DEBT AND SPENDING

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Household debt (as percent of income) decreased in 2nd quarter 2008 for the US. This is a dramatic reversal from the years preceding, where household debt and leverage grew substantially. I expect household de-leveraging will continue and will likely play a crucial role in US economic growth over the next one to three years, with spending growing more slowly as households restructure their balance sheets by decreasing debt.

- Leverage in the US household sector, particularly mortgage debt, increased dramatically during the early part of this decade. Figure 1 shows total household debt as a ratio to income. During the 1990s debt grew by 1.2% per year while from 2000 to 2007 it grew at 5.2% per year, with 93% 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 has left households with little cushion in terms of current income.[2]

- For the most recent period available (2nd quarter 2008) household debt has declined as a percent of personal income, as seen in figure 1. This is first decrease since 2000. Most notably, the decrease is largely due to falling mortgage debt.

- The slower growth in household debt has likely been partly a result of households walking away from bad (mortgage) debts; a hypothesis consistent with the substantial losses on mortgage debt suffered in the financial system.

- I expect that households will also slow down spending to finance de-leveraging. The most recent (August) personal income and spending figures do show slow growth in spending, and I expect this will persist, leading to a recession.

- Household net worth and assets are also falling, as shown in figure 3. This will likely also put downward pressure on household spending.

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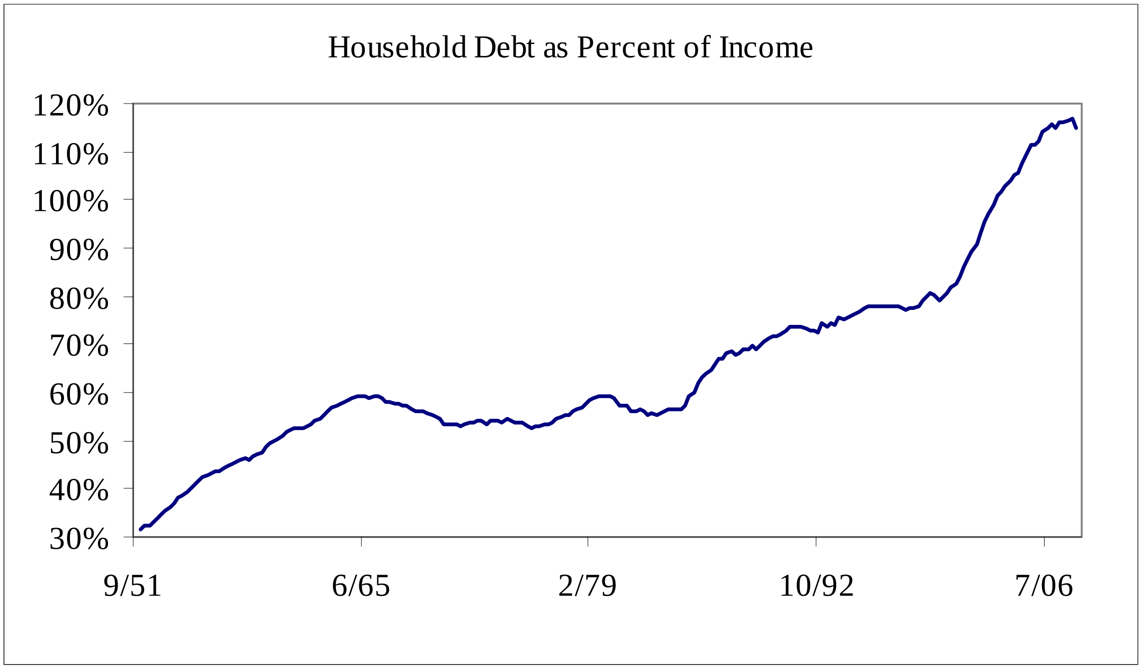
[1] "Debt" refers to household debt outstanding as a percent of personal income. (Personal Income is used rather than Disposable Personal Income because of the distortion to DPI for 2nd quarter 2008 due to the economic stimulus package.) Household debt is from the Federal Reserve's *Flow of Funds Accounts of the United States* and personal income (PI) is from the Bureau of Economic Analysis. Debt as percent of PI grew by 1.19% per year (compounded) over the decade of the 1990s, with 62% of the growth attributable to mortgage debt. From 2000 to 2007 the growth was 45.19% per year, with 93% attributable to mortgage debt.

[2] The fall in 2nd quarter 2008 is due to tax rebates from the economic stimulus package.

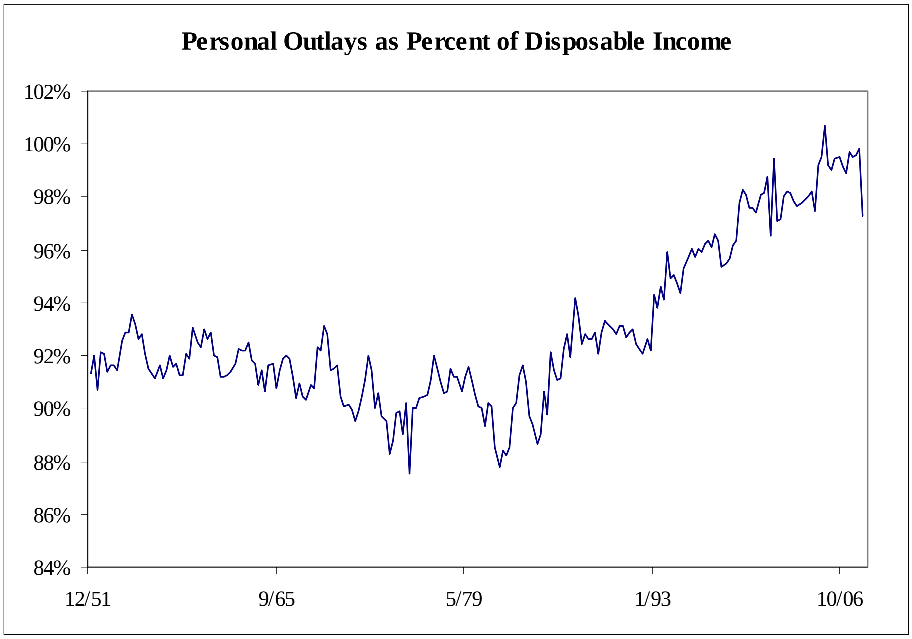
- Any decrease in spending will have a potentially serious impact on US economic growth, since consumer spending has been a major engine of GDP growth. For the period 2000-2006 GDP grew at 2.40% per year, with consumer spending contributing 2.05% (or 85%) of that. This is high by historical standards,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

Figure 1 – Household Debt – With 2008 Q2 data



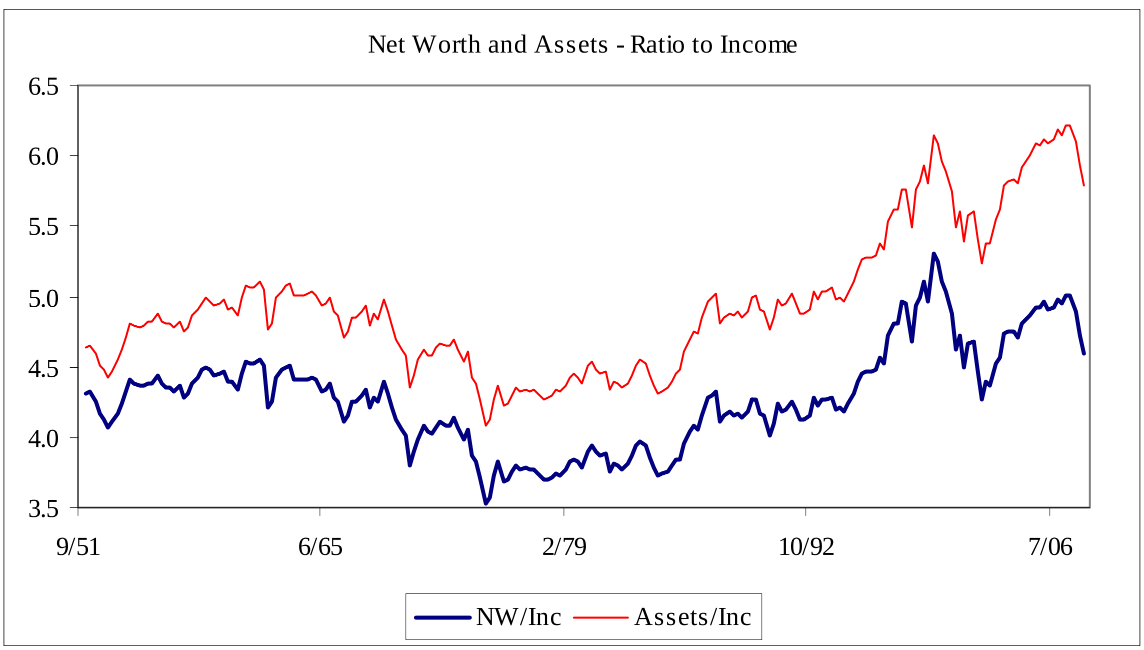
Household debt is from the Federal Reserve Board's quarterly Flow of Funds. Personal Income is from the Bureau of Economic Analysis

Figure 2 – Personal Outlays as a percent of Income



Source – Bureau of Economic Analysis

Figure 3 – Net Worth and Assets



Source – Federal Reserve's quarterly Flow of Funds