Jeffrey M. Lacker

The U.S. economy turned in a strong performance in 2005, with overall output and incomes expanding at a fairly brisk pace, while prices remained relatively stable. A major contributor to economic growth was consumer spending, despite a sluggish fourth quarter in which spending on high-dollar durable goods, in particular, fell sharply from the previous period. The American consumer, it seems clear, remains at the center of the current economic expansion.

But not everyone is convinced that this is a positive development. Some worry that households are getting in over their heads, spending freely with little thought about the future. A quick glance at some of the data seemingly confirms this belief. For instance, in 2004 the ratio of all consumer debt to disposable personal income was about 108 percent. That number has grown pretty steadily over the past fifty years. It stood at 35 percent in 1952, grew to roughly 60 percent in the 1960s and 1970s, and then continued sharply upward from the 1980s to present.

Does this mean that households are in for a rude awakening down the road? To answer that question, we need to consider why the debt-to-income ratio has grown. First, let's consider the debt side of the equation. It has been driven, in large measure, by the growth in mortgage debt. Since most people do not buy homes with cash but finance them, growth in homeownership tends to increase mortgage debt. And, indeed, homeownership has been rising, from 55 percent in 1950 to 69 percent in 2005. Also, we would expect mortgage debt to increase if the prices of homes increased. That, too, has occurred, especially since the mid-1990s. Put the two together, and it's not surprising that household debt has been on the rise.

Let's turn to income. It has a major effect on people's willingness to borrow. In particular, a household's beliefs about income growth will largely determine how much debt it is willing to incur. During periods of relatively stagnant real income growth—such as the 1970s—the debt-to-income ratio remains pretty stable, as people tend to be cautious about taking on debt. During periods of relatively robust income growth—such as the mid-1990s to present—the debt-to-income ratio often rises, as people grow optimistic about their future ability to repay debt.

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This describes the demand side for credit. At the same time, there have been major changes in the supply side. Technological improvements have made it easier for lenders to assess the creditworthiness of borrowers and to tailor loan terms accordingly. Most borrowers have been made better off by these changes. They have seen a reduction in the cost of borrowing or an increase in access to credit.

In addition, the credit market has become more competitive. New lenders have entered, driving down interest-rate spreads. Part of the increase in competition can also be attributed to technological improvements. For instance, thirty years ago, if a household wanted a mortgage loan, it almost certainly borrowed from a local institution. Now, consumers can search from a nationwide pool of potential lenders. Increased competition has helped drive down average borrowing costs.

So when you look at the landscape as a whole, it's not surprising that demand for credit has increased as supply has become more accessible and affordable. Consumers, on average, can borrow more efficiently than in the past. We shouldn't dismiss concerns about the rising debt-to-income ratio, but we must understand the factors that have contributed to its growth. The actions of consumers appear much more rational than at first blush.

Credit market developments have been something that I and others at this Bank have been thinking about a lot recently. Last summer, I addressed both the North Carolina and Virginia Bankers Associations on the topic of "retail financial innovation." In those talks, I cautioned against steps to stifle the expansion of new financial products. Those products, like many others, can be abused—both by consumers and lenders. Consumers can take on more debt than they ought to, and lenders can prey on people who are not financially savvy. Indeed, given the complexity of today's financial instruments, even those who *are* financially savvy can have difficulty evaluating borrowing options. But for the great majority of people—across all income groups—innovation in the financial industry has brought significant benefits.

As the essay in this year's Annual Report stresses, the expansion in retail credit has allowed consumers to more easily smooth consumption over their lifetimes. People can borrow when they are young, pay down that debt and save during the peak earning years, and draw upon their savings in retirement. Such smoothing helps people to consume in a relatively consistent, predictable fashion throughout their lives, rather than enjoying a few fat years sandwiched between many lean ones. New financial instruments have also helped people who suffer one-time shocks to their income stream. For instance, those who become sick and are temporarily unable to work can more easily sustain that shock through borrowing than before, knowing that they will be able to repay the debt when they return to work.

Overall, I'm convinced that retail financial innovation has improved most people's lives. It's no panacea, to be sure. There are cases where new financial products are not particularly useful. For instance, many people suffering systematic shocks to their income, such as those employed in industries that are in decline and unlikely to rebound, will be unable to borrow to smooth their consumption in the pattern just described. And there are cases where households will make borrowing decisions that will have negative outcomes. But borrowing, by definition, is a forward-looking activity. As such, we should not judge credit market decisions based upon their results alone, good or bad. Rather, we should judge them from the perspective of the borrower. Does a particular financial instrument present a household with a distribution of outcomes that, on average, is better than in its absence? If so, that instrument serves an important social purpose. I think that an examination of the evidence will find that most new financial instruments meet that standard.

**Jeffrey M. Lacker** • President