

Monetary Trends



Is Household Debt Too High?

American households' credit-market debt—mainly first and second mortgages, credit-card borrowings and auto loans—reached nearly 81 percent of personal income in the second quarter of 1998. The solid line in the figure below shows that the debt-to-income ratio of the household sector rose by about two percentage points per year between 1953 and 1965 and again between 1984 and 1998. The intervening 19-year period showed no net growth in the debt ratio.

Why might household debt grow faster than income? If households were becoming younger on average, one might expect the debt-to-current income ratio to rise as spending on education, durable goods or housing temporarily outstripped earnings. Young adults (ages 20-39) were, however, a *declining* proportion of the adult working-age population (ages 20-64) during both of the rising-debt periods noted above. This casts doubt on a conventional life-cycle explanation of the two extended surges of household borrowing in the post-war era.

Another potential explanation for rising debt ratios is that households may borrow more for current consumption purposes when their wealth rises rapidly. In fact, household net worth (the value of stocks, bonds, houses, insurance policies, etc., minus total debt) did rise strongly relative to income during the 1950s and early 1960s and again during much of the 1980s and 1990s.

The rapid increase in household debt in the 1980s and 1990s is worrisome for at least two reasons. First, the household debt ratio is higher than it has ever been before. Thus, households are committed to an unprecedented level of debt service in the future, whether expectations of higher income growth materialize or not.

The second unique aspect is that this rise has occurred while interest rates are relatively high. In contrast to earlier periods, the rate of household income

growth has been lower than the level of consumer interest rates throughout the 1980s and 1990s. The broken line in the figure shows the difference between four-quarter growth of personal income and the average effective rate on new home mortgages (a proxy for the cost of household borrowing, observed at the beginning of each four-quarter span). Income growth exceeded the level of the mortgage rate by about one percentage point on average between 1950 and 1979. From 1980 through 1997, on the other hand, actual four-quarter personal income growth averaged more than four percentage points *less* than the effective mortgage rate.

Thus, a critical question for many households has become: “Will our income growth accelerate enough to stay ahead of our rapidly compounding debt?” Rising asset prices may give households the confidence to borrow heavily against future income growth, but we cannot, in the aggregate, consume capital gains. Only rapidly rising future household incomes themselves—wages, salaries, dividends and interest—can service the debt households have accumulated.

—William R. Emmons

