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# America's Two Economies: Wal-Mart And Wall Street

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Successive economic reports on consumer behavior have sown confusion among analysts. For instance, a recent newspaper headline read: "Wal-Mart Deepens Gloom as Retailers Feel Left Behind."

It's not just the Bentonville giant that's feeling pain; both Macy's (M) and Kohl's (KSS) reported disappointing results as well. Weakness in retail sales is across the board, hitting even cosmetics and beauty products.

Meanwhile, another recent headline read: "U.S. Car Plants to Shift to Top Gear." While car sales are not back to their 2005 peaks, plants are operating with record capacity utilization. Additionally, the housing market is improving.

In what kind of world do cars sell and cosmetics don't?

It turns out that it is in a world that Milton Friedman explained to us almost 60 years ago in a work titled "A Theory of the Consumption Function." In writing it, he grappled with the deficiencies of then-standard macroeconomics.

Textbooks treated consumption as mechanistically linked to current, measured income. As soon as one thinks seriously about it, it is an absurd proposition. Wage earners do not spend their entire paycheck on the day it is received — certainly not if they have a family. Consumption is spread out over the period between paychecks. Workers, whose income fluctuates in a known or expected way with the season, adjust their spending over the entire year. Windfalls, like inheritances, are not, on average, spent the day after their receipt.

**Permanent Vs. Temporary**

Friedman reasoned to a new theory of consumption, which was based on a distinction between "permanent" income and "transitory" or temporary income. Consumers behave differently depending on whether an inflow of money is viewed as signaling a new, higher permanent income or merely a transitory event. An increase in a consumer's expected permanent income funds an increase in permanent consumption. An increase in income not viewed as permanent is largely saved.

His analysis has profound implications for current policy efforts at fiscal and monetary stimulus. To anticipate the conclusion, if Friedman was right, all efforts at using temporary measures to effect permanent change are bound to fail.

**Why Autos Are In Demand**

Temporary fluctuations in income are absorbed by a buffer stock of savings. Shortfalls are met by a drawdown of savings, and windfalls can add to liquid assets. Importantly for the current situation, Friedman considered another form of consumer saving from temporarily higher income. He suggested that "the timing of the replacement of durable goods and of additions to the stock of such goods (is) likely to some extent to be adjusted so as to coincide with windfalls." Purchases of durable goods, which yield their services over time, are one vehicle for storing temporary additions to income.

Voila, the boom in vehicular sales today. To understand this, I extend Friedman's analysis to temporary fluctuations in wealth (an extension implicit in his analysis).

The Fed's efforts have focused on selective asset purchases and accompanying low interest rates. The asset purchases directly benefitted the sellers. Those were typically banks, which translated into benefits to shareholders of the banks.

Lower rates have driven a bull market in bonds and equities, benefitting the broader category of holders of financial assets.

Proponents and critics of the Fed's stimulus policy agree on one thing: It is temporary. Thus, Fed stimulus is grist for Friedman's analytic mill.

The timing of tapering; the speed with which interest rates will rise; and what proportion of bond and equity prices are a bubble and what constitute permanent values — these and other factors are susceptible to probabilistic analysis by each investor.

But some portion of the stock market rise is surely unsustainable (temporary), as we have already witnessed with bonds, and the recent decline in stock prices is testimony to that.

Friedman's reference to "the timing of the replacement of durable goods" is especially relevant. During the Great Recession, the average age of cars on the road rose to an all-time high. True, cars last longer than ever before. Nonetheless, consumers were clearly deferring purchases of replacements because of the temporary depressed state of both their finances and incomes.

What the Fed's policy accomplished was to jump-start replacement of vehicles by its vaunted "wealth effect."

What the Fed did not accomplish, however, was to increase permanent income or permanent wealth. Permanent wealth is created by savings that finance the purchases of productive capital, which generates the revenue both to reproduce the investment and create profits for its owners. Purchases of consumer durables, financed by increases in transitory income and wealth, do not create sustained economic growth. Temporary stimulus does not create permanent benefits. And therein lies the Wal-Mart (WMT) part of this story. The wealth effect only works for those with wealth.

Large numbers of ordinary Americans have benefitted little or not at all from the rise in equity prices. And their most valuable assets, their homes, remain under water in many cases and only recently have begun to experience price appreciation (but not recovery to previous values).

Wages are stagnant; working hours curtailed; and large numbers are underemployed or working involuntarily part time. Discouraged workers are at a record high. As Wal-Mart's CFO Charles Holley, said, "We have to remember how actual Americans live."

Friedman's analysis is as relevant today as when written in 1957. And it is as timely as when the Swedish Central Bank cited it in awarding him the Nobel Prize in economics in 1976.

Permanent economic improvements can be sustained only by permanent improvements in economic fundamentals. None such are part of the current economic policy mix. Instead, we have a Wal-Mart economy and a Wall Street economy, and the twain have yet to meet.

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