Federal Reserve Chairman Alan Greenspan's controversial statement, that over the long run the rate of asset value growth cannot be higher than that of household incomes, has caused quite a stir. Analysts and reporters erroneously assumed that Greenspan implied that stock prices should be growing at approximately 6% rather than 10% to 20% - a return far lower than investors expect. But that is not what Greenspan was saying, and I will clarify this point later in this article. First, let me say that Greenspan is correct in his assertion, and there are several reasons why.

• If wealth keeps rising relative to incomes, people will stop working because they could theoretically live by consuming assets rather than by earning wages. The economy would then collapse because people would consume far more than what they would produce.

• If stock market wealth continued to increase faster than income, people would increase their spending and save less out of labor income. This trend would lower new investment, reduce the stock of capital and cause economic growth to decline.

good news for corporations and consumers

• Historical data does not support the recent upward trend in stock values relative to output. Output and national income have always risen in the same proportion as the increase in physical capital, providing for balanced growth. If capital continued to rise relative to household incomes, more of the national output would go to capital, and less to labor.

While the above points hold in the long-term, there is tremendous variation in the ratio of stock wealth to household income in the short-term. For instance, the ratio of stock wealth to GDP is currently at an all-time high, recently surpassing the previous high set in 1929. I'm not implying we are poised for a market crash, since there are many good reasons for the ratio of stock wealth to GDP to be so high. These include rapid productivity growth due to information technology, the stability of our macro-economy, and the globalization of markets, to name a few.

Despite the constraints of share value growth, Greenspan's words don't indicate that stock returns should be limited to the growth of household incomes, which have increased at an average rate no more than 6% a year. Greenspan's comments
referred to the aggregate value of all stocks. The value of stocks differs from returns since returns include dividends, stock buybacks, and other cash payouts made by firms. Over time stock returns have significantly outpaced the growth of income due to these factors.

Greenspan's comments don't imply that he is targeting the stock market for a potential interest rate increase. Although the rising market has produced a wealth effect that has created excess demand in the system, he hasn't said the stock market is overvalued. As he has said in the past, his chief concerns are tightness in the labor market and the rising trade deficit.