



# You're a Mean One, Mr. Grinch

*Debt Is Haunting the American  
Consumer and Harming the Economy*

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December 2007

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American Consumer and  
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## You're a Mean One, Mr. Grinch

“**D**uh,” the defining word in an ever-present car ad this holiday season, also summarizes what is happening to holiday shoppers. It should be obvious to anyone paying attention and paying credit card bills that American consumers have amassed record amounts of debt.

But what may not be clear to everyone except those trying to pay for holiday presents while failing to balance all their other debts payments is that consumers only have two choices: borrow less or go broke. Either way, more and more families will be joining those who are already slowing their spending as income growth slows and other means of borrowing shrink. If this does not happen during the 2007 holiday shopping season, it most likely will happen when debt bills come due early next year.

The basic economic arithmetic is clear. Without faster income growth, which will likely not occur in a slowing economy, consumers will ultimately max out on their debt. And with less access to home equity loans or other lines of credit, the implications are dire. A quick look at the data on income growth, family indebtedness, consumer spending, and bankruptcy filings tell the story.

### Income Growth Slows

Income growth has slowed in recent months relative to the increases experienced a year earlier. In October 2007, income was 3.0 percent higher in inflation-adjusted terms than a year earlier, down from a year-over-year growth rate of 4.0 percent in September, and a 4.6 percent growth rate in August. Additionally, income in October 2006 was 4.4 percent higher than a year earlier.<sup>1</sup>

Growth of inflation-adjusted wages has slowed even more. In October 2007, real wages were 2.2 percent higher than they were in October 2006, which were 4.7 percent higher than they were in October 2005. Also, in August 2007, real wages were 4.5 percent higher than a year earlier, indicating that the year-over-year growth rate of real wages fell by 51 percent in just two months.

Moreover, October's year-over-year increase in real wages was the lowest since August 2006. As the U.S. economy slows this holiday season and in 2008, consumers can be pretty sure that wages won't grow any time soon.

<sup>1</sup> Authors' calculations based on Bureau of Economic Analysis, 2007, National Income and Product Accounts, Washington, DC: BEA, Tables 2.6 and 2.8.4.

## Families Borrow More Slowly

This slowdown in income growth is hitting families at a time when they have amassed record levels of debt. By the third quarter of 2007, total debt stood at 133.0 percent of disposable (after tax) income (See Figure 1, below).<sup>2</sup> For this business cycle, which started in March 2001, debt relative to disposable income has expanded four times faster than it did during the previous business cycle.

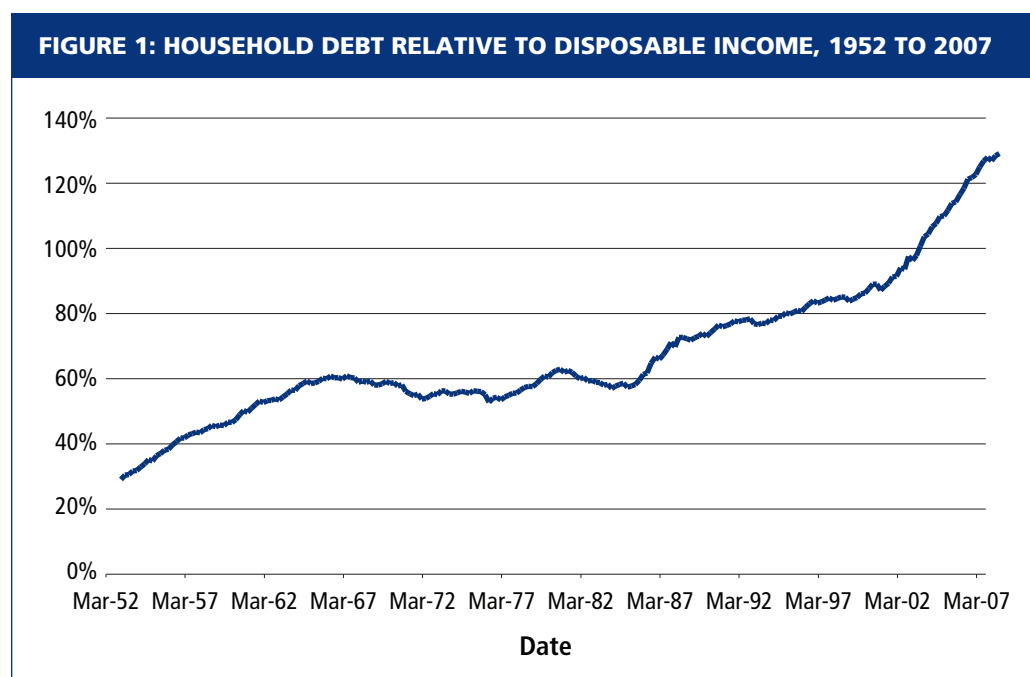
Mortgages were the primary driving force of this accelerated debt accumulation. The total of all outstanding mortgages increased, relative to disposable income, more than six times faster after March 2001 than in the previous business cycle.

But that dynamic is reversing fast. We know that because the increase in the ratio of debt to disposable income has

slowed over the course of the past year. Between September 2006 and September 2007, total debt relative to disposable income increased by a quarterly rate of only 0.6 percentage points. In comparison, from March 2001 to September 2007, the quarterly rate of increase was 1.6 percentage points, or almost three times as large as the debt growth over the past year.

Slowing debt to disposable income is largely a phenomenon driven by mortgages. Mortgages relative to disposable income rose by a quarterly rate of only 0.5 percentage points from September 2006 to September 2007, or less than one third of the average quarterly growth rate from March 2001 to September 2006.<sup>3</sup>

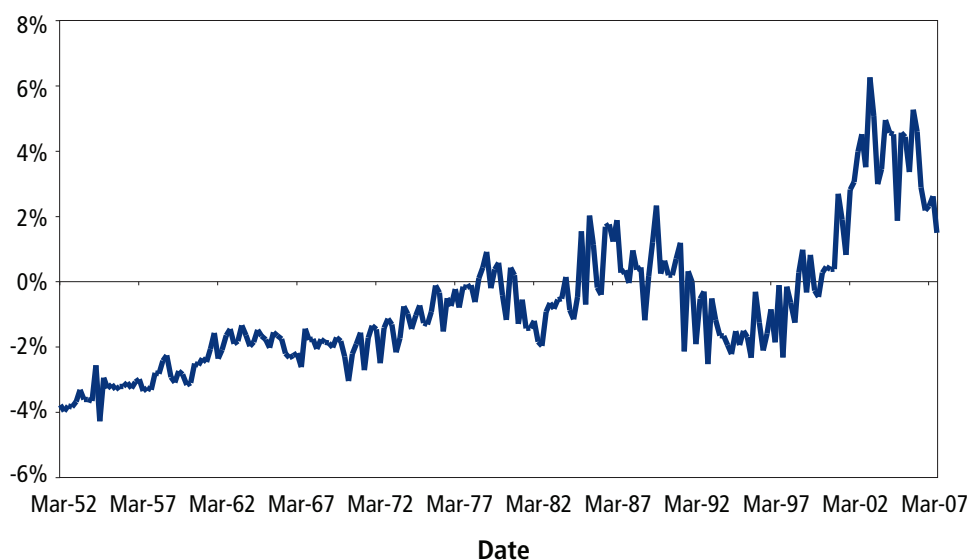
This is just a longer way of saying that people withdrew less equity from their homes. In September 2007, the difference between new mortgages and what



Notes: Authors' calculations based on Board of Governors, Federal Reserve System, 2007, Release Z.1 Flow of Funds Accounts of the United States, Washington, DC: Board of Governors.

<sup>2</sup> Real disposable income was 2.7 percent higher in October 2007 than in October 2006, which itself was an increase of 3.7 percent over real disposable income in October 2005.

<sup>3</sup> All changes are calculated based on Board of Governors, Federal Reserve System, 2007, Release Z.1 Flow of Funds Accounts of the United States, Washington, DC: Board of Governors, Tables L.100 and F.100.

**FIGURE 2: NEW MORTGAGES MINUS REAL ESTATE SPENDING RELATIVE TO DISPOSABLE INCOME, 1952 TO 2007**

Notes: Authors' calculations based on Board of Governors, Federal Reserve System, 2007, Release Z.1 Flow of Funds Accounts of the United States, Washington, DC: Board of Governors.

people spent on their homes—the new mortgage debt available for spending on other items—amounted to 1.5 percent of disposable income (See Figure 2 above). This was the lowest share since the fourth quarter of 2001.

To put this in perspective, at the height of the mortgage boom in the first quarter of 2006, families cashed out \$125 billion worth of equity in their homes in just one quarter. By the third quarter of 2007, home equity withdrawals amounted to only \$38 billion. This is a drop of 69.2 percent in additional financial resources that families have at their disposable to spend.

This slowdown in borrowing is clearly the consequence of the end of the housing boom. Families simply did not see the equity in their homes increase as much as

it had in the past. Home equity relative to disposable income has fallen for seven consecutive quarters. By September 2007 home equity amounted to 125.2 percent of disposable income, the lowest level since the end of 2004.<sup>4</sup>

This same period of time also saw the longest decline in home equity relative to disposable income since the end of December 1992. The drop in home equity relative to disposable income from September 2006 to September 2007 was 5.4 percentage points, the largest year-over-year drop since June 1992.<sup>5</sup>

## Pulling Back on Spending

Many consumers are well aware they are reaching the limits of their spending and credit capabilities. We know this because

<sup>4</sup> Wealth is typically set in relation to disposable income. Importantly, wealth is a store of future income. Since families build wealth to maintain their standard of living in the future by drawing down their wealth in the future, wealth needs to keep pace at least with disposable income growth.

<sup>5</sup> Author's calculations based on Board of Governors (2007).

census data show a deceleration in retail sales growth over the past several years. In December 2006, inflation-adjusted retail sales (not adjusted for seasonal fluctuations) rose by 17.2 percent, down from a 19.0 percent increase the previous December and 20.5 percent growth rate in December 2004.

Compared to a year earlier, real retail sales rose by 1.1 percent from December 2005 to December 2006, down from a 1.8 percent increase between December 2004 and December 2005. These growth rates were well below the 5.0 percent increase experienced between December 2003 and December 2004.

For two years running now, holiday sales increases have slowed. This doesn't bode well for this year's holiday season as the repayment of debt weighs more heavily on consumers than in prior years.

A similar picture of decelerating spending surfaces when we look at retail and food services sales, excluding motor vehicle and parts dealers.<sup>6</sup> December 2006 saw a 20.5 percent increase in real retail and food service sales, down from a 21.6 percent increase the previous December and a 23.2 percent increase in December 2004.

This monthly sales snapshot over the past three Decembers is mirrored in annual year-on-year figures. Between December 2005 and December 2006 retail and food service sales grew by only 1.6 percent compared to a 3.6 percent increase from December 2004 to December 2005 and a 4.9 percent increase between December 2003 and December 2004. Again, the slowdown during the holiday shopping season is noticeable for the previous two years.

The same slowdown shows up when the data are adjusted for typical seasonal swings in sales. Seasonally adjusted retail sales increased by 0.6 percent in December 2006, which is slightly higher than the 0.1 percent increase experienced in December 2005, but lower than the 1.0 percent growth of December 2004.

The year-on-year data shows a similar picture. From December 2005 to December 2006, seasonally adjusted total retail sales rose by 2.9 percent, which is slightly above the 2.0 percent experienced between Decembers 2004 and 2005, but less robust than the 4.7 percent growth between Decembers 2003 and 2004.

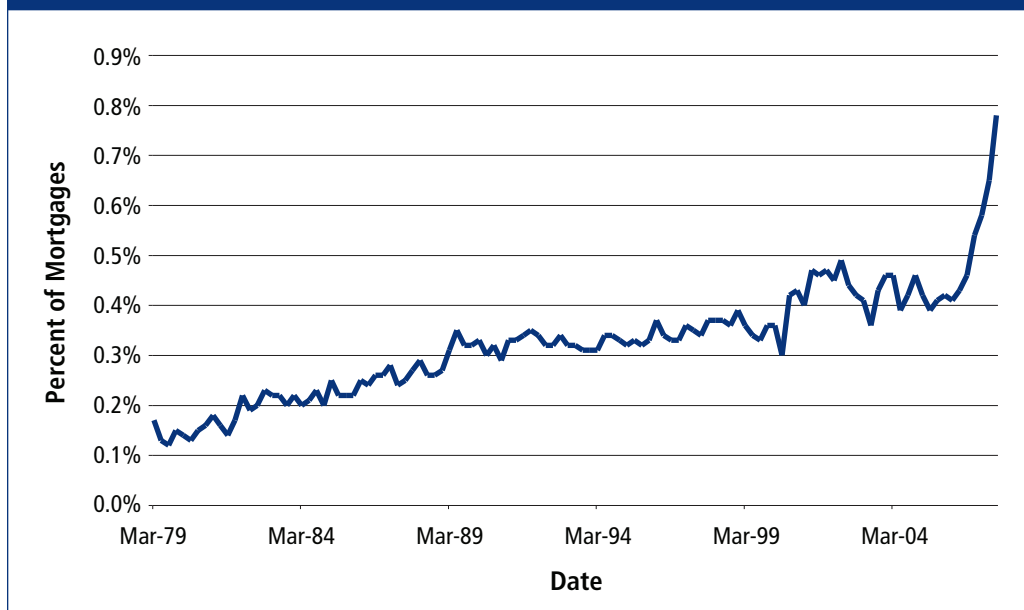
To complete this picture of a slowing consumer-driven economy, combined retail and food service sales—excluding motor vehicles and parts dealers—also show slower growth in seasonally adjusted data. Inflation-adjusted sales grew by 3.5 percent between December 2005 and December 2006, down from a 4.2 percent growth between December 2004 and December 2005, and 4.7 percent between Decembers 2003 and 2004.

Since consumers have carried the economy forward for much of the almost seven-year long business cycle, the slowdown in retail sales during the previous two years ultimately rang in slower economic growth in 2007 and likely bodes ill for 2008. Consumers may very well be unable to carry the economy out of its current slowdown, which in turn means that economic and income growth could stay low for some time—making it harder for people to pay off their debt.

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<sup>6</sup> Car and parts dealers are often excluded since their sales can be very volatile.

**FIGURE 3: SHARE OF MORTGAGES, WHERE FORECLOSURE PROCEDURES HAVE STARTED, 1979 TO 2007**



Source: Mortgage Bankers Association, 2007, National Delinquency Survey, Washington, DC: MBAA.

## Going Broke

Many families, however, have already reached the end of the road to more indebtedness. Measures of financial distress are soaring.

For instance, in the third quarter of 2007, 0.8 percent of all mortgages entered into foreclosures, the highest share on record (See Figure 3 above). This also marks the first time that the foreclosure rate has increased for six consecutive quarters. And it is by far the largest year-over-year increase in the foreclosure rate.

In addition, the share of all mortgages in foreclosure was 1.6 percent in the third quarter—another record.<sup>7</sup> What's more, this record came after six quarters of increasing foreclosures as a share of all mortgages and the largest year-

over-year jump in the foreclosure share, a 0.6 percentage point increase from 1.1 percent of total mortgages in the third quarter of 2006 to 1.7 percent to the fourth quarter of 2007.

The national bankruptcy rate has also steadily increased. After the bankruptcy rate fell precipitously following the enactment of new bankruptcy legislation at the end of 2005, the ratio of bankruptcies to the total population has continued to increase.

In the first quarter of 2006, there were 1.5 bankruptcy cases per 1,000 people. There were 2.3 cases per 1,000 in the fourth quarter of 2006 and 2.8 cases per 1,000 people in the third quarter of 2007.<sup>8</sup> This means that over the course of less than two years, the bankruptcy rate grew by a noticeable 85.2 percent.

<sup>7</sup> See Mortgage Bankers Association, 2007, National Delinquency Survey, Washington, DC: MBAA, for details.

<sup>8</sup> Authors' calculations based on American Bankruptcy Institute, 2007, Quarterly Non-Business Filings, Washington, DC: ABI, and U.S. Census Bureau, 2007, Population Estimates – National, Washington, DC: Census.

## Conclusion

**I**n an economy experiencing as much turmoil as the U.S. economy is today, only one thing is certain—it will take some time before economists can confidently report unambiguously good news again. How much worse the economic pain will get, and how much longer it will last, remain to be seen, but even if consumer spending holds up reasonably well during the 2007 holiday season, the downward adjustment will inevitably come.

Consumers, after all, will have only two choices in the near term: pay their bills or default. Neither one speaks for strong consumption any time soon.



# Center for American Progress



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