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Statement by

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Potential Economic Concerns Regarding Consumer Debt

Thank you, Congressman Kennedy. It is my pleasure to be here today to discuss some financial developments in the household sector, particularly with regard to growing levels of consumer debt. My message will be that of a real two-handed economist. Some of the information I will be presenting can be viewed as a very positive social development. But some of the same information may also be pointing to trouble ahead.

The Democratization of Credit

Let me begin with the good news. One of the key points in the consumer debt discussion that has been overlooked by many commentators is that credit in America has been enormously democratized. One of the side effects of the advent of the credit card has been to remove liquidity constraints from millions of American families. The net effect on these families is a substantially greater capacity to meet emergencies and an improved financial quality of life.

In the Survey of Consumer Finances, conducted by the Federal Reserve, the proportion of families earning under $10,000 reporting having credit card debt outstanding rose from 11.1 percent in 1983 to 13.4 percent in 1989 and 23.7 percent in 1992. The same proportions for families earning between $10,000 and $25,000 rose from 26.8 percent in 1983 to 29.1 percent in 1989 and 43.2 percent in 1992. By 1992, more than half of all households earning between $10,000 and $25,000 reported having access to at least one general purpose credit card.

By contrast, the share of families earning between $25,000 and $50,000 having a credit card balance was essentially flat between 1983 and 1992. During the same period the share of upper income families using credit card debt declined. In short, a clear trend toward the democratization of credit access is evidenced by the numbers.

The same sense of democratization can be observed through the use of racial or ethnic comparisons. The proportion of white families holding outstanding credit card debt was essentially unchanged in the last two Surveys of Consumer Finances -- 42.5 percent in 1989 and 43.8 percent in 1992. The growth in credit card use for credit among non-whites was much greater: from 34.1 percent in 1989 to 41.9 percent in 1992. Again, I believe that we should view increased access to credit as a socially desirable development.

The same can be said of access to conventional home purchase loans. Conventional home purchase loans granted to blacks rose 54.7 percent between 1993 and 1994. Nor was this a one-year event, but part of a multi-year trend. For black applicants, the increase from 1991 to 1992 was 26 percent followed by a 36 percent increase from the same reporting institutions between 1992 and 1993.

The explosive increases in mortgages granted to underserved populations can also be seen in terms of income. In 1990, for example, only 14 percent of all conventional home purchase mortgages went to individuals earning less than 80 percent of their area's median income. By contrast, more than 63 percent of such loans went to individuals earning more than 120 percent of their area's median income. In 1994, the proportion of mortgages going to low and moderate income families in the population rose to 24 percent, while those going to the upper income group fell to 49 percent.

Thus, a portion of the increased levels of both installment and housing debt is attributable to what I would consider a very positive sociological development. American financial institutions are extending credit to both income and racial or ethnic groups that traditionally have been underserved.

The Growth of Consumer Debt

At the same time that access to consumer credit has become more widespread, it has also grown explosively. Let me stress at the outset that only a relatively limited portion of this explosive growth in quantity can be attributed to the increased access for underserved groups. Consequently, any concerns I may express about the rapid growth in consumer credit should not be taken as criticism of the trend toward the more widespread availability of credit in our society.

The explosive growth of consumer credit can be seen from just a few summary statistics. Between October 1994 and October 1995, outstanding credit card balances rose 19.2 percent, or some $65 billion. Overall consumer debt rose $126 billion, or 13.4 percent. By contrast, personal income rose only 5.7 percent.

This trend has been going on for some time. Since the end of 1992, consumer revolving credit (what we call credit cards) outstanding has grown by 50 percent. Stated differently, we Americans have increased our credit card balances by $500 for every man, woman, and child in the country since 1992. That's a $2000 increase in credit card debt for a four person family, on average, in less than three years. That's on top of an increase in other forms of consumer debt of a similar amount.

Let me stress that there is a good deal of division among economists I have spoken with about this issue. It should be noted, for example, that this growth of consumer debt has helped finance a robust rate of growth in consumer durable purchases. It is quite natural that such durables would be purchased on credit. It is also the case that these households are making a conscious choice, and individually know far more about their capacity to handle this debt than we ever could. The very low rate of unemployment now prevailing has, perhaps, created a widespread conviction among households that risks to household income have substantially diminished. Furthermore, the value of household assets has risen dramatically, thanks in part to a booming stock market.

Nor can it be said that income adjusted consumer debt burdens are at record levels given some of the most commonly used measures. For example, non-mortgage consumer debt service rose to 10.9 percent of disposable personal income during the third quarter of 1995. This debt service burden measure is the most frequently cited measure of potential cash flow problems which debt may be imposing. The debt service burden had fallen as low as 9.9 percent during the fourth quarter of 1992. But, debt service burdens briefly exceeded current levels during 1989 and 1990 and were consistently higher than current levels from 1964 through 1975. In addition, mortgage debt service burdens are currently only 5.9 percent of disposable personal income. The substantial reduction in inflation expectations and, therefore, interest rates has allowed this measure to drop from a record 7 percent at the end of 1989. So, on net, total debt service burdens are slightly lower than they were during the late 1980s and early 1990s.

However, there is a difference between debt service, which involves how much a household must pay each month to cover their debt obligations, and the level of debt, which is the total amount they must pay back eventually. The role of declining interest rates is crucial to this distinction. Although declines in interest rates helped push down the debt service burden -- that is, how much households must pay each month -- they did not lower the level of debt to income. In fact, it seems as though households took advantage of the burden reduction from lower interest rates to increase their overall debt levels. Non-mortgage consumer debt was at a record 18.9 percent of disposable personal income in the third quarter. Mortgage debt was at a record 62.9 percent of income. Total consumer debt therefore is now at 81.8 percent of income. By contrast, the same measure was under 70 percent as recently as the first quarter of 1987. It is difficult to make a definitive professional assessment regarding the riskiness of this new record level of debt, in large part because consumers are now able to service more debt due to lower interest rates.

Reasons for Concern About Debt Levels

So the case can certainly be made that consumers are behaving in a prudent fashion, appropriate to current economic conditions. On the other hand, I would like to share with you some of the particular concerns that I have regarding this greatly increased use of debt. While I do not believe that current levels of consumer debt are necessarily bad, I do believe that they may be signalling a potentially more troubling story for the economy in the future. Let me suggest five reasons why I am troubled with current debt ratios.

First, the wage share of household income growth has been particularly depressed during the past three years. During the expansion of the 1980s, for example, the growth in wage and salary income made up nearly 60 percent of the growth in total personal income.

During the last three years, only 53 percent of personal income growth has gone to wages and salaries. This depression in the wage share of income, if sustained, should lead us to be cautious for a wide variety of reasons.

Wages are more closely associated with actual consumer spending than is capital income. For example, the MPS model, which the Fed uses, along with other models, to predict economic behavior suggests that the marginal propensity to consume out of wage income is 0.7, while it is only 0.4 percent out of capital income. Thus, the six point drop in the share of wages in personal income growth, if sustained, would imply a significant drop in the share of income which consumers would normally devote to consumption activity, and presumably also to servicing consumer debt.

In addition, substantial portions of capital income are not received by households in a spendable form. Much personal dividend and interest income is received by intermediaries such as 401(k)plans and IRAs, to which the consumer does not have ready access. IRS data show that while nearly all wage income is received in taxable form, the same can be said of only half of personal dividend income and only 30 percent of interest income. Thus, a smaller wage portion of personal income means, in effect, that less personal income is actually easily usable to finance consumer spending, or to repay credit card debt.

Thus, this poor performance of wages in the past three years suggests the <u>possibility</u> of a troubling hypothesis. Households <u>may</u> be adding debt in order to sustain desired consumption levels which cannot be justified by their earnings. Thanks to lower interest rates, they have been able to do this because of increased access to credit and the ability to increase debt levels without increasing debt service burdens. Whether or not this is the case, I think that at the very least, the poor performance of wages means that the actual burdens of debt and debt service are probably understated relative to past history.

Second, this relative decline in wage growth augments other evidence that the distribution of income is moving in a way which is less supportive of widespread consumer debt. During the late 1980s and early 1990s, the share of income received by the top 5 percent of households temporarily stopped increasing as it had done since the late 1960s. But, the trend seems to have resumed in 1993 and again in 1994, with the share of income going to the top 5 percent rising from 18.6 percent in 1992 to 20.0 percent in 1993 and 21.2 percent in 1994, according to the Census Bureau. While these movements are relatively small and certainly do not imply any fundamental change in income equality, they do suggest that the share of income going to those most likely to be carrying credit card and other consumer debt is declining. Thus, the recent increases in debt to income and debt service to income ratios probably understate the actual rise in these burdens for substantial sections of the population.

Third, the argument that consumers are borrowing to finance wealth-enhancing durable purchases has become substantially less convincing in recent years. It is both economically natural and sound to borrow to purchase an item like a car which will provide value for a large number of years. As any consumer intuitively knows, he or she is O.K. as long as the market value of the car, taking account of its depreciating value, is more than the amount still owed on the car. The Federal Reserve's Flow of Funds Accounts call this Excess Net Investment, that is purchases of durable goods less their depreciation less borrowing to finance their purchase. In 1993, this measure declined to about half the level it had held for the preceding 7 years. In 1994 it turned negative for the first time in history. In other words, American consumers in 1994 were adding more to their consumer credit balances than they were to the net stock of their household durables. The story for 1995 is incomplete, but not promising. The first quarter was positive in this regard and the second quarter negative. But, recent experience suggests a seasonal pattern in which the first quarter is usually the best quarter for debt repayment with conditions deteriorating throughout the rest of the year.

Fourth, I am not as comforted as some are about the rising stock market assisting the household sector's ability to finance its increasing debt burden. My concerns are two-fold. In the aggregate, households are making spectacular gains in the market. In the second quarter of this year, for example, the net worth of mutual fund shares and corporate equities held directly by households was $1.3 trillion higher than at the end of 1992. It is of course, even higher today than it was in the second quarter. But households have recently been liquidating this wealth. During 1994, for example, households were modest net sellers of these securities. During the first half of 1995 the pace of net sales has increased substantially to a $70 billion average annual rate.

I am also concerned that the distribution of easily accessible stock market gains -- those outside of pensions -- are not distributed in a way to allow them to offset the debts of households with large consumer debts. An analysis of the distribution of dividend receipts on tax returns bears this out. More than three fourths of all dividends were received by just 2.5 percent of households, while 80 percent of households received no dividends at all. Demographically, the bulk of dividend receiving households were among the elderly and the very well to do -- groups unlikely to have above average debt service burdens. Because dividends are probably fairly closely correlated with stock holdings, this evidence suggests that the vast bulk of stock market gains were not received by people who can easily use them to retire high levels of consumer debt.

Finally, I am concerned at the relatively high level of credit problems being encountered at this stage of the business cycle. By most measures, these are very good times. Unemployment, at roughly 5.5 percent, is historically quite low. We are in the fifth year of an economic expansion. In spite of this, credit card delinquency rates at commercial banks are at the same levels they hit in 1991, when the unemployment rate was far higher and the recession was ending. Auto loan delinquencies at finance companies are at levels which exceed those reached during the last recession.

We know credit problems are cyclical. And while we all hope that the current economic expansion will continue unabated into the indefinite future, history suggests that that is not a likely outcome. We should therefore be concerned about problems which may emerge in any future cyclical downturn.

But, in spite of these dangers, let us not lose sight of the tremendous advantages to be had by widespread access to credit. I think that the financial services industry has made enormous strides in extending credit to traditionally underserved populations and I am very concerned that the prospect of future credit problems may be used by some to retard efforts in this regard.

There is no question that the democratization of credit entails risks. That is a natural result whenever any market is being developed or any traditionally underserved population is gaining access to a product for the first time. Businesses entering these markets should take precautions to minimize these risks and should market and price their products to take account of their path breaking efforts. In the end, even after considering the potential costs in terms of credit riskiness during a prospective economic downturn, both the economic and the social fabric of this country will be stronger for the efforts of the financial services industry to bring access to credit to those who have not had it in the past.

Thank you.