DEBT AND SPENDING

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Household debt in the US is falling and the savings rate is rising. During the 2000s households took on increased levels of debt, primarily mortgage debt, and since the early 1980s the savings rate has fallen. There was always a likelihood that these trends would reverse and households would pay down debt by slowing spending (increasing the savings rate). The financial crisis has been the trigger starting this process of household de-leveraging. In turn the de-leveraging and the lower spending associated with the higher savings rate has ensured that the financial crisis results in a severe recession.

For the 3rd quarter of 2008, debt as a percent of income fell for the second consecutive quarter. Even more importantly, the absolute level of debt fell for the first time in at least 50 years. This is a dramatic reversal from preceding years, where household debt and leverage grew substantially. We are now in an environment where households are decreasing their level of debt relative to income. At the same time, however, household net worth is falling faster and the level of debt relative to wealth is rising. This means that household de-leveraging is likely to continue for some time and the savings rate is likely to continue higher. I expect that the slow-down in consumer spending will accelerate over the next six to twelve months until debt is reduced somewhat and the savings rate is at levels closer to 5% than the current 2%. The recession will likely be severe and continue through 2009.

- 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]

- For the 2nd and 3rd quarters of 2008 household debt as percent of income declined, again seen in figure 1. Most notably, the decrease is largely due to falling mortgage debt.

- During this decade spending has increased, to almost 100% of disposable income. This means that the savings rate (income less spending divided by spending) has been at close to

[1] "Debt" refers to household debt outstanding as a percent of income. (Disposable Personal Income is used even though tax rebates somewhat distort the figures for 2nd quarter 2008.) 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 1.19% 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.

zero, 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]

- 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.

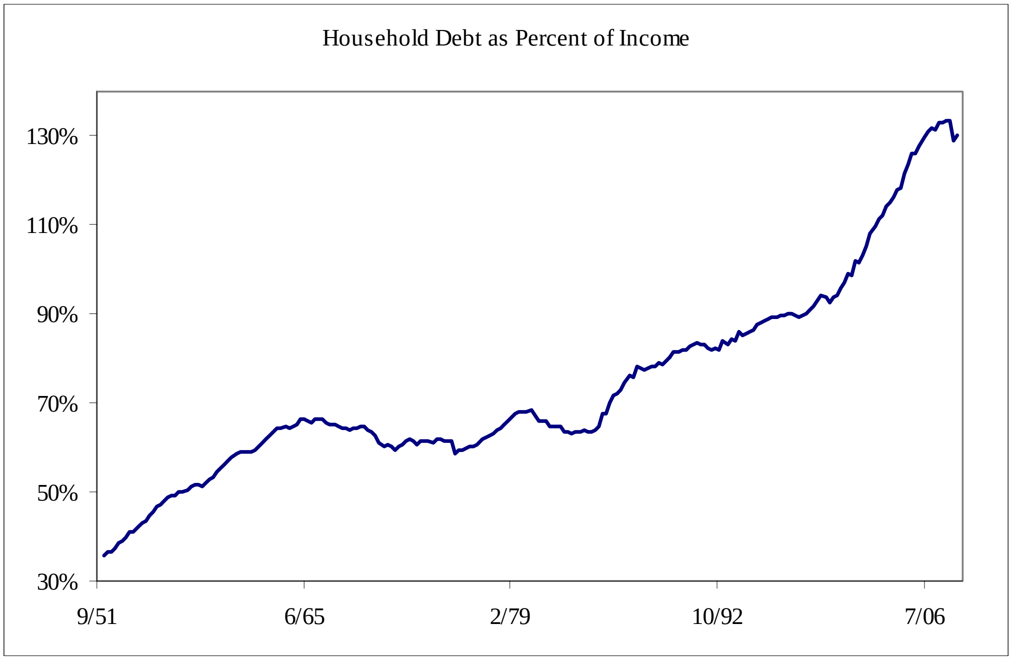
- I expect that households will continue to slow down spending to finance de-leveraging. The monthly personal income and spending figures for October and November show continued increases in the savings rate (to 2.4% and 2.8%). As unemployment increases during the current recession personal income will also likely fall, which will reinforce the trend toward lower spending.

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

- 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 translates directly to lower GDP growth.

[2] The rise in 2nd quarter 2008 is due to tax rebates from the economic stimulus package, while the higher savings rate for 3rd quarter is due to lower spending. For October and November 2008 the savings rate has continued to increase, to 2.4% for October and 2.8% for November.

Figure 1a – 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 1b – Househodl Debt, Net Worth, and Assets

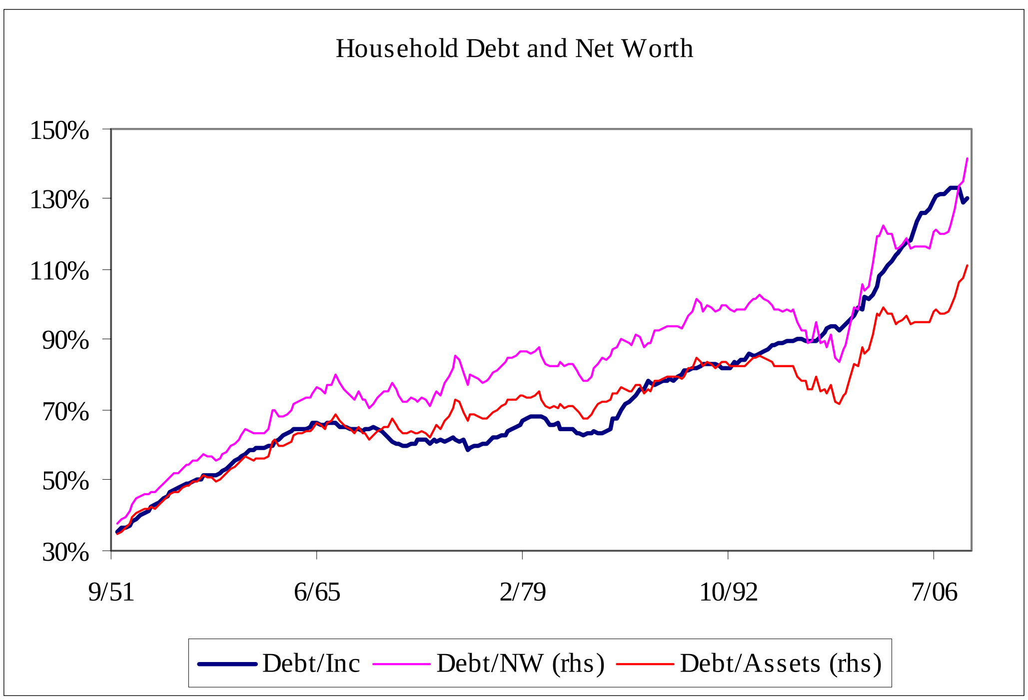
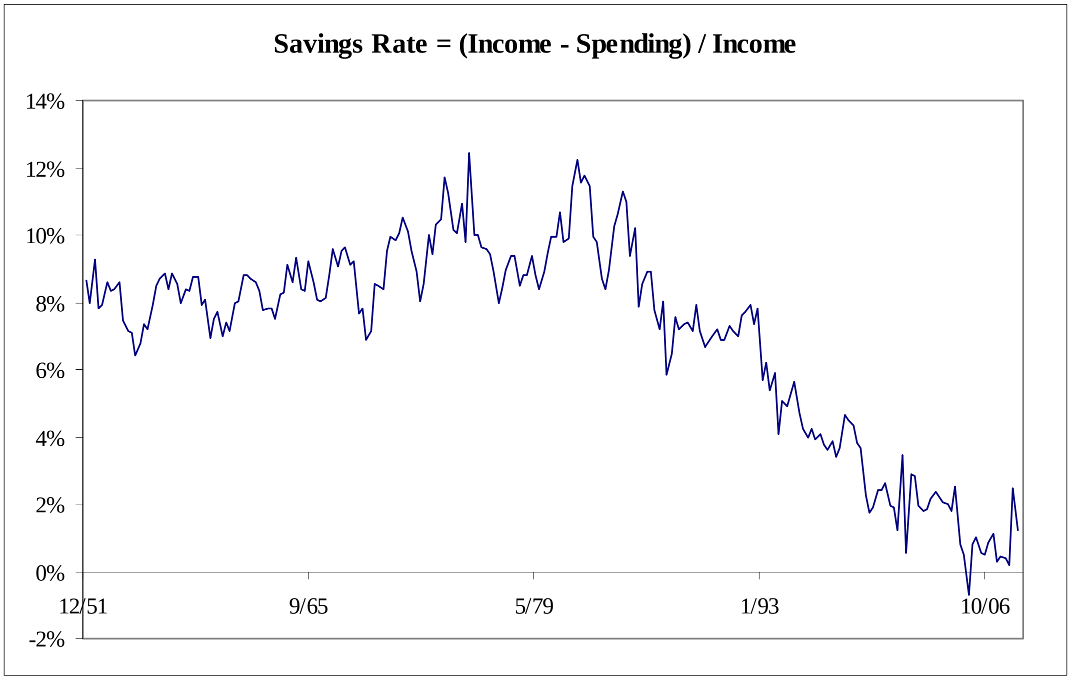
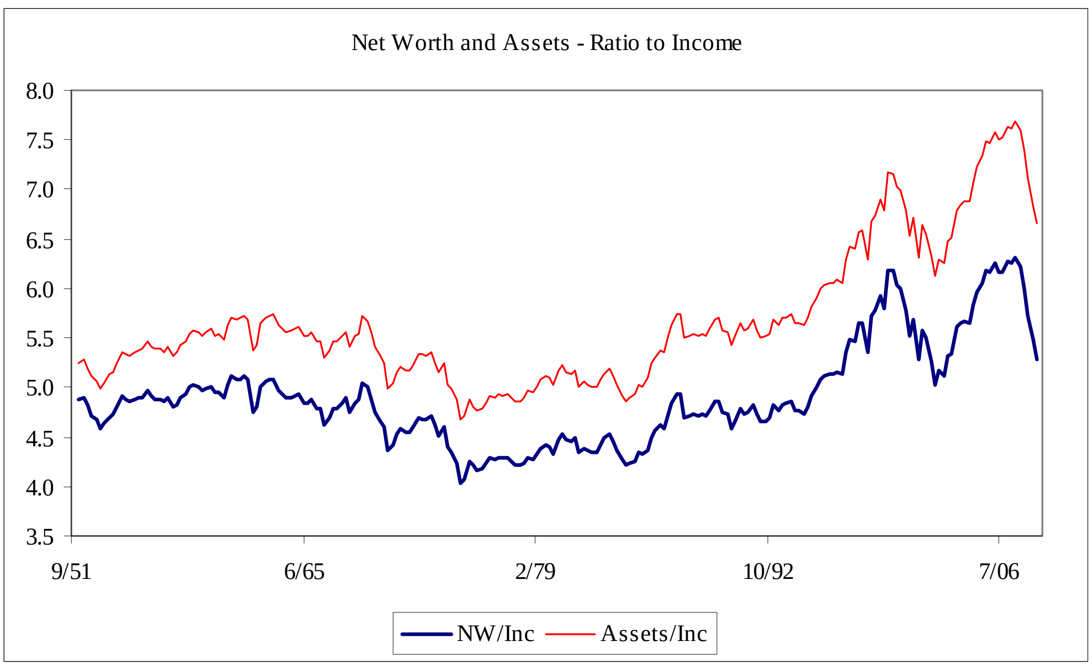


Figure 2 – Savings Rate



Source – Bureau of Economic Analysis

Figure 3 – Net Worth and Assets



Source – Federal Reserve's quarterly Flow of Funds