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American *Hangover*

Unless income rises, the ongoing consumer debt reduction could cripple the recovery.

BY MARTIN N. BAILY AND SUSAN LUND

The U.S. consumer's seven-year borrowing binge has ended, and the economic hangover is painful. Millions of Americans have started paying down debt amassed during the days of easy credit and bubbling home values. And with joblessness rising and the economic outlook uncertain, many are borrowing less and saving more. While this new financial sobriety makes sense for individual households, the collective result has been a large drop in personal spending—a major reason for the sharp GDP contraction that began last year. Looking ahead, a key question is whether U.S. households will dig out of debt without further cutting consumption and crippling a U.S. and global recovery.

Several forces are behind the growth of U.S. household debt in recent years and the reversal now under way. Between 2000 and 2007, U.S. households led a national borrowing binge, nearly doubling their outstanding debt to $13.5 trillion. The pace was faster than the growth of their incomes, their spending, or the nation's GDP. The amount of U.S household debt amassed by 2007 was unprecedented, whether measured as a share of GDP (96 percent), or as a ratio of liabilities to disposable income (136 percent).

But as the global financial and economic crisis worsened at the end of last year, a shift occurred: U.S. households for the first time since World War II reduced their debt outstanding.

The hit to consumption from this deleveraging will depend on whether it is accompanied by personal income growth. If household incomes stagnate, each percentage point reduction in the debt-to-income ratio will require nearly one percentage point more personal saving. And each extra point in the saving rate translates into at least $100 billion less spending—a serious potential drag on economic growth.

If incomes were to rise, households could reduce their debt burden without having to trim consumption as much. But policymakers cannot assume income growth will pick up once GDP rebounds. On the contrary, average U.S. household incomes, adjusted for inflation, have barely budged since 2000. And incomes are unlikely to pick up significantly in the short term, amid the financial crisis and economic recession.

THE RISE OF CONSUMER DEBT

Any change in U.S. consumer behavior could have profound implications for the U.S. and global economies. Over the past decade, rising U.S. household spending has served as the main engine of U.S. economic growth. From 2000 to 2007, U.S. annual personal consumption grew by 44 percent, from $7 trillion to $10 trillion—faster than either GDP or household income. Consumption accounted for 79 percent of real U.S. GDP growth during this period—high by comparison with both U.S. and international experience.

The spendthrift ways of the U.S. consumer have fueled global economic growth as well. The United States has accounted for one-third of the total growth in global

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private consumption since 1990. From 2000 to 2007, U.S. imports grew from an amount equal to 15 percent of U.S. GDP to 17 percent, boosting aggregate global demand by $952 billion in nominal terms. Moreover, U.S. consumer spending boosts global economic activity in ways that are not measured. For example, companies in Germany might hire workers and invest in factories that export machines to China for the manufacture of exports to the United States. Korea, Taiwan, and other Asian countries produce components that are exported to China, where they are assembled into products exported to U.S. consumers.

Powering the U.S. spending spree through 2007 were three strong stimulants: a surge in household borrowing, a decline in saving, and a rapid appreciation of assets.

Household borrowing rose along with incomes for decades. But after 2000, interest rates fell well below their long-term average because of the combination of U.S. monetary policy and rising foreign purchases of U.S. government bonds by Asian governments and oil exporters. When low rates were combined with looser lending standards, consumer borrowing soared. From 2000 through 2007, the ratio of household debt to disposable income shot up from 101 percent to 136 percent—as much in seven years as in the previous quarter-century. Even with low interest rates, the ratio of household debt service payments to income rose to a record high.

Most of this borrowing fueled consumption. For instance, from 2003 through the third quarter of 2008, U.S. households extracted $2.3 trillion of equity from their homes in the form of home equity loans and cash-out refinancings. Nearly 40 percent of this—$897 billion, an amount bigger than the 2008 U.S. government stimulus package—went directly to finance home improvement or personal consumption. And much of the remaining 60 percent of extracted cash was used to pay down credit card debt, auto loans, and other liabilities, thus financing consumption indirectly. The money not spent on consumption was invested, helping fuel gains in stock markets and other financial assets.

Meanwhile, consumers also spent more because they were saving less of their disposable income. The U.S. personal saving rate has fallen steadily in recent decades, from 12.2 percent in 1981 to 2.4 percent in 2000. But in part because of the surge in borrowing, the saving rate fell through the floor in recent years, to a low of 1.2 percent in 2005. To put it in perspective, all else being equal, if consumers saved at the same rate as in 1980, they would have spent roughly $1 trillion less in 2007 alone.

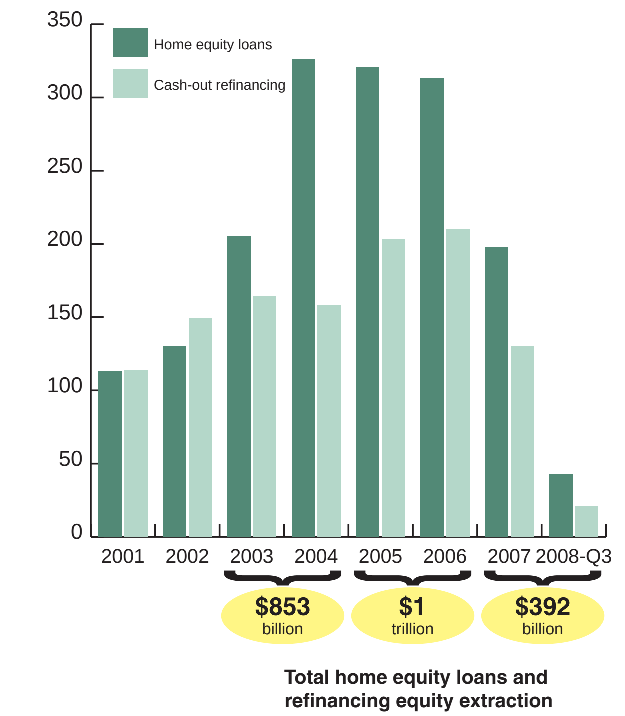
Households were able to borrow more and save less in part because of the "wealth effect" of rapid appreciation of their home values and investment portfolios. Household wealth increased by nearly $27 trillion between 2000 and 2007, of which more than two-thirds was due to the rising values of homes, equities, and other financial assets. The remaining third of the gain came from households putting more money into mutual funds, 401(k) plans, or other saving vehicles.

Economists differ over exactly how rising wealth affects consumption. But many would agree that generally, for every $1 increase in wealth, consumers tend to spend around 5 cents more. By this formula, roughly one-third of U.S. consumption growth after 2000 was spurred by rising wealth. But the effect was likely greater in the recent period than in the past because homeowners could so easily tap the growing equity in their homes through cash-out refinancing, home equity loans and lines of credit, and other loans using the home as collateral—turning their homes into virtual ATMs.

The financial crisis has now thrown this process into reverse. Household wealth has shrunk and remains well below its peak level with the housing and equity market declines over the past year. Easy credit has been replaced by tighter lending standards, lower borrowing limits on credit cards, and canceled home equity lines of credit. Unemployment is climbing, consumer spending is declining, and the saving rate is rising.

Consumer deleveraging could result in hundreds of billions of dollars worth of foregone consumption in coming years.

Home equity loans and cash-out refinancings provided consumers with $2.3 trillion of financing since 2003
Billions of dollars, not seasonally adjusted



Sources: Federal Reserve via Haver Analytics; McKinsey Global Institute analysis.

Household wealth has eroded sharply by several measures. By the first quarter of 2009, the value of U.S. household net worth had declined by about $12.9 trillion from its peak in 2007—a drop of 32 percent after adjusting for inflation (although stock market gains since March have made up a small portion). This is a greater real decline than during the Great Depression of 1929 to 1933, when falling wealth was accompanied by price deflation.

The loss of household wealth is more devastating than in previous recessions because asset values are falling across the board. By comparison, during the dot-com bust of 2000, equity market declines were huge but were offset by rapidly appreciating home values.

At the same time, the credit crunch and recession have caused many U.S. employers to cut jobs, hours, and pay. The economy shed 6.7 million jobs from December 2007, when the recession began, through July 2009. Tax cuts helped boost disposable income, but total personal income has fallen. Wages and salaries, the largest component of personal income, fell by 4.3 percent in June compared to a year ago.

Until recently, households could use credit to smooth out consumption through the ups and downs of the job market. But now banks, battered by mounting credit losses and plunging equity prices, have tightened lending standards for consumers and businesses. Net new borrowing by households has fallen sharply from its peak in the second quarter of 2006 and turned negative in the fourth quarter of 2008. For the first time since World War II, total household debt outstanding fell rather than rose. It is unclear how much of this debt reduction is voluntary and how much is involuntary. Part reflects lower demand for credit, while part is the result of the tighter lending standards, and rising defaults on mortgages and consumer debt. Either way, consumers are reducing their debt burdens—deleveraging.

With the confluence of plummeting wealth, jobs, and credit, consumer confidence was recently at a forty-one-year low and remains well below normal levels or those of the 2001 recession. Even those with jobs fear for their futures. Many households are using their cash to pay down credit cards rather than buy new goods. Others are putting money away for a rainy day in the form of deposits and less risky debt securities. Consumer credit outstanding has fallen for five straight months since January this year.

As a result, U.S. consumer spending is plunging. Spending has fallen by 2 percent over the last year to June while retail sales plummeted in 2008 at the fastest rate and by the largest amount in the post-World War II period. Retail sales plummeted in 2008 at the fastest rate and by the largest amount in the post-World War II period. Autos and consumer durables have been hard-hit, as have all forms of discretionary spending. The decline of consumer demand has now rippled through the supply chain to affect manufacturing and other industries.

The flip side of falling consumption has been a rise in the personal saving rate to 5.2 percent in the second quarter of 2009, its highest level since 1998. The whole world is reeling from the effects of a more frugal U.S. consumer. U.S. demand for imports has dried up, contributing to a plunge in global trade. In some Asian countries, such as Korea, Taiwan, and Singapore, exports were down as much as 35 percent year-on-year in the first quarter of 2009.

The drop in consumer spending is hurting the U.S. and world economies right now, but some adjustment is necessary to produce more balance in the long run. For a decade or more, the U.S. current account deficit grew larger, reflecting a gap between saving and investment by households, businesses, and government. By 2007, the deficit reached 5.3 percent of GDP and required most of the world's surplus

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capital to fund it. The crisis has thrown this situation into reverse, causing the U.S. current account deficit to decline to an estimated 2.9 percent of GDP in the first quarter of 2009.

WILL CONSUMER DELEVERAGING SINK THE RECOVERY?

Two key questions for the economy going forward are how U.S. household leverage will decline, and what effect it will have on consumer spending. The potential magnitude is startling: by 2007, the household debt-to-income ratio was 24 percentage points above where it would have been had it kept to its long-term trend, a difference worth some $2.5 trillion.

History offers little guidance on how household deleveraging will play out. Although there are many differences, the Great Depression is instructive as a point of comparison. Between 1930 and 1935, household liabilities fell by one-third. A large portion of this may have been defaults; one academic paper estimates that nearly half of the urban households with mortgages were in default by the beginning of 1934. Something similar is happening today as home foreclosures rise: Federal Reserve data show that U.S. household debt outstanding fell in the fourth quarter of 2008 and the first quarter of 2009, in large part because the value of outstanding mortgages declined.

Several scenarios emerge. In a recessionary scenario, in which the household saving rate reaches 8 percent, U.S. household leverage could recede to 2000 levels within five years. The economic impact of such deleveraging will depend on whether incomes grow. Without income growth, consumers can save more only by spending less. This would feed a downward spiral in which falling demand causes businesses to cut jobs, causing consumption to fall further, and so on.

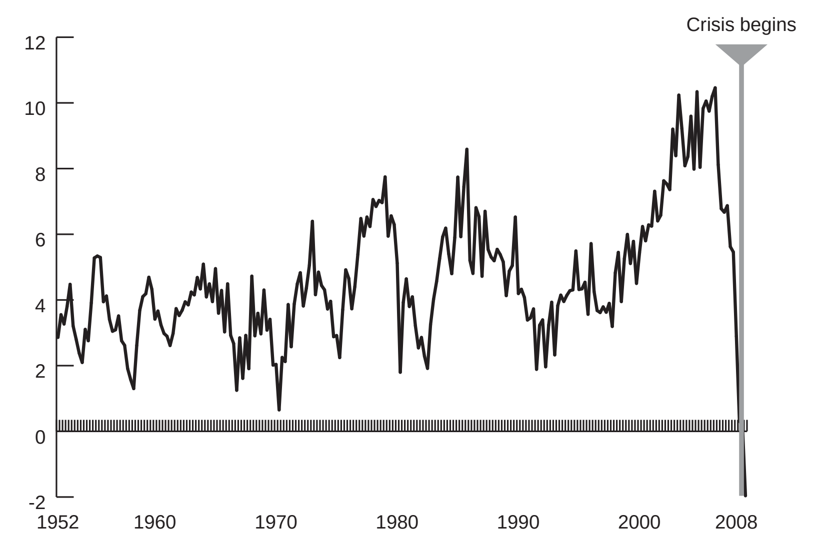
If incomes stagnate, as they have for most U.S. households since 2000, each percentage point reduction in the debt-to-income ratio would require nearly one percentage point more in the personal saving rate. And each extra point in the saving rate translates into $100 billion less spending. But with rising incomes, households can reduce their debt burden without having to trim consumption as much. For example, if incomes grow by 2 percent per year, households could reduce their debt-to-income ratio by five percentage points with a personal saving rate of just 2.4 percent. This would require a spending reduction of $267 billion per year, all else being equal. If incomes do not grow, the same reduction in household leverage would require more than twice as much saving, translating into $539 billion less consumption.

Other factors could influence the effects of deleveraging as well. If it were to occur over a shorter number of years, consumption could drop more sharply. But if households reduce their debts gradually, the spending pullback could be milder. Finally, the inflationary environment will have an impact: Because debt outstanding is fixed in nominal terms, higher inflation would hasten and ease the deleveraging process. Conversely, as during the Depression, deflation would cause debt burdens to grow heavier, making deleveraging more difficult for U.S. households and the economy.

But the bottom line is this: Given that the U.S. household debt-to-income ratio rose to 24 percentage points above its long-term trend, it is easy to see how consumer deleveraging could result in hundreds of billions of dollars worth of foregone consumption in coming years.

The U.S. credit bubble has burst, and the economic damage is extensive. In the immediate term, U.S. policymakers are right to focus on stabilizing the banking system and stimulating GDP growth. But over the next three to five years, they must also seek measures to boost broad-based growth in personal incomes. This will mean crafting the right mix of policies to generate both job growth and productivity gains. If these efforts fail, the restraints on consumer spending could cripple any recovery. But if they succeed, the result would healthier U.S. and global economies. ◆

Household net new borrowing has turned negative for the first time in the postwar period
Net new borrowing of U.S. households, percent of GDP



Sources: Federal Reserve via Haver Analytics; McKinsey Global Institute analysis.