Household debt burden: how heavy is it?

Households have borrowed at an unprecedented pace in the past two years. Total household debt—instalment, noninstalment, and mortgage—jumped by more than 35 percent or $290 billion. With the heady growth of borrowing outpacing the advance of income, indebtedness relative to spendable income has risen to its highest level in the postwar period.

The borrowing binge in perspective

Consumer spending has played a key role in spurring the economic advance. In the past two years this spending has been financed by a step-up in consumer borrowing. Led by a surge in home mortgage borrowing in 1977, households have assumed debt at an exceptionally fast rate. During 1977 and 1978, mortgage indebtedness rose by about $200 billion while instalment debt grew about $80 billion and noninstalment debt increased by $10 billion (upper panel of Chart 1). By the end of 1978, the ratio of debt outstanding to disposable personal income stood at an all-time high of 70.8 percent.

This higher level of indebtedness and higher interest rates have caused debt servicing requirements, *i.e.,* debt repayments for principal and interest, to advance also. To some extent, these increases have been moderated by the lengthening maturity on most kinds of debt. A notable example is the lengthened maturity of automobile loans. While in the past new-car financing was limited predominantly to three years, these loan maturities have been extended to four years and, in some cases, to as long as five years. As a consequence, the average maturity of automobile loans by finance companies has increased by close to 11 percent between 1976 and 1978, from thirty-nine months to forty-three months. Even with the longer loan maturities, however, repayments rose relative to income during the past two years. In 1978, instalment and mortgage debt repayments reached a historic peak of 20.9 percent of disposable personal income (bottom panel of Chart 1).[1] While repayments slowed relative to disposable personal income in the closing months of 1978 and the first three months of 1979, the ratio of repayments to income remains high as compared with past levels.[2]

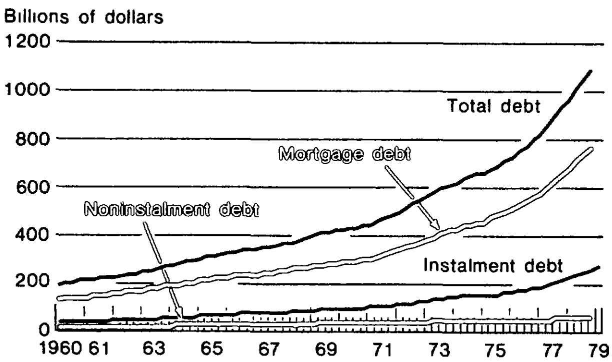
Despite the very high levels of debt and repayments, there is little direct evidence that households have had difficulty repaying loans. The delinquency rate—the percentage of instalment loans past due thirty days or more—on most categories of commercial bank loans was essentially flat in 1978 and remained well below the levels associated with the 1974-75 recession. The delinquency rate on bank credit card debt, which had climbed sharply from 1.8 percent in December 1977 to 2.6 percent at the end of 1978, fell back to a much lower 2 percent level by March of this year, substantially below the levels attained in prior years. Similarly, while the personal bankruptcy rate—the number of personal bankruptcies per 100,000 people of age 20 or more—rose during 1978, it eased a bit in the first quarter of 1979 In any event, in the past three years

[1] For purposes of historical comparison, the debt repayment figures used here do not incorporate the most recent revisions The most important change was the reclassification of gasoline credit card debt from noninstalment to instalment debt Data reflecting these revisions begin only in 1970 With the revised data, debt repayments attained a historic peak of 23 percent of disposable personal income in the third quarter of 1978

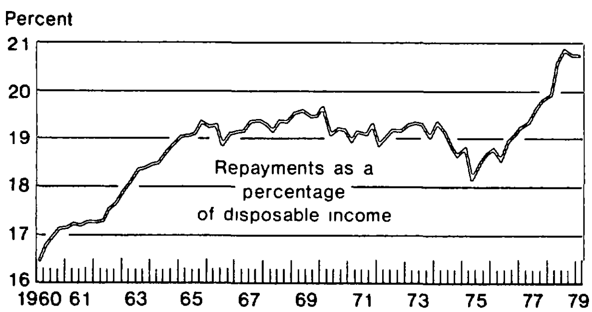
[2] Repayments may better indicate than debt itself whether households are overextended The repayments represent the prior claim on income that borrowing eventually entails The smaller the fraction of income that must be devoted periodically to paying back the loans, the greater the ability to carry a particular level of debt

Chart 1

Household indebtedness has risen to an all-time high . . .



. . . propelling repayments to historically high levels relative to disposable personal income.



Sources United States Department of Commerce and Board of Governors of the Federal Reserve System

the bankruptcy rate has been comparable to its level in the early 1970's.

An important explanation why households have experienced little difficulty repaying debt obviously rests with the continued growth of income and employment. Another explanation is that consumers have sizable assets to fall back upon in the event their incomes are disrupted. While debt reached a historic peak in 1978 at close to 30 percent of financial assets, higher than its levels of about 20 percent in the 1960's, in recent years a substantial fraction of these assets have been held in highly "liquid" forms such as money market mutual funds or time deposits. The ease with which assets can be turned into cash is an important factor in assessing the ability of households to repay debt in the event of a disruption in income. Relative to liquid assets, debt last year remained within the bounds attained in the 1960's.[3]

Why has indebtedness surged?

Part of the burgeoning growth of household indebtedness reflects the advanced stage of the business cycle. In periods of economic expansion, debt normally rises more rapidly than income In the current expansion, the sharp acceleration in the inflation rate has played a direct role in encouraging households to assume debt. Debt repayments are fixed in dollar terms. During inflationary periods individuals expect these repayments to become easier to manage over time as their incomes rise with inflation. Moreover, in recent years interest rates on consumer loans have failed to rise as rapidly as inflation. Consequently, after taking into account the expected inflation rate, the cost of borrowing on many kinds of instalment and home mortgage debt has declined and, in some cases, turned negative.

During the current business expansion, the growth of indebtedness has been stimulated by several developments that facilitate the reliance of households on debt to finance purchases A major factor contributing to this growth has been the continued aggressive marketing by commercial banks and other financial institutions to enlarge their shares of the consumer loan market. The expansion of preauthorized credit lines for consumers—through credit cards and overdraft facilities, etc.—has made it much more convenient for consumers to use credit. At the same time, the lengthening of loan maturities, by lowering the periodic debt servicing requirements, also has served to ease the assumption of debt. Another development that facilitated the use of credit was the introduction of six-month money market certificates in mid-1978 These instruments bolstered deposit flows at thrift institutions and commercial banks, increasing the availability of funds for home mortgages and other kinds of loans.

The introduction of the six-month certificates lent particular support to the growth of home mortgages. The upsurge in mortgages and their repayments reflected in part escalating home prices and higher mortgage interest rates These greater purchasing costs have been reflected to a substantial extent in the outstanding stock of mortgages and their repayments because of the high level of new home construction and record sales of existing homes Households have turned increasingly to home ownership as a hedge against inflation.

Whatever the complex factors encouraging consumer borrowing, the debt- and repayments-to-income ratios

[3] Liquid assets are defined here as demand deposits and currency, time and savings accounts, and money market fund shares

indicate that households apparently are heavily burdened with debt. At the same time, however, a host of other factors—including changes in the distribution of debt across the population—suggests that the indebtedness of households, while still a source of concern, is less ominous than appears at first glance.

The distribution of debt

The debt- and repayments-to-income ratios used to characterize the debt position of households cover all households. As a consequence, they fail to take account of the distribution of debt or debt repayments across households Both mortgage and instalment indebtedness appears to be more broadly distributed among the population than in the past. In particular, the percentage of households holding home mortgages is estimated to have risen significantly between the 1960's and 1977 (upper panel of Chart 2). The distribution of instalment debt has also broadened, but to a lesser extent. Much of the wider ownership of indebtedness is the result of a greater fraction of households in most age categories assuming debt now than in the past. Only a small part of the increased ownership reflects a compositional shift in the population toward younger families, those which are likely to be more heavily in debt than other age households

Weighting disposable income by the percentage of households with debt makes allowance for the broader ownership of indebtedness. After making this allowance, the ratio of *debt to income* in 1978 still is high but below its previous peak When the *repayments-to-income* ratio is adjusted for the percentage of households with instalment and mortgage debt, the adjusted ratio in 1978 is at a historic peak although it is close to its level in the late 1960's and early 1970's On a per household with debt basis, then, debt and repayments relative to income appear to be closer to historical experience than suggested by the aggregate ratios.

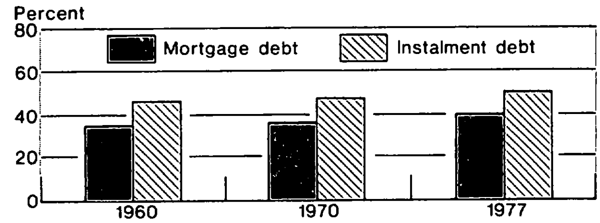
Another demographic development that bears on the increased indebtedness of households is the growing number of families with both spouses working. Two-worker families may find debt less risky to carry because both spouses are unlikely to experience work disruptions such as sickness or unemployment at the same time In contrast, many of the second workers probably are new to the labor force and may be prone to layoffs in the event of an economic downturn.

The wider distribution of debt and other demographic developments help explain part of the increase in the debt and repayments ratios Other factors point to a somewhat lighter burden than that implied by the aggregate ratios. Among these are the role of credit cards and the tax system.

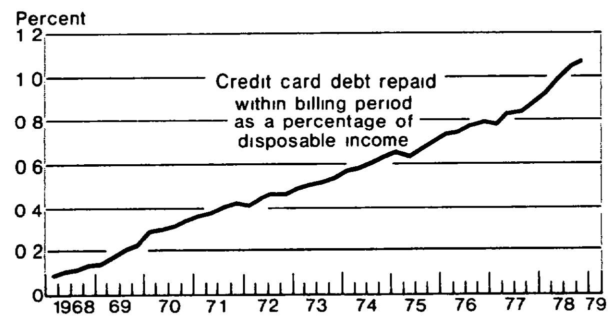
Chart 2

The burden of carrying the debt is not extraordinarily heavy . . .

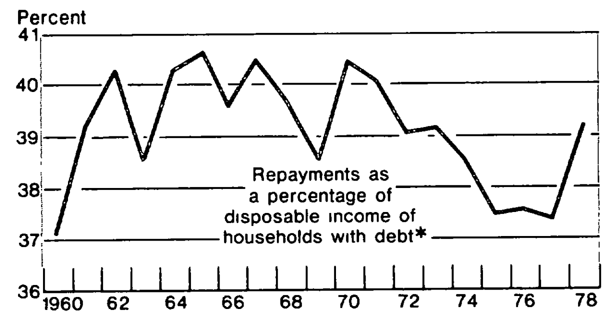
. . . as a higher percentage of households hold debt . . .



. . . and close to 40 percent of the credit card debt is repaid within the billing period.



Taking into account these and other factors, repayments relative to income are similar to earlier levels.



* Federal Reserve Bank of New York adjustments for "on time" credit card payments, the tax subsidy on mortgage interest payments, the percentage of households with debt, realized capital gains, and automobile lease payments

Sources United States Department of Commerce, Internal Revenue Service, Statistics of Income, Federal Budget, United States Census Bureau, Board of Governors of the Federal Reserve System, and Federal Reserve Bank of New York

Credit cards

The increase in indebtedness and repayments has been exaggerated by the growing use of credit cards. For instance, by one estimate, between 1970 and 1978 the number of active bank credit card accounts more than tripled from 15 million to 47 million. All credit card purchases are counted as extensions of debt, and their repayments as debt liquidations. The expanded use of credit cards has contributed to the rise in the repayments ratio.

To the extent that consumers make purchases with credit cards and then pay for the purchases on an instalment basis, the outstanding balance on cards should be counted as indebtedness. However, for many consumers, credit cards serve only as a substitute for cash. For them, credit cards act as a convenient method of payment, where the outstanding credit card balance is paid in full during the billing period. With respect to bank credit cards, the fastest growing form of credit cards, such "on-time" payments are estimated on the basis of trade information to be about 40 percent of the repayments Their inclusion in the repayments ratio biases this ratio upward as a measure of debt burden (middle panel of Chart 2) If these payments are excluded from the repayments-to-income ratio, the advance of the ratio during the past two years is pared by about a fifth.

Tax incentives

Debtors who itemize deductions in calculating income taxes receive a tax break because interest payments can be itemized as a deduction in arriving at taxable income The deduction reduces taxable income which in turn lowers taxes To be sure, this tax savings is reflected in the debt- and repayments-to-income ratios through disposable income, their denominators. Disposable income is personal income net of taxes and therefore is higher as a result of the tax savings realized on interest deductions. However, because the tax savings are small relative to disposable income, increases in the tax savings affect the ratios to a lesser extent than the corresponding increases in interest payments. Thus, the ratios do not reflect accurately the aftertax indebtedness burden. An accurate measurement of the burden requires that the tax savings be subtracted from the debt repayments. After this adjustment, the repayments-to-income ratio rises somewhat more slowly during this economic expansion.

Other factors

A complete picture of the indebtedness of households should include several factors not represented in the conventionally defined debt- and repayments-to-income ratios. One such factor is the availability of capital gains to repay debt. In particular, because the ratios emphasize a "cash flow" approach to representing income, "realized" capital gains—those gains which are converted into money—should be included in the ratios as a part of income Another factor that should be represented in the ratios is leasing, which has become an increasingly popular method for individuals to acquire the use of an automobile. The contractual lease payments represent a prior claim on income in much the same way as do automobile loan repayments and thus should be added to debt repayments to get a better measure of consumers' obligations. The inclusion of lease payments and realized capital gains have small effects on the debt- and repayments-to-income ratios and tend to offset each other.

Conclusion

How heavy a burden is the indebtedness of households? The debt-to-income ratio remains high but below its previous peak when the factors discussed above are taken into account. Moreover, much of the indebtedness, particularly home mortgages, is offset by assets in the balance sheets of consumers. For such debt, households may be concerned more about the required repayments than the size of the outstanding indebtedness

The burden of repaying debt is considerably less onerous than the standard ratios indicate. Adjusting the repayments-to-income ratio for the percentage of households with debt, "on time" credit card payments, and the other factors discussed here, the adjusted ratio in 1978 is within the range experienced in the 1960's and early 1970's (lower panel of Chart 2). This suggests that the financial position of households is less precarious than suggested by the conventional indebtedness measures. Nevertheless, in the event of an economic downturn the burden of indebtedness is likely to worsen as income and the value of assets decline. Indeed, in such circumstances the incidences of loan delinquencies and personal bankruptcies are likely to increase. As a consequence, the financial condition of households should continue to receive close attention.

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