

Rights, which has organized both law suits, says Judge Duggan's ruling is "so confused" and Judge Friedman's ruling is such "a blockbuster" that even a liberal panel of judges on the Court of Appeals would have trouble making a convincing case to uphold the former and overturn the latter.

Meanwhile, advocates of preference schemes have taken heart from the Supreme Court's April ruling in *Hunt v. Cromartie*, in which the majority refused to overturn a North Carolina redistricting scheme, even though a lower court found it used race as the "predominant factor" in its drawing of lines. Justice O'Connor, who had previously condemned race-based districting schemes, shifted sides.

The rejoicing may be premature. Justice Breyer's majority opinion emphasized that the legislature's motives were not necessarily racial: boundary lines concentrating black voters in particular districts might well have aimed at maximizing the concentration of Democratic voters. And the Court has always granted wide latitude to states to divide their legislative districts along arbitrary, partisan lines. Anyway, in redistricting the state does not treat individual voters differently, but only gives plots of land new boundaries.

By contrast, Michigan and other state universities really are treating individual students differently on the basis of their race. University admissions offices can't claim race is just a proxy for some other, more relevant attribute—not when their claim that students of different races present "diverse" viewpoints is so little removed from the claim that students of different races are just, well, different.

If the Supreme Court tells university administrators to ignore race, many will still find ways to consider it surreptitiously. There is still value in driving demeaning racial stereotypes into furtive corners. A clear ruling against racial profiling in university admissions will do something valuable if it forces public university administrators to stop talking about students of different skin pigment as if they were specimens in a private menagerie. ➤

# The Wealth Effect Is a Myth

## Stocks react to the economy, not the other way around

BY BRIAN WESBURY

One of the most enduring, but misleading, myths about the U.S. economy is that a rising stock market boosts economic activity. The so-called "wealth effect" is blamed for overheating the economy in the late 1990s, while the "negative wealth effect" is blamed for creating a slowdown in 2001.

The theory is that rising stock prices and increased wealth cause consumers to spend more of what they earn. Spending thus rises faster than production, putting stress on the economy and ultimately creating inflation.

The theory is deeply flawed. There is no historical evidence of any long-term relationship between stock prices and spending or inflation.

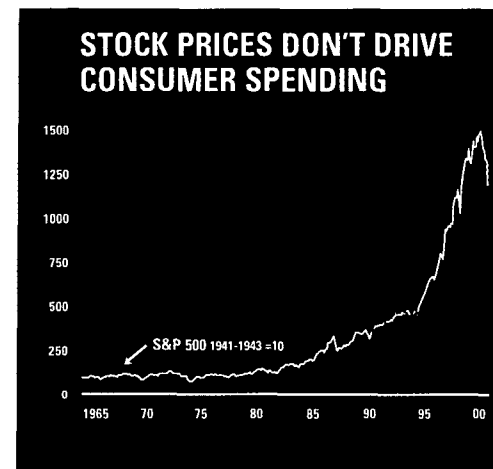
And it is misleading because instead of crediting the 20-year boom to innovation, creativity, and productivity—and the incentives that drive them—demand-side economists use the wealth effect to pass off the boom as a mirage caused by rising stock prices. Similarly, rather than blame the recession this year on bad policy, many blame it on weak stocks and the bursting of the so-called bubble.

The danger is that, as with all demand-side theory since Keynes, the wealth effect is used to excuse government efforts to fine-tune the economy, the most recent devastating example being Alan Greenspan's determination to bring down the Nasdaq by 40 percent.

### BAD THEORY

A bad theory can often be spotted when it becomes circular, like arguing that a gasoline engine provides power because the pistons push the crankshaft and, in turn, the crankshaft moves the pistons.

Similarly, the "wealth effect" says that rising stock prices boost consumption. This excess spending, in turn, boosts corporate profits, employment, and then inflation. Higher profits send stock prices up and rising incomes increase the demand for stocks. Then rising stock prices increase consumption and the circle begins all over again in some theoretical perpetual motion machine.



A much better theory suggests that stock prices react to the economy, rather than the other way around. In this view of the world, entrepreneurial effort creates new and more productive technologies. Higher productivity boosts incomes, expected profits, and investment. This increases employment and economic growth and, at the same time, stock prices.

The spark plugs for this development are low taxes, stable money, respect for property rights, and free trade. Wherever these conditions exist, wealth is created at an amazing rate and the stock market performs well. It is no mystery.

### THE SAVINGS PARADOX

Those who believe in the wealth effect often point to the diminished savings rate as a sign that consumers, feeling

flush as their portfolios swell, are spending above their means. After all, savings rates have fallen from 8.7 percent of disposable personal income in 1992 to a negative 1.0 percent in 2001.

A closer look shows that consumer overspending can't be driving this decline in savings. During the past five years, personal income rose a total of 33 percent, while personal consumption expenditures increased 36 percent. This small difference could not possibly have driven the savings rate into negative territory. What actually caused the collapse in savings rates was a surge in tax payments—up 64 percent in the past five years. Because savings rates are calculated using after-tax income, the surge in taxes is the real culprit behind negative savings, not excess consumption.

## NO HISTORICAL EVIDENCE

If the wealth effect worked we would expect to see a correlation between rising stock prices and rising consumer spending. But as the chart shows, there has been virtually no correlation. Between 1965 and 1982, the S&P rose an average of just 1.4 percent per year, while consumption jumped from a 7.5 percent annual growth rate to over 12 percent. Since 1981 stock prices have increased roughly 1200 percent, while the pace of increase in spending has actually slowed. If the wealth effect exists at all, it stayed hidden for almost 40 years before showing itself in 1999.

The theory has even less evidence when it comes to inflation. In 1965, the personal consumption deflator excluding food and energy (Greenspan's favorite measure of inflation) was rising at a measly 1.3 percent annualized rate. By the early 1980s, despite a stagnant stock market, it was climbing 10 percent annually.

Since the boom began in the early 1980s, inflation has done nothing but fall, and through April of this year, the "core" PCE deflator had risen just 1.7 percent from year-ago levels.

## SEE NO EVIL

All of this evidence does not sway Alan Greenspan or other members of the Fed. Greenspan told the U.S. Congress in February that "changes in stock market wealth have become a more important determinant of shifts in consumer spending relative to changes in current household income than was the case just five to seven years ago."

However, this is just a convenient way to avoid any blame for the problems that the economy is having this year. If the "bubble theory" and the

alternative is to lean against the economic pressures that may accompany a rise in asset prices, bubble or not."

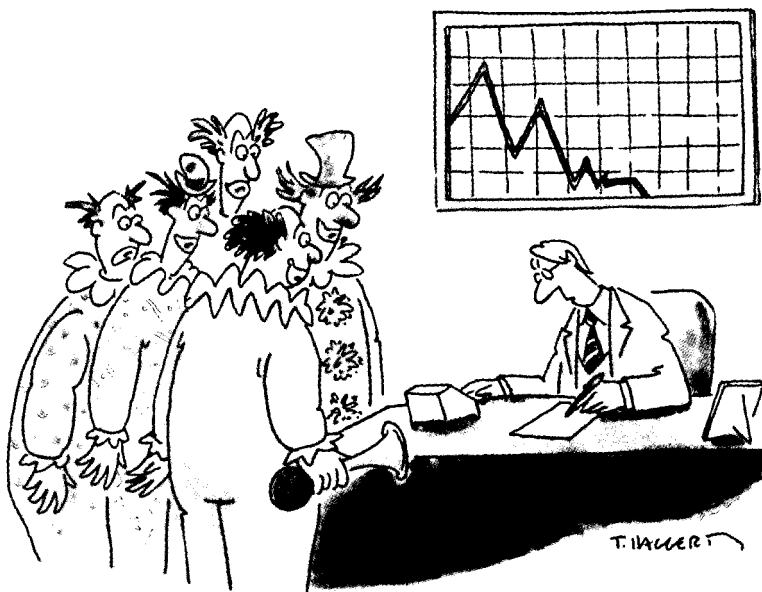
This is a recipe for disaster. In the 1970s, because of high taxes and burdensome regulation, the economy and stock market were stagnant. The Fed "leaned" against these dismal forces, attempting to use loose monetary policy to solve problems created by fiscal policy. This created an ugly episode of inflation. In the 1980s and 1990s, with tax rates much lower and the force of technology boosting the economy, the Fed has attempted to lean

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"wealth effect" are real, then the Fed has simply been prudently reacting to potential dangers.

Thus in a speech in late May Greenspan said the Fed's only "realistic

the other way with over-tight money, inviting deflation and ultimately contributing to the massive deflation of financial assets that started in the spring of last year. ↵



*"Miss Hendricks, don't bother, they're here."*

## CALIFORNIA DREAMING

Had William Tucker interviewed me before claiming I caused the California electricity mess ("California Unplugged," *TAS*, April 2001), he could have avoided embarrassing himself and misleading your readers. I'm not talking about routine sloppiness.... The big problem is a chain of serious errors in fact and logic.

First, Tucker believes Internet growth is causing electricity demand to soar.

### CORRESPONDENCE

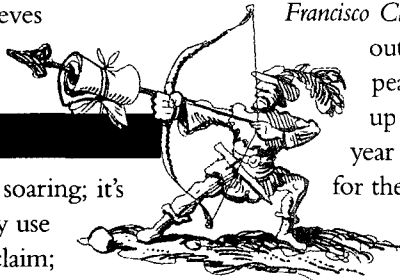
It's not, and demand isn't soaring; it's crawling. The Internet's tiny use of electricity isn't just my claim; it's an irrefutable, carefully measured fact (<http://enduse.lbl.gov/Projects/InfoTech.html>) now accepted by virtually every professional organization in electricity and information technology.

Tucker claims "both California's and the nation's energy consumption figures belie" this. Sorry, but the national data, which he doesn't cite, show no "Internet effect" whatever. Neither do California's data. The state's per-capita use of electricity, which he claims jumped after 1996, has stayed about flat for a quarter-century, and according to the data on the California Energy Commission's Website, was up at most 0.3 percent from 1990 to 2000 (actually down using the 2000 Census's population data). California's electrical consumption during the '90s grew with its population, but at an average rate of only 1.15 percent per year, half as fast as the economy grew.

Tucker also seems to have some data source unavailable to the rest of us. He says state electricity demand grew 8 percent in 1999; the CEC's Website reports 0.94 percent.... He also claims 12 percent electricity consumption growth in Silicon Valley in 2000; the CEC reports 3.1 percent in 1999 and 3.6 percent in 2000. The "server farms" he might have in mind use less—probably much less—than 1.6 percent of Bay Area and 0.2 percent of U.S. electricity. In short, Tucker's thesis is as false as his data.

Tucker also believes California's power supplies were overwhelmed by soaring peak demand: "By the spring [of 2000], month-to-month peak usages were up 21 percent over 1999." Wrong again. The peak hour in May 2000 did have 21 percent higher demand than the peak hour in May 1999, but that's a meaningless fluke. As a March 11 *San Francisco Chronicle* feature pointed

out, the average of daily peaks in May 2000 was up 12.8 percent over a year earlier; the same figure for the hot summer of May–September 2000, 8.3 percent; the same for all of 2000,



## **"The Internet's tiny use of electricity isn't just my claim; it's an irrefutable, carefully measured fact..."**

4.8 percent; and the peak hour for all of 2000 (adding back voluntary curtailments) was 0.15 percent lower than the peak hour in 1999. The weather-corrected average monthly peak in 2000 was up less than 1 percent, and for July through September, it was below 1999's. In short, peak loads changed little in 2000.

Tucker then combines his spurious explanation for nonexistent demand growth with his equally false belief that California added no generating capacity after 1994, leaving the state "woefully short of power." Electricity, yes; capacity to make it, no. Tucker doesn't ask why a system that had readily met a peak load of 53 GW (53 billion watts) in summer 1999 could suffer rolling blackouts at 29 GW in winter 2000–01. Half the state's power plants didn't suddenly disappear; they were still there, but many were calling in sick—not always, it seems, legitimately. Two-thirds of the competitive bidding

space was held by seven firms, each of which could move the market. Botched restructuring, concentrated market power, and strategic bidding made it more profitable for those dominant suppliers to sell less electricity at a higher price than to sell more at a lower price. Having the same firms build more plants will only give them more capacity to withhold and no less reason to do so.

As to my role in the fiasco, I acknowledge having long urged and helped California to pursue the best buys first—typically efficient use of electricity, then cost-effective cogeneration and renewables.... I also helped make regulation emulate efficient market outcomes by rewarding utilities for cutting customers' bills, not for selling more electricity. These highly successful and profitable policies didn't cause the crisis and, if continued, would have forestalled it. But in the mid-1990s, they were abandoned, over my vigorous protests, and dreadful policy blunders created today's disaster. Tucker falsely blames me for that result—which was avoided by the municipal utilities that continued to follow my suggested path.

The central thermal power stations Tucker favors are seldom ordered anymore in competitive market economies, because onsite and local generation is cheaper, faster, lower-risk, more benign, and more reliable. Anyone who knows the field will instruct him that the transition to smaller plants is irreversibly underway, driven not by ideology but by market economics. Doubters are welcome to finance giant nuclear or coal plants and lose their shirts.

I'm a long-standing fan and practitioner of market mechanisms. Using them properly is a key part of California's energy solution....

AMORY B. LOVINS, CEO (RESEARCH)

ROCKY MOUNTAIN INSTITUTE, SNOWMASS, COLO.

## **WILLIAM TUCKER RESPONDS:**

Amory Lovins's response is proof that there is no real knowledge without practical application. He can quote statistics and fudge figures until everyone is blue in the