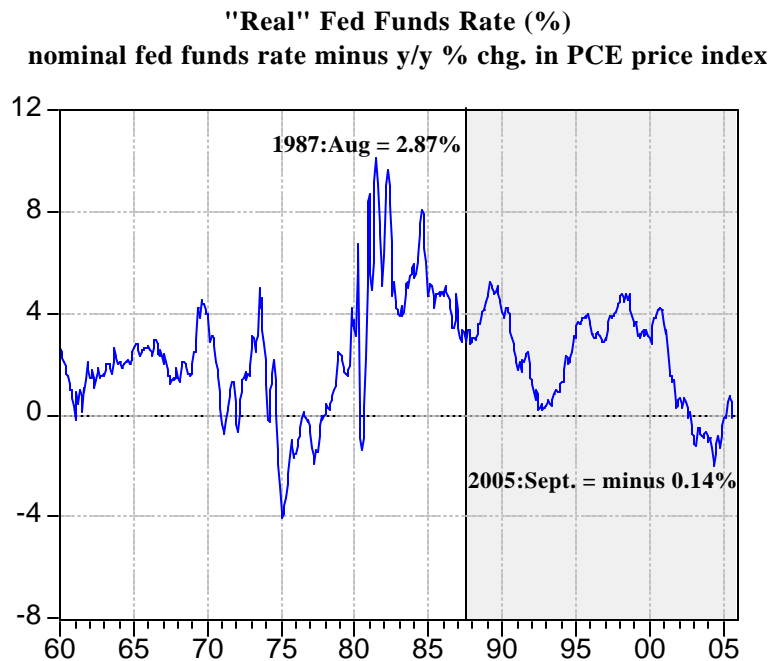
"So I think we are skating on increasingly thin ice. On the present trajectory, the deficits and imbalances will increase. At some point, the sense of confidence in capital markets that

today so benignly supports the flow of funds to the United States and the growing world economy could fade. Then some event, or combination of events, could come along to disturb markets, with damaging volatility in both exchange markets and interest rates. We had a taste of that in the stagflation of the 1970s -- a volatile and depressed dollar, inflationary pressures, a sudden increase in interest rates and a couple of big recessions."

Below are a series of charts illustrating aspects of record U.S. indebtedness. Although I have used most of these charts in various previous commentaries, they are assembled here in one place for your edification. The shaded areas in the charts denote Greenspan's tenure as chairman of the Federal Reserve.

**Greenspan kept inflation-adjusted interest rates in negative territory for an extended period of time after the bursting of the NASDAQ bubble.**

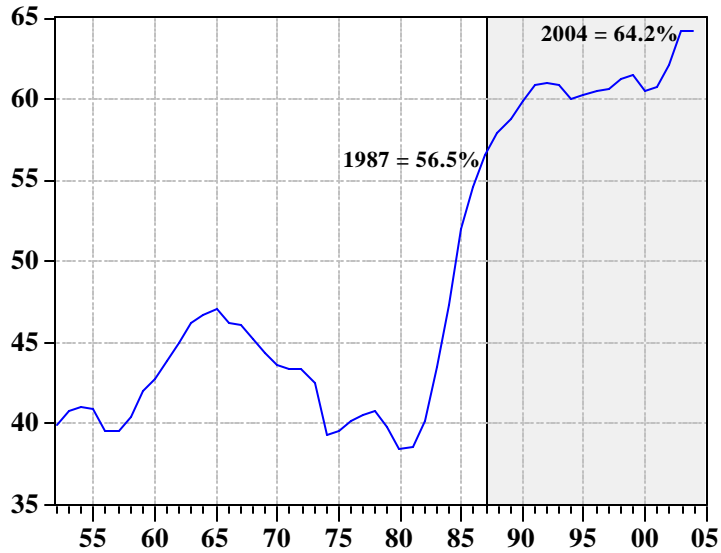
**Chart 1**



Low real interest rates have resulted in record leverage in the U.S. economy.

Chart 2

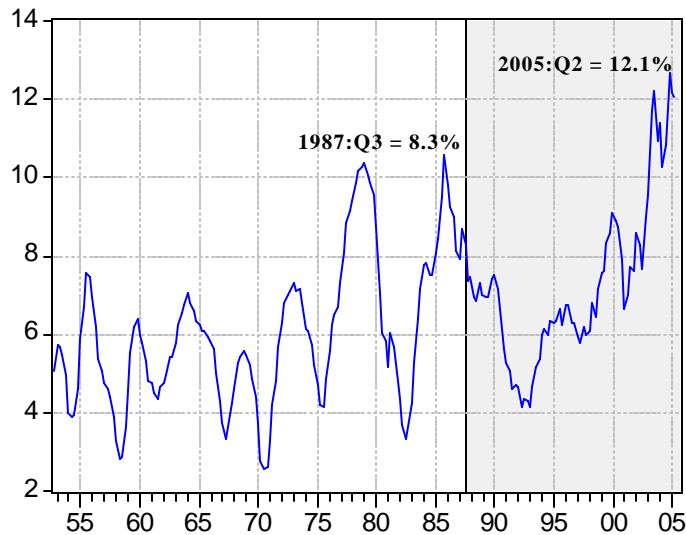
Nonfinancial Debt as % of Total Capital Stock  
(including consumer durable goods)



Low real interest rates have led to record household borrowing.

Chart 3

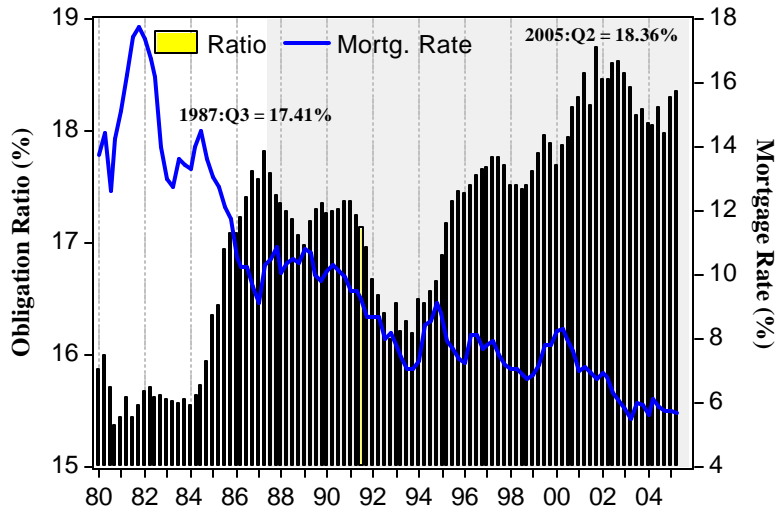
Households: Chg. in Total Liabilities / Disposable Personal Income  
% 4-qtr. moving average



**Record household borrowing has led to escalating debt-service burdens despite low nominal interest rates.**

**Chart 4**

**Household Financial Obligations Ratio\* vs. 30-Yr. Mortgage Rate**  
%

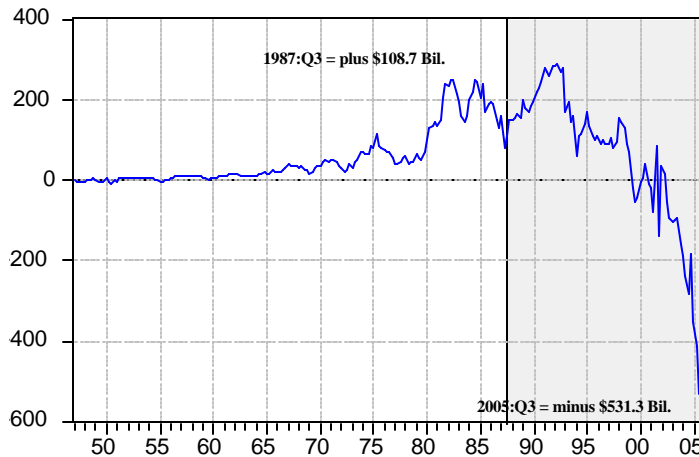


\* payments of required principal/interest, motor vehicle rental, housing rental, homeowners' insurance and property taxes as % of DPI

**Households spent a record annualized \$531 billion more than they earned after taxes in the third quarter of 2005, continuing the trend of net household deficits that began in the late 1990s.**

**Chart 5**

**Household Surplus (+) or Deficit (-)\***  
\$ Bil. SAAR

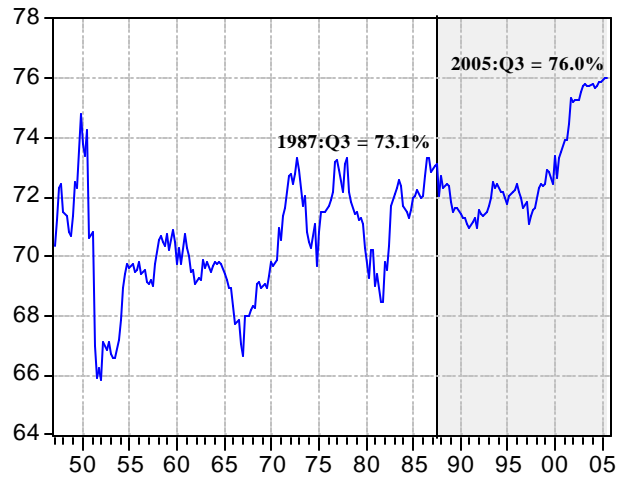


\* disposable personal income minus expenditures on consumer goods/services and residential investment

Household spending is a record high 76% of GDP.

Chart 6

Real Household Expenditures\* as % of Real GDP

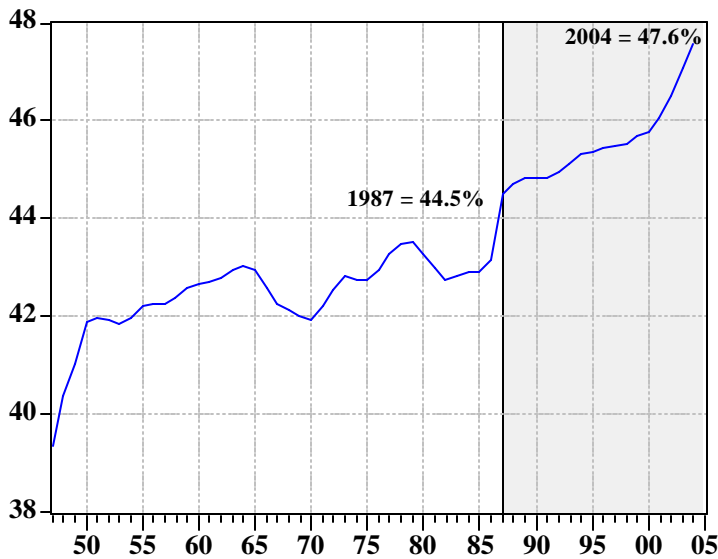


\* sum of expenditures on real goods/services and residential investment

Record household spending has led to household tangible assets rising to a record percentage of our total national stock of tangible assets.

Chart 7

Real Capital Stock: Household\* as % of Total



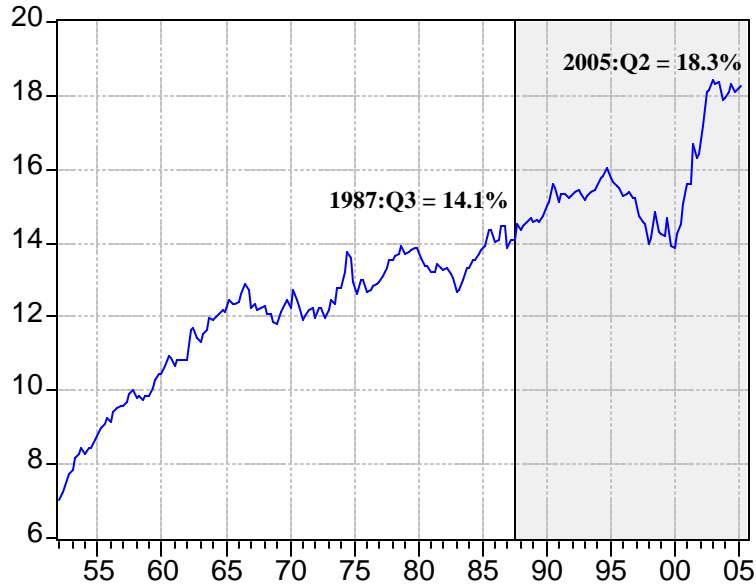
\* Private residential fixed assets plus consumer durable goods

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**Record household borrowing has led to record household leverage.**

**Chart 8**

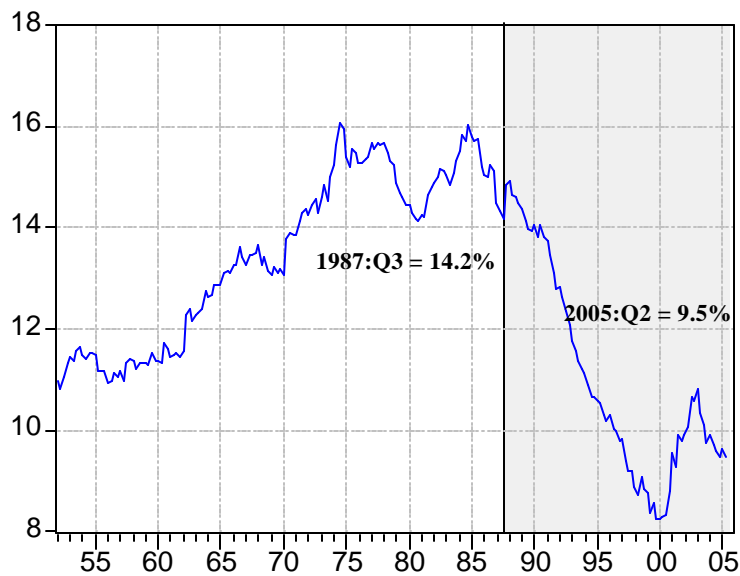
**Households: Total Liabilities as % of Mkt. Value of Total Assets**



**While leverage is at record highs, household liquidity is at near record lows.**

**Chart 9**

**Households: Deposits as % Mkt. Value of Total Assets**

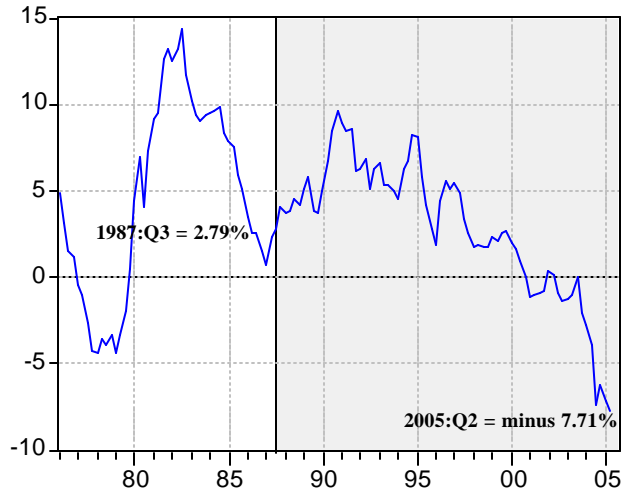


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**Mortgage rates relative to house price increases are at record lows.**

**Chart 10**

**"Real" 30-Yr. Mortgage Rate\***  
%

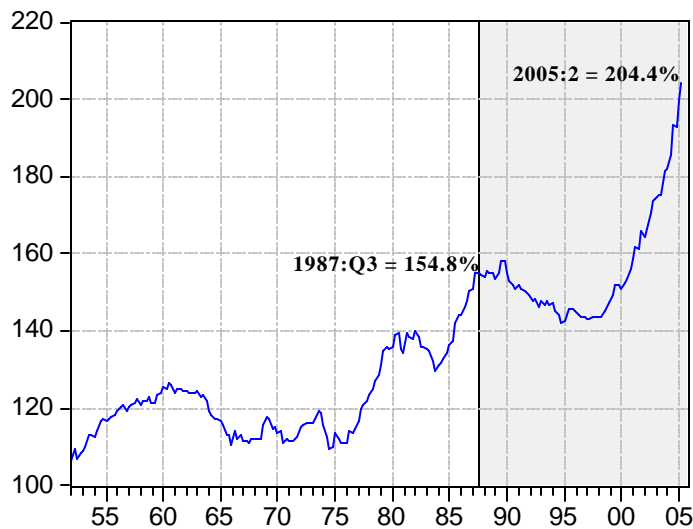


\* nominal 30-yr. mortgage rate minus y/y % chg. in OFHEO house price index

**In a vicious cycle, low "real" mortgage rates have resulted in a record high market value of residential real estate relative to after-tax household income as house prices get bid up.**

**Chart 11**

**Mkt. Value of Res. Real Estate as % Disposable Personal Income**

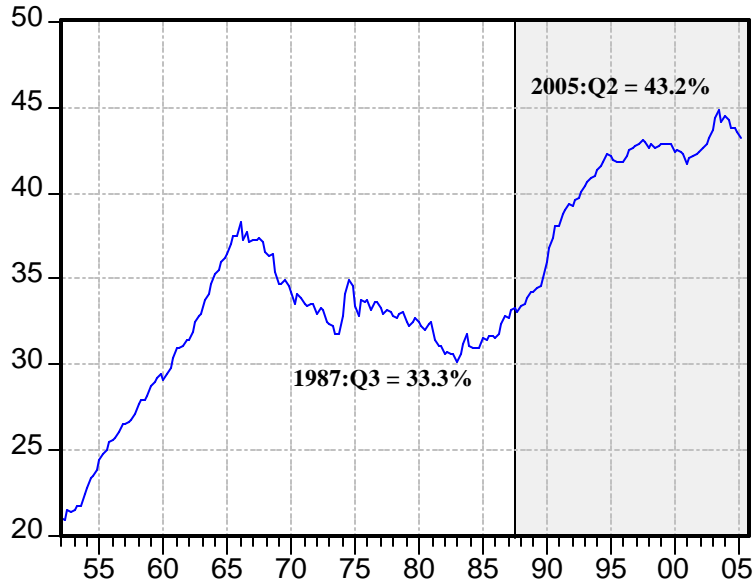


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Record low “real” mortgage rates have resulted in record high leverage in residential real estate.

Chart 12

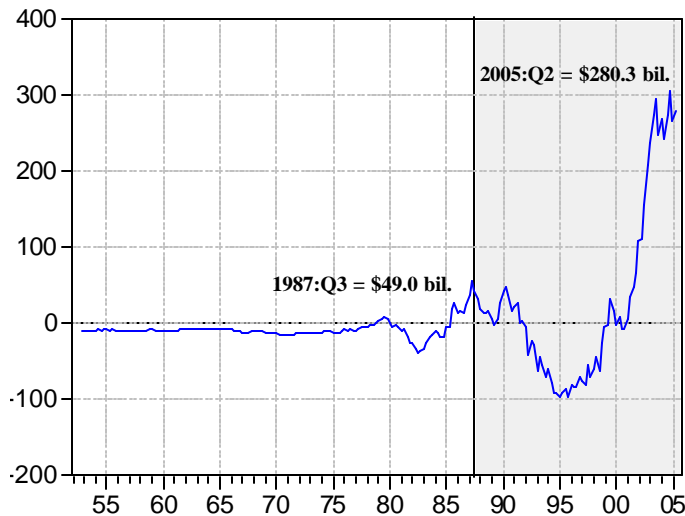
Mortgage Debt as % of Mkt. Value of Owner-Occupied Res. Real Estate



Part of the increase in housing leverage has resulted from home-“owners” treating their houses as their personal ATM machines.

Chart 13

Net Home Equity Extraction  
SAAR \$billions 4-qtr. moving average

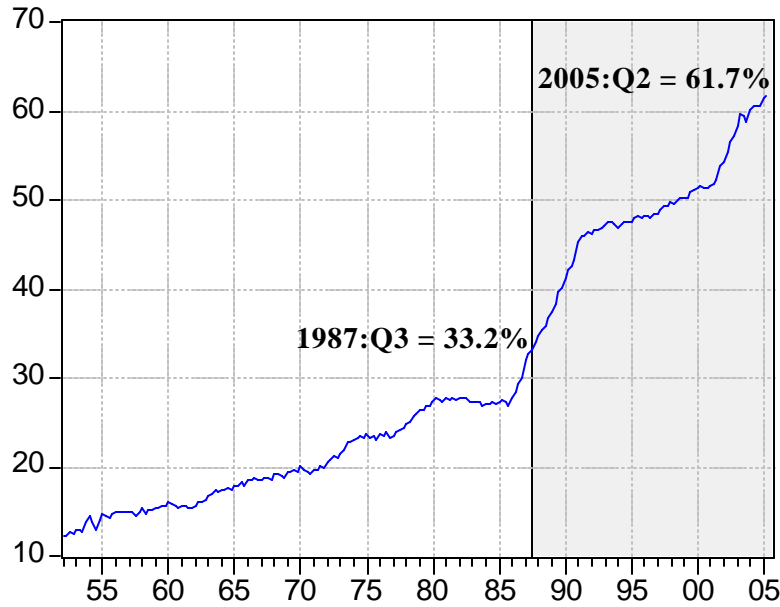


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The U.S. banking system has record exposure to the mortgage market.

Chart 14

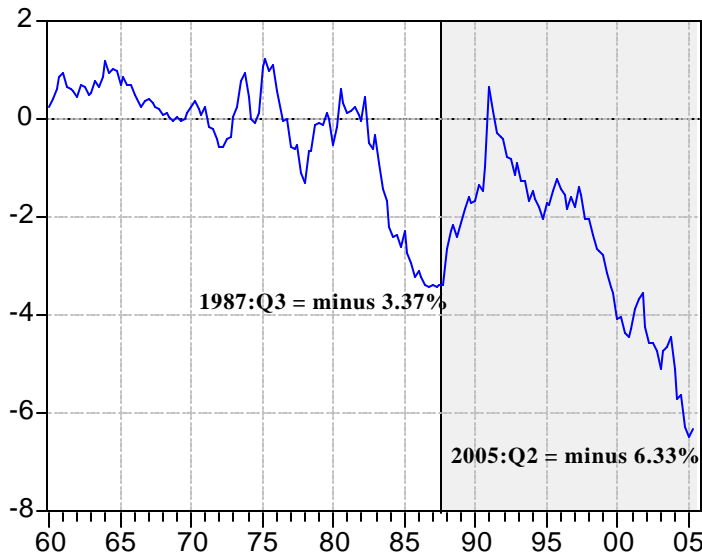
**U.S. Banks: Mortgage-Related Assets / Total Earning Assets  
(percent)**



The surge in household borrowing has led to record external deficits.

Chart 15

**U.S. Current Account Surplus (+) or Deficit (-) as % GDP**

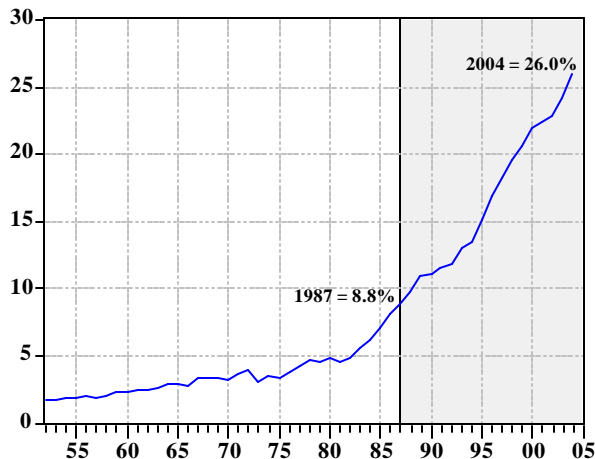


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**Record external deficits have led to record foreign ownership of U.S. tangible assets, meaning that earnings from these assets will accrue to foreign investors.**

**Chart 16**

**Foreign "Ownership" of Total U.S. Capital Stock\***  
%



\* Total financial liabilities to foreign entities as a % of total nominal capital stock

**The potential adverse consequences of Greenspan's legacy of debt are:**

- ▶ **McMansions and SUVs will not make us more productive in the future.**
- ▶ **Foreign creditors could start to question how we will be able to pay future interest and dividend payments without resorting to "printing" dollars.**
- ▶ **If foreign creditors should question our ability and willingness to repay them without resorting to the currency printing press, there could be a run on the dollar.**
- ▶ **A run on the dollar would lead to sharply higher U.S. interest rates.**
- ▶ **Sharply higher interest rates would do great harm to household finances and the housing market.**
- ▶ **A sharp decline in the housing market would result in a spike in mortgage defaults.**
- ▶ **A rise in mortgage defaults would cripple the banking system.**
- ▶ **A crippled banking system would render Fed interest rate cuts less potent in reviving the economy.**

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