Bridgewater®
Daily Observations
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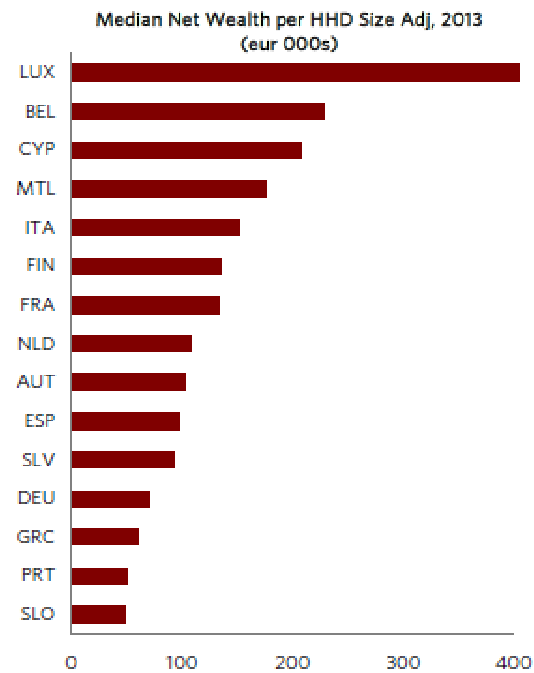
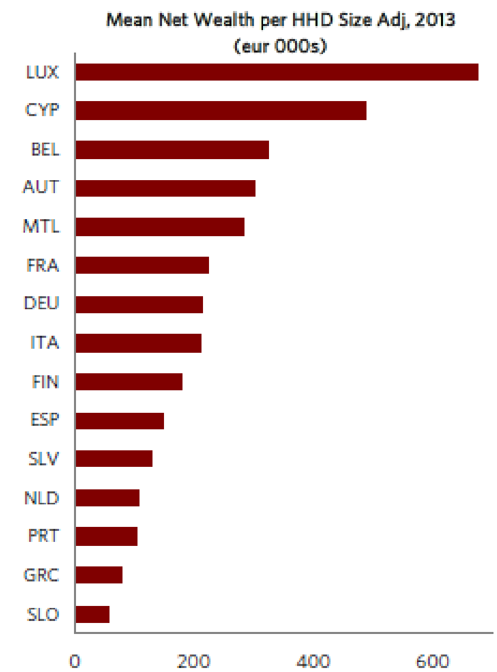
Wealth Differences in Europe

While the recent ECB study on wealth differences in Europe justifiably drew a lot of attention, it did not convey as clear and rich of a picture as possible. In today's *Observations* we will tweak these numbers and share some thoughts about them.

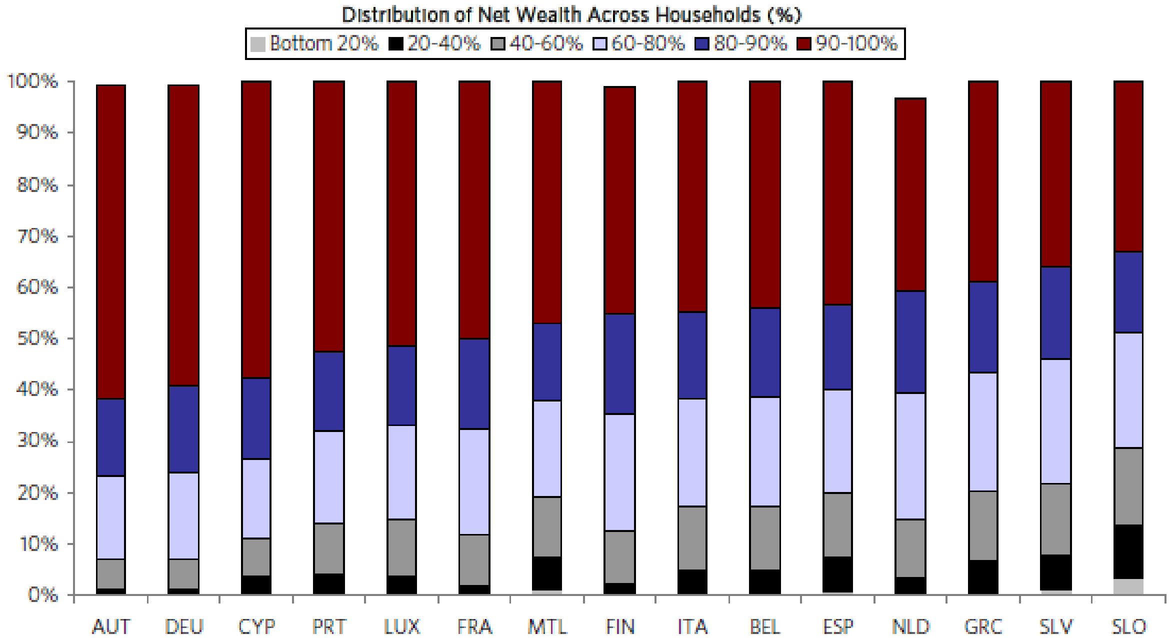
The synthesis of that report – that Spanish and Italian households are much wealthier than German households, three times when you compare the median household – needs to be modified because that picture is based on statistics in 2008-2010. Since then things (most importantly real estate prices) have changed. After adjusting for these changes, we see that 1) the median Italian household is still more than twice as rich as the median German household, and the mean Italian household has about the same wealth as the mean German household and 2) the median Spanish household is still more than 30% richer than the median German household and the mean Spanish household is poorer by 30% than the mean German household. The below charts show the net household wealth numbers across European countries.



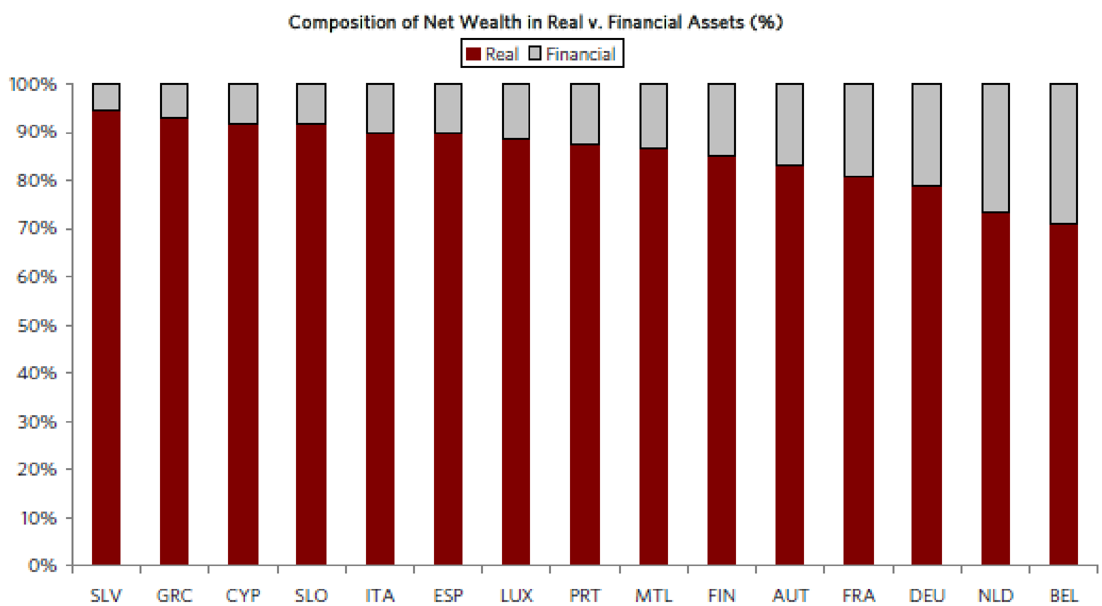


Note: Rescaled to Euroland average household size to make figures comparable across countries given different household sizes; net wealth adjusted for asset prices changes since reported period.

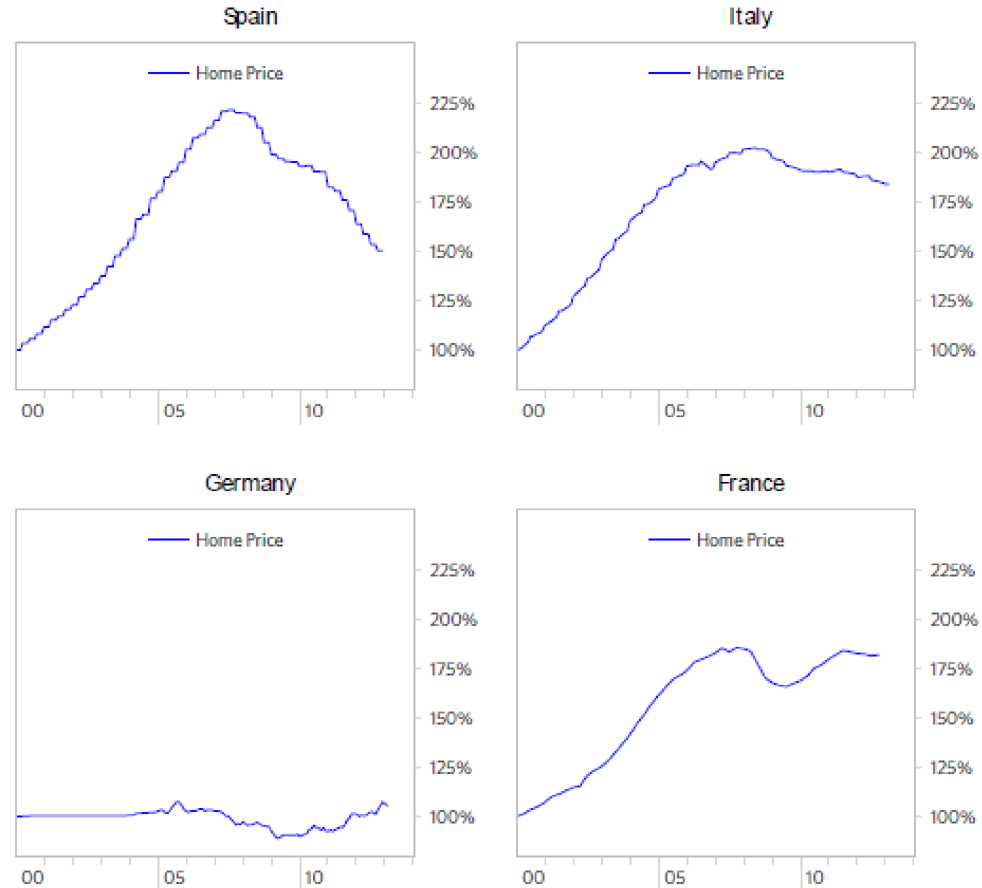
The differences between the previous two charts are due to differences in wealth distributions as conveyed in the next chart. As shown below, Germany has a greater concentration of wealth among the wealthy – the top 10% own about 60% of the wealth – than in Italy and Spain (where the top 10% own less than half the wealth).



The important thing to note is that the differences in the wealth are largely due to investments in real estate. In particular, Italians and Spaniards have more of their wealth in real estate than Germans, and since 2000 the Italian and Spanish real estate markets have been a lot stronger than the German real estate market. This difference has important implications. Countries such as Italy and Spain, in which the households have high percentages of their wealth in real estate, are more likely to have negative wealth effects and greater liquidity challenges in the years ahead. These differences are shown in the below chart.

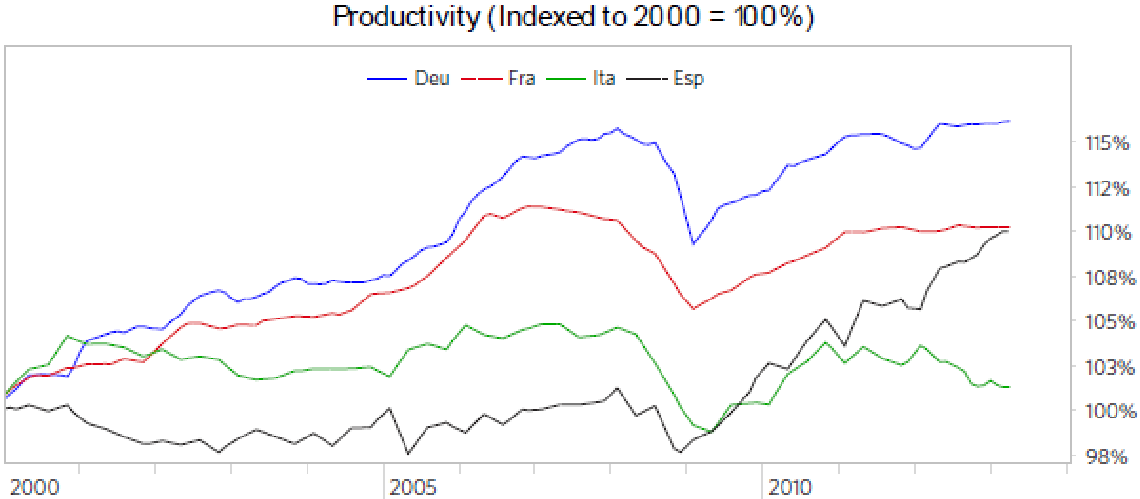


As shown, average home prices in Germany, France, Italy and Spain since 2000 do a good job of painting the picture. Knowing the differences in the economic and debt conditions of these countries and seeing how the debt bubbles affected relative real estate prices over the last number of years, one can visualize how these real estate prices will converge over the next number of years. A bubble classically consists of banks lending a lot of money to households to buy real estate that produces a self-reinforcing debt and home price acceleration that continues until the bubble bursts. You can see these bubbles reflected in these home price charts, and you can imagine how the busts will transpire. It looks to us as though Italian real estate prices have barely adjusted (and are likely to fall 25%–50%) and that Spanish home prices, while down 30% from the top, still have room to fall. These sorts of price declines will obviously have significant negative effects on wealth, economic activity and lenders.

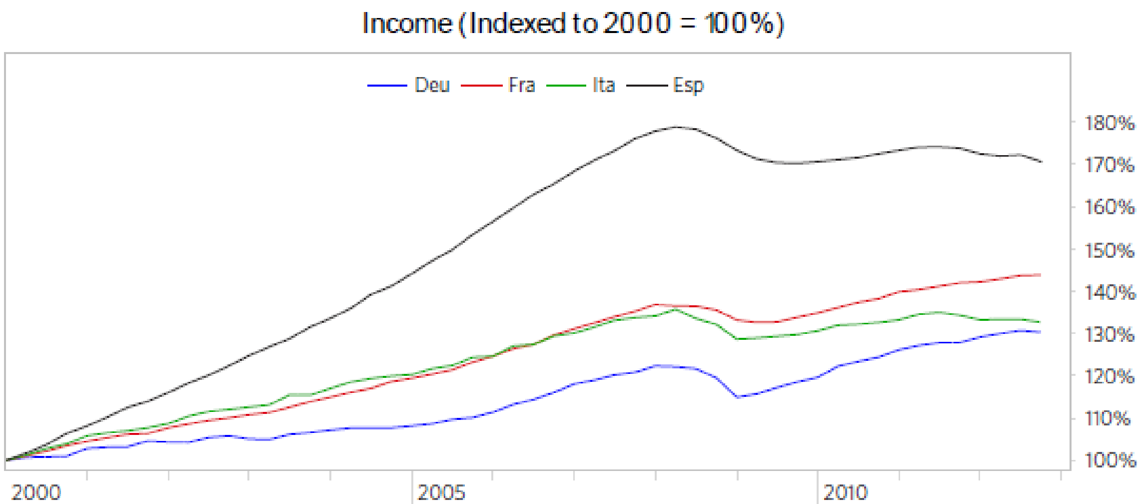


Note: Price indices above indexed to 2000 = 100%.

Over the long-run productivity, income and wealth (including real estate prices) align. When they get out of line, we can expect them to converge. The shifts in wealth that we have seen occur largely through the real estate bubbles and bank debt bubbles are clear aberrations. The chart below shows productivity for these four major countries since 2000. Note how Germany has outperformed, even though that was not reflected in housing price changes.



The next chart shows incomes of these countries. As conveyed, Spain's income rose nearly 80% during the boom whereas German incomes rose modestly by 20%. Once again, there was little relationship with these countries' relative productivity gains. That was because there was a debt financed real estate bubble that distorted the picture. Getting into debt to build and buy up homes that had their prices pushed up as a result of that debt-financed buying and counting those excessive prices as wealth creates a distorted picture of wealth. This "greater wealth" of Italians and Spaniards is going to disappear, which will cause them to have negative "wealth effects."



Of course this picture makes it seem silly to expect Germany to transfer wealth to Italians and Spaniards and makes it seem sensible for rich Italians and Spaniards to transfer the wealth to the poor ones. That is the obvious path. Regardless of the study, we would not expect substantial increases in German fiscal transfers to Italy and Spain, even after the German election. Since a) bank capital has to come from such fiscal transfers (because the ECB can only provide liquidity to well capitalized banks), b) the amount of money that can come from fiscal transfers is so limited and c) bank vulnerabilities that are likely to arise from lower net-worth's and worse incomes of Italians and Spaniards are significant, it follows that German policy makers want to make sure that their commitments to bail out bank creditors are made selectively.

Other Countries

Russia: Slowing Growth as the Effects of Prior Oil Price Increases Fade, but Room to Ease

Russia's economy has recovered fully from the financial crisis, supported primarily by sustained high oil prices as well as a recovery in domestic credit creation. However, there are signs that these supports have begun to moderate-- growth has slowed from the previous healthy levels, while the economy remains around capacity. One of the main ways in which higher oil prices support the economy is by generating higher government revenues, which in turn allow the government to increase spending (primarily through subsidizing household incomes). But after time, the effects of a rise in oil prices flow through to spending, and the higher prices are necessary to maintain levels of activity and are not as supportive to further growth. After very large structural increases over the past few years, the government's support to household incomes has flattened out at high levels, and household consumption growth has begun to slow. Investment has also been supported by the high oil prices, but it too has slowed substantially in recent months, and timely measures point to roughly zero investment growth. Additionally, credit creation, which had been healthy, has also begun to moderate, in part due to tighter domestic liquidity conditions. The central bank has so far maintained relatively tight monetary policy in response to rising inflation through the end of last year. Inflation has since fallen as temporary pressures have faded and the economy has weakened, and the central bank has now switched toward more neutral policy, while markets are discounting easing over the next few months. Additionally, the government has been discussing fiscal stimulation, which there is likely room for, particularly if oil prices remain high given the government's large reserve funds and very low debt levels. So while growth has moderated and remains reliant on continued oil income, the government and central bank have significant room to provide stimulation to offset the recent weakness which should provide supports to growth in coming months.

The charts below show that while growth had been strong coming out of the crisis, it has clearly slowed over the last few months to a little below potential. In level terms, the economy is operating around capacity.