RIGHTING THE UPSIDE-DOWN ECONOMY:
CREATING A SUSTAINABLE RECOVERY
Transcript
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It is a pleasure to participate with such a distinguished group of panelists in this critical examination of the U.S. economy. The Center for American Progress is to be commended for organizing such an impressive program. Today's symposium will no doubt raise numerous provocative questions and policy issues as we explore the prospects for a sustained economic expansion that offers good jobs with good wages to hard working American families.

One of the most notable features of the U.S. economy over the last 25 years is the increasingly prominent role of the American consumer (accounting for nearly 70 percent of Gross Domestic Product) which has been facilitated by the concurrent "revolution" in consumer lending under the auspices of banking deregulation. Indeed, instant access to consumer credit is a distinguishing feature of the "new economy," one that we all enjoy through an enhanced material standard of living. What is striking – a key question for U.S. today – is how the shift in consumer power based on present versus future earning power will impact the future vigor of the American economy. In the spirit of the upcoming summer Olympics, I would like to present an analogy that epitomizes our shared concern over the current debt-driven growth of the U.S. economy. That is, whether U.S. households are healthy, well-conditioned athletes (balanced assets and financial obligations) or precariously dependent on muscle enhancing steroids (soaring debt levels). The answer will shed light on the long-term vitality of the U.S. economic expansion and its public policy implications.

In my brief remarks, I would like to address four major issues regarding the importance of consumer debt to the U.S. economy. First, its recent growth and current burden on American households. Second, its cost and future impact on household consumption. Third, the role of household "sentiment" in sustaining domestic consumption and expenditures. And fourth, how globalization will impinge upon the ability of debt-dependent households to continue to propel the American economy and, in the process, assume a less important role in the international "Neoliberal" trade regime.

Most of us here today are familiar with the ongoing trends in U.S. consumer debt levels. Over the last decade, total consumer debt (mortgage, installment, revolving) has more than doubled: from about $4.4 trillion in 1994 to over $9.1 trillion today. During this period, mortgage debt has climbed from $3.5 to $7.2 trillion while other forms of consumer debt have jumped from $905 billion to over $2 trillion. Overall, U.S. per capita consumer debt (including mortgages) exceeds $33,000. Like America's national dependence on cheap energy (U.S. petroleum consumption is over four times greater than the next largest international consumer), the U.S. reliance on cheap credit dwarfs the household debt levels of our peer nations throughout the world. Therefore, in assessing the long-term vitality of the U.S. economic expansion, two key questions demand our attention. First, how much consumer debt can American households effectively manage and, second, how long can we expect the rest of the world to be willing to finance our elevated standard of living?

Since the 1981-82 recession, when the current phase of globalization ushered in the dramatic restructuring of U.S. goods production industries, American households – especially those experiencing stagnant incomes and unanticipated job loss – have become increasing dependent on consumer credit to balance their family budgets. Between 1984 and 1994, during the most aggressive marketing of bank credit cards to new middle- and working-class clients, net "revolving" debt jumped from $73.7 billion to $279.8 billion. Today, outstanding net revolving debt is nearly $640 billion and the "real" cost of credit card borrowing (finance charges and fees) has nearly tripled since its low in 1982. This is not insignificant since finance costs are not included in the Consumer Price Index (CPI) which statistically attenuates the official measurement of inflation.

Not surprisingly, the focus of bank credit card marketing and other lending practices shifted in the 1980s from "convenience" users to more profitable "revolving" debtors – even those between jobs. As a result, household demand and related consumer debt accumulation patterns have changed dramatically since the early 1980s when households sought to reduce their debt loads during recessions and other periods of financial distress. That is, consumer demand has traditionally risen and fallen in accordance with the macro-economic business cycle. For example, between early 1981 and early 1983, U.S. non-mortgage consumer debt increased modestly (9.3 percent) while personal bankruptcy remained relatively stable at about 300,000 per year (declining in 1983); installment debt increased from $295.8 billion to $322.4 billion while net revolving debt rose from $52.6 to $57.5 billion. During the more prosperous 1980s, consumer debt climbed sharply (increasing effective household demand) which heralded a new era in consumer debt capacity and subsequent household financial distress: personal bankruptcies doubled to over 600,000 in 1989. This countercyclical trend – the rise in personal bankruptcies during a period of economic prosperity – augured the increasingly central role of consumer credit to the expansion of the U.S. economy.

During the 1989-91 recession, installment debt for durable goods (autos, furniture, appliances) actually declined by 10 percent (from $584.7 billion in November 1989 to $525.2 in July 1992) whereas more costly revolving debt jumped by 28 percent in the same period (from net $179.2 billion to $230.2 billion). The major durable goods industries quickly realized from this experience that "easy" financing terms are more effective in stimulating "big ticket" purchases during economic downturns than price-sensitive sales campaigns. Hence, the genesis of "0 percent financing" and "cash back" purchase programs from the auto industry. Not surprisingly, the 1989-91 recession produced an unprecedented number of personal bankruptcies, climbing nearly 50 percent to over 900,000 in 1992. This was due to the inability of financially overextended households to cope with wage stagnation, job loss, rising medical expenses, and family crises (such as divorce, parental care, support of dependent children). Indeed, during the 2001 recession, both consumer installment and revolving debt steadily increased. For example, between February 2001 and February 2003, non-revolving debt increased 15.4 percent (from 1.04 trillion to 1.20 trillion) while net revolving debt jumped 6.7 percent – from $576.7 billion to $615.3 billion. Consequently, consumer credit rather than the judicious use of household savings has emerged as the financial rudder of the American middle-class as it steered through the treacherous shoals of a volatile labor market, more costly medical care, higher education expenses, and rising debt-service obligations.

The 1990s was truly an extraordinary decade for American households since the U.S. achieved the ignominiously distinction of possessing the greatest economic inequality of the Western industrialized countries. Indeed, while Americans witnessed the longest economic expansion in U.S. history, it featured a new and unexpected trend: personal bankruptcies soared while unemployment plummeted. In 1992, unemployment (over 7.5 percent) and personal bankruptcies (over 900,000) peaked; two years later, 1994, bankruptcies had fallen to less than 800,000. Although U.S. unemployment steadily declined through the end of the decade (4.0 percent in 2000), personal bankruptcies jumped above 1.4 million in 1998, temporarily dipping to 1.2 million in 2002, before climbing to its historic high of 1.6 million in 2003. Clearly, with over 12 million personal bankruptcy filings over the last ten years, American households are finding it increasingly difficult to manage their new fiscal realities. Over the last six years, for example, the average household credit card debt (among the three out of five households with outstanding balances) has jumped from about $10,000 in 1998 to nearly $13,000 in mid-2004. This raises important questions regarding the ability of American households to sustain long-term economic growth in the context of stagnant wages, modest job growth (especially low-wage occupations), and a sharply rising cost of living. The situation is even more difficult for distressed households as public social services are cut-back or eliminated while cash-strapped local governments raise taxes and seek new sources of revenues through private-public partnerships and new cost-sharing arrangements.

Another striking feature of the last decade is the widening wealth gap between the most affluent households and the U.S. middle class. For those who have not glanced at their 401(k) statements since late 2000, asset formation has become an increasingly difficult challenge for households struggling to pay their monthly bills. Indeed, the data are unambiguous. For most members of the American middle and working classes, the "wealth effect" is largely a rhetorical mirage. The top ten percent of all U.S. households were the primary beneficiaries of the booming '90s – especially the top one percent. For instance, the net worth of the top one percent households climbed from $9.1 million in 1989 to over $10.5 million in 2001 while the net worth of the next nine percent households rose from $898,000 to over $1,000,000 in 2001. And what about the middle-class? If we look at the third income decile--the 20 percent of American families in the middle of the U.S. income distribution--what is striking is the illusion of wealth and prosperity among this group. Between 1989 and 2001, average household debt from grew 37 percent (from $34,000 to $46,600), more than double the rate of household asset formation at about 17 percent (from $89,100 to $104,400). Overall, the net worth of middle income families rose an average of $2,700 over this 12-year period to $57,800. This represents an annual increase in net household wealth of only 0.4 percent. These trends are consistent with a key household financial health indicator. That is, the extraordinary decline in personal savings, from over seven percent in 1993 to nearly zero in 2000. Hence, the revolution in consumer lending has meant not so much that people are more adept at managing their household finances. Rather, easier access to consumer credit has provided opportunities for household consumption that were not possible two decades ago or, at a minimum, would have been deferred.

So, the central question is how much more debt can American consumers effectively manage. Looking at the most recent statistics, we see that the financial squeeze on the American middle-class is exacerbated by the soaring cost of housing. Since 1989, the debt service obligation for housing (as a percentage of discretionary household income) has jumped sharply – from 57 to 85 percent. Other consumer debt has risen from 20 to 24 percent while home equity loans have jumped from about seven to 12 percent. This suggests that Americans are compensating for higher cost housing and other sharply rising expenses by reducing their family savings, tapping into their household assets such as home equity loans, and relying on costly installment and revolving loans. Of course, the number one asset of most Americans is their homes. Even so, record Chapter Seven bankruptcies and spiking home foreclosure rates suggest that increasing numbers of American homeowners have cashed out most of their housing related equity. Moreover, a potential housing "asset bubble" could swiftly erase tens of billions of dollars of household wealth as 30-year mortgages begin to march past the seven percent threshold.

Obviously, some sectors of the American middle and working classes have reached their household debt capacity in terms of their access to bank loans. They have exhausted their traditional lending sources including off-book, informal loans. This raises the related question of the national dependence on cheap credit. One of the assumptions about the de-regulation of the financial services industry was that the cost of consumer credit would fall significantly for the middle-class. True, those with excellent credit ratings and low debt/income ratios have seen their borrowing costs fall over the last few years, including zero percent credit card offers and 2.9 percent home equity loans. For the heavily indebted middle- and working classes, however, the reality is that the cost of credit has increased significantly in "real" terms after adjusting for inflation. And, for millions of middle-class households, lower interest rates have been primarily due to reductions in the Federal Reserve lending rates to its member banks rather than less onerous government regulation, greater competition, or synergy enhancing corporate mergers. Remember, only four years ago the U.S. Federal Reserve's Fund rate was six and a half percent compared to one and a quarter percent today. Consequently, with inevitably higher borrowing rates on the horizon, U.S. households are less prepared for the financial strain of increasing interest rates and finance charges than previous generations. And, of course, they are less able to increase their savings for retirement.

In terms of residential mortgages, the frenzy in refinancings and home purchases has enhanced household cash flow with the lowest interest rates in 46 years. But, as the U.S. economy confronts the limits of consumer and public sector debt-financed stimuli, American households are responding to higher borrowing costs through interest rate hedging such as adjustable rate mortgages [ARMs], interest-deferred installment loans, and short-term, low-rate balance transfers on their credit cards. For instance, the percentage of homes purchased with adjustable rate mortgages over the last twelve months has jumped from 12 percent to 34 percent. If the average American family moves every 5-7 years, the income boost of low-interest mortgages could become the bane of the U.S. economy in only a few years as 5 percent mortgages are replaced with 7 percent-8 percent loans. Furthermore, nearly all credit card contracts today feature amendments that specify adjustable interest rates. In fact, as the Fed Fund rate steadily declined, banks actually established interest rate "floors" so that the finance charges for consumers would not fall in accordance with lower bank borrowing costs. In other words, banks have not been passing on their lower costs to consumers in the form of revolving and installment loans for over a year.

The picture of the U.S. economy that is emerging is a fragile patchwork of “Two Americas” where social inequality is tempering job expansion, wage growth, asset formation, and the benefits of lower borrowing expenses. For example, the cost of borrowing on credit cards if you can pay off the balance each month (“convenience use”) is literally free and, if you have access to home equity loans, the cost is less than 5 percent while the finance charges are tax deductible. But, if you are among the increasing number of financially squeezed households, then you must accept loans at 12, 15, 19, and even 24 percent interest rates. And if you are “maxed out” without the option of additional bank loans, then you have no choice but to accept legal “loan shark” rates such as pawnshop loans at 10 percent-25 percent per month, rent-to-own contracts at 15 percent to 30 percent per month, and “payday” loans at 20 percent to 70 percent per month.

If current U.S. economic policy is dependent on the rapacious appetite of American households, then our national dependence on cheap credit may become even more important than the reliance on inexpensive petroleum supplies. For example, over the last twenty years, the “real” cost of borrowing on credit cards has nearly tripled, led by rising penalty and transaction fees (from $1.7 billion in 1996 to about $11 billion in 2003) and the widening “spread” between the banks’ cost of funds and the interest rate charged to consumers. This explains why the finance subsidiaries of many corporations are much more profitable than their manufacturing and retail divisions. GE Finance, for example, has grown so much faster than its “core” divisions that it was spun off into an independent company whereas Circuit City lost money on its core retail operations in the early 2000s and its profitability was largely attributed to its finance operations. Consequently, a key to the past growth of the U.S. economy has been easy access to relatively low-cost consumer credit – a condition that will invariably change to the detriment of middle- and working class households.

How much longer can American households continue to consume at their current standard of living? This is an especially important issue because the first legislative initiative of the current administration was consumer bankruptcy reform – largely pushed by the major money-center banks and their credit card subsidiaries. One way that the American consumer-driven economy has retained its resiliency – even during economic downturns – is by allowing people to file for bankruptcy when they can no longer pay their bills. The U.S. Congress offers this option to corporations and individuals--regardless of the factors underlying their financial insolvency – so that they can swiftly return to their role of contributing to economic growth. It is noteworthy that banks have not previously opposed this statutory provision because of their ability to levy increasingly higher finance charges and fees which more than compensates for larger default rates. If many financially distressed households are denied this historic right, then the bankruptcy reform legislation will negatively impact the U.S. economic expansion. That is, millions of American families would be forced to sharply curb their consumption activities and accept a long-term form of debt peonage that primarily benefits the banking industry and its record profits.

A third issue concerns the role of consumer sentiment in the expansion of the U.S. economy. The June 2004 release of the Consumer Board survey of consumer attitudes reports a modest improvement in Americans’ attitudes towards their economic future. Job growth has improved but anxiety over wage stagnation, inflation, and costs of the Iraq invasion are tempering Americans’ optimism in the short-term. This is significant because household consumption, especially costly purchases, tend to be influenced by consumers' perception of their future economic situation – regardless of present financial circumstances – even unemployment. It is for this reason that politicians emphasize optimistic economic forecasts in the hope that Americans will positively respond to their exhortations to consume and realize their rosy prognostications. Unfortunately, the reality is that the U.S. economy recently has been propelled by refinancing of home mortgages (past consumption) and the use of consumer credit (future earnings) with the expectation of a resurgence of national economic prosperity. However, with the stimuli of personal tax refunds and public sector expenditures winding down together with rising interest rates, we are already witnessing a slowdown in "big ticket" purchases such as new homes and mortgage refinancing. As U.S. households confront these ominous economic realities, they are also facing more stringent credit standards which will increase the cost and availability of consumer loans. Indeed, it is not just the rising cost of credit but access to credit that will impinge on domestic consumption growth and the vitality of the current economic expansion. Furthermore, it is not just consumers but also small business people that are affected by a "credit crunch." This adverse impact on the credit needs of the small-business sector – the backbone of job growth in America – directly affects employment. In the process, it can reduce consumer optimism and thus indirectly temper household discretionary consumption.

A final issue concerns the future prospects of American debt-financed consumption within the larger global political economy. Can the U.S. sustain its dominance in the international economy and continue to successfully pressure other countries to continue to lend U.S. money at relatively low rates?" For instance, the accumulation of hundreds of billions of dollars of currency reserves in China, Japan and other national banks is essentially a free loan to the United States. But, with the Euro appreciating about 25 percent against the dollar, more and more countries and hedge fund managers are buying Euros to reduce the cost of international transactions and thus speculating against the value of the dollar and low U.S. interest rates.

More significantly, at the structural level of international trade, is the inevitably diminished importance of the U.S. as the leading global consumer. Between 1990 and 2000, the total volume of international merchandise trade nearly doubled (87 percent), climbing from $3.45 trillion to $6.45 trillion. Although U.S. merchandise trade volume doubled (from $394 to $781 billion) during the decade, the U.S. share of global trade increased only modestly (from 11.2 percent to 12.1 percent). During this period, the U.S. share of global imports rose from 15.3 percent to 19.7 percent. Furthermore, our appetite for international goods and services was increasingly financed with borrowed money from foreign lenders as the balance-of-trade deficit soared from $111 billion in 1990 to $452 billion in 2000. Clearly, the U.S. cannot maintain this share of global imports following the next surge in international trade. In fact, U.S. consumption of total global merchandise imports has already fallen to 18.9 percent in 2002 while U.S. exports have fallen to only 10.7 percent of global merchandise trade. The result is a widening of the balance-of-trade deficit to $484 billion in 2002. Together with a projected federal deficit of over one-half trillion dollars over the next two years and an abysmally low savings rate of about two percent, the U.S. pressure on international capital markets will assume staggering levels.

The current dominance of the Neoliberal trade regime (emphasizing low wages, taxes, labor standards, public sector growth, and government regulation) ensures continued downward pressures on household income in the U.S. and throughout the world. As U.S. trade partners necessarily seek non-U.S. markets for expanded levels of production, including the expansion of their own domestic markets, it means that the future ability of the global economy to absorb higher levels of trade will become increasingly dependent on national and regional access to consumer credit. Indeed, U.S., British, and Japanese banks have taken the lead in initiating the global deregulation of consumer financial services through the General Agreement on Trade in Services (GATS) under the auspices of the World Trade Organization (WTO); over 90 countries are signatories to the GATS.

Clearly, the future growth of domestic and regional markets will depend upon greater access to consumer credit which will intensify competition for capital in international markets. The strategy of increasing national employment levels by encouraging domestic consumption will impinge on international capital markets in two ways. First, currency-rich countries like China and Japan will allocate more of their dollar reserves to domestic consumer loans such as credit cards. Second, countries with aggressive programs to increase their domestic consumer economies will be forced to sell asset-backed securities (credit card debt) in the international secondary markets that will compete with U.S. bank issues. The ill-fated attempt of Korea to accelerate the growth of its domestic consumer economy through the indiscriminate allocation of consumer credit cards in the early 2000s highlights the risks of this policy as well as the local-national-international linkages of credit card financed consumption. Furthermore, global banks such as Citigroup (branches in 103 countries) and HSBC are rapidly expanding their consumer lending operations throughout the world. This has already contributed to sharp increases in consumer debt levels and plummeting savings rates in European countries like Great Britain, Latin American countries such as Mexico, and Asian countries such as Korea.

Ultimately, the promotion of regressive corporate/personal tax rates and downward pressure on wages ensures that the U.S. cannot increase its current market share of international trade (imports). If other countries must resort to cultivating new export markets as well as their own internal consumer economies, one of the major foreign policy challenges of the next presidential administration will be to secure adequate levels of borrowing at relatively low finance rates. This, of course, will intensify pressure on financially distressed middle- and working class households to propel the U.S. economic expansion. In the absence of widespread job and wage-growth, the heavily indebted consumer will remain the key problematic and challenge to a sustained U.S. economic recovery.