Are Consumers Tapped Out? Household Deleveraging and the Outlook for Consumer Spending

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Introduction

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- "…many households will continue to strive to rebuild their net-worth positions in response to past – and possibly future – falls in residential land prices. I believe that the decline in household net worth, precipitated by falls in land values…will remain important in the recovery."

  – *Narayana Kocherlakota (2/6/2011)*

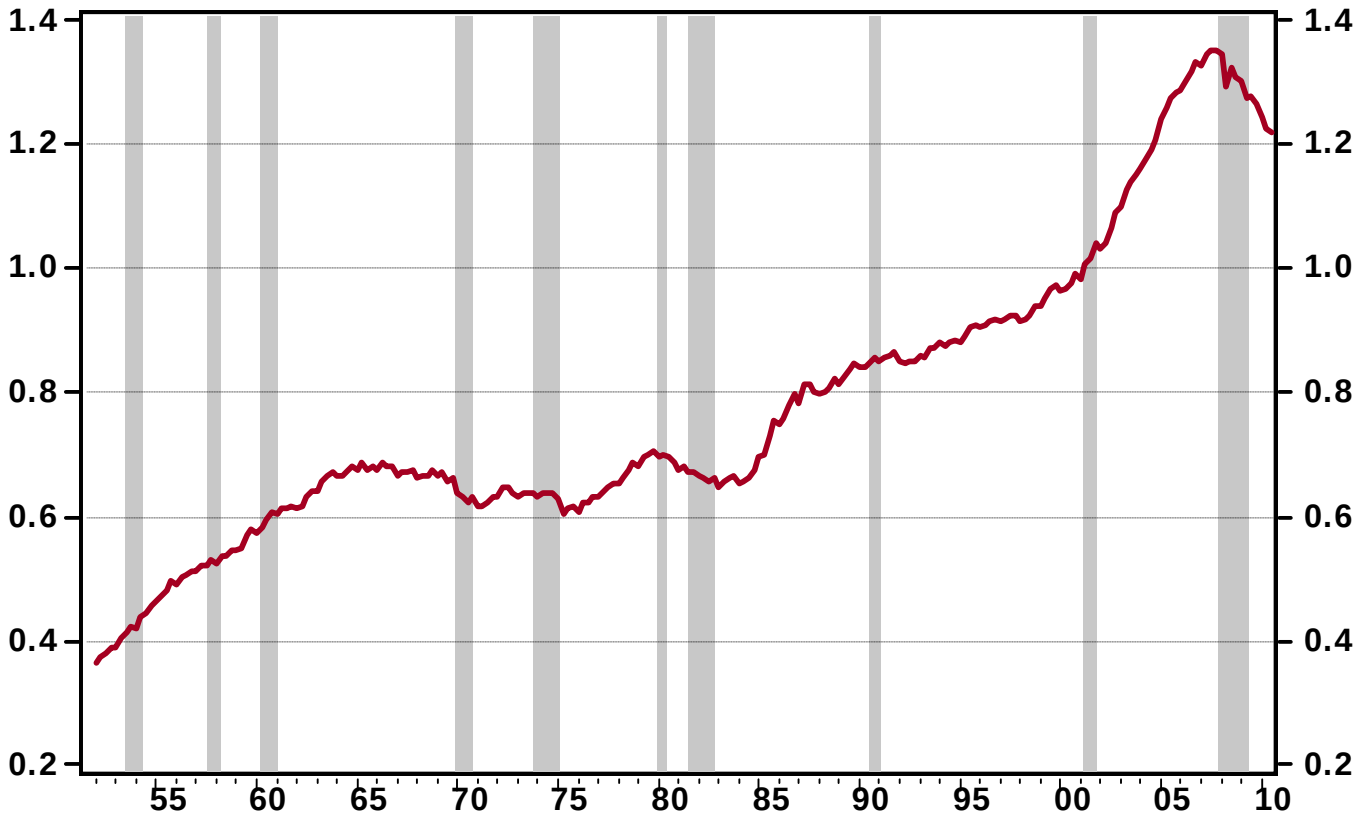
Introduction

- "The recent decline in the personal saving rate also suggests that many households have made substantial progress toward repairing their balance sheets… That prudence, combined with significant gains in equity values since early 2009, has led to substantial improvements in the financial positions of many households… Given these stronger fundamentals, it seems quite reasonable to project robust growth in consumer spending this year."

– Jeffrey Lacker (2/8/2011)

The Great Leveraging

Household Debt Relative to Disposable Personal Income



Source: Haver Analytics

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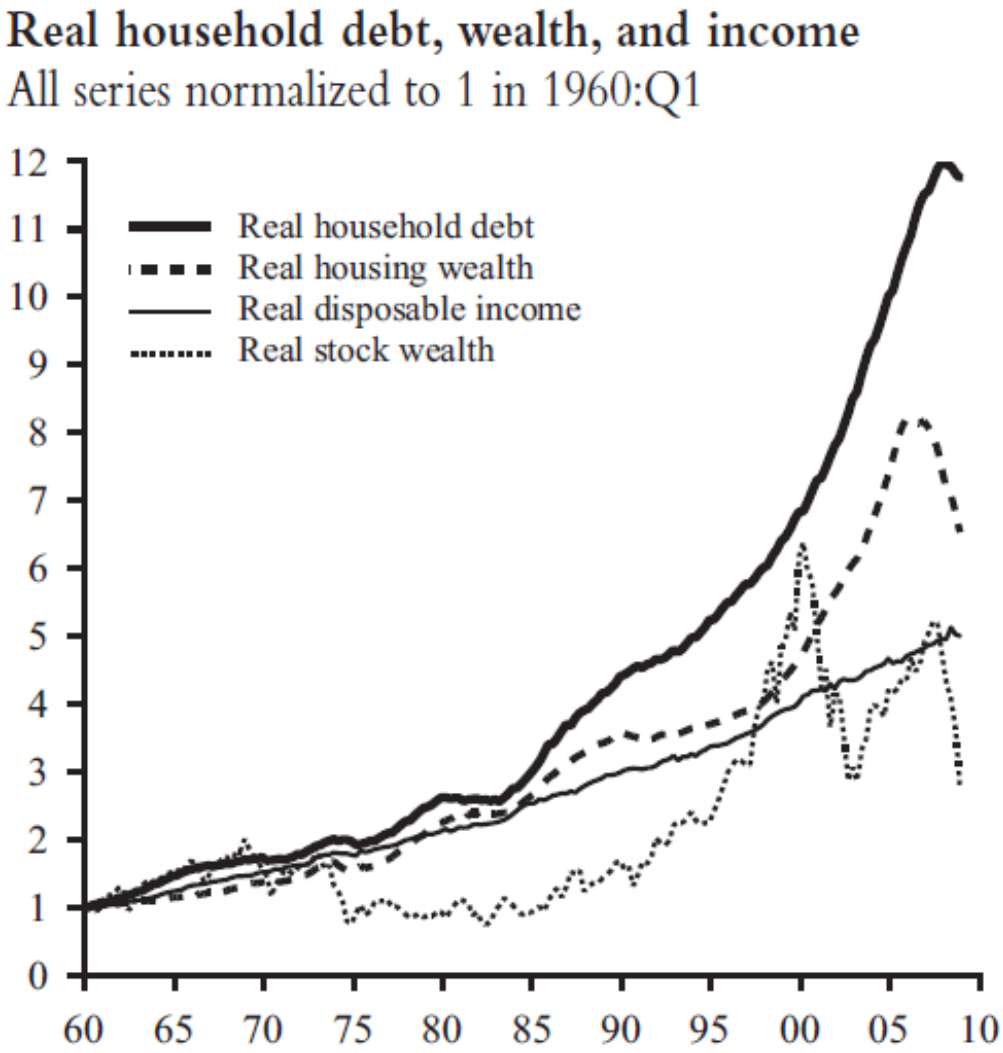

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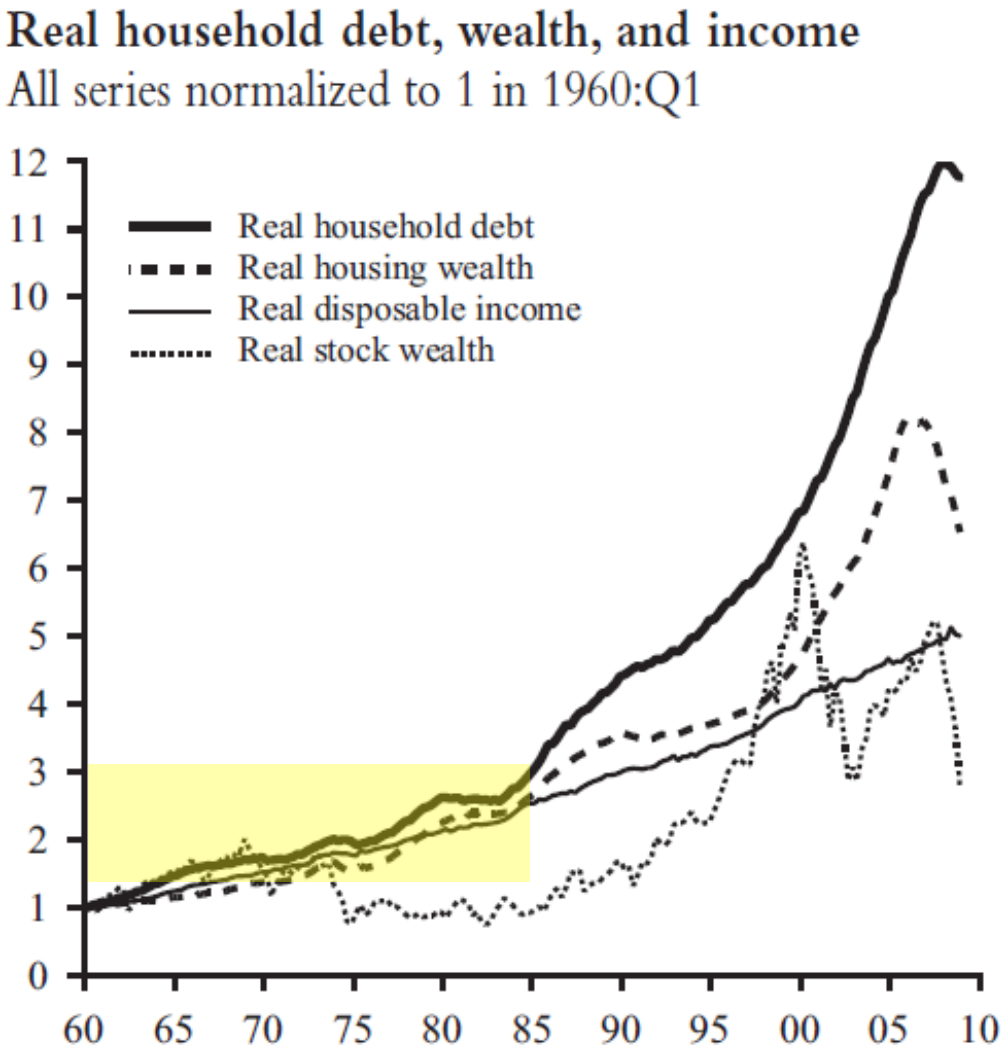

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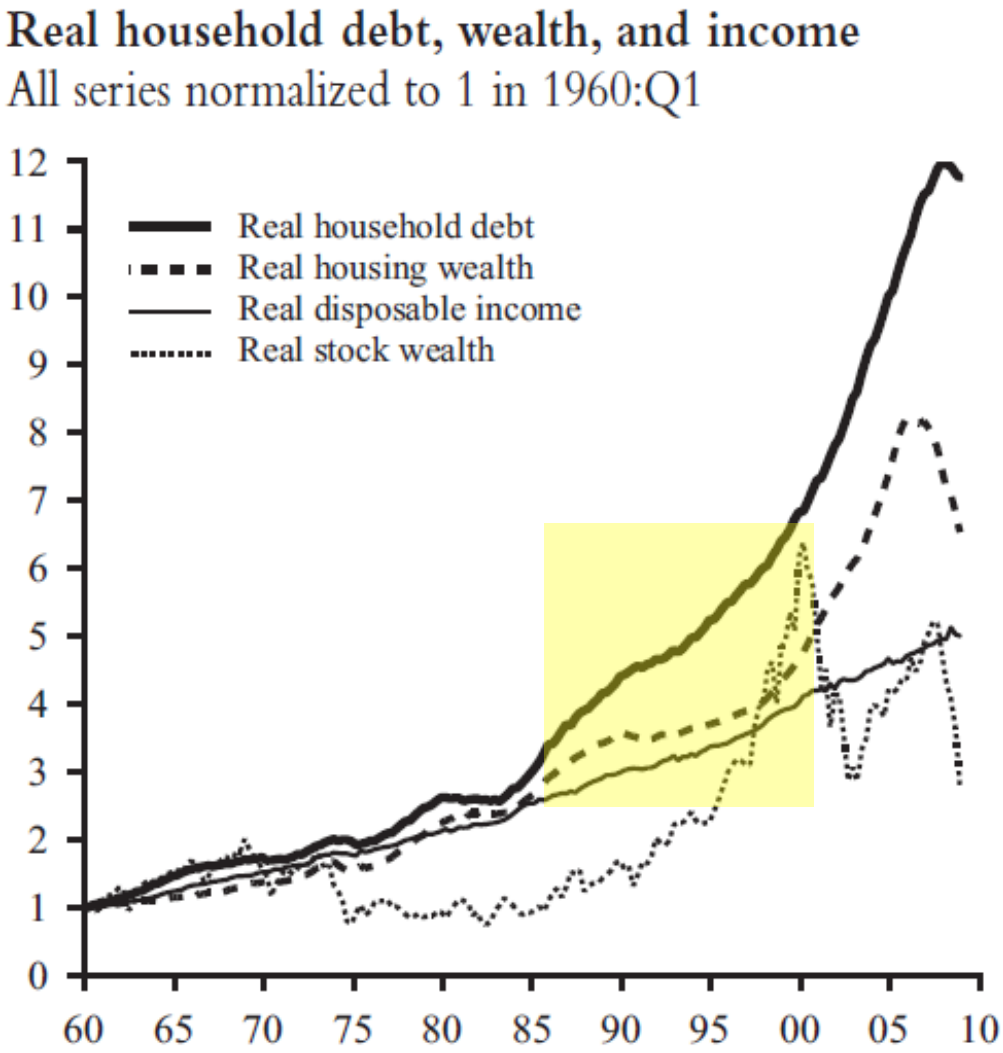

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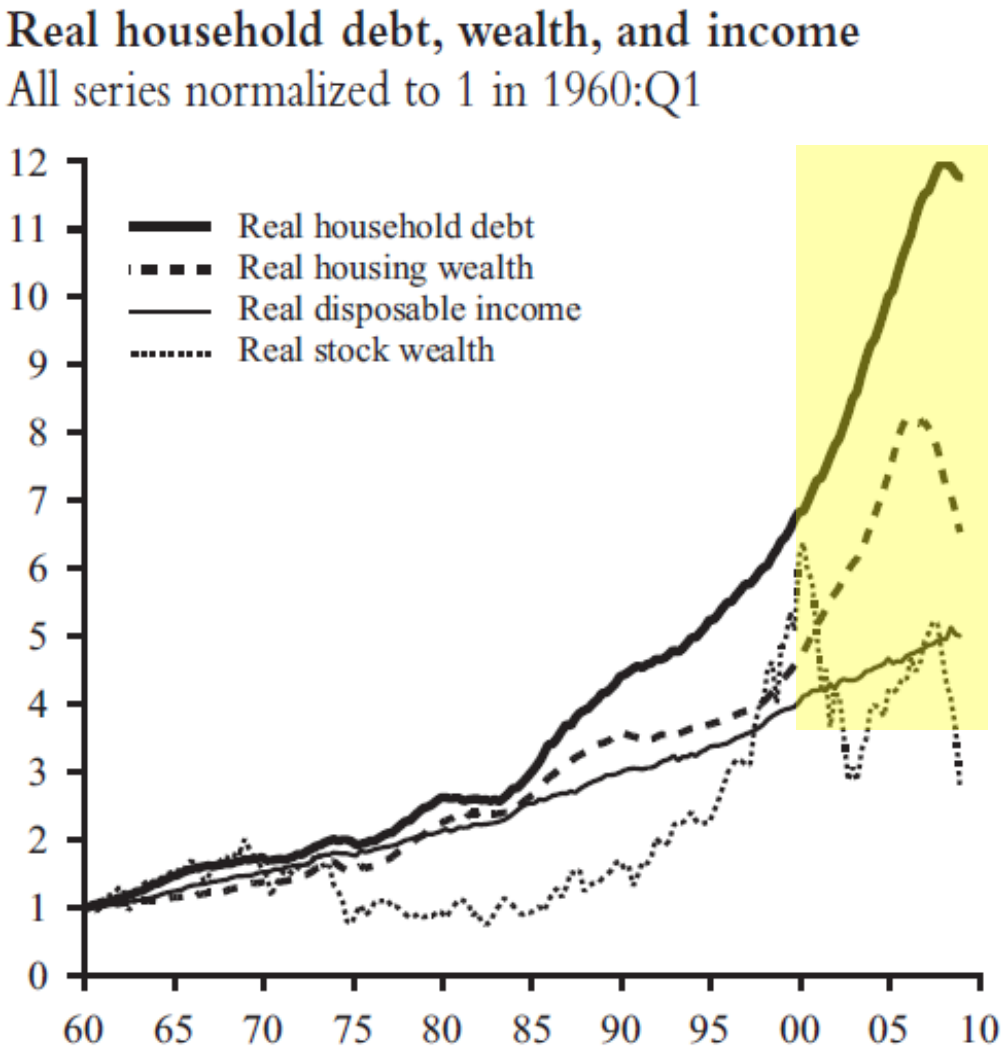

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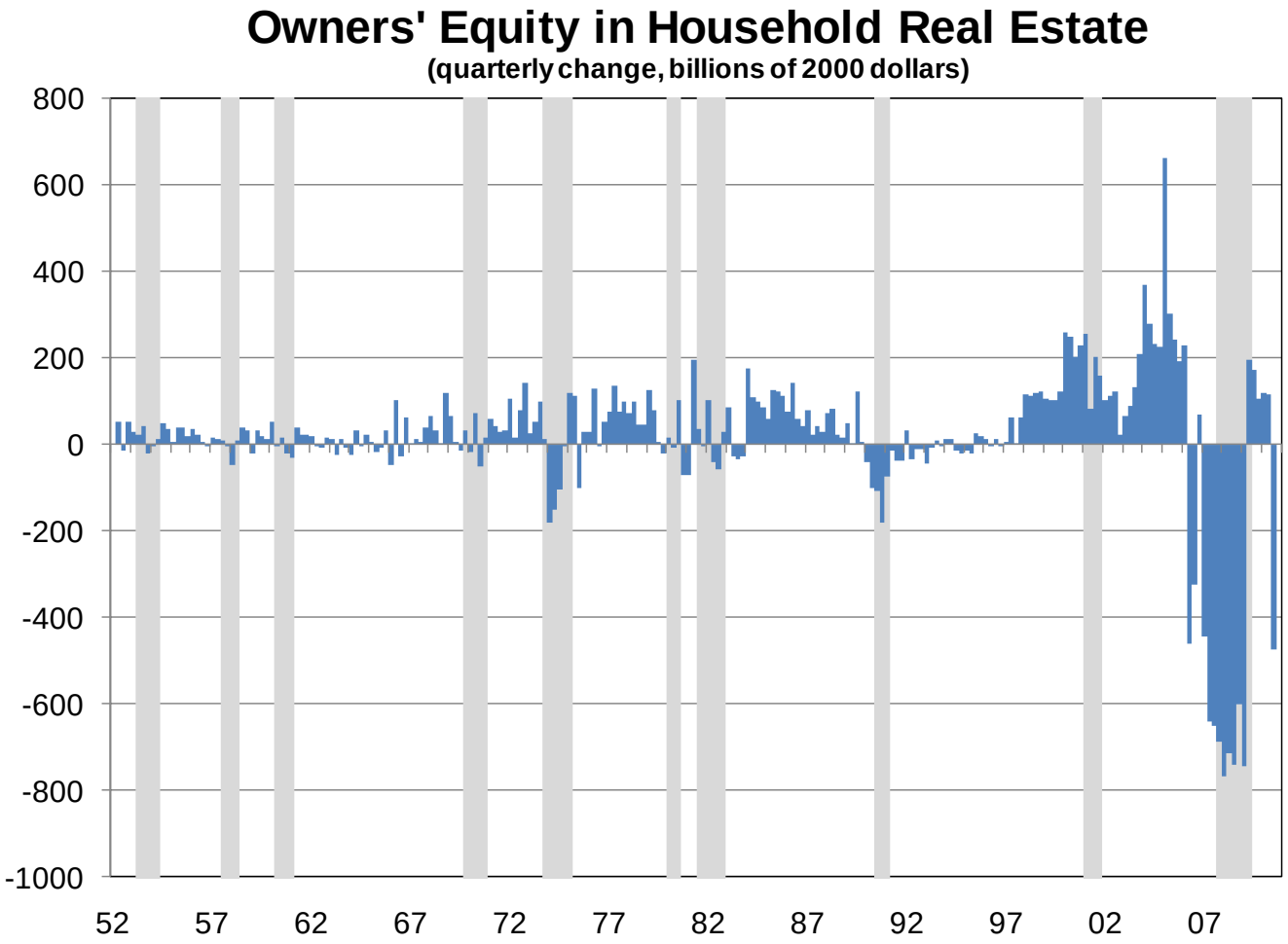
Wealth Effect: Changes in Equity → Spending



Source: Federal Reserve

How Does Leverage Impact Spending?

- According to work by Frederic Mishkin, the size of household liabilities will be a factor in times of financial distress – liquidity hypothesis
  - Very intuitive theory—consumers who face financial distress would prefer to be holding highly liquid financial assets (cash) rather than illiquid tangible assets (consumer durables)

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- Mishkin found that in the Great Depression and the 1973-1975 recession, “balance-sheet effects” strongly contributed to both economic downturns

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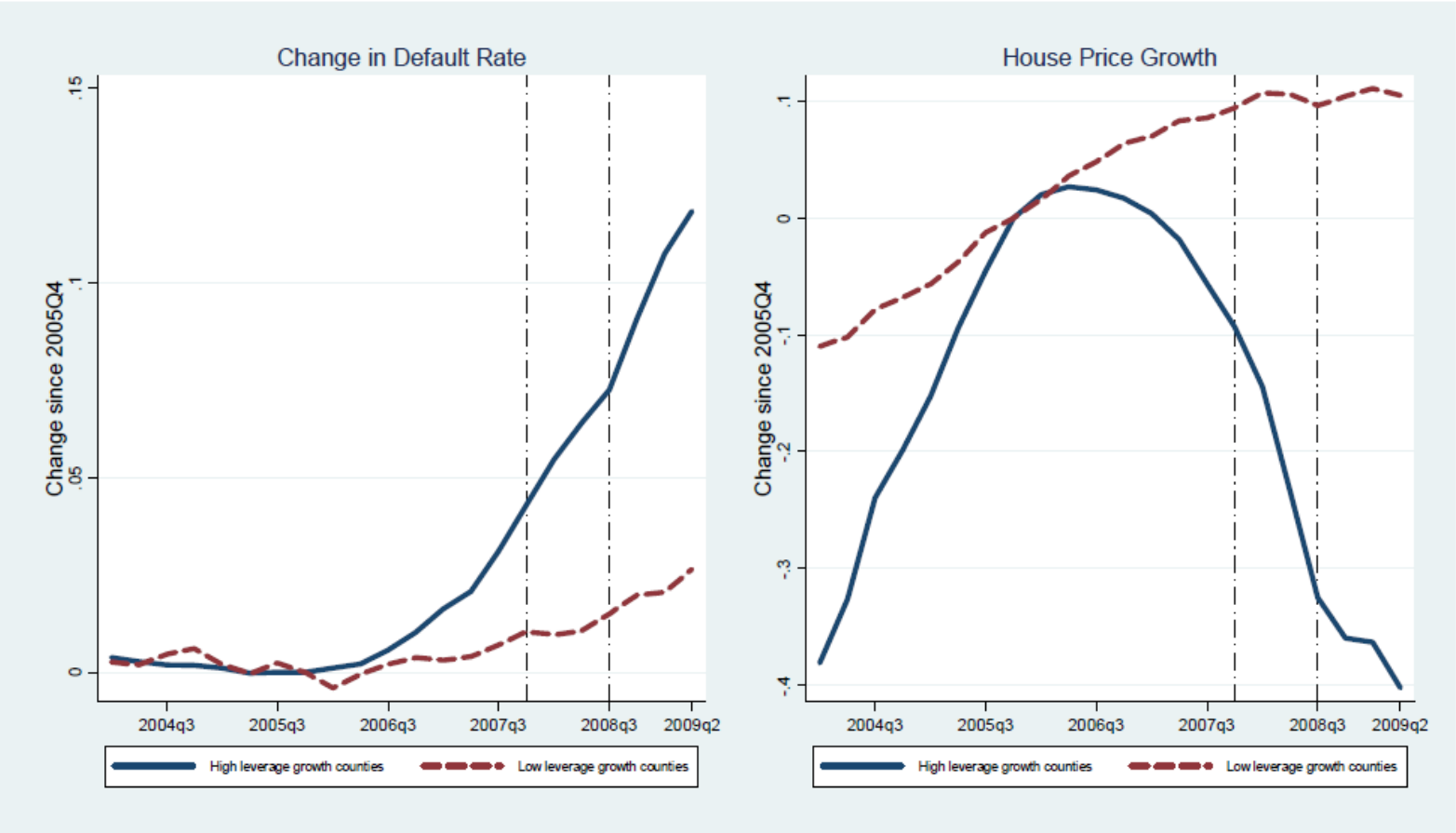
Figure 5A

Default Rates and House Price Growth in High and Low Leverage Growth Counties

High leverage growth counties are defined to be the top 10% of counties by the increase in the debt to income ratio from 2002Q4 to 2006Q4. Low leverage growth counties are in the bottom 10% based on the same measure. The left panel plots the change in the default rate for high and low leverage growth counties since 2005, and the right panel plots the growth rate for high and low leverage growth counties since 2005.



Mian and Sufi , *Household Leverage and the Recession of 2007 to 2009* (2010)

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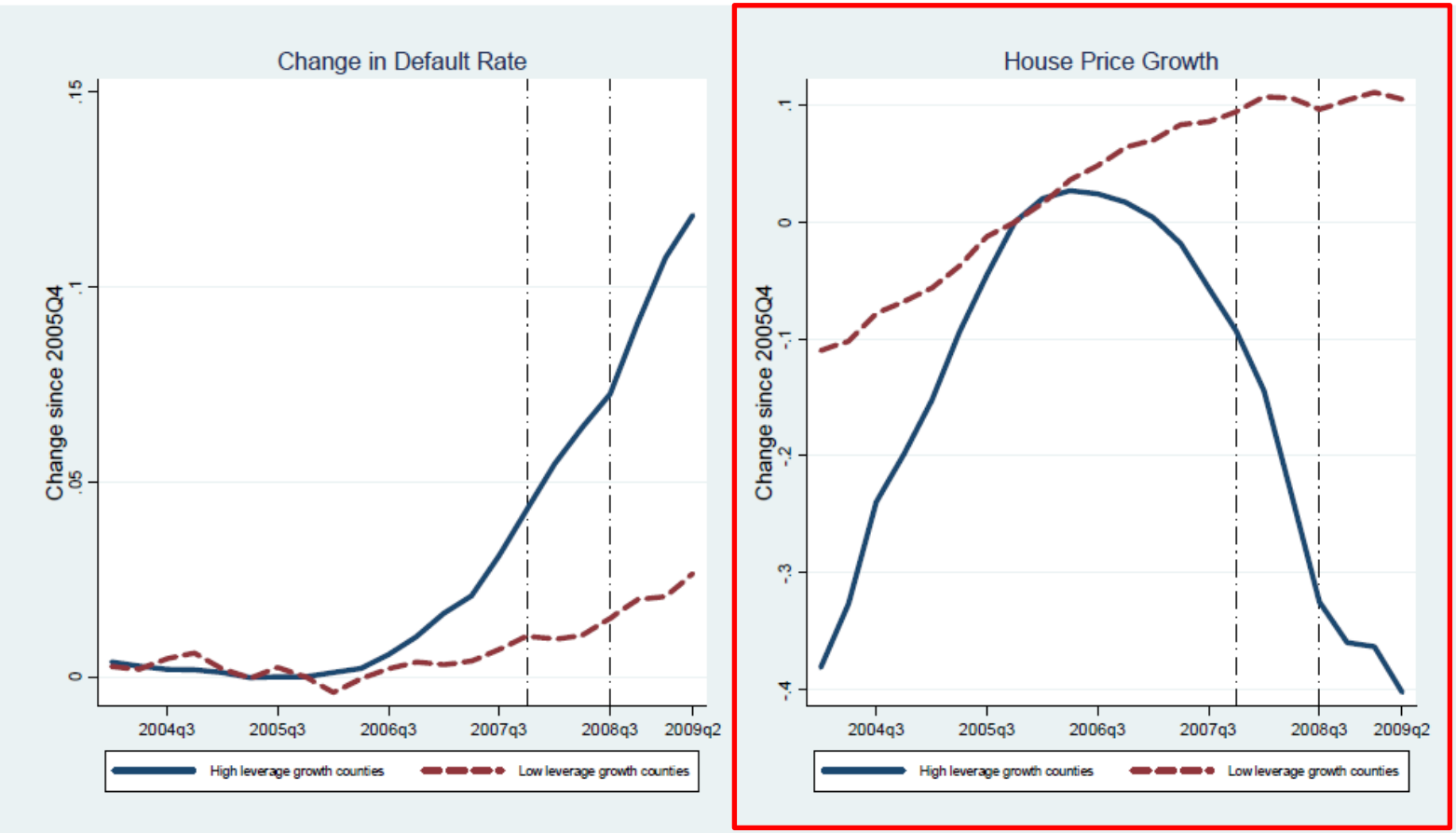

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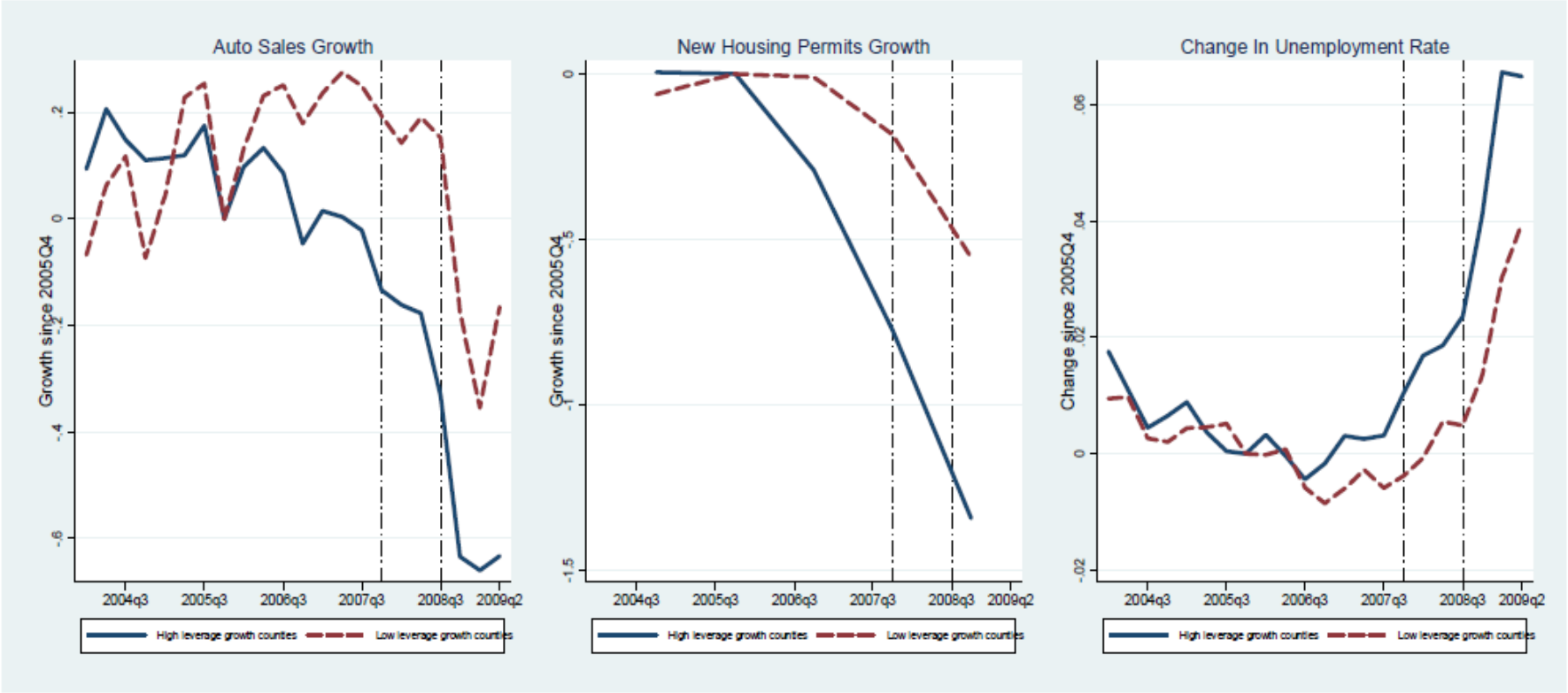

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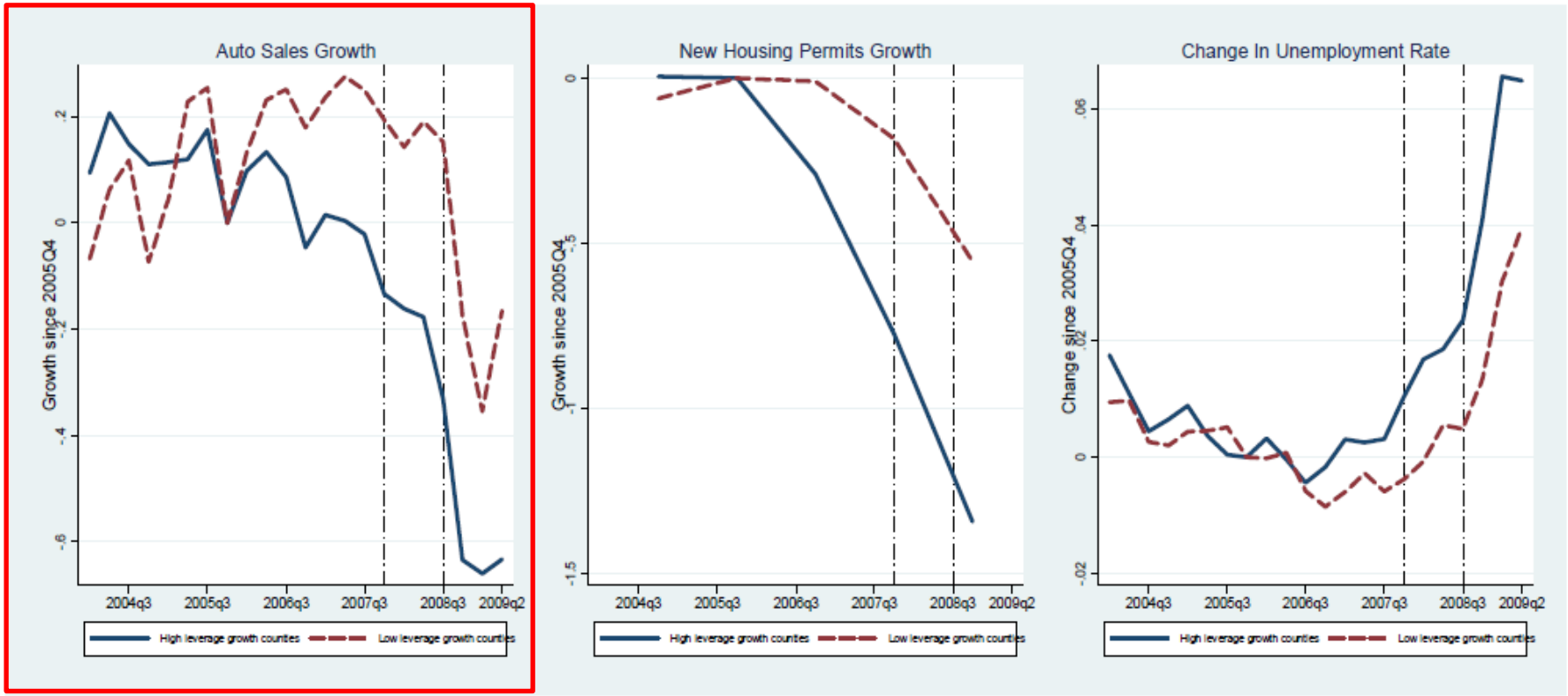

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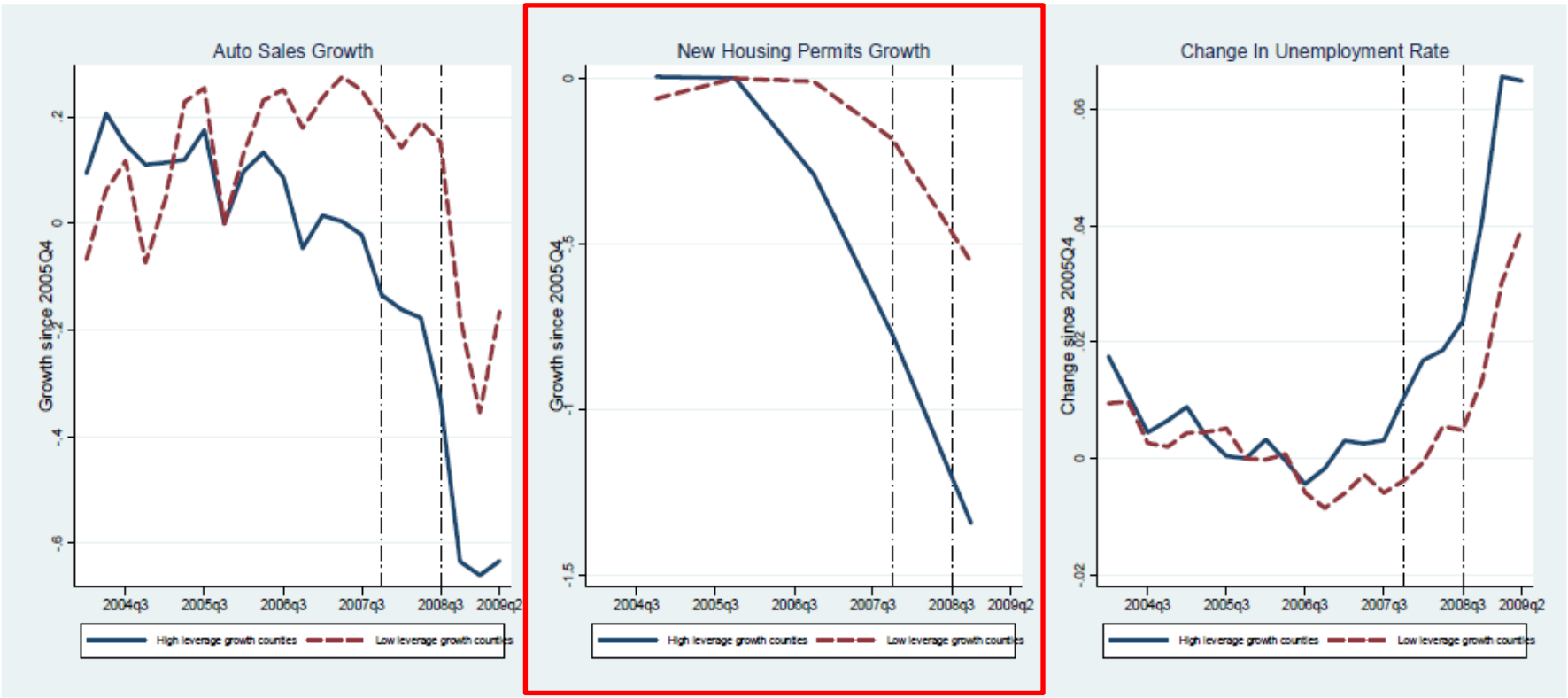

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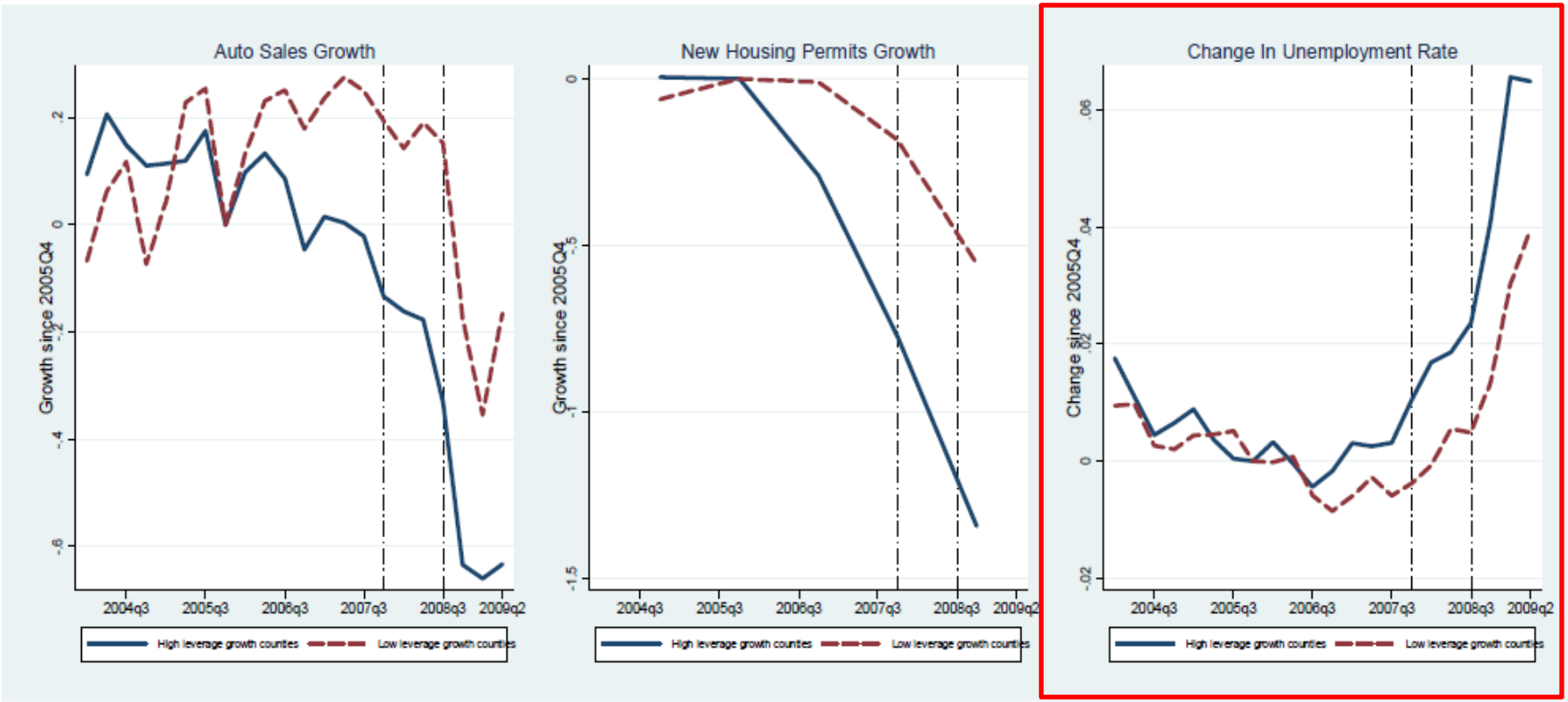

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  - Enormous wave of mortgage defaults and a sharp increase in defaults on credit cards and other consumer loans

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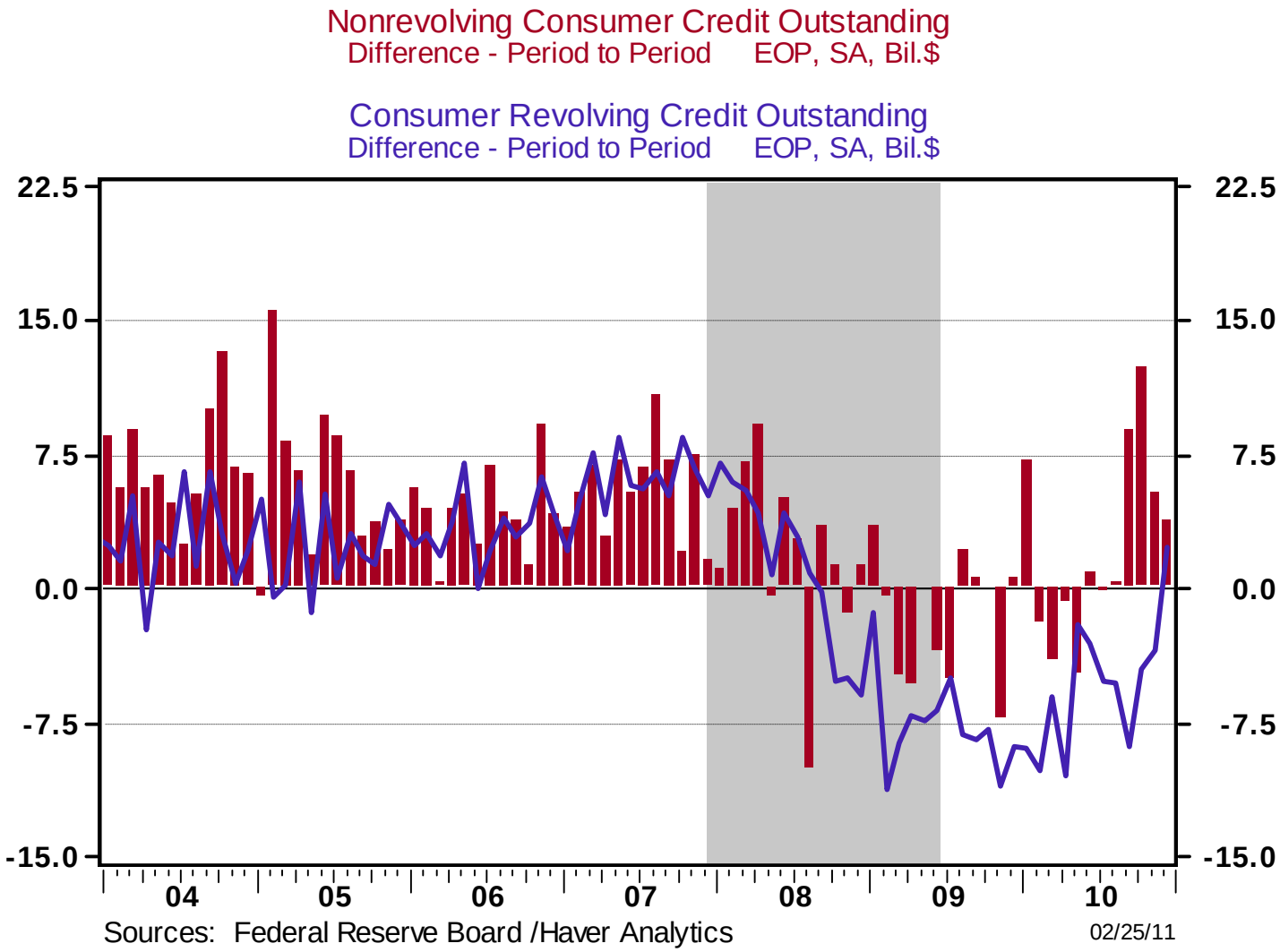
- However, rate of seriously delinquent mortgages remains elevated and it will take to work through these loans; default rates will remain elevated in the near-term

Indications of Improving Credit Conditions



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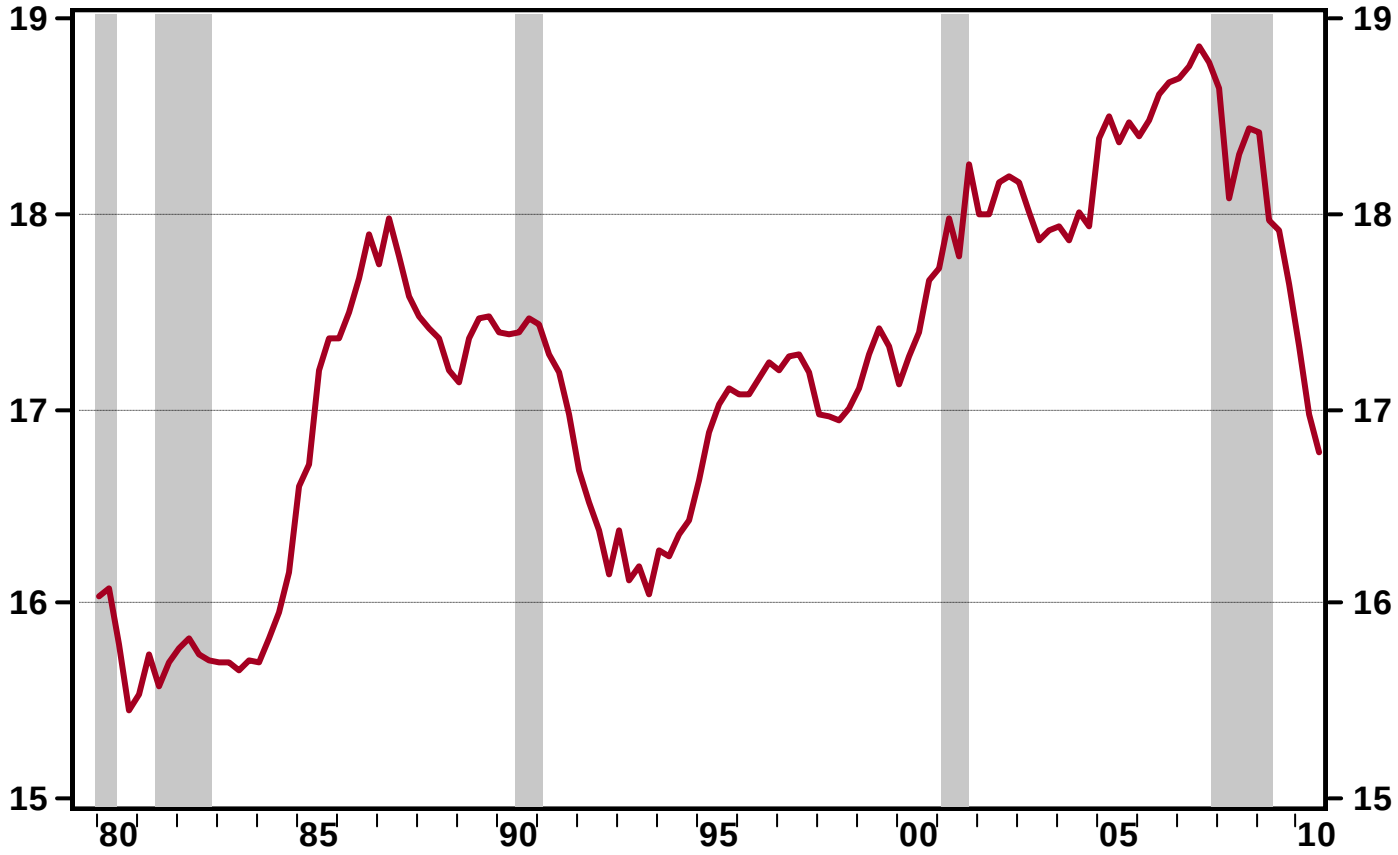
Indications of Improving Credit Conditions

Household Financial Obligation Ratio

SA, %



Source: Federal Reserve Board /Haver Analytics

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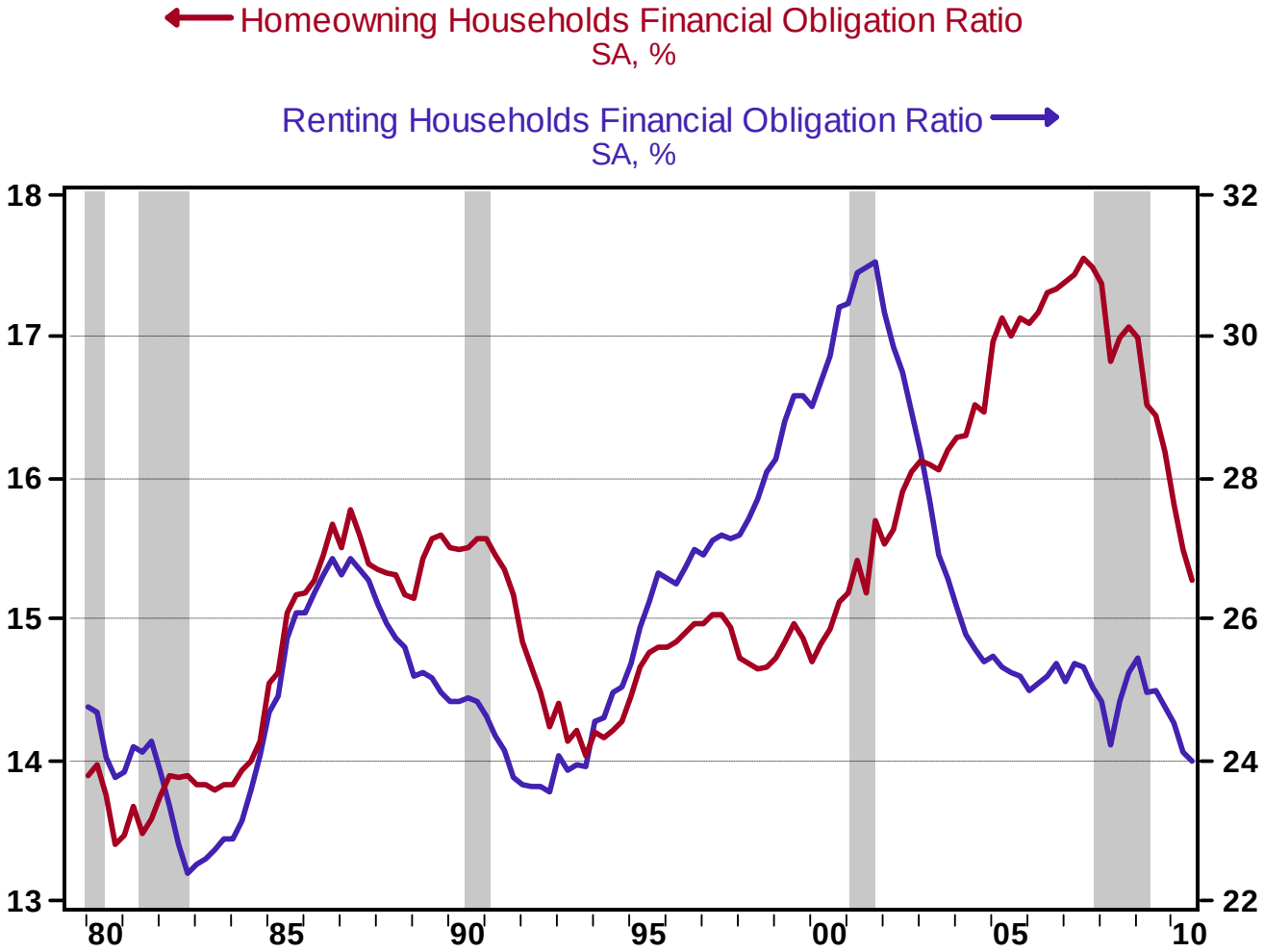

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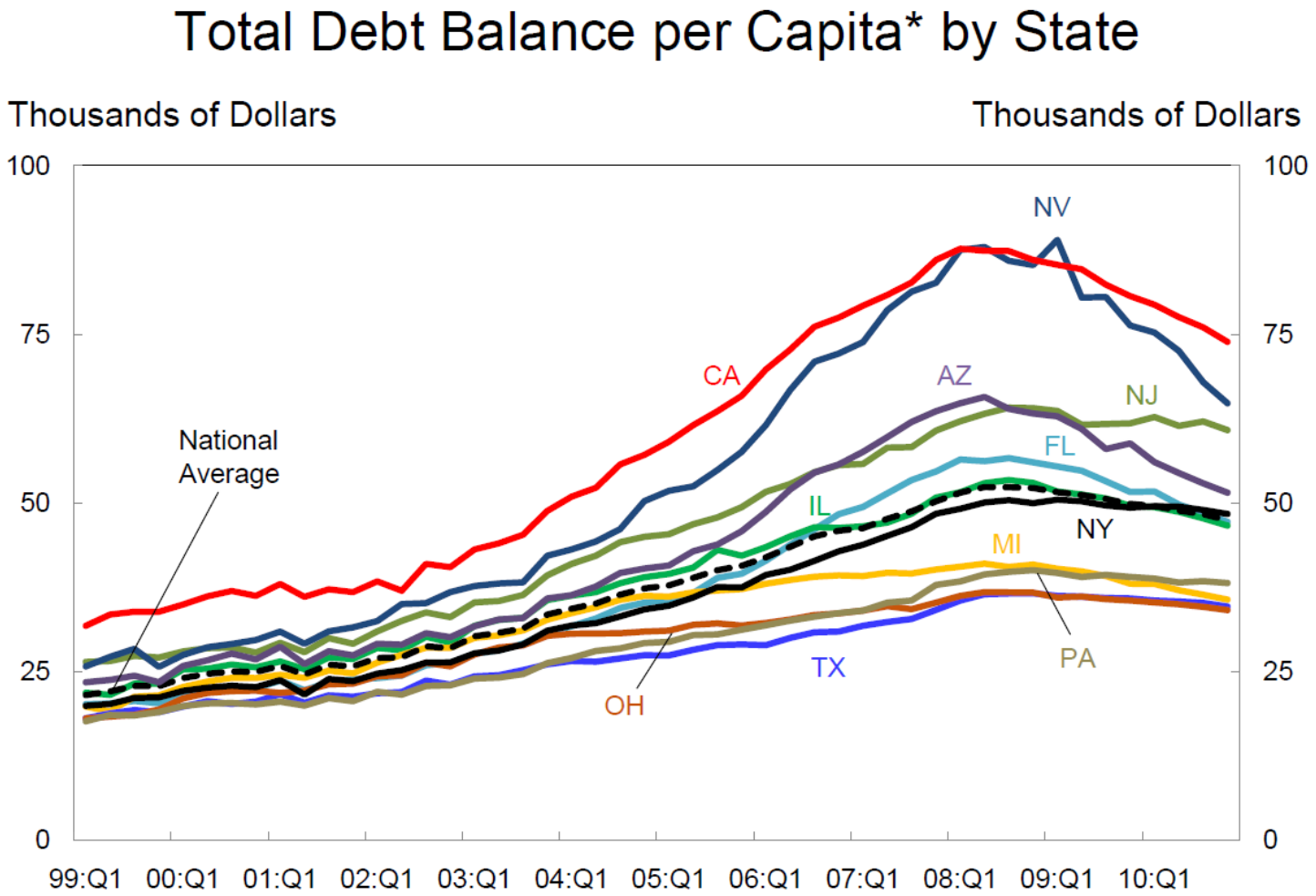
Conditions Vary Considerably by State



Source: FRBNY Consumer Credit Panel

* Based on the population with a credit report

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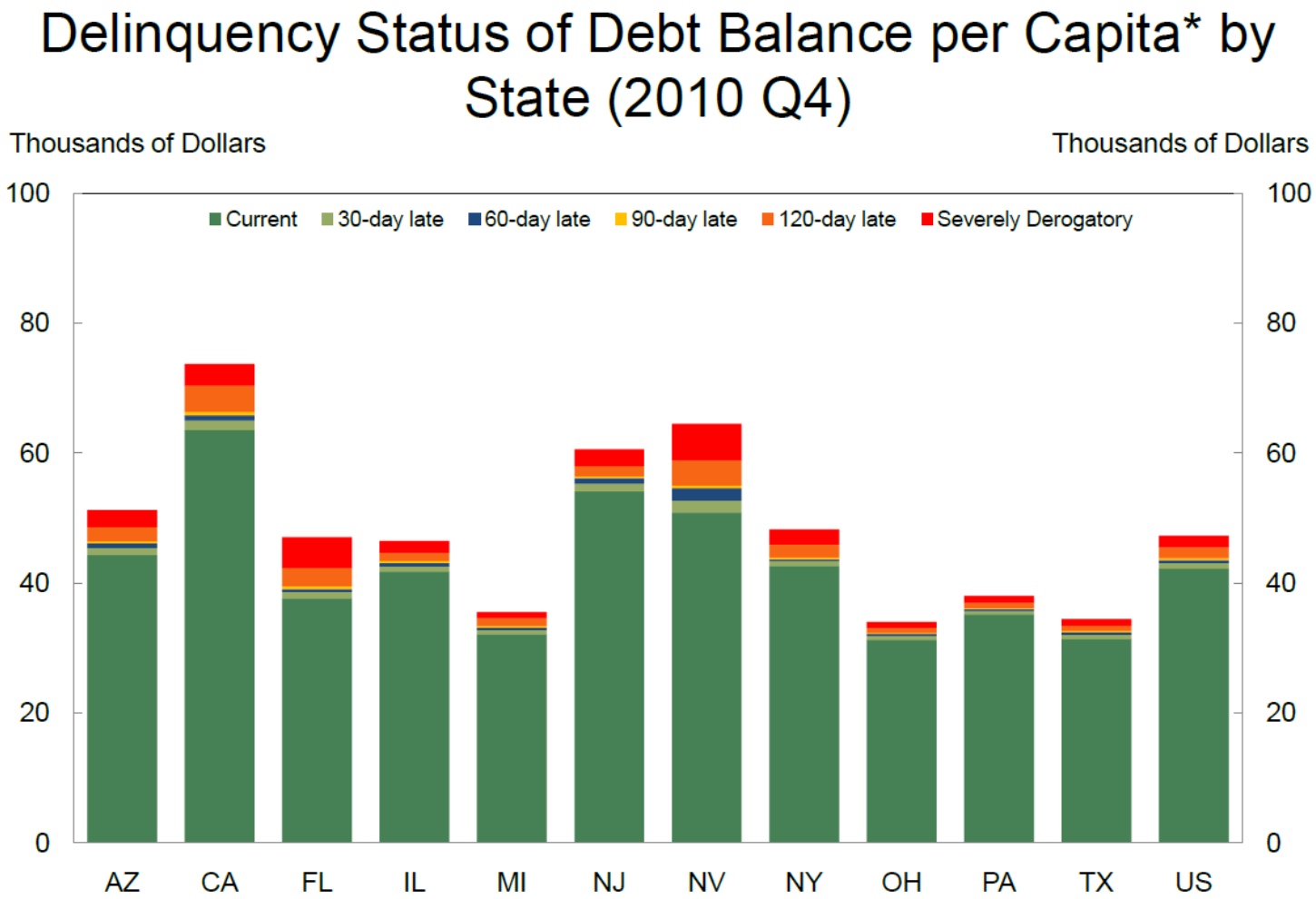

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- Sharp decline in housing and equity wealth negatively impacted consumer spending (wealth effects)
- Highly leveraged areas of the country experienced more severe declines in economic activity (balance sheet effects); this is consistent with Mishkin's liquidity theory
- Those states/households that were more highly-indebted will take longer to fully recover
- Looking ahead, there are signs that households have made significant progress in repairing balance sheets; this is consistent with expectations for solid consumer spending

The views expressed here are those of the author, and do not necessarily represent those of the Federal Reserve Bank of Richmond or the Federal Reserve System.

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