Consumer Debt: A Christmas Story

Retail Spending May Slump This Holiday Season

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Retailers across the country began spreading holiday cheer earlier than usual this fall. Since mid-October, elves, snowmen, and reindeer have graced the aisles of supermarkets, department stores, home improvement outlets, shopping malls, and strip malls alongside displays of ghoulish ghosts, pilgrims, and turkeys. "Hallow-Thanks-Mas" is now one huge holiday shopping spree.

These ubiquitous decorations, along with serious retail shopping sales incentives, were supposed to lure shoppers into stores amid weakening job growth, a slumping housing market, burgeoning consumer debt, and growing home mortgage payments. Unfortunately, early indications suggest that American consumers are more attuned to these worrisome economic trends than they are to all the decorative lures and sales bargains.

Retailers certainly have reason to worry. Wal-Mart Stores, Inc., the country's largest retailer and a bellwether for retail spending across the nation, announced after the Thanksgiving holiday weekend that same store sales declined by 0.1 percent in November. This comes after retail sales outside of services had declined for three months in a row by October, according to the Census Bureau. This decline is even more surprising given that consumers' spending power grew because of declining oil prices over the same period.

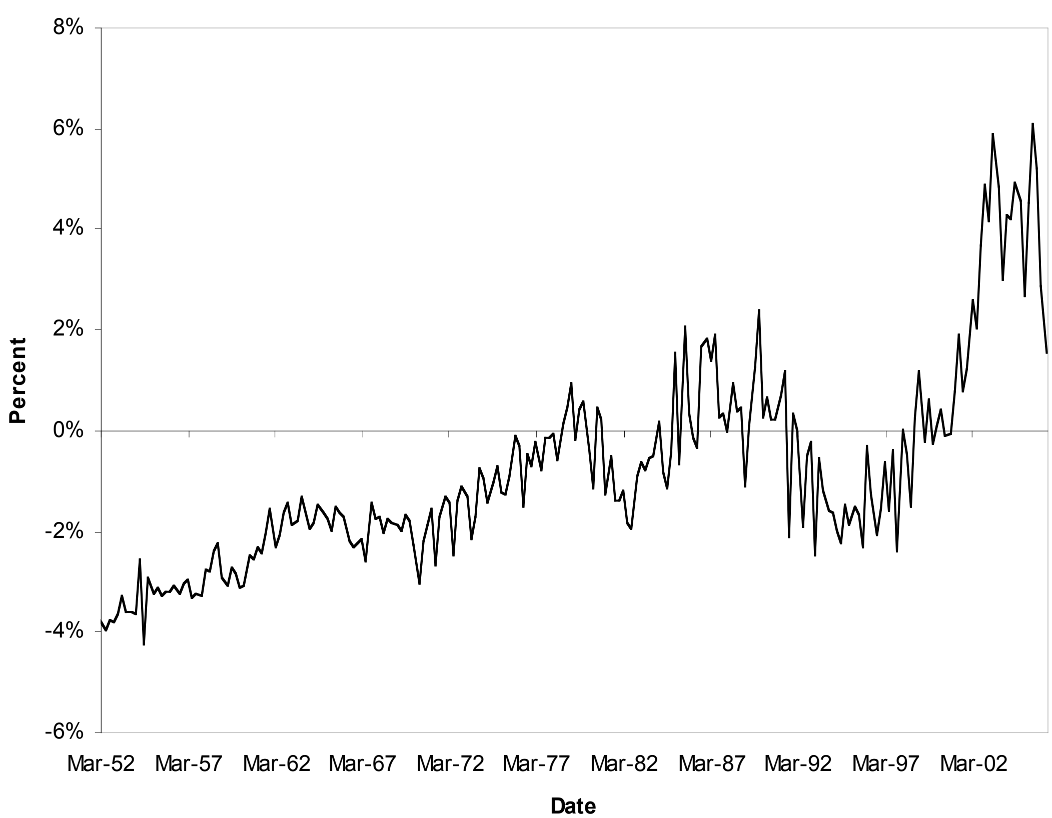
This slowdown in retail spending comes on the heels of a weakening job market, which could lead to slower income growth in the months ahead. Average monthly job creation so far in 2006 stands at 147,000—a 16 percent decline from 2004 levels, the strongest calendar year in terms of job creation in this business cycle, which started in March 2001. In 2004 new jobs per month averaged 175,000; in 2005 they averaged 165,000 per month. Even more worrisome: October marked the second month in a row of declining employment growth. Job growth in October 2006 was less than half of that in August of this year.

Over the past several holiday seasons, retail sales were buoyed by record consumer borrowing even as job growth slowed and housing, energy, and health care costs jumped sharply. By the end of June 2006, the last quarter for which data is available, total consumer debt stood [at a record 129.3 percent of disposable income](). But will the trend continue this holiday season?

Over the course of the current business cycle, consumer credit relative to disposable income grew more than four times faster than during the 1990s. The rise in debt levels has contributed to higher debt payments, which averaged 14.4 percent of disposable income in the second quarter of 2006, the highest level since the Federal Reserve started collecting these data. This debt boom was fueled by additional mortgages taken out against higher home values—a phenomenon known as mortgage equity withdrawals, or MEWs. This no longer is the case.

First consider MEWs, which declined sharply in the first half of this year. They amounted to $36 billion in the second quarter of 2006, down from $67 billion in the first quarter, and more than $100 billion each quarter between March and September 2005. Relative to disposable income, MEWs fell to 1.5 percent in June 2006 (figure 1), the lowest level since 2001.

Figure 1: Mortgage Equity Withdrawals/Investments Relative to Disposable Income



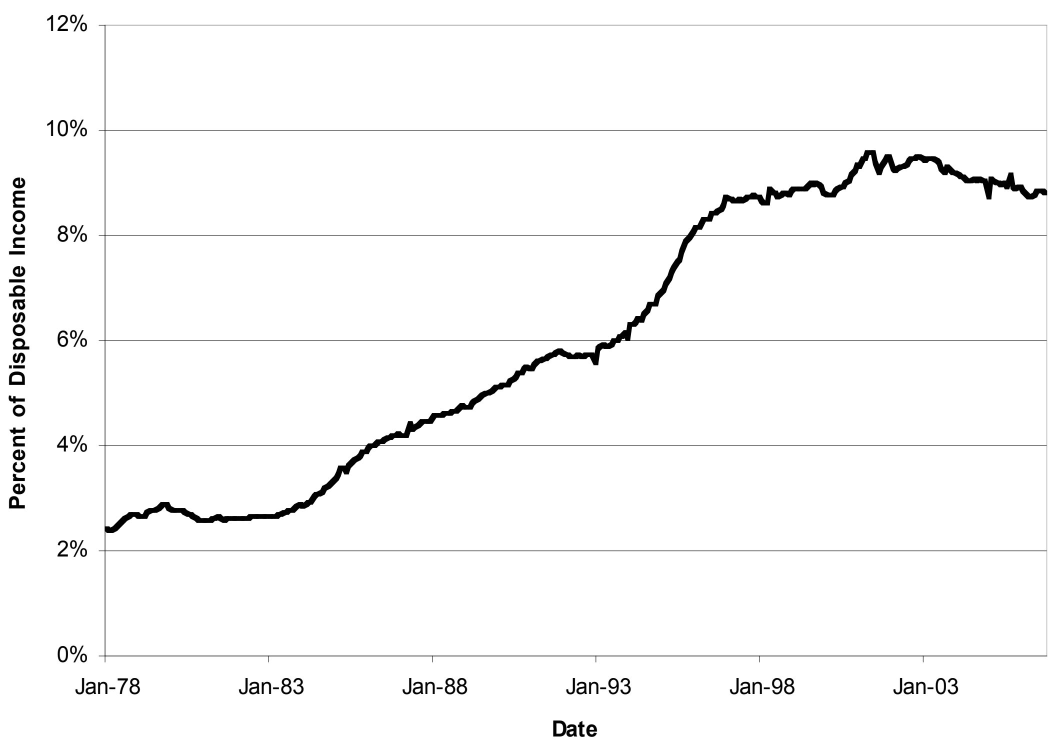
Notes: Calculations based on data from Board of Governors, Federal Reserve System, 2006, Flow of Funds Accounts of the United States, Washington, D.C.: BOG. Mortgage equity withdrawals/investments are defined as the difference between new mortgages and new investments in residential real estate. A positive difference indicates a mortgage equity withdrawal, a negative one a mortgage equity investment.

Families have become more hesitant to take on debt faster than their homes appreciate, largely because home values no longer appreciate at the rate that they once did. The housing boom is coming to an end and is apparently dragging the mortgage boom down with it. Without faster income growth or faster debt growth elsewhere, this could put a serious damper on consumer spending, especially with the holiday spending season around the corner.

Then consider total consumer credit, which is also dropping. Families are not charging their credit cards to compensate for fewer new mortgages. Total consumer credit (credit cards, car loans, and similar loans) dropped by an annualized rate of 0.6 percent in October 2006—the largest decline in 14 years. Credit card debt grew by an annualized four percent in October, much less than the 6.7 percent increase in August and September and the double digit growth rates in June and July of this year.

Importantly, credit card debt relative to disposable income continued to slump—as it has throughout the current business cycle (see figure 2). Over the past few years families borrowed more against their homes but also rolled more of their credit card debt into their new mortgages. This trend has not changed as shoppers head into this year's holiday season, an ominous sign against the backdrop of sharply falling MEWs.

Figure 2: Credit Card Debt Relative to Disposable Income, 1978 to 2006



Notes: Calculations based on Board of Governors, Federal Reserve System, 2006, Release G.19 Consumer Credit, Washington, D.C.: BOG, and Bureau of Economic Analysis, Personal Income and Its Disposition, Washington, D.C.: BEA. Credit card debt is equal to revolving credit. Credit card debt includes all new outstanding credit card debt, comprising new charges and balances carried forward. Data are presented only from 1978 forward to maintain consistency in the data. All prior data points also show lower credit card levels and a rising credit card debt trend.

The elves, snowmen, and reindeer appeared sooner than usual this holiday season, yet consumers apparently are reassessing their priorities amid slower job growth and the end of the housing boom. Taking out more credit to finance consumption just does not seem to be such a good idea anymore. After a period of borrowing to make ends meet, which lifted household credit to record levels, families may feel it is time to concentrate on repaying some of this debt and curbing consumption. This year's Christmas story may bring little joy to retailers, with important implications for the overall economy.