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Household Leveraging and Deleveraging

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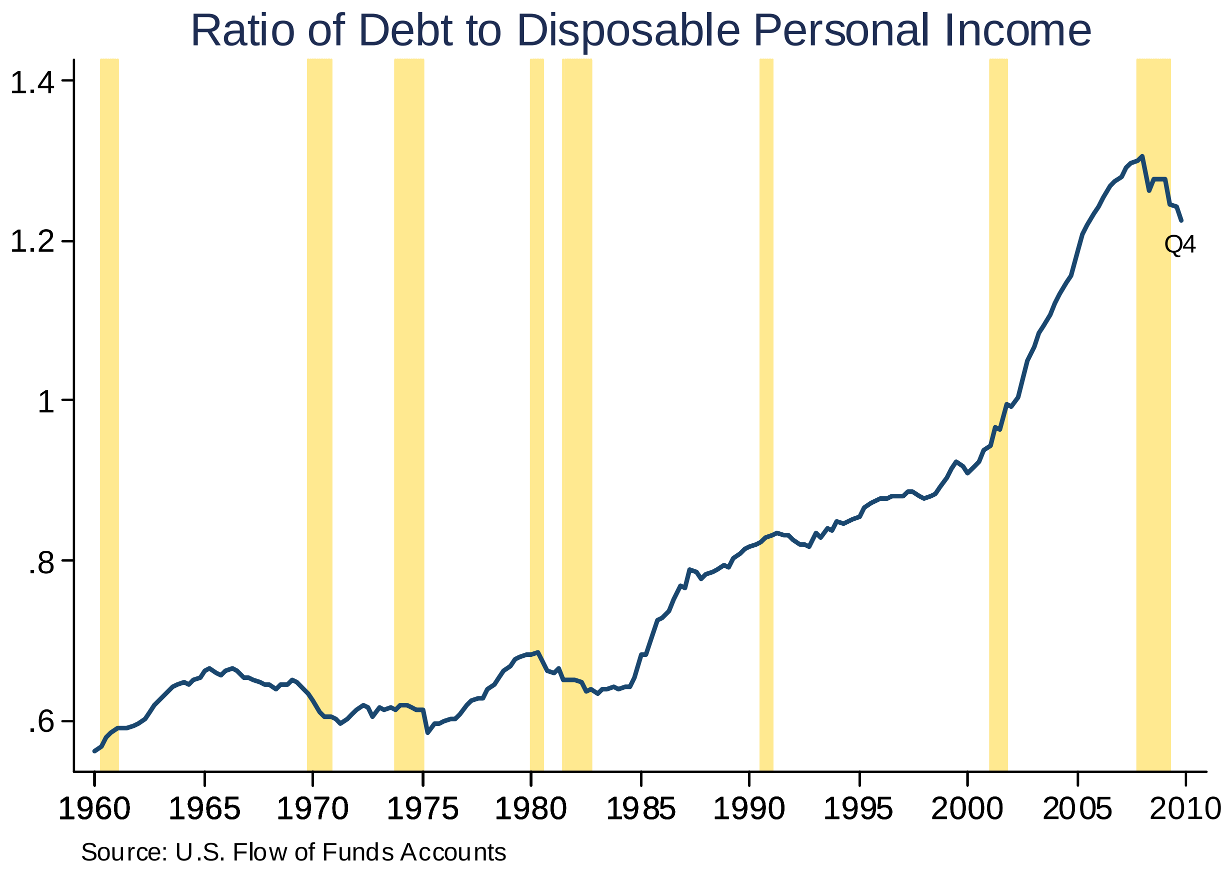


Big Questions

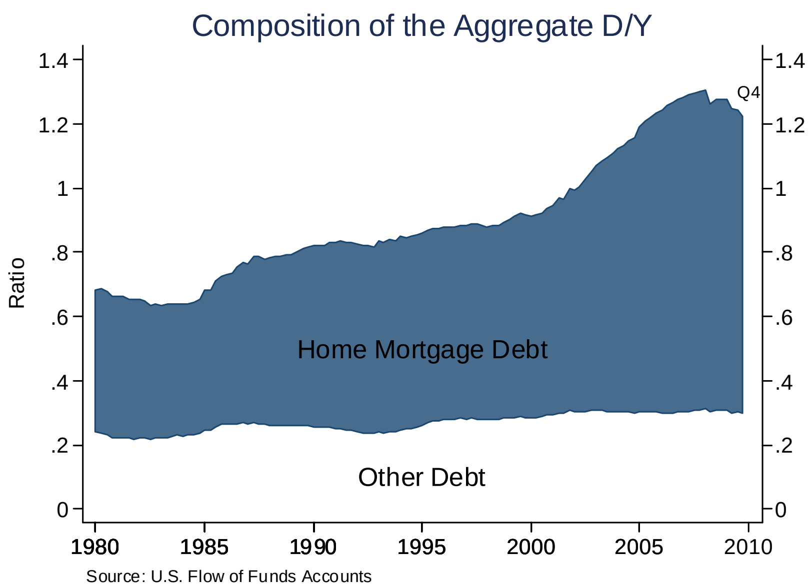
- About the past: What explains the pre-crisis uptrend in debt? Were these factors a good or bad thing for households and the economy?
- About the present: How is the deleveraging occurring? Is the deleveraging a good or bad thing for households and the economy?
- About the future: How much more deleveraging should we expect?

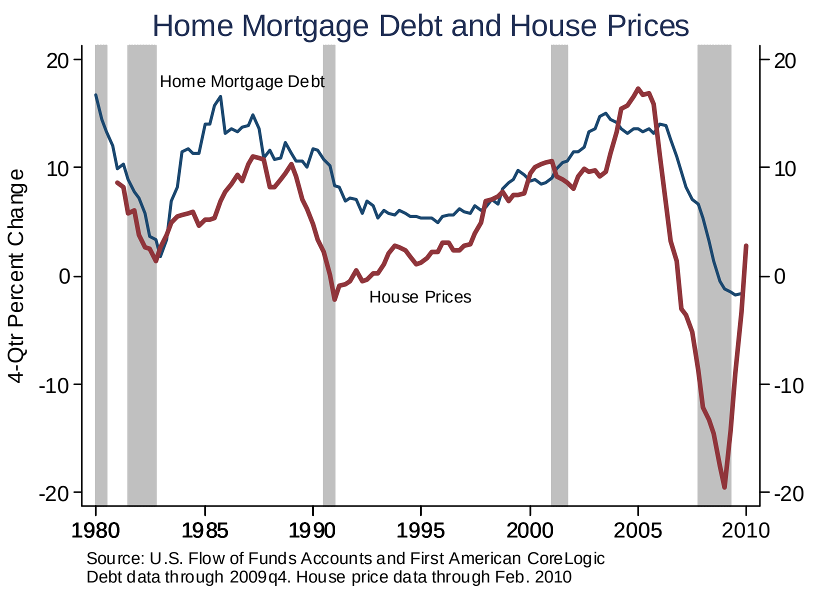
Why Did Household Debt Rise?

"The most important factors behind the rise in debt and the associated decline in saving out of current income have probably been the combination of increasing house prices and financial innovation."

Dynan and Kohn, *The Rise in U.S. Household Indebtedness: Causes and Consequences* (2007)

Home Prices and Rising Debt

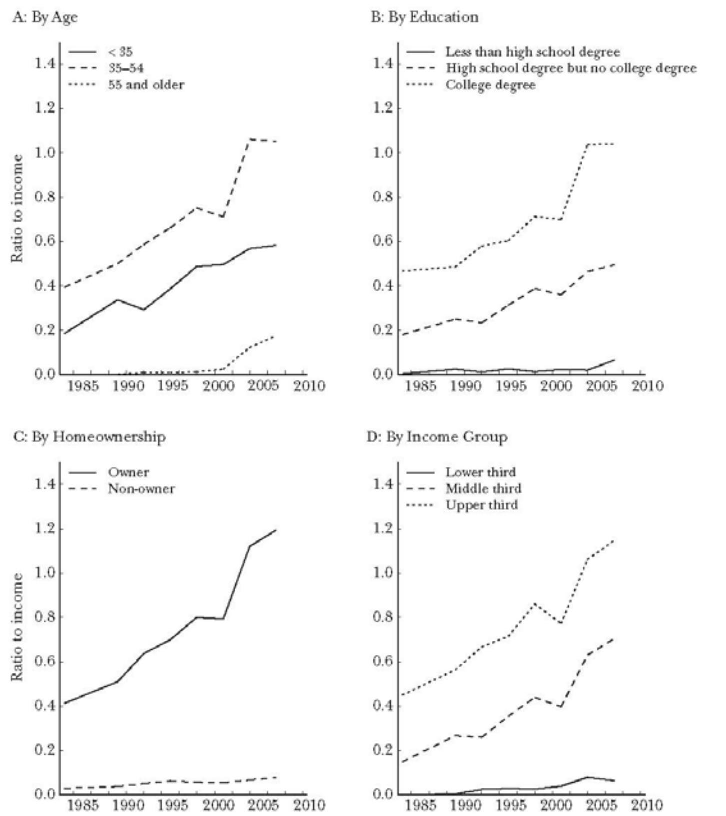




Financial Innovation and Rising Debt

- “Democratization” of credit explains only a small part of the rise.
- Rather, the key factors were easier access and lower cost of credit for those who already had access to debt markets.
- Note that quantifying the role of FI difficult:
  - » FI broad and has occurred gradually.
  - » FI has interacted with other factors.

Evolution of Median Household Debt by Demographic Group



Source: 1983–2007 waves of the Survey of Consumer Finances.

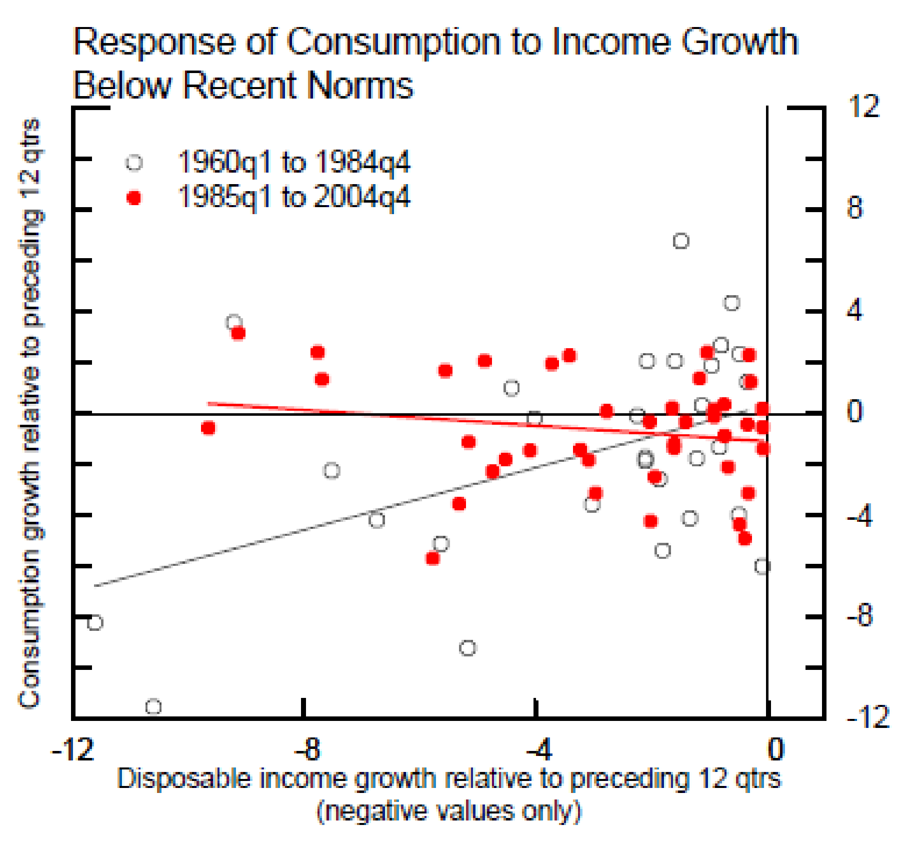
Consistent with the incremental and thorough-going nature of financial innovation, increases in borrowing have been gradual and widespread.

Consequences of Greater Credit Availability

“Developments in lending practices and loans markets that have enhanced the ability of households and firms to borrow … should be added to the list of likely contributors to the mid-1980s stabilization.”

Dynan, Elmendorf, and Sichel, *Can Financial Innovation Help to Explain the Reduced Volatility of Economic Activity?* (2006)

Greater Access to Credit Probably Explains Reduced Sensitivity of Consumption to Income Declines after Mid-1980s



BUT, downsides to greater access to credit have become painfully clear ...

Share of Income Committed to Debt Service Has Risen

- From Dynan (*Journal of Economic Perspectives*, 2009):
  - Median DSR rose from .05 in 1983 to .13 in 2007.
  - Percent of households with DSR > 0.40 rose from 4% in 1983 to 11% in 2007.
- Households with higher DSRs more likely to have trouble making payments.

Greater Leverage Has Increased Exposure to House Price Shocks

Change in Wealth Implied by a 20% Decline in House Prices (as a Fraction of Income)

	1983	1995	2007
All Households	-.30	-.33	-.49
Households in Lowest 1/3 of Income Distn	-.46	-.57	-.77

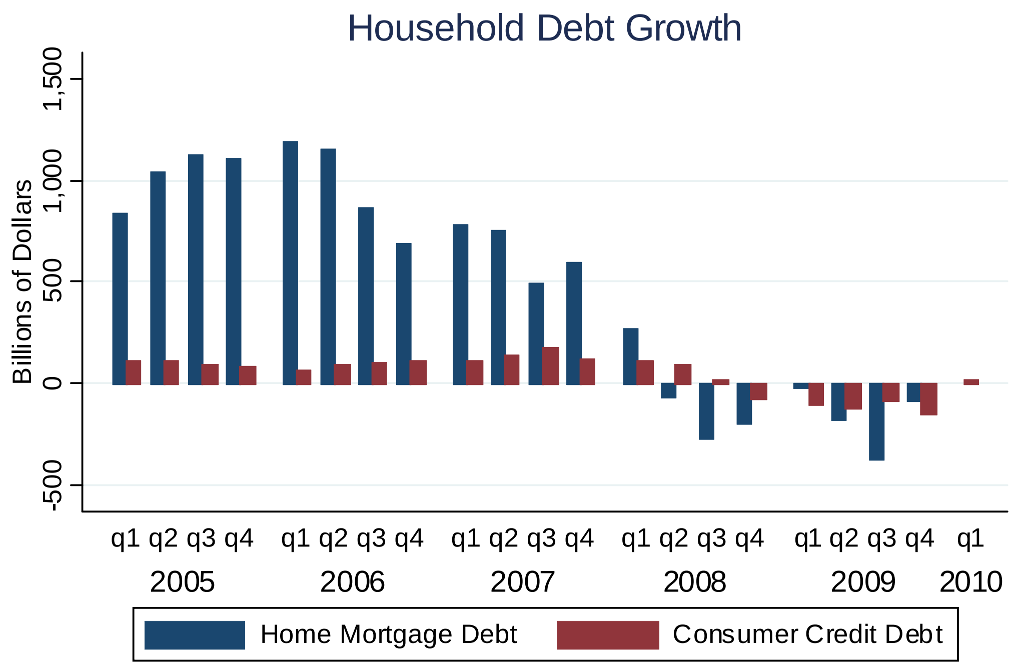
Source: Dynan (2009) based on the Survey of Consumer Finances.

Lessons about Household Leverage

- Useful for getting around income constraints …
  - To smooth consumption.
  - To pursue higher returns via investment.
- But exposes households to more risk if things do not turn out as expected.
- FURTHER, financial crisis has taught us that it can hurt a much broader group than those who borrow if risk-taking is correlated across households.

Household Deleveraging

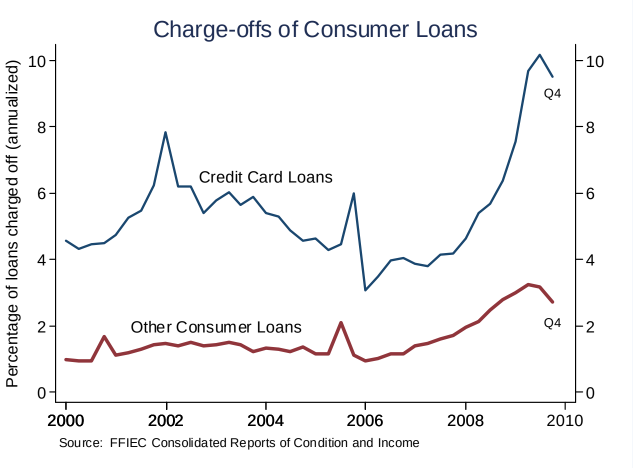
Both Mortgage and Consumer Debt Are Shrinking

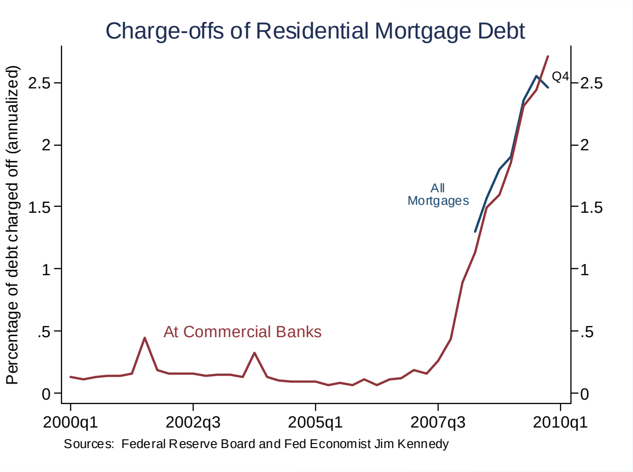


Source: U.S. Flow of Funds Accounts and Fed G.19 data release.
2010q1 consumer credit is estimated

How is deleveraging occurring?

Importance of Defaults



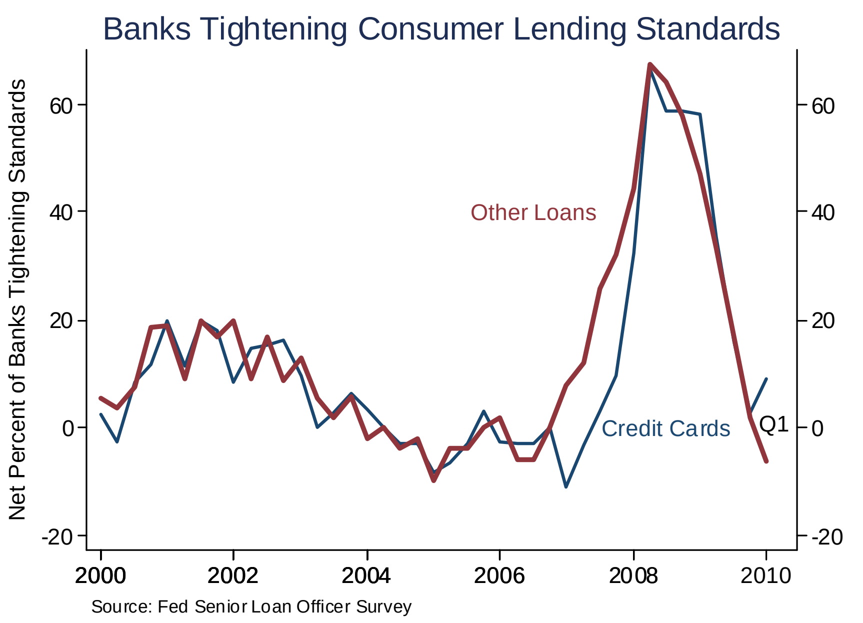


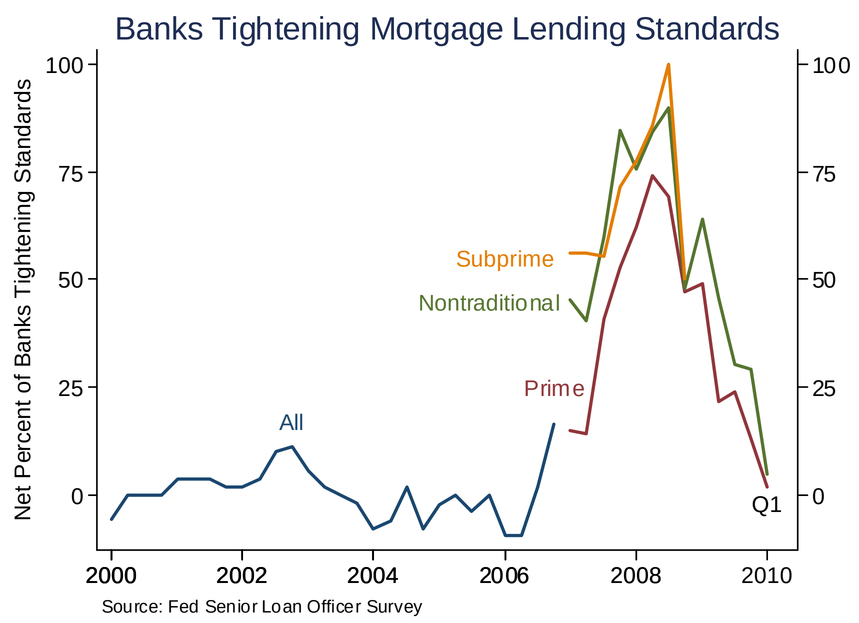
If charge-offs had not been unusually elevated …

Consumer credit would have declined 2¾% in 2009 instead of declining 4½% (charge-offs explain 60% of decline).

Mortgage debt would have been flat in 2009 instead of declining 2% (charge-offs explain all of decline).

Evidence of Supply Constraints





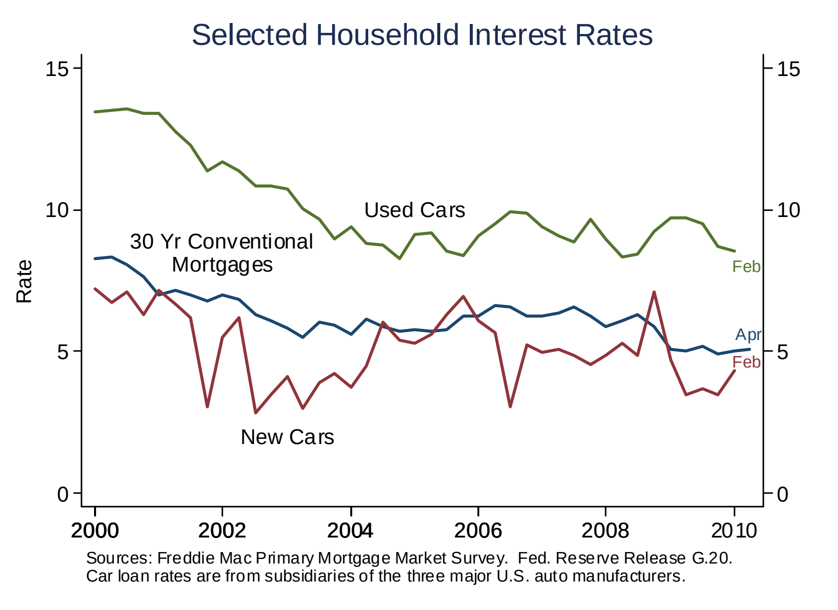
More Evidence of Supply Constraints

- Loan officer survey: 2/3 reported loan standards for nonprime households unlikely to return to long-term averages "for foreseeable future."
- Private nonprime mortgage market still closed.
- Lower credit card limits, higher LTVs on new car loans.
- More austere regulatory environment (CARD act, new HOEPA regs, push for CFPA).

Demand for Loans Also Down

- Not surprising in a downturn when demand for consumer goods and services falling.
- 1/5 of senior loan officers (on net) reported that demand for consumer loans had fallen relative to 3 months earlier in May 2010 (well after consumption trough).
- But, signal from other possible indicators of greater prudence among households fairly weak.

Disentangling Supply vs. Demand



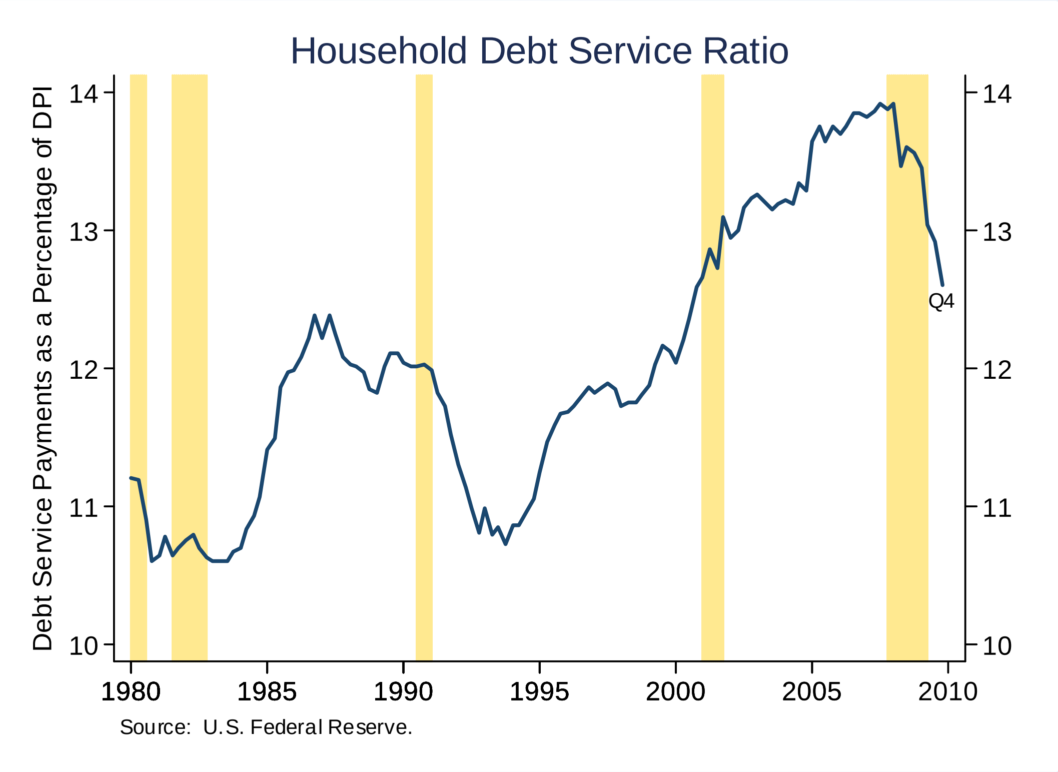
Looking at price is a traditional way to see if demand or supply effects are more important.

But these measures tell us only part of story because there is non-price rationing too.

Is the Deleveraging a Good Thing or Bad Thing for the Economy?

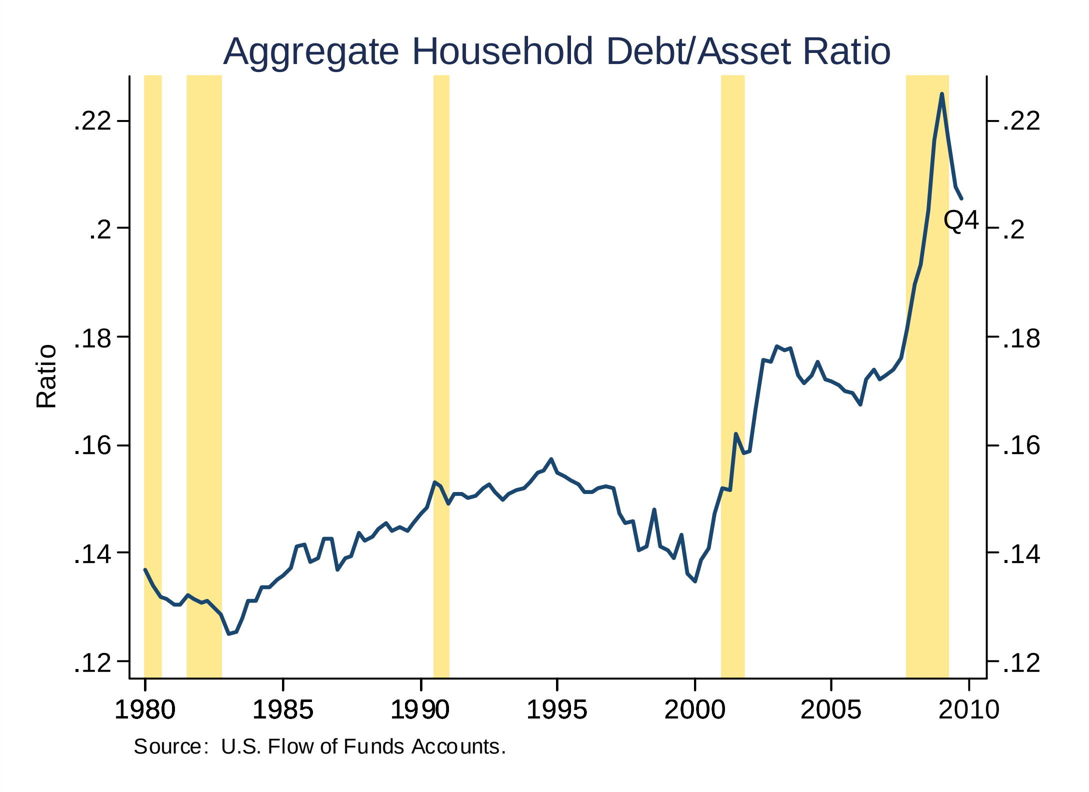
- **Short run:** Inability / unwillingness to borrow is dampening the pace of recovery.
- **Longer run:** Deleveraging puts households and the broader economy in a more solid and sustainable position.
  - » Regardless of how it occurs.
  - » Lower debt service payments have already made much more cash available for spending.

Aggregate DSR Has Fallen by 1.25 Percentage Points



Looking Ahead

High D/A Suggests Potential for Considerably More Deleveraging



Future Deleveraging Most Likely to Occur in the Mortgage Area

- Mortgage charge-offs likely to remain high.
  - » Foreclosures are on the rise again after having been forestalled by HAMP and other factors.
- Even as lenders' standards ease, new borrowing should be dampened by lack of home equity.
  - » CoreLogic: Close to 30% of mortgage borrowers have little or no equity (50% or more in the hardest-hit states).

Scope for Further Deleveraging in the Consumer Credit Area Less Clear

- Delinquency rates are very high, particularly for credit cards, and soft labor markets should keep them high => more charge-offs to come.
- But borrowing is likely to pick up with consumer demand.
- Q1 saw first increase in outstanding consumer credit since 2008:Q3 (up 0.4% but if charge-offs not elevated the increase would have been around 3%).

Conclusions

- More deleveraging seems likely, especially in the mortgage area.
- The deleveraging reflects a combination of households defaulting and borrowing less (different in some ways but gets them to the same place).
- Big unanswered question: **Who** is deleveraging?