JOINT ECONOMIC COMMITTEE

ROBERT F. BENNETT, CHAIRMAN — SEPTEMBER 8, 2004

HOUSEHOLD DEBT AND THE ECONOMY

Many analysts have expressed concern about the growth of consumer debt and its effect on the U.S. economy. Some fear that the combination of increasing debt and higher interest rates will impair the ability of households to meet their monthly financial obligations. However, interest payments as a percentage of disposable income have actually fallen since the end of the recession in 2001. Total household debt has increased since the end of the recession, but the vast majority of the increase can be attributed to the growth of home mortgage debt spurred by historically low mortgage interest rates.

Highlights

- More than 90 percent of the increase in total household debt since the end of the recession is due to growth in home mortgage debt.
- As a share of total household debt, consumer credit has fallen to its lowest level in a decade.
- After rising throughout the 1990s, the burden of household debt has fallen in recent years.
- Total household assets are more than five times larger than total household liabilities.

Growth in debt is driven by mortgage borrowing

> "Many households have used low interest rates to re-finance their homes and pay off higher interest debt."

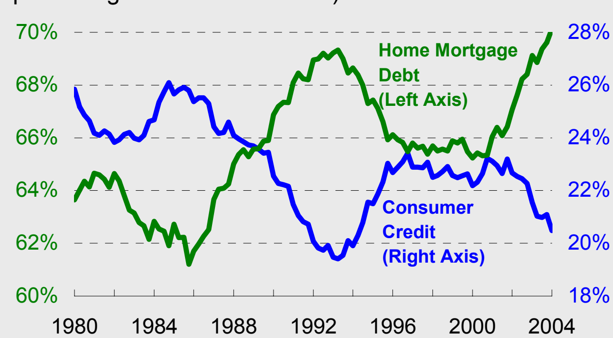
Since the end of the recession in 2001, over 90 percent of the increase in total household debt is due to the growth of home mortgage debt, which has increased by 25 percent after adjusting for inflation. In contrast, consumer credit (e.g., credit cards and automobile loans), increased by only 4 percent over the same period of time.

According to the Federal Reserve, roughly 80 percent of all household debt – including both mortgage debt and non-mortgage debt – is subject to fixed rates. Because such a small share of debt is subject to variable rates, American households will not be as exposed to rising interest rates as many observers assume.

Consumer credit is falling as a share of total household debt

Consumer Credit Falls 1

(Consumer credit and home mortgage debt as a percentage of household debt)



Sources: Federal Reserve Board, Bureau of Economic Analysis

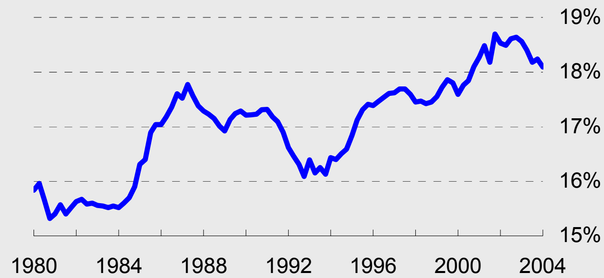
Many analysts note the growth of overall consumer credit as an indicator of increasing financial stress for households. While it is true that consumer credit has increased, the recent average rate of growth is actually far lower than its historical average. Consumer credit has increased at an average annual rate of 4.2 percent since 1980. In contrast, it has increased at an average annual rate of only 1.6 percent since the end of the recession. During that same time period, disposable personal income increased at an average annual rate of 3.4 percent – more than double the rate of growth of consumer credit. As shown in Figure 1, an even closer look at the data reveals that consumer credit is actually falling as a share of total household debt. In contrast, home mortgage debt has significantly increased as a share of total household debt as many households have re-financed their homes in part to pay off higher interest debt.

The burden of household debt is falling

Though total household debt is often used as another measure of financial stress, certain other measures can be more informative because they take into account both debt obligations and the ability to pay them. A primary indicator used by the Federal Reserve is the *financial obligations ratio*, which measures the recurring expenses of households, such as payments on mortgage debt and auto leases, relative to the disposable income of those households.

Household Debt Burden Peaks in 2001 2

(Financial obligations as a percentage of disposable income, SA*)



*Financial obligations includes payments on mortgage debt, rent, auto leases, homeowners' insurance, and property taxes.

Sources: Federal Reserve Board, Bureau of Economic Analysis

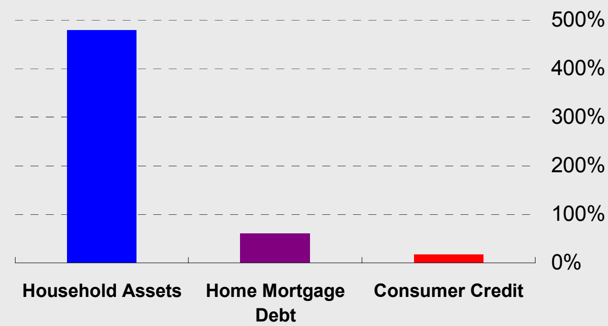
Households with higher financial obligations ratios are more likely to default on their monthly obligations than those with lower ratios. After rising throughout the 1990s and peaking in late 2001 after the end of the recession, the overall financial obligations ratio in the U.S. has actually fallen (Figure 2).

Household assets are much larger than household liabilities

It is also interesting to note the size and growth of different components of household balance sheets relative to the overall size of the U.S. economy. While household debt and its components appear to be quite large at first glance, household assets and net worth are much larger. Total household assets are now nearly 5 times larger than the size of the entire U.S. economy (Figure 3).

Household Assets Outnumber Liabilities 3

(Household balance sheet components as a percentage of GDP)



Sources: Federal Reserve Board, Bureau of Economic Analysis

Mortgage debt has grown from 32 percent of gross domestic product (GDP) in 1980 to over 60 percent today. This increase is reflected in part in the record-high homeownership rate in the U.S. Consumer credit grew more slowly, increasing from 13 percent of GDP in 1980 to 18 percent today.

The household sector is in "good shape"

Much of the rise in household debt since the end of the recession reflects the brisk growth of mortgage borrowing, which has been driven by historically low interest rates. Over the past few years, many households have used historically low interest rates to purchase homes for the first time; others have re-financed their homes and paid off higher interest debt. During a recent speech, Federal Reserve Chairman Alan Greenspan stated, "Overall the household sector seems to be in good shape, and much of the apparent increase in the household sector's debt ratios over the past decade reflects factors that do not suggest increasing household financial stress."[1]

[1] Remarks by Chairman Alan Greenspan, "Understanding Household Debt Obligations," February 23, 2004