Can the Consumer Keep it Up?

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What keeps the factories humming, the malls bustling, the shows running, the resorts flourishing, and the payrolls mushrooming? In a word, spending. It’s a tough job, but someone has to do it. And Americans do it well. Indeed, when it comes to spending, the U.S. is in a class by itself. The Great American Spending Machine has been working overtime since the early 1990s, and now some fear that a breakdown is imminent.

Why the concern? Economists cite two primary reasons why the current pace of consumption expenditure may not be sustainable in the near term (say, over the next two years). Both have to do with actual or potential changes in the status of household balance sheets. The first factor is what we will call the “stock market effect.” The second reason has to do with a sharp increase in household debt liabilities since 1993.

The propensity to spend is influenced by changes in the value of household wealth. For example, when people observe that the market value of their mutual fund holdings and 401(k) retirement plans are moving steadily higher, they are more inclined to spend lavishly for sport utility vehicles, consumer electronics, furniture, exotic vacations, home improvements, and the like. The stock market has been a reliable source of nourishment to consumer hubris throughout the decade (the Dow Jones Industrial Average crossed the 3,000 mark in July 1990--it was as high as 11,326 in August of this year). But has the bull market run its course? And if so, what are the implications for output and employment?

There are some respected voices (including Federal Reserve Chairman Alan Greenspan and members of the editorial board of the Economist magazine) who say that share prices in the U.S. have come unhinged from “fundamentals” (like earnings) and that a major market correction is inevitable. It is not a matter of if, only when (incidentally, the market slid by 11.5 percent between August 22 and October 15). If the bubble does burst, it might have a dampening effect on consumer spending. The potency of the stock market effect is likely to be magnified by the fact that a broader segment of households own corporate shares (either outright or indirectly through mutual funds, insurance policies, or pensions) today than at any time during the post-war era. On the other hand, recent experience indicates that consumers take a sanguine view about market corrections. The average opinion seems to be that dips in the market are not the end of the world, but rather just another buying opportunity.

A key factor undergirding the spending prowess of U.S. households in the 90s has been the wide availability of consumer credit. Standards for the issue of credit cards have been eased, and many have been inundated with “pre-approved” credit card solicitations. Giant banks like Citicorp are
frantically rushing to grab the fat profit margins offered by credit card receivables, and in the
process have turned consumer lending into a primary line of business. Commercials that offer
home equity loans at the other end of an 800 number are a frequent annoyance to TV viewers.
The widened availability of credit has stimulated aggregate consumption by augmenting the
spending power of lower and middle-income households (though I note that the data show that
even many upper income households are borrowing heavily these days).

The growth of consumer and mortgage debt outstanding in the current economic expansion has
been staggering. Total consumer credit outstanding (credit card accounts and installment loans)
increased by 71 percent (or $557.6 billion) between April 1991 and May 1999. The surge in
installment and credit card borrowing has taken place alongside a protracted boom in residential
housing construction and strong sales of existing homes. As a result, mortgage debt owed by
households rose to $5.1 trillion in March 1999 from $3.2 trillion six years earlier.

A build-up of debt on household balance sheets is not terribly worrisome (that is, from a
macroeconomic perspective) so long as the percent of income claimed by debt servicing remains
roughly constant from one period to the next. A sharp increase in the share of income allocated to
debt servicing raises a red flag for economists. It signals that the economy is approaching a “debt
threshold”—that is, a point at which many households can no longer afford to borrow to finance
their spending.

My estimates indicate that, even if you make pessimistic assumptions about the trend of interest
rates and income growth for the years 2000 and 2001, the percent of total after-tax income
required to meet the minimum payment of interest and principal stipulated in consumer and
mortgage debt contracts will increase only slightly (from 20.3 to 22.8 percent). These numbers
are misleading, however, since middle and lower income households typically have more debt
relative to income that high income households. Hence, even a slight increase in the aggregate
ratio of debt service to income over the next two years will be sufficient to push a sizable number
of households to the point of financial distress—with negative consequences for spending.