Consumer Indebtedness
and the Withering of the American Dream

BY TERESA A. SULLIVAN

In the summer of 2008, the Standard and Poor's 100 quietly dropped a low-performing stock and replaced it with one performing better. Though the event was not unusual, the two stocks involved were surprising: MasterCard replaced General Motors.[1] It was once said that what was good for General Motors was good for the nation. This may have been a bit of hyperbole, but General Motors has provided access to the middle class for thousands of workers.

Despite the popularity of MasterCard's tagline, "For everything else, there's MasterCard," it is less clear that MasterCard has contributed much to the sustenance of the American dream. In fact, an increasing number of American families find themselves crushed under consumer debt. If major steps are not taken soon, the American dream could collapse.

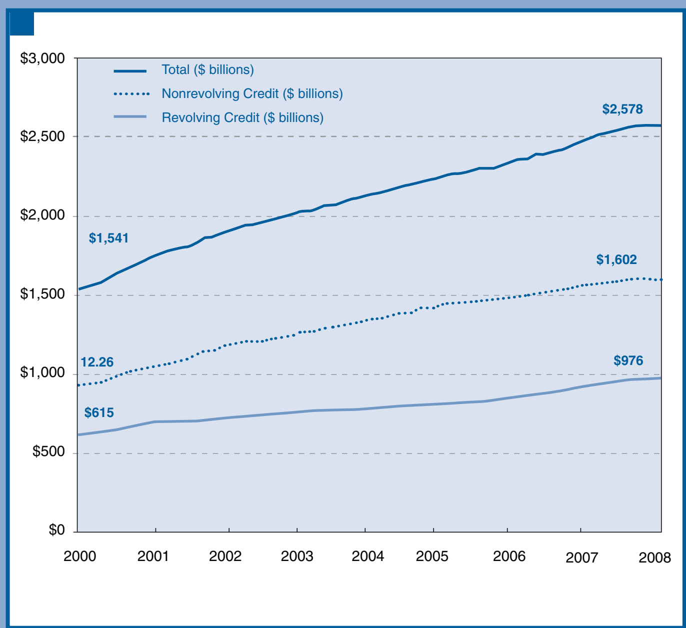
A mere six months ago, when I presented data on trends in consumer indebtedness, I characterized those trends as alarming. But little did I know just how bad things might get. A solution has become more difficult to envision, let alone implement. Below, I provide up-to-date trend data on the state of consumer indebtedness, data showing that more and more Americans are finding themselves deep in debt. I then review the sea changes in the financial system and credit markets that brought this about and discuss how the rise in indebtedness is occurring just as asset values are declining. I close by arguing for policies that might combat these trends.

Consumer Indebtedness

Since 2000, total outstanding consumer credit has grown by over $1 *trillion* (see Figure 1). Divided by the number of adults in the United States over age 18, this works out to an increase of approximately $4,400 per person. Approximately two-thirds of this increase has come in the form of nonrevolving debt, while the remaining one-third comes in the form of revolving debt. (Revolving debt includes credit card debt, while nonrevolving debt includes mortgages or auto loans.) Despite some recent flattening in the *rate* of acquiring new debt, the volume of existing debt is staggering—and repayment is getting harder.

Repayment is a function of disposable income, and consumers (at least homeowners) are taking on more debt as a percentage of their disposable income. Figure 2 shows trends in two key indicators of consumers' debt burden: the debt service ratio and the financial obligations ratio (DSR and FOR, respectively). The Federal Reserve defines the DSR as the percentage of disposable personal income devoted to consumers' minimum estimated debt payments for their mortgages and consumer debt. The FOR adds to the DSR numerator the estimated payments for automobile leases, rent for tenant-occupied property, homeowners' insurance, and property tax payments. By both measures, many Americans are increasingly burdened by debt.

FIGURE 1. Trends in Consumers' Outstanding Credit (in billions of dollars, 2000–2008)



Source: Federal Reserve

Taking just the DSR, we see that Americans' debt payments were over 12 percent of their disposable income in 2000, and this has risen to just over 14 percent of disposable income in 2008. Given the additional obligations that many Americans bear, the situation is even worse than the DSR suggests. Homeowners' total financial obligations have risen from over 15 percent of disposable income in 2000 to over 17.5 percent of disposable income in 2008. Renters have been more successful in reducing the extent of their financial obligations, though their obligations relative to their income have always been much higher than for homeowners. Keep in mind that these percentages reflect only consumers' minimum estimated debt payments. For credit card debt, high interest rates will continue to apply to the balance. A more reasonable repayment schedule would involve a far higher commitment of disposable income. The important point is that, at least for homeowners, even minimum estimated debt payments are taking up an increasing proportion of their income.

Cause for Alarm

It might well be argued that the foregoing increases in indebtedness aren't all that substantial. Indeed, given the dire economic forecasts of our time, one might well have expected even steeper increases than those revealed here. There are two main reasons the trends in Figures 1 and 2 are so troubling. First, as unemployment continues to rise, an increasing number of Americans won't have the income to pay off their debts.

A December 2008 report from Congressional Oversight Panel for Economic Stabilization, headed by my longtime colleague Elizabeth Warren, puts it as follows:

> The crisis affects Americans' ability to pay their bills, to secure their retirement, to continue their educations, and to provide for their families. The unemployment rate is the highest it has been in fourteen years. In the last three months, 1.2 million Americans lost their jobs; 533,000 in November 2008 alone. Service sector employment levels, in particular, fell far faster than expected last month. One in ten mortgage holders is now in default, unable to make payments on their homes. More than 200,000 families and small businesses filed for bankruptcy protection in the last two months.[2]

Taken together, the rise in consumer indebtedness and the crumbling of the economy suggest dire consequences for large swaths of the American public. With ever greater outstanding financial obligations, any shock such as unemployment is likely to cast many an American family into financial ruin.

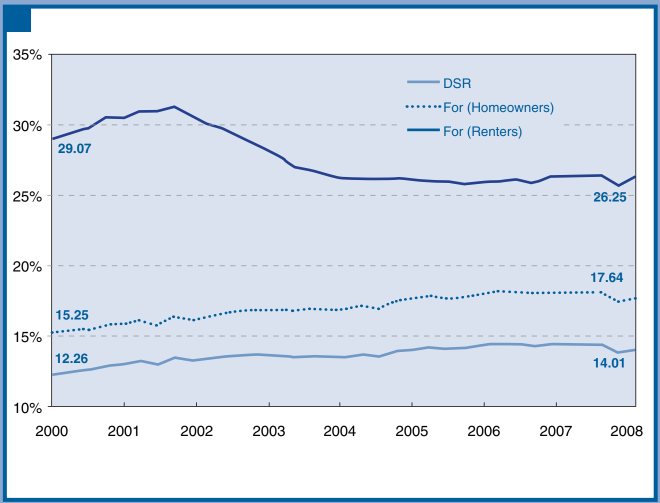
If income streams become a less reliable source of debt relief, how about assets? Might those who are deep in consumer debt and out of work at least convert their assets to cash to pay it off? In answering this question, note that the average family has two main assets, the family home and the retirement fund. Until the last year or two, home prices were rising in most parts of the country, and lenders made it very easy for homeowners to borrow against their increasing equity. Home equity loans had been advertised widely and were considered smart financial instruments by some experts because the interest on home mortgages, including home equity loans, is deductible on federal income tax. Credit card companies also got into the act, offering home equity lines of credit.

As is now well known, a vicious cycle began to eat away at home values in almost all parts of the country, and foreclosures from adjustable-rate mortgages and home equity defaults have increased. Many neighborhoods, including upscale ones, have numerous vacancies. Ordinary home sellers have trouble finding buyers, in part because buyers are having trouble finding financing. And those homes must now compete on the market with foreclosed homes being sold at fire-sale prices by banks and other lenders. Most home-owning families have lost net worth over the past 12 months because of the erosion of the value of their home, and this has happened even if they did nothing at all in the credit or real estate markets.

But the news gets even worse. With the stock market collapse, many families have suffered dramatic losses in the value of their other substantial asset: their retirement (and related) accounts. The overvaluing of risky subprime mortgages affected many lenders and many investors in the secondary market, with eventual disastrous effects on the stock market more generally. Although recent legislation may help prop up the market, there are other sources of market instability. Among these are energy prices, the eroding value of the dollar, and the very high federal deficit.

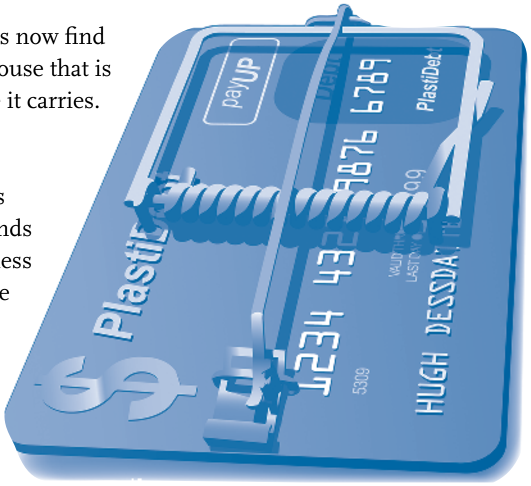
Thus, the average family stands to lose value in both of its major investments—the home and the retirement fund. These sources cannot, then, be relied upon to pay back debt. In the

FIGURE 2. Trends in Consumer Debt Burdens (as a percentage of disposable income)



Source: Federal Reserve

case of home mortgages, many families now find themselves "upside down," or with a house that is suddenly worth less than the mortgage it carries.



Rebuilding Consumer Solvency

How might we begin digging ourselves out? While reversing the long-term trends toward mounting consumer indebtedness is undoubtedly an enormous task, there are a number of practical steps that we can take now to prevent consumers from being irrevocably buried in debt and to maintain their solvency. At the same time, we can provide the proper framework of incentives so that consumers change the patterns of behavior that led to mounting indebtedness in the first place. I outline some of these changes below.

Debt relief and bailouts: After Congress approved approximately $750 billion dollars for the U.S. Treasury to bail out various companies struggling to stay afloat, large numbers of companies came out of the woodwork looking for a slice of the government-approved money. And within months, the Treasury had doled out approximately half of the approved funds.

Little was done, however, to ensure that those companies being bailed out in turn took steps to protect consumers. Under the government's Capital Purchase Program (CPP), which allows the treasury to inject money into companies in return for preferred stocks and equity warrants in those companies, more could be done to ensure that program beneficiaries provide debt relief to consumers as a precondition for receiving funds. As it stands, companies may receive funds without doing anything to modify consumers' loans or provide foreclosure relief to ensure that actual consumers and borrowers are "bailed out" as well. Making relief a condition for CPP funding would be a promising step for future disbursals of government aid.

It would also be wise to consider other modifications to government aid, such as those proposed by FDIC chairwoman Sheila Bair. In particular, Bair has strongly advocated redesigning incentives for companies to engage in loan modifications for consumers. These would include reimbursing mortgage servicers for costs associated with loan modifications and arranging for the FDIC to share the risks involved in consumer re-defaults. As it stands, many firms are not participating in programs designed to ensure that troubled borrowers stay afloat, so proposals to provide a proper framework of lender incentives could help to expand the scope of loan modification policies. These changes, however, are merely stopgaps to prevent the crisis from deepening.

Reduce borrowing: Also necessary are long-term strategies to reduce consumers' borrowing and encourage saving. Numerous studies in behavioral economics document how saving is much more likely when it is presented to consumers as the default rather than merely as an option. The Earned Income Tax Credit, for example, could be reformed to promote automatic savings. Government programs that match savings could also be used to promote desired behavior, though such programs may have to wait until brighter fiscal days.

Although we probably want savings to increase in the long run, it is not clear whether such changes are best implemented in the midst of the current crisis. Because banks are hoarding rather than lending, the effects of promoting savings might not be felt immediately (in the form of trickle-down investments), and a direct Keynesian stimulus is of course most everyone's prescription for now.

Lastly, stronger regulation and enforcement of credit-granting companies should be undertaken. In particular, Congress and legislatures should reconsider whether there is some level of interest rate that could again be regarded as usurious. The regulatory requirement to provide factual information to tobacco users has been at least partially successful. Requirements for simple information for debtors—such as the number of months required to repay a balance at the minimum rate of repayment—could empower more consumers to make better choices.

A Bailout for the American Family

Americans are gradually but increasingly becoming buried by debt. According to recent congressional testimony by Professor Robert Lawless, total outstanding consumer debt now exceeds annual national personal income in the United States.[3] At the same time, the American consumer is being hit by a disintegrating economy, with neither income nor assets a secure source of repayment. The confluence of these two trends is a "perfect storm" threatening consumer solvency and the foundation of the American dream. The main solution, as described above, is to direct the bailout to American families. Although longer-range reforms to promote savings over debt accumulation are desirable, for now we are in the perverse position of needing to encourage spending, if not by consumers, then by the government.

NOTES

1. http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aFsz.09VBIdc, "Mastercard to Replace," July 10, 2008

2. Available at: http://cop.senate.gov/hearings/index.cfm

3. Available at: judiciary.senate.gov/pdf/08-12-04LawlessTestimony.pdf

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