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Household Deleveraging and the Outlook for Consumer Spending

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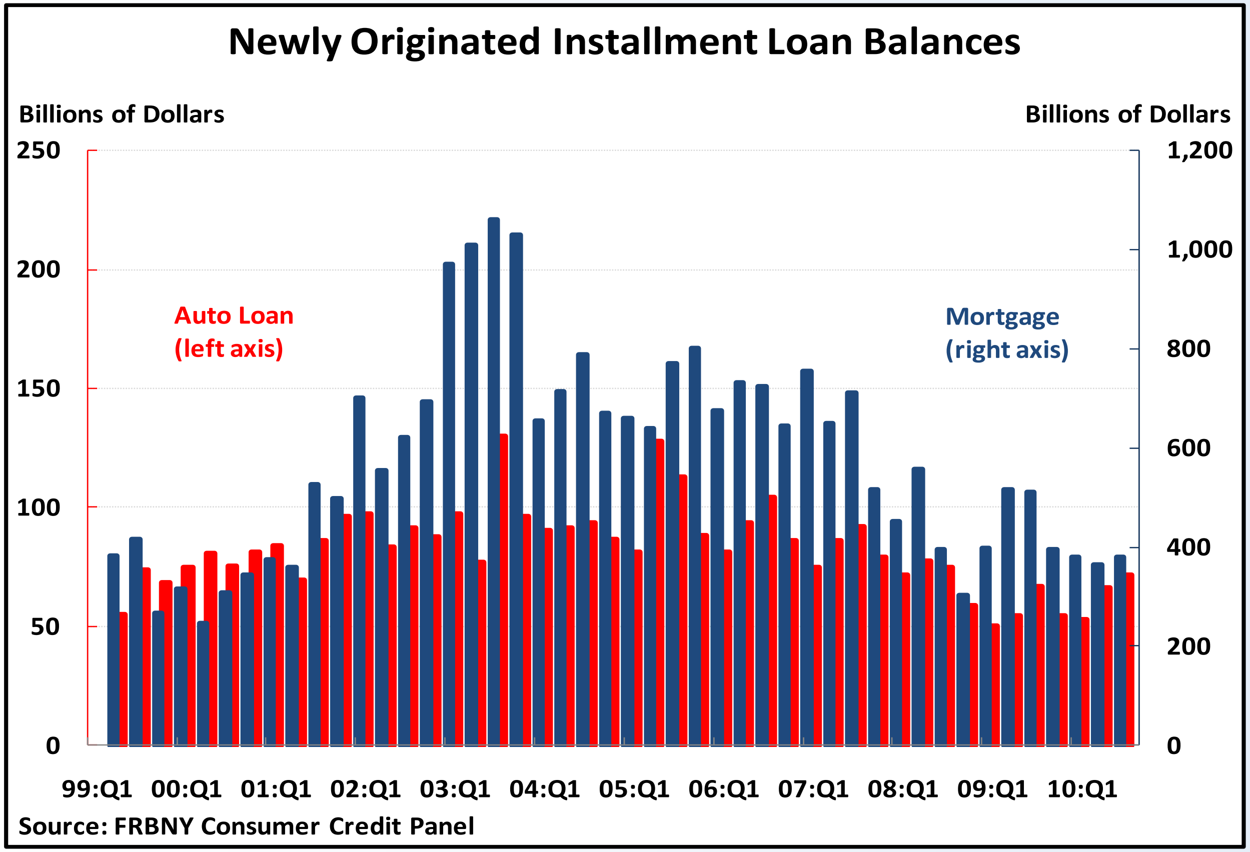
December 8, 2010

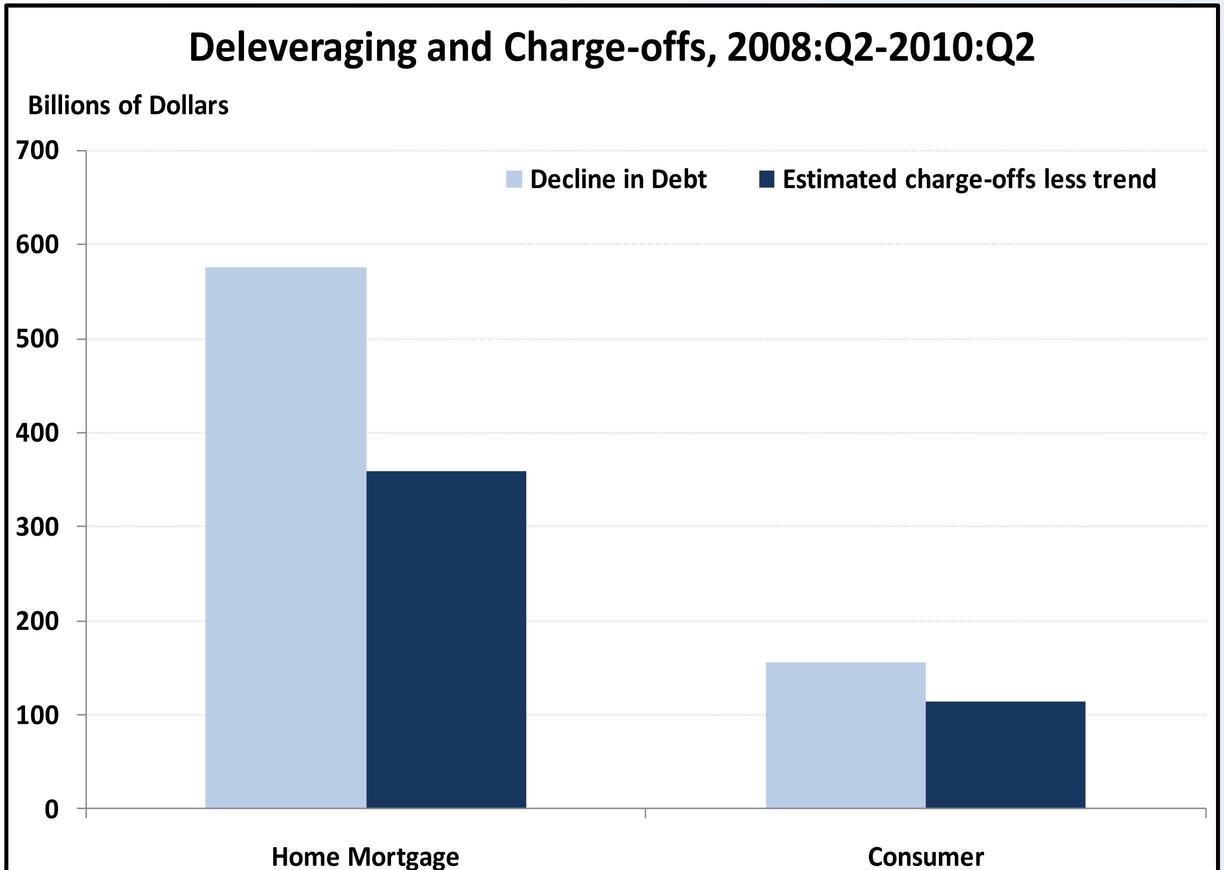
This presentation was prepared for the Macroeconomic Advisers, LLC 109th Quarterly Outlook Meeting in Washington, DC. The views expressed are my own and not necessarily those of others affiliated with Brookings.

Some Facts about “The Great Deleveraging”

Some of the deleveraging can be accounted for by a reduction in new borrowing

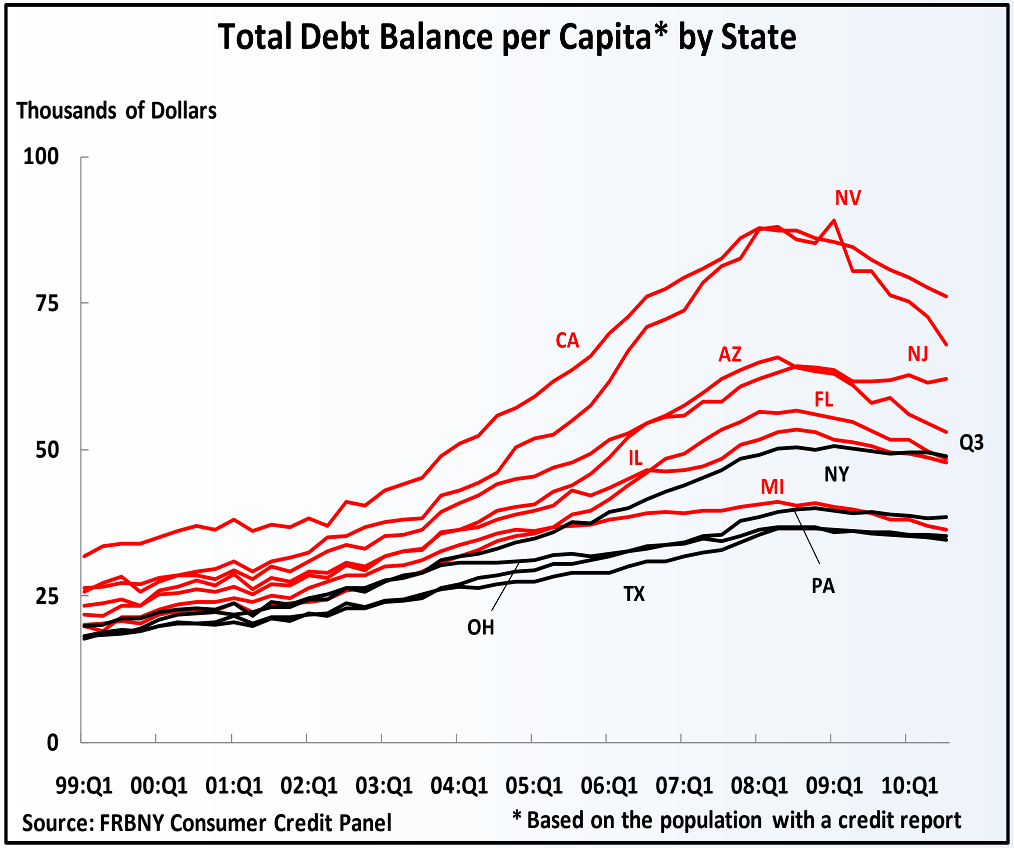


The enormous wave of loan defaults has also contributed importantly to deleveraging



Source: U.S. Flow of Funds accounts, G.19 release, and author's calculations.

State-level comparisons also underscore the importance of defaults

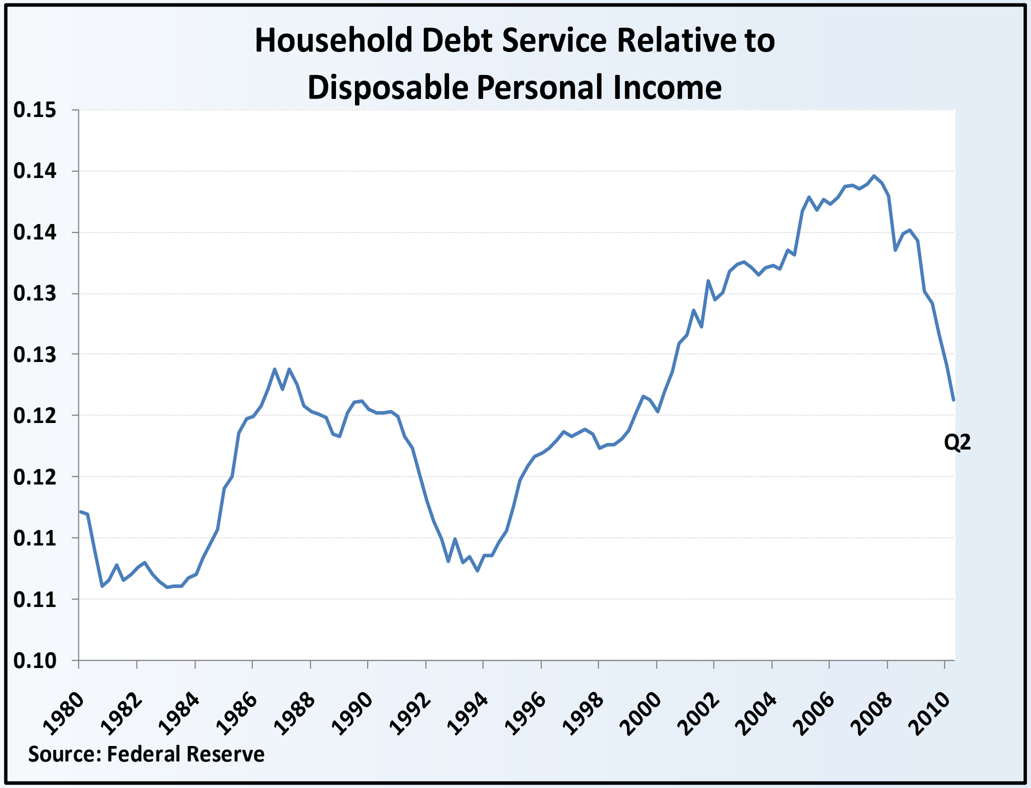


Declines in debt much larger in states that have seen more mortgage distress (states in red have serious delinquency rates > 10%)

There is more deleveraging to come (I)

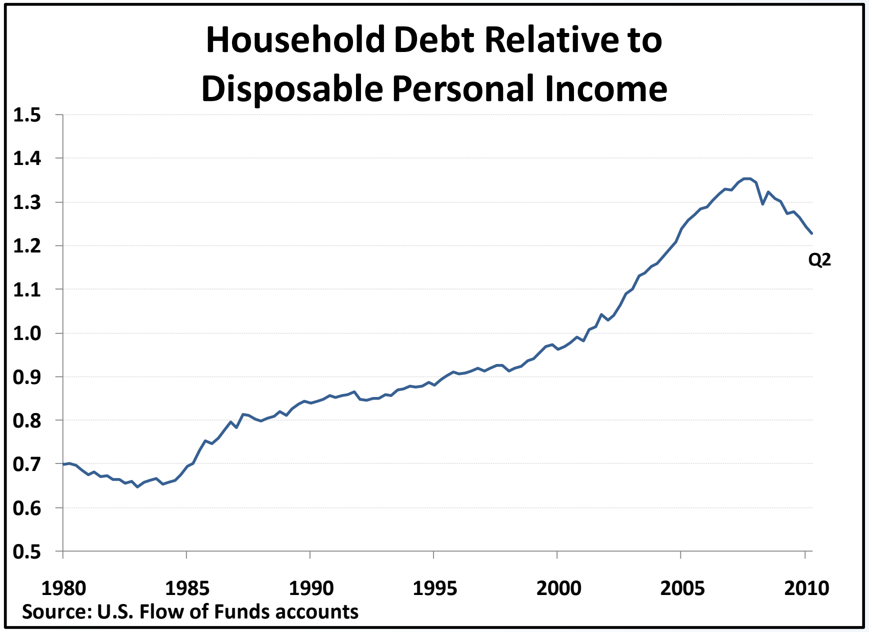
Different measures tell us different things about how much progress we've made.

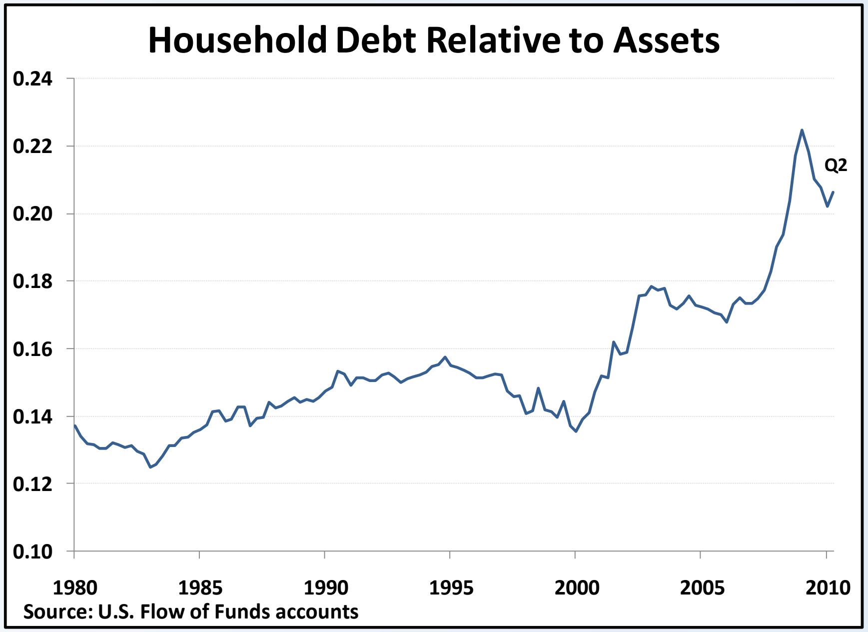
Some measures suggest we've made a lot of progress …



There is more deleveraging to come (II)

… but other measures suggest we've made less progress …

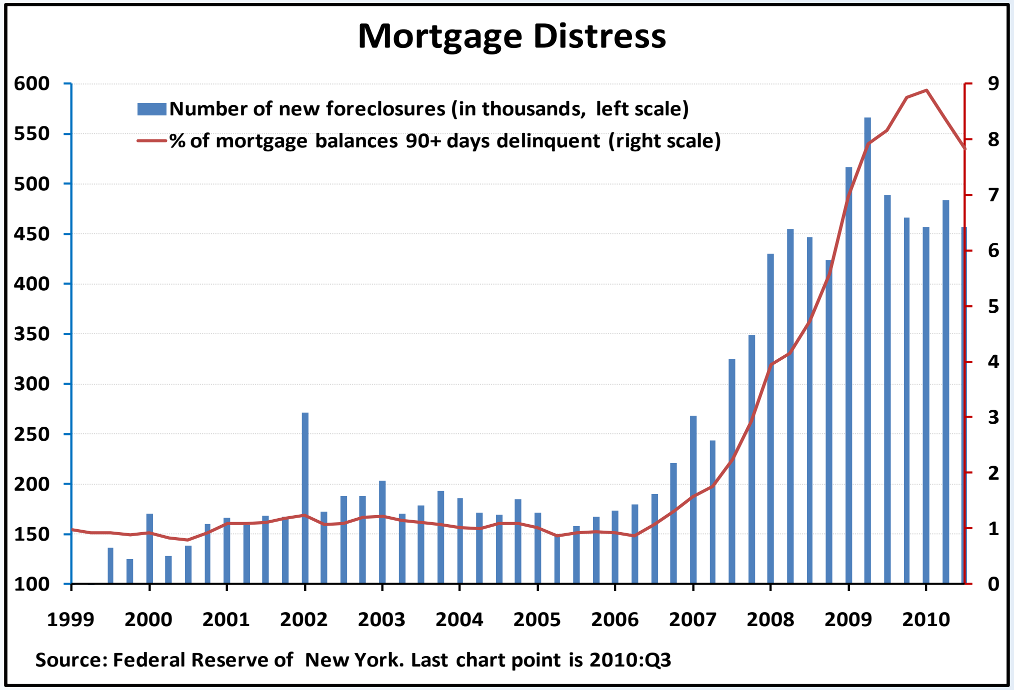




There is more deleveraging to come (III)

… and other indicators point to many more mortgage defaults.

- Weak labor markets
- Close to ¼ of mortgages "under water"
- < 500K HAMP modifications; and many may fail given average "back-end" DTI of 63%
- Large "shadow inventory" of foreclosures



Deleveraging and Consumption

The relationship between net worth and debt

- Arithmetic link: net worth = assets – debt
- But, choosing more or less debt to finance the purchase of assets doesn’t lower or raise net worth—it just changes leverage (means that the same level of net worth can be associated with very different levels of debt)
- Lifecycle hypothesis says consumption should be a function of net worth; no direct tie between the degree of leverage and consumption

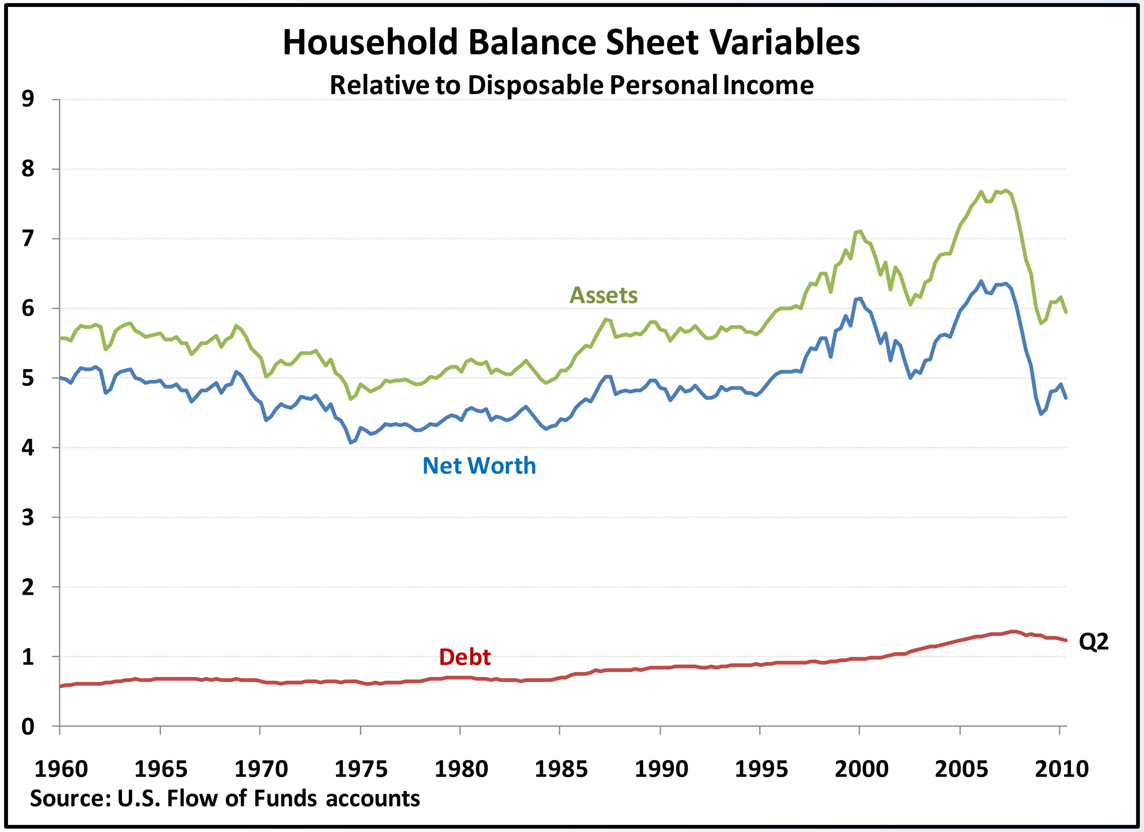
Why might debt matter above and beyond its influence on net worth?

- Mishkin's liquidity hypothesis: when the probability of financial distress is high, you increase saving in order to pay down debt or buildup a larger buffer of liquid assets

- One factor that may precipitate financial distress: high debt payments relative to your resources

- Mishkin's story was that households choose to increase saving, but a variant would be that financial institutions impose this on households by restricting lending (dissaving)

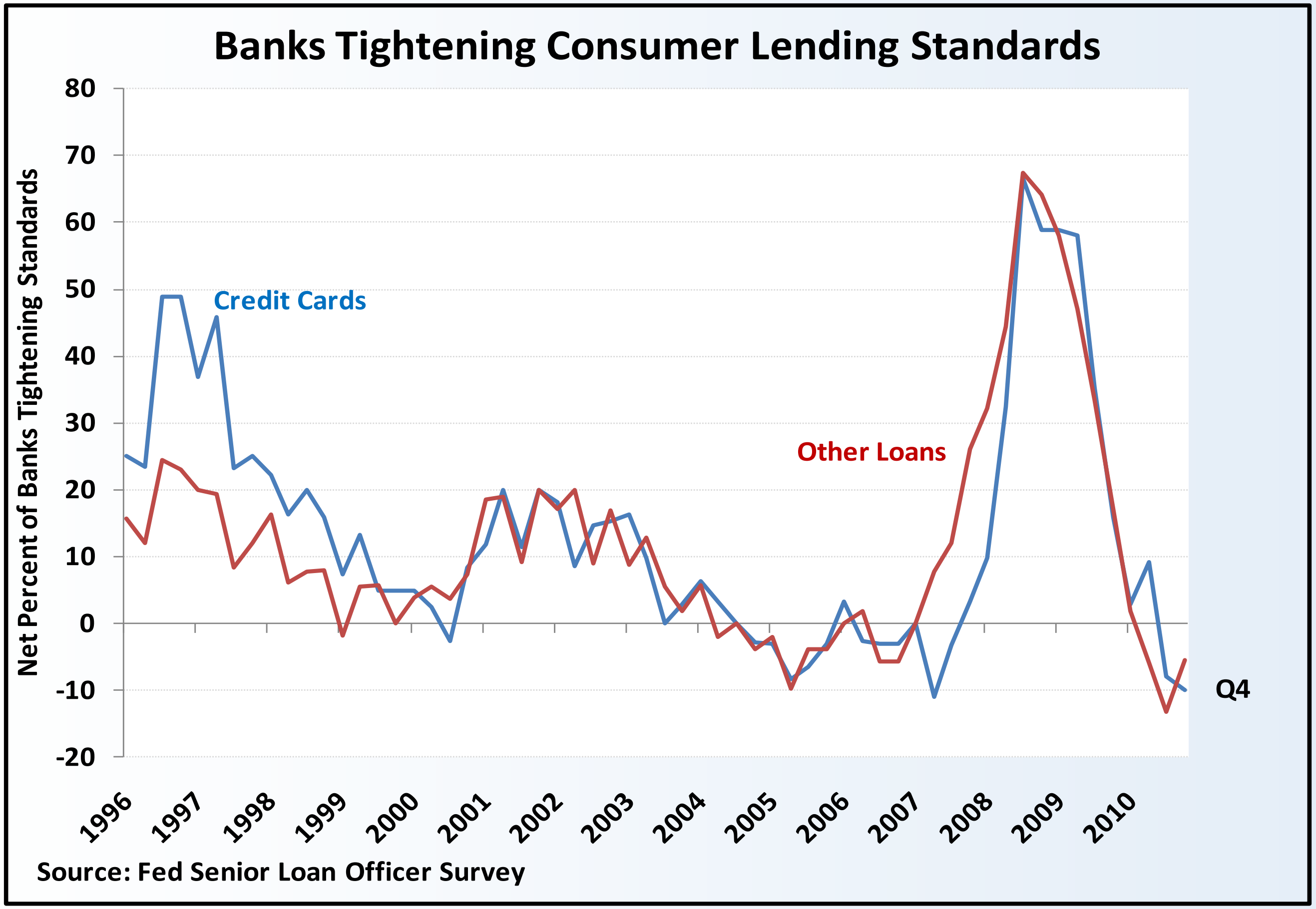
That said, it may difficult to detect a role for debt in a macro model because there is so little quarter-to-quarter variation

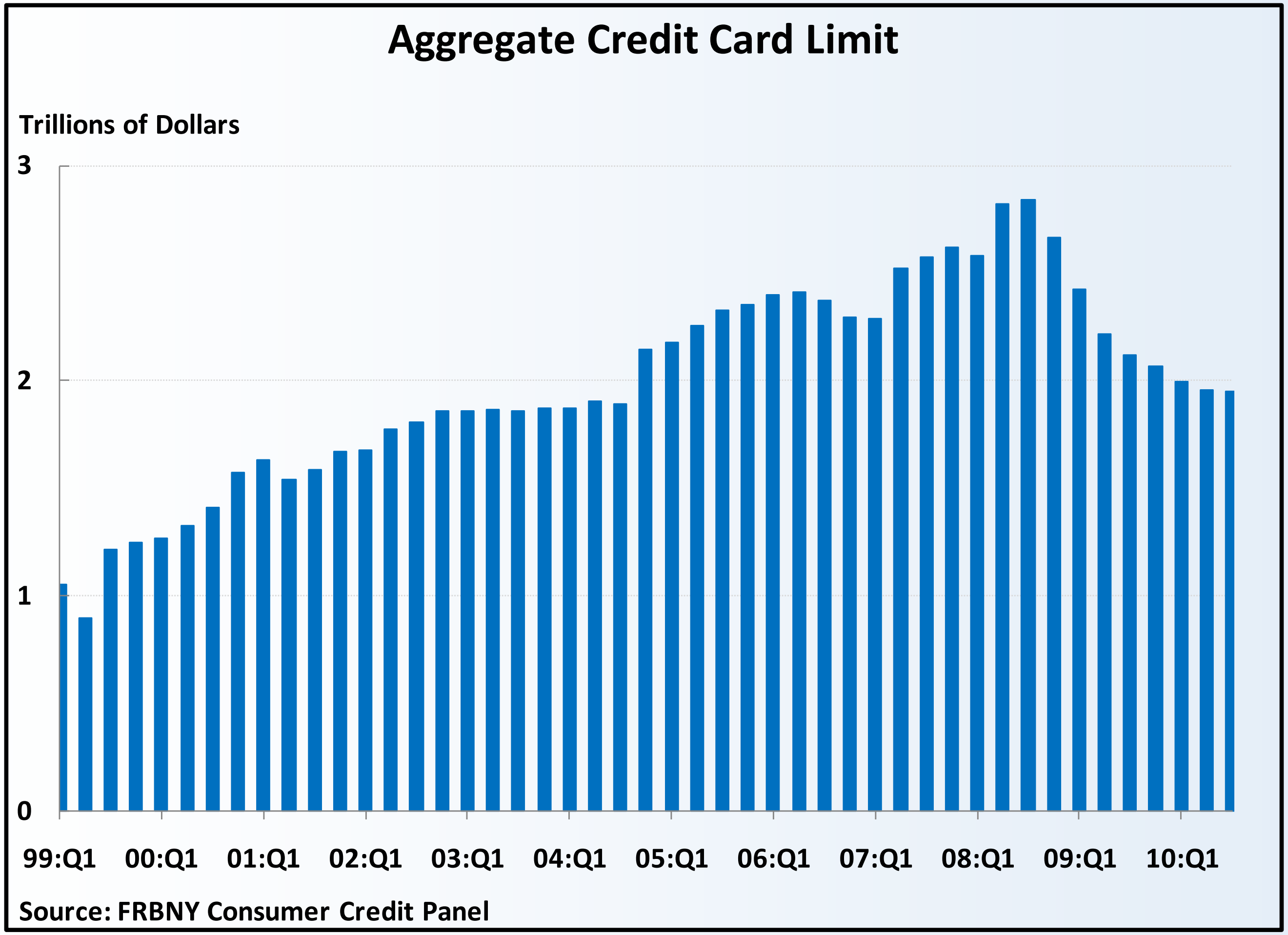


If we can't use a model, what can we say about how deleveraging is likely to affect consumption growth?

New borrowing should pick up and that should be a positive for spending

- Supply constraints easing:
  - Tightening of loan terms and standards beginning to unwind
  - Decline in credit limits has tapered off
  - Possibility of some sort of government program that would allow more homeowners to refinance and take advantage of low mortgage rates


Banks Tightening Consumer Lending Standards
Net Percent of Banks Tightening Standards
80
70
60
50
40
30
20
10
0
-10
-20
Credit Cards
Other Loans
Q4
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
Source: Fed Senior Loan Officer Survey


Aggregate Credit Card Limit
Trillions of Dollars
3
2
1
0
99:Q1
00:Q1
01:Q1
02:Q1
03:Q1
04:Q1
05:Q1
06:Q1
07:Q1
08:Q1
09:Q1
10:Q1
Source: FRBNY Consumer Credit Panel

Caveat regarding new borrowing: what about demand effects?

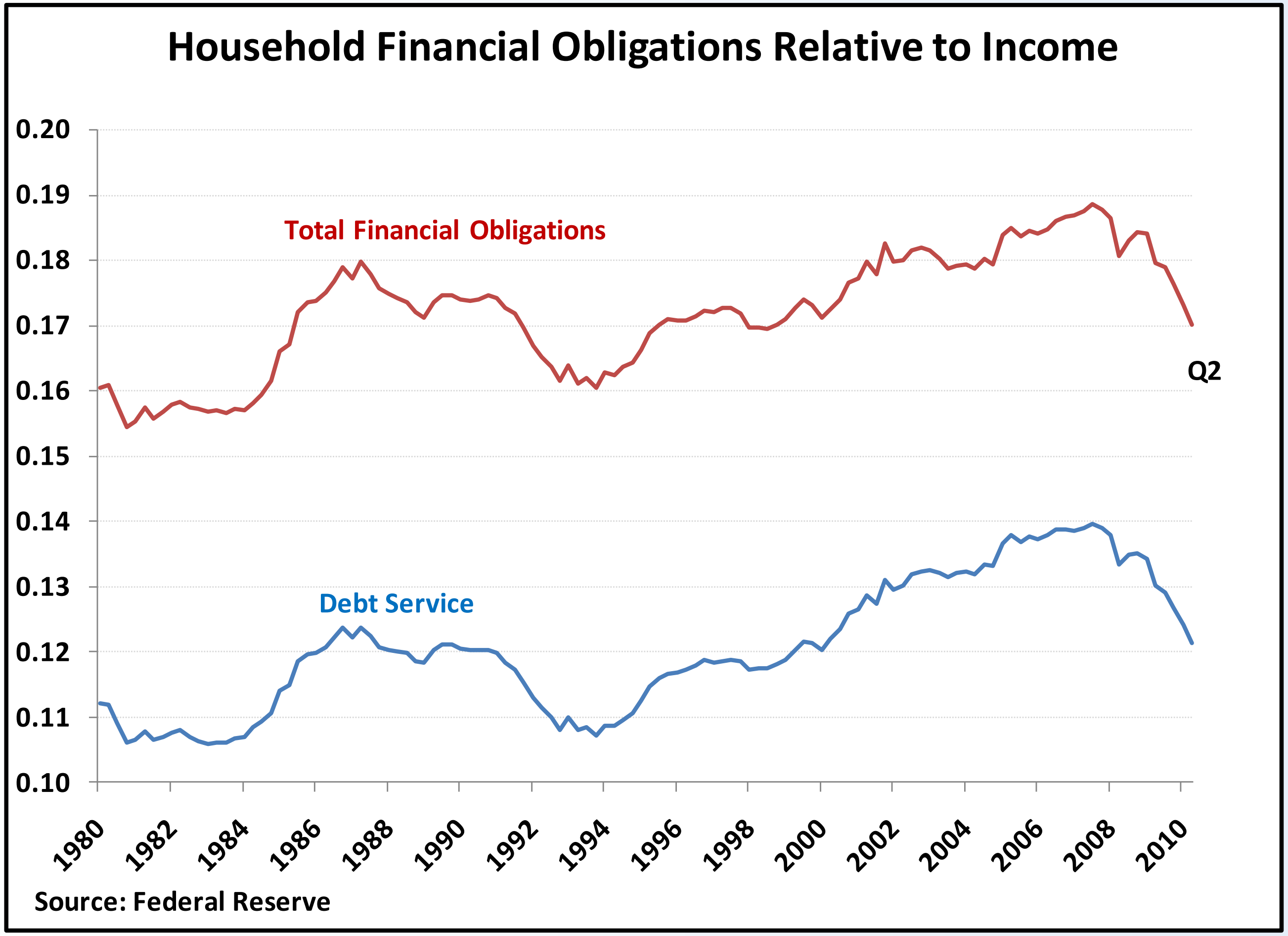
- Recall that Mishkin's story hinged on households' views about whether they had sufficiently reduced the probability of financial distress

  » Hard to assess: this is where micro data on balance sheets (or even just good survey data on attitudes) would be really helpful

- Fact that loan originations picking up suggests that supply effects may be more relevant

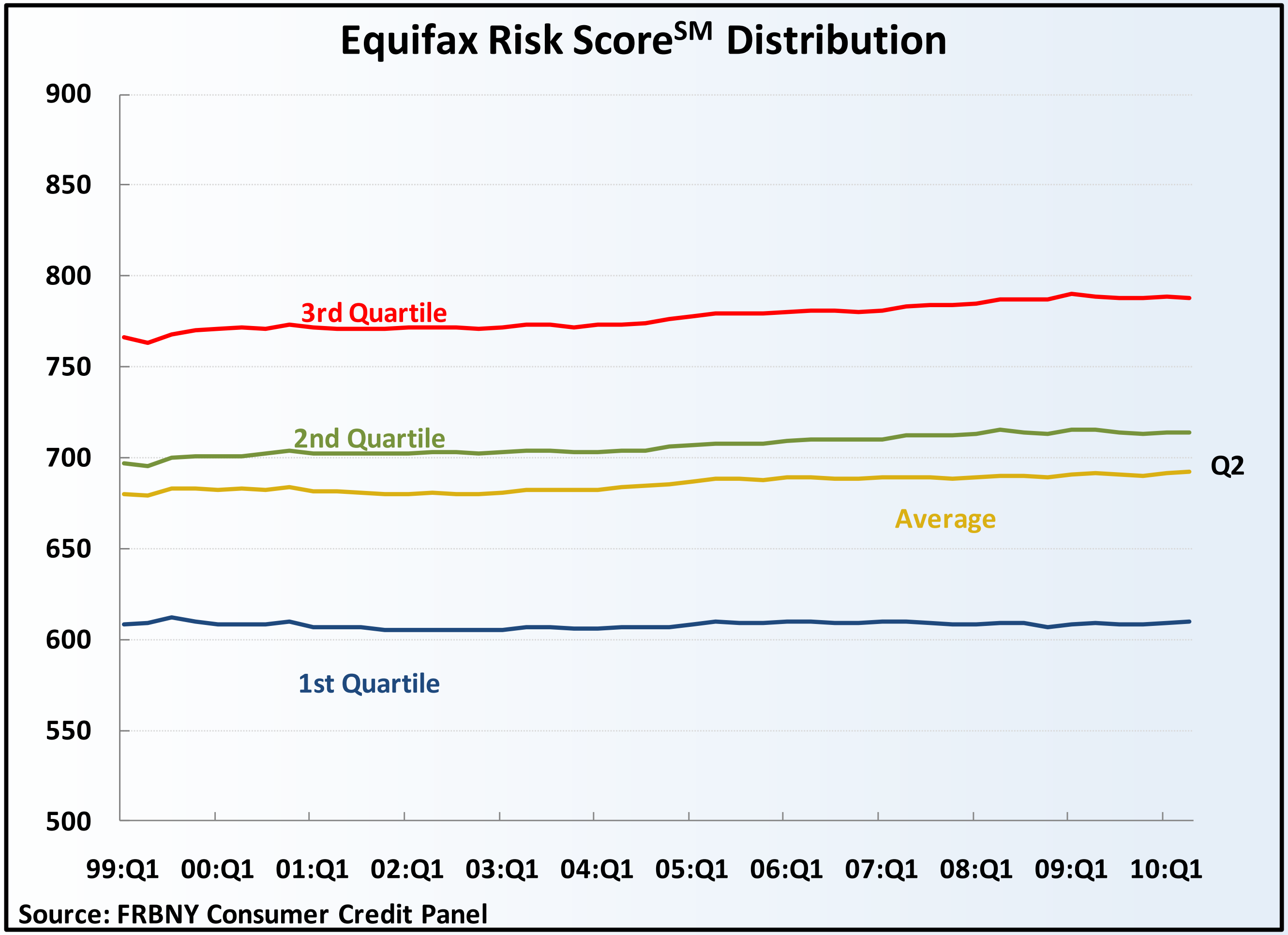
Further mortgage defaults could be a positive or negative for the spending of those who default

- Relieved of onerous debt payments.
  - » Probably a positive
  - » Though households still generally have to pay for new housing
    - – One mystery here is this should imply a smaller decline in the FOR than the DSR and that's not what we are seeing (next slide)


Household Financial Obligations Relative to Income
Total Financial Obligations
Debt Service
Q2
0.20
0.19
0.18
0.17
0.16
0.15
0.14
0.13
0.12
0.11
0.10
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
Source: Federal Reserve

Further mortgage defaults could be a positive or negative for the spending of those who default (cont'd)

- Hit to credit scores from defaulting
  - Should be a negative: for example, Han and Li (forthcoming, JMCB) found bankruptcy associated with reduced access to unsecured debt and higher cost of borrowing generally
  - Interesting, though, that credit score measures have not changed that much (next slide)


Equifax Risk Score^{SM} Distribution
900
850
800
750
700
650
600
550
500
3rd Quartile
2nd Quartile
Q2
Average
1st Quartile
99:Q1
00:Q1
01:Q1
02:Q1
03:Q1
04:Q1
05:Q1
06:Q1
07:Q1
08:Q1
09:Q1
10:Q1
Source: FRBNY Consumer Credit Panel

However, the biggest issue about further mortgage defaults may not be the direct effects

- Rather, the biggest issue for consumer spending is probably the risks related to indirect effects:
  - » More charge-offs could hurt the still-fragile banking system, and, in turn, cause banks to pull back again on lending
  - » REO properties could flood the housing market and induce a significant further decline in home prices, producing another round of negative wealth effects

Concluding thoughts

- Deleveraging has held back the recovery, but unclear that it will hold down future consumption independent of wealth effects
- Over the longer-run, deleveraging will leave households in a more sustainable position and reduce the likelihood of another crisis
- As we go forward with credit regulation, we need to bear in mind that an overly restrictive credit environment could have negative consequences for macro dynamics: Dynan, Elmendorf and Sichel (2006): greater access to credit contributed to reduced macro volatility between mid-80s and mid-00s