DEBT AND SPENDING

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Household debt and leverage is a critical element in understanding US economic growth during the decade so far. Over the next few years, household balance sheet restructuring has the potential to play an equally crucial, and unfavorable, role.

- Leverage in the US household sector, particularly mortgage debt, has increased dramatically during this decade and is at unprecedented levels. Figure 1 shows total household debt as a ratio to income. During the 1990s debt grew by 1.5% per year while from 2000 to 2006 it grew at 5.5% per year, with 94% due to mortgage debt.[1]

- During this decade spending has increased, to almost 100% of disposable income, as seen in figure 2. This is likely related to the increase in debt, but in any case leaves households with little cushion in terms of current income.

- Household balance sheets are stretched by historical standards. Household debt service is high – figure 3a shows that the financial obligations ratio (debt service as a percent of income) stands at an all-time high of about 19%. Figure 3b shows that most of the rise in the past few years has been due to mortgage debt.

- Balance sheets may be further stressed in the near future, since many recent mortgages have been adjustable with low introductory rates. As these re-set to higher rates, debt service will rise.

- Recent events in the financial markets have decreased the availability of easy credit, particularly mortgage credit. The market disruption started in the subprime mortgage market and spilled over to a more general liquidity crunch. As a result many mortgage providers have pulled out of the market, remaining providers have tightened lending standards, and in general liquidity has fallen.

- Limited credit availability and a stagnant housing market mean that households will not have the same opportunity to take a second mortgage or refinance in response to adverse conditions

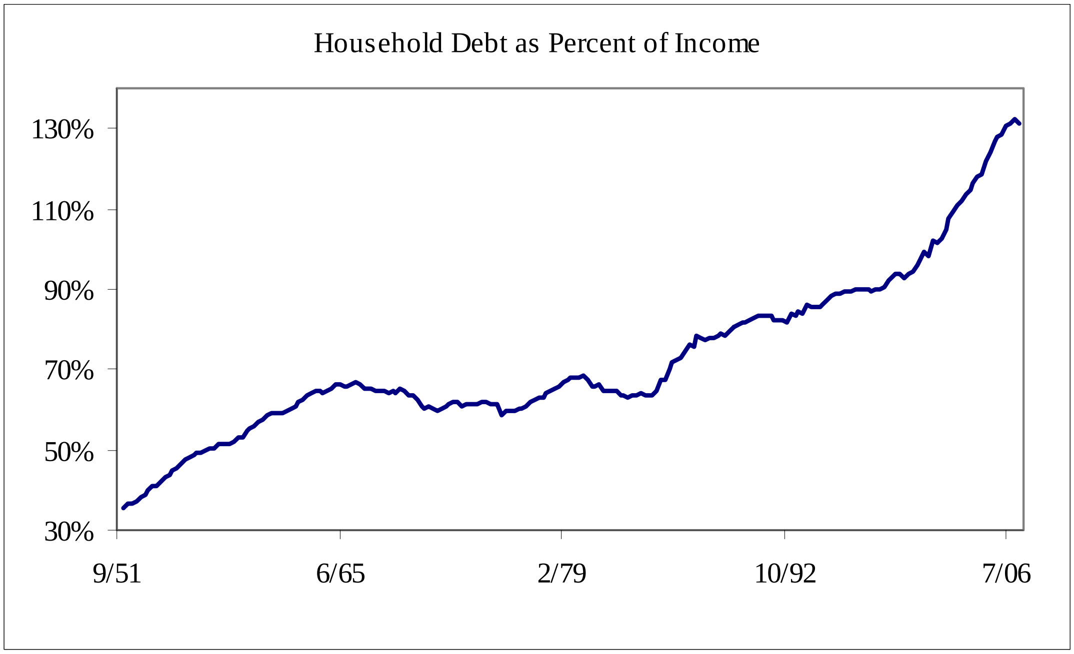
[1] "Debt" refers to household debt outstanding as a percent of disposable personal income. Household debt is from the Federal Reserve's *Flow of Funds Accounts of the United States* and disposable personal income (DPI) is from the Bureau of Economic Analysis. Debt as percent of DPI grew by 1.50% per year (compounded) over the decade of the 1990s, with 62% of the growth attributable to mortgage debt. From 2000 to 2006 the growth was 5.48% per year, with 94% due to mortgage debt.

as they might have in the past. The primary alternative will be to re-structure the household balance sheet through retaining earnings – decrease spending relative to income.

- Any decrease in spending will have a potentially serious impact on US economic growth, since consumer spending has been a major engine of GDP growth. For the period 2000-2006 GDP grew at 2.40% per year, with consumer spending contributing 2.05% (or 85%) of that. This is high by historical standards, and any fall in spending will translate directly to lower GDP growth.

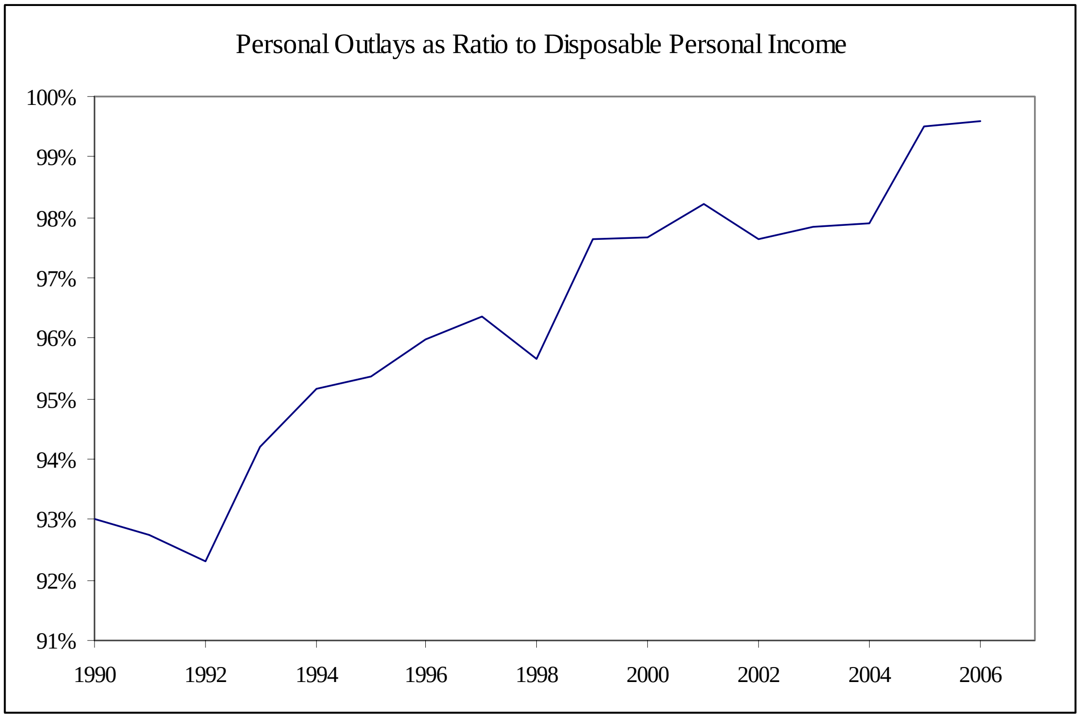
There is a risk that the household leveraging of the recent past will reverse, with spending slowing as households pay down debt with current income, unable to re-finance and roll over existing debt. The risk is particularly acute because almost all the recent increase in household debt has been in mortgage debt. New mortgage and refinancing activity will be limited due to stagnate or falling house prices, recent tightening of lending standards, and recent disruptions in the market for securitized mortgage products. The likely inability to refinance on more favorable terms will be particularly significant for those households with adjustable-rate mortgages that are in the process of re-setting to higher rates. The risk is that this will translate into lower spending and a recession.

Figure 1 – Household Debt – With 2007 Q1 data



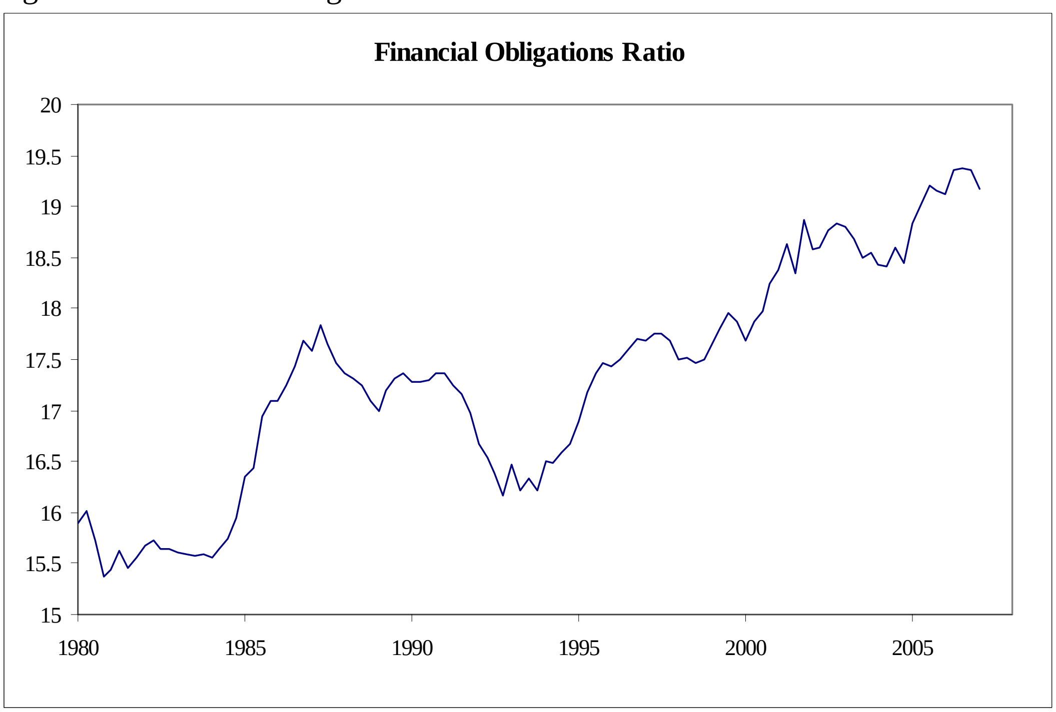
Household debt is from the Federal Reserve Board’s quarterly Flow of Funds. Disposable Personal Income is from the Bureau of Economic Analysis

Figure 2 – Personal Outlays as a percent of Disposable Personal Income



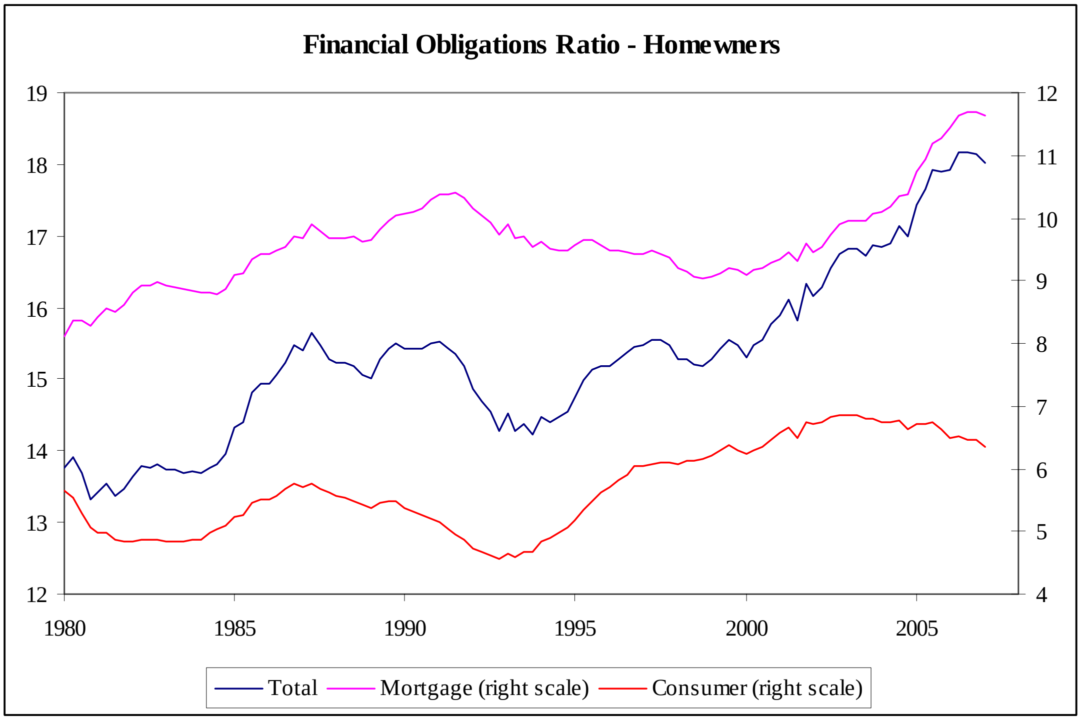
Source – Bureau of Economic Analysis

Figure 3a –Financial Obligations Ratio



Financial Obligations Ratio is an estimate of the ratio of debt and other payments to disposable personal income. Debt payments consist of the estimated required payments on outstanding mortgage and consumer debt. Other payments are automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance, and property tax payments. Source: Federal Reserve Board.

Figure 3b – Financial Obligations Ratio for Homeowners



Source: Federal Reserve Board.