

ECONOMICS: US PERSPECTIVES—JUNE 25, 2010

US Households Continue to Reduce Debt Burdens and Boost Liquidity

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Although the deleveraging process still has a long way to go, households are visibly in much better financial shape today than before the recession. We believe these improvements will help sustain modest consumer spending growth as the year unfolds.

Households have made plenty of progress in reducing their financial obligations over the past 18 months, while simultaneously freeing up cash. Although many US households still face financial stress on their personal balance sheets, marked improvements in the aggregate debt and liquidity position of US households have reduced the risk of a sharp pullback in consumer spending.

Of course, consumer psychology was jarred by the economic and financial crisis and Americans are still cautious about spending. But in our view, fragile consumer sentiment is counterbalanced by lower household financial payments and more liquidity, which will support moderate growth in consumer spending in the months ahead.

During the first quarter, the household financial obligation ratio, which measures debt and other obligatory financial payments as a percentage of disposable income, fell 0.3 percentage points to 17.4%, the fifth consecutive quarterly decline and the lowest reading since

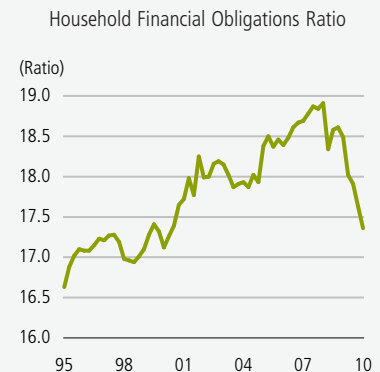
mid-2000 (**Display 1**). From its peak in the first quarter of 2008, the household financial obligation has dropped by a record 1.6 percentage points.

Deleveraging Likely to Persist

Still, US households are not out of the woods just yet. While the record pace of deleveraging is a welcome development, households have only lowered the financial obligation ratio to its historical average level. History shows that households swing from long cycles of borrowing to long cycles of deleveraging. This suggests that although the decline in financial obligations has been relatively large so far, momentum for further debt reduction is likely to persist.

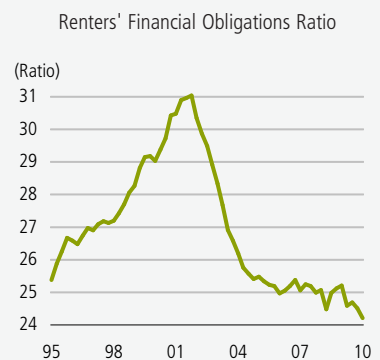
Financial obligations are not uniform across households. The Federal Reserve Board splits the household financial obligation ratio into two groups, one for homeowner households, and another for renters. Renters tend to have higher obligation ratios of about 25% because they have significantly lower income levels, so their financial obligations absorb a

Display 1
Record Drop in Financial Burden



Source: Federal Reserve Board and Haver Analytics

Display 2
Sharp Drop in Renters' Financial Payments



Source: Federal Reserve Board and Haver Analytics

much larger share of disposable income. In the first quarter, the financial obligation ratio of renters fell 0.3 percentage points to 24.2%, the lowest since the early 1990s (**Display 2, previous page**).

Meanwhile, financial obligations for the homeowners have also fallen, but at a more moderate pace, due to the heavy burden of mortgage debt accumulated in recent years as well as institutional delays in the loan modification and foreclosure process. The financial obligation ratio for homeowners was 15.9% in the first quarter (**Display 3**), down 0.3 points from the fourth quarter of 2009, and the lowest ratio since 2002.

Homeowners have benefited from a sharp drop in non-mortgage financial payments, as consumer credit contracted and interest payments declined by \$60 billion over the past three years. Indeed, the non-mortgage financial payments ratio for homeowning households fell to 5.4% in the first quarter, the lowest reading since the mid-1990s (**Display 4**).

The financial obligation ratio of mortgages to disposable income was 10.52% in the first quarter, off 0.13 percentage points from the previous quarter, and back to levels last seen in early 2006 (**Display 5**). The entire decline is explained by the \$50 billion drop in mortgage interest payments from its peak in early 2008.

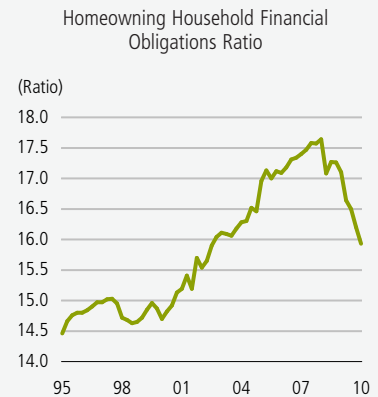
Based on our estimates, mortgage payments have been fairly constant in recent quarters, despite the substantial loan modification and foreclosures that are reportedly underway. In fact, there is often a considerable lag from the point when a homeowner defaults on a mortgage and when the bank takes possession of the property. Eventually, all homes that flow through the foreclosure process will reappear on the household balance sheet. However, with distressed property discounts of at least 40% to 50%, the overall debt levels of households will decline along with financial obligation payments.

More Adjustments to Come

The bottom line is that households have been very responsive in restoring debt and liquidity positions to more tolerable levels. Deleveraging is always a painful process, but the adjustment has proceeded faster than we had expected, especially given the environment of very weak income growth, which makes it much harder for people to shake off debt.

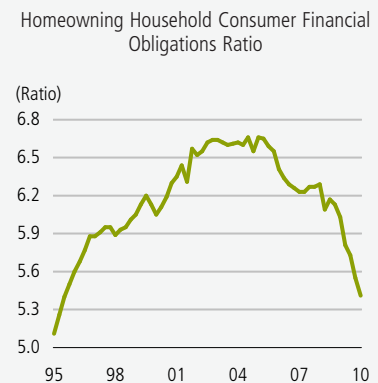
Although this process still has a long way to go, households are visibly in much better financial shape today than when the recession exposed the dangerous degree of US personal debt. We believe these improvements offer hope that incremental flows from job and wage growth, as labor markets slowly improve, should help sustain a modest consumer spending growth rate of about 2.5% in 2010 and 2011. ■

Display 3
Homeowners Debt Burden Drops...



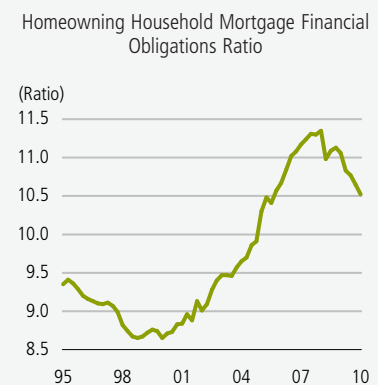
Source: Federal Reserve Board and Haver Analytics

Display 4
...amid Sharp Fall in Non-Mortgage Debt Burden...



Source: Federal Reserve Board and Haver Analytics

Display 5
...and Slower Decline in Mortgage Burden



Source: Federal Reserve Board and Haver Analytics

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