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The Best of Times -- The Worst of Times

Remarks by

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Thank you. It's a pleasure to be here tonight to discuss economic trends. As economic and investment professionals, you've all come to appreciate how easy it is to make a forecast these days. Whatever the question, the answer is three. What will real growth be? About three. What will inflation be? About three. What about short rates? Three something.

Tonight, however, I am going to resist the temptation of just uttering the number three and sitting down. After all, if I did so, you might think that I didn't earn my dinner. And if word got out that economics was as easy as one, two, three, we'd all be in for a pay cut.

While the magic number for the economy is three, the grade we should give our current economic performance is a ten. I believe that the reason for this is clear. For the past twelve years, my predecessors and colleagues at the Federal Reserve have labored successfully to establish credibility as opponents of inflation. The result has been a steady and continuous decline in the long bond rate of more than sixty basis points per year -- a remarkable cumulative reduction of 800 basis points in the benchmark ten year Treasury bond, for example.

This long term sustained reduction in inflation expectations and interest rates has provided our economy with one of the most favorable environments for maximizing America's economic potential in more than two decades. It has, for example, created the highest level of housing affordability since 1973 and one of the lowest costs of productive capital since the early 1960s. I believe that the potential benefits of this environment are widely recognized and are the principal cause of our currently improving economy.

The financial health of the private sector has also improved substantially. Chairman Greenspan's metaphor of diminished financial headwinds is a particularly apt description of this phenomenon. The deleveraging process which began in the late 1980s has left corporate balance sheets in a much improved position. Our nation's banks are as healthy as they have been in many years. Furthermore, the decline in mortgage interest rates and other key lending rates have worked to lower the overall debt payment burden of the household sector.

But tonight I would like to focus on the household sector and take a detailed look at consumer spending patterns and balance sheets. I believe that the details suggest more cause for concern than the aggregate statistics indicate. For what seems to be one of the best of times financially for our country as a whole stands, in contrast, to what is arguably one of the riskiest times that large parts of the household sector have faced in many years.

While the conventional forecast of sustained three percent growth is certainly the most likely economic scenario, I believe that the financial condition of much of the household sector poses one of the most significant downside risks to the current economic environment. Note that I say "much of" the household sector, for many households are doing quite well, historically speaking. Furthermore, my concerns do not reflect on the short term outlook, but on the long-term sustainability of the current level of household spending.

My case tonight is that the aggregate statistics mask the potential risk to key components of the household sector for two reasons. First, financial innovations and tax law developments have induced many households to assume a less liquid financial position than has previously been the case. Second, demographic and labor market developments have weakened the financial position of the core households of our country -- the middle-aged and middle-class -- far more than the aggregate statistics indicate.

To better understand how financial innovations and changes in the tax laws have altered household behavior, let us begin with a comparison of household spending behavior in 1993 versus 1992. Personal income in 1993 was $244 billion higher than the year before. Uncle Sam took $37 billion more in personal taxes, meaning that disposable personal income was $207 billion higher. But, personal outlays rose $254 billion. In Keynesian jargon, the marginal propensity to consume last year was about 1.2 -- $1.20 extra was spent for every dollar of extra income. This is, of course, unsustainable in the long term. The short-term result was a decline in the personal saving rate to 4.0 percent -- one of the lowest on record.

In and of itself, this historically low saving rate suggests that households were stretching their budgets last year to maintain their consumption. But, a closer look at the components of savings suggests that their "stretching" was even more extreme than the data indicate when it comes to the liquidity of their balance sheets.

One of the most striking elements of the data was the increased use of tax sheltered forms of saving, notably a build-up of pension fund and life insurance reserves. In 1992, the buildup of reserves in these two tax sheltered vehicles amounted to half of the net acquisition of financial assets by the household sector. In 1993 however, these tax sheltered investments rose to nearly 70 percent of net acquisition of financial assets. So while total personal saving fell $47 billion in 1993 compared with 1992, tax sheltered personal saving rose $67 billion. That means that saving outside of these two vehicles had to fall by $114 billion between the two years.

The ramification of this $114 billion decline in other savings becomes clear when one examines where this decline in unsheltered saving came from. Data on household balance sheets suggest that it primarily came from bank accounts and sharply reduced net purchases of liquid financial market securities. We are all aware that banks have received a smaller portion of household wealth as a result of today's interest rate environment. Although bank accounts did manage to grow by some $17 billion in 1992, the total amount of bank deposits actually fell $18 billion in 1993. On net, therefore, bank deposits represented $35 billion of the decline in unsheltered saving in 1993 compared to 1992.

The household ownership of securities has also seen a rapid transformation with the rapid growth of mutual funds. In 1992, households acquired, on net, individual securities (including security credits) of $58 billion and increased their mutual fund balances by $171 billion. Broadly speaking therefore, net investment in all securities rose $229 billion. In 1993, by contrast, net acquisition of individual securities fell $115 billion while purchases of mutual funds rose $269 billion. The net investment in all securities in 1993 therefore was only $154 billion, down $75 billion from 1992.

Much has been made of the mutual fund boom in 1993. While the growth of funds that year did set a record, total purchase of securities by households both directly and indirectly through mutual funds was much lower in 1993 than 1992. These numbers show that the accelerated liquidation of individual stocks and bonds by the household sector swamped the increased purchases of mutual funds in 1993 relative to 1992.

The reason for such behavior is certainly understandable. The increased use of tax sheltered vehicles is a normal reaction to the higher rates which were retroactively imposed in last year's tax bill. Individuals are clearly increasing the share of their assets which they hold in taxable form. But tax sheltered investments are not perfect substitutes for taxable investments. In other words, the difference is more than just taxes. There are three key differences which impact the financial health of the household sector.

The first difference is that the buildup of pension and life insurance reserves is an inherently less liquid form of saving than are either bank deposits or securities. Withdrawal is seldom easy, is often constrained by law or covenant, and often involves punitive tax consequences. This reduced liquidity suggests that, in an emergency, households have less easy access to their assets than they otherwise would.

The second difference involves the actual dollar value of saving which is occurring. The data on tax sheltered saving are reported in before-tax magnitudes. When withdrawn, most of this saving will be taxed at a federal tax rate of 28 percent and a state tax rate of around 5 percent. As actual after-tax net wealth goes, each dollar of tax sheltered saving is really only worth 67 cents. Furthermore, because of a 10 percent withdrawal penalty, in liquid terms, each dollar is really only worth 57 cents. On a tax-adjusted basis therefore, household savings is even lower than the aggregate data indicate.

The third difference is a distributional one. Households with access to defined contribution pension plans are generally more affluent than, say, holders of bank accounts, or even mutual funds. While there are an estimated 14 million households with 401(k) or 403(b) plans, 18 million own mutual funds and 83 million of the country's 96 million households have bank accounts. The shift into tax-sheltered saving by the household sector as a whole may indicate that those households most likely to be financially vulnerable are seeing the biggest reduction in their financial cushion. The reason this difference is of concern is the qualitative version of the decrease in household liquidity. Not only are households less liquid in the aggregate, but it may be that those who need liquidity the most are the most financially stretched.

This data on household wealth is consistent with evidence I will present later on household earning that middle income households are increasingly stretched. While the data are not sufficiently disaggregated to prove the point conclusively, they strongly indicate both lower levels and less liquid forms of saving than aggregate evidence suggests. Most important, the data suggest that relying on historical comparisons are tricky and liable to overstate the current financial health of households.

A look at the liability side of the household balance sheet also reveals trouble spots. In order to finance increased spending, installment credit rose $38 billion faster in 1993 than in 1992 while mortgages grew $20 billion faster. Granted, residential real estate sales were growing along with purchases of consumer durables, so we should expect some rise in this type of debt. But, a closer look at the numbers indicates that a good part of the increase in mortgage debt was probably not being used to finance home purchases, but was probably diverted to consumption.

Let's look at mortgages. During 1993, total household ownership of residential structures and the land on which they sit rose $221 billion in value. During the same period, mortgage debt owed by households rose $191 billion. In other words, the rise in mortgage debt was 86 percent of the rise in the value of residential property. But the standard bank or finance company mortgage has a standard loan to value ratio of only 80 percent.

This 80 percent figure actually exaggerates the maximum plausible amount of mortgage financing of home purchases. This is because while new homeowners may be mortgaging their properties to the hilt, existing homeowners are in the process of retiring the mortgage debt on the property they bought in previous years. On average then, the increase in mortgages in any one year should be well under 80 percent of the increased value of residential property holdings.

Even in periods such as the 1980s, which are supposedly eras of high debt growth, the rise in mortgages is much less than 80 percent of the rise in household ownership of residential property. Between 1981 and 1989 for example, mortgages rose $1253 billion while residential property holdings rose $2486 billion, implying a 50 percent ratio of additional mortgages to additional property holdings. Applying this 50 percent ratio to 1993 suggests that $80 billion of the $191 billion rise in mortgage debt during that year was used for consumption or some purpose other than strictly home purchase.

Tax advantages might explain why an individual household would opt to borrow against the equity value of its home since mortgage interest payments are tax deductible while personal interest payments are not. While explainable, the increased use of mortgage finance contributes to the rise in long-term debt to finance present consumption. This might be considered a potentially troubling development for household balance sheets.

On the debt front, much has been made of the declining debt service share households face due to the decline in interest rates and the retiring of some debt during the early 1990s. For example, debt service as a percent of disposable income declined to 16 percent in 1993, back down to the 1985 level and not far from the historic norm of 15 percent for the 1960-1985 period. The case of the debt service ratio illustrates my second point about aggregate statistics -- they can mask the effect that demographic trends have on the household sector's financial position.

For example, consider that the elderly and the very well-to-do are unlikely to engage in significant debt financing of consumption for obvious reasons. Yet, these two groups of the population have enjoyed a very significant rise in the share of income they receive. In 1960, for example, the elderly received just 7 percent of household income. By 1993 their share was over 16 percent. Similarly, the share of income going to the top 1 percent of households has risen from 9 percent in 1960 to 13 percent today. In aggregate therefore, the share of income going to these two groups has risen from 16 percent to 29 percent.

Consequently the share of income received by everyone else -- those likely to borrow -- has fallen from 84 percent of income to 71 percent.

This means that even a constant debt burden as a share of total income actually involves a much higher burden on those likely to be shouldering that debt. If one adjusts the debt service burden for these demographic factors, the average debt service burden for those most likely to borrow during the 1960-1985 period turns out to be roughly 18 percent. The 1993 level of this measure of debt service burden stands at 23 percent. Instead of being within one percentage point of the historic norm, debt service has risen by 5 percentage points to consume 28 percent more of disposable personal income for this group. In terms of total debt outstanding, the demographic adjustment raises the ratio of total debt outstanding to disposable income from 77 percent to 108 percent.

This squeeze on the relative income position and consequent ability to service debt by the middle-aged middle-class is also evident from an analysis of the functional distribution of income -- how the pie is divided among wages, interest, and dividends. By and large this middle group lives off the wages and salary income it earns. While 89 percent of all wages are received by those under 65 in households making less than $200,000, only 30 percent of interest is received by such households and only 28 percent of dividends. Of course, non-elderly middle class households are also negligible recipients of transfer payments.

During 1993, however, only 38 percent of the gains in personal income were paid in the form of wages, net of social insurance taxes, 28 percent was paid as capital income and 22 percent paid in the form of transfers. The remaining 12 percent represented fringe benefits. This is the lowest wage share of personal income gains in recent times. Even during the 1981-1989 period, an era which some political mythology describes as an era in which the middle-class got squeezed, 52 percent of income gains were paid in the form of wages, 28 percent was paid to capital, 14 percent in the form of transfers and 6 percent in fringes. Furthermore, forecasts of personal income growth suggest that this wage share is unlikely to grow much and will not attain the levels of the 1980s.

Compensation and productivity data tell much the same story. Between 1981 and 1989, output per hour in the non-farm business sector grew 8.7 percent. Real compensation per hour rose only 3.9 percent. This higher compensation absorbed about 45 percent of productivity gains. During 1993, output per hour in the non-farm business sector grew 1.5 percent. Real compensation per hour rose only 0.2 percent. Thus, higher compensation absorbed about 13 percent of productivity gains.

Thus, data from a wide variety of perspectives show that the income base of the middle class eroded in 1993 relative to the experience of the 1980s. This occurred at the same time that debt burdens on this group maintained near-record high levels and households were stretching their budgets to historically unprecedented levels to maintain consumption. There is not a lot of evidence that these pressures will be alleviated at any point in the foreseeable future.

Further, this data seems to be reflected in consumer attitudes. Last fall, Money magazine and ABC News did a comprehensive interview of 2,154 American households. The respondents clearly recognized that a national recovery was underway and were optimistic about the nation's economic future. Furthermore, they rated this a very good time to buy both homes and cars, no doubt a reflection of the current low interest rate environment which holds down monthly payments. But, households were far less sanguine about their personal finances. They did not feel that the general national picture affected their daily lives. One other key finding in the Money/ABC poll summarizes this concern. In spite of a clearly better economy in late 1993 relative to a year earlier, and widespread media coverage that this was so, the number of respondents seeing America in long term decline was up 13 percentage points from 43 percent to 56 percent. This may be evidence that, in their own way, households recognize the potentially unsustainable condition of their finances.

Americans seem to be currently stretching their finances because they see the business cycle induced improvements in the economy and are therefore willing to assume a riskier position for their balance sheets. This pattern was very similar to what happened during the 1980s when the personal saving rate fell from nearly 8.6 in 1982 at the trough of the recession to 4.3 percent by 1987, with expansion fully underway. Following the 1973-1975 recession, the personal saving rate fell from 8.9 percent at the recession's trough in 1974 to 6.3 percent by 1977, when that expansion was fully underway.

The importance of these declines in saving as a spur to inducing economic growth should not be underestimated. In the 1980s, for example, had the personal saving rate stayed at its 1982 level, personal consumption expenditures would have been $131 billion lower in real terms in 1987, ceteris paribus. That $131 billion represents 17 percent of the growth in real GDP during those 5 years.

In the current cycle, the personal saving rate dropped from a high of 5.3 percent in 1992 to 4.0 percent in 1993. Using the same analysis as above, a real increase in personal consumption of $56 billion was due to the decline in the saving rate. That $56 billion amounts to 38 percent of the $146 billion increase in real GDP in 1993 over 1992. Thus, the decline in personal saving was more than twice as important last year as it was during the 1980s as a spur to growth in the overall economy.

An obvious problem for economic growth in the next two years is that a sustained decline in the personal saving rate as a means of financing higher consumption seems unlikely. 1993 represented a record low in this measure. Furthermore, the 1993 tax legislation is going to affect household cash flow for the first time this year. This tax increase is likely to lower the saving rate still further, all else equal.

The Administration correctly argued that the drag on spending from their proposed tax increase would be reduced because the great majority of the increase fell on upper income taxpayers. The Administration's 1995 Budget (p.59) shows that of a $41.3 billion increase in taxes, $32.9 billion or 80 percent, falls on taxpayers earning over $200,000. Just for argument sake, let's say that the 80 percent share that the wealthy pay comes out of personal saving while the remaining 20 percent comes out of consumption. That would mean that the tax increases would cause a mere $8 billion drag on aggregate expenditure. But, it would involve a 14 percent decline in personal saving and a personal saving rate of 3.5 percent, without any increase in consumption.

Where this fall in saving would come from on the household balance sheet is certainly an area of pure conjecture, but the magnitude of the adjustment involved is troubling. For example, let's say that bank deposits stay even in 1994 with their 1993 level while other parts of the household balance sheet continue at their 1993 pace. Then, net purchases of financial market instruments including mutual funds would fall to just $83 billion, one third of their 1992 level. Such a decline could have significant repercussions for market performance.

In sum, I believe that the household sector poses one of the most serious risks to the continuation of this recovery. Again, I believe that the consensus forecast of roughly 3 percent growth is the most likely outcome for the rest of 1994. But, we must realize that the situation in the household sector is far less positive than it was during the 1980s. Not only is personal saving at a record low, but households are less liquid than at any time in memory. Furthermore, the capacity for income growth to improve those balance sheets is greatly inhibited as the wage share of income growth is also at historic lows. Unexpected shocks to the system from higher taxes, higher energy prices, or even significantly higher inflation, could cause difficulties for what is already a challenging situation.