Consumer debt on the rise

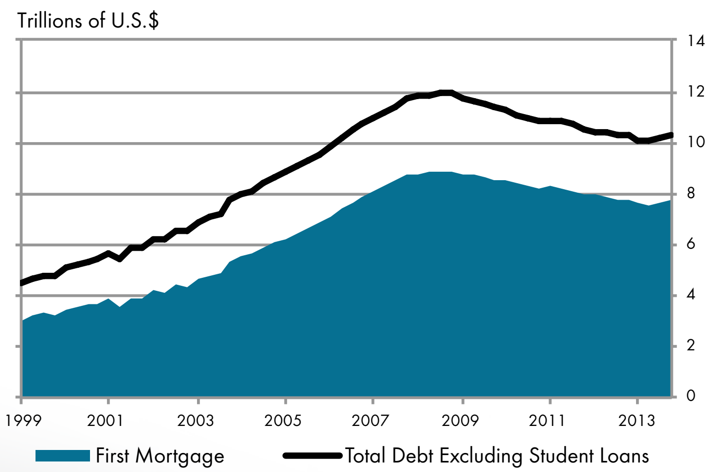
The dynamics behind the numbers

When economic conditions worsened in 2007, Americans' grip on their wallets tightened. In addition to cutting spending, consumers also paid down existing debt or simply lacked the means to take on additional debt. Some defaulted on existing credit obligations.

This shift, which began in mid-2008, resulted in a five-year downward trend in consumer debt. Now it looks like that trend has reversed as consumers are spending again and accumulating more debt.

According to Federal Reserve Bank of Kansas City Assistant Economist John Carter Braxton and Research Director Troy Davig, consumer debt increased for two consecutive quarters, rising by nearly $300 billion in the second half of 2013.

CONSUMER DEBT



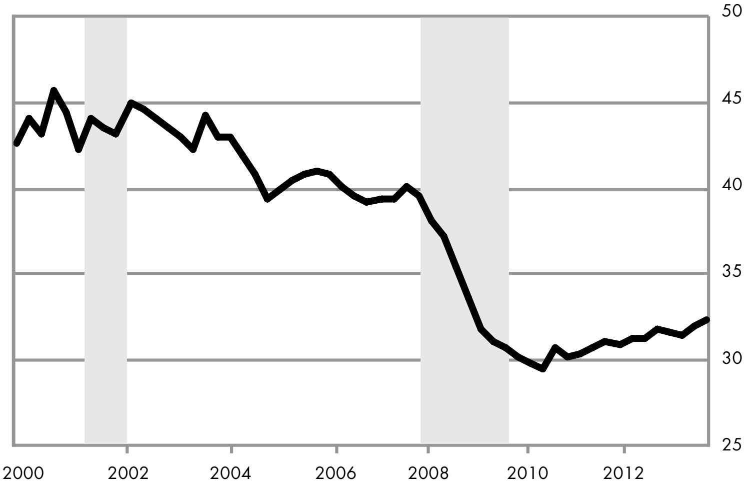
The increase indicates some individuals have repaired their finances—at least in the aggregate—since the crisis and feel like they can borrow again. And although financial advisers often warn of the dangers of debt, consumer spending is necessary for economic growth and accounts for 70 percent of the economy. But there is good debt and there is bad debt.

Borrowing by credit-worthy households to buy a long-lived asset, such as a house or an automobile, is often beneficial to borrowers, lenders and the broader economy, according to Braxton and Davig's recent research, *Consumer Debt Dynamics: An Update.*

There are instances though, when credit standards slide, allowing consumers to accumulate more debt than they can handle. Although consumer debt produces great economic growth, it usually ends in disruption when done by uncreditworthy borrowers. A worst case scenario is the Great Recession.

Determining when credit growth accelerates beyond what supports longer-run, sustainable economic growth is a challenge for policymakers. A valuable resource for tracking consumer credit trends is the Federal Reserve Bank of New York's Consumer Credit Panel. The panel is a nationally representative sample of individual credit records maintained by Equifax that follows the same consumers quarter by quarter.

PERCENTAGE OF CONSUMERS INCREASING DEBT RELATIVE TO YEAR EARLIER

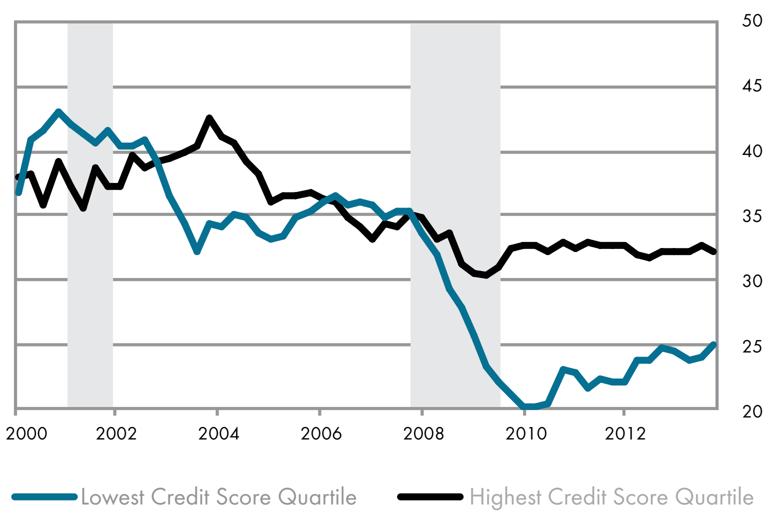


Gray bars denote NBER recession dates.

According to the data, the percentage of consumers that increased debt relative to a year earlier was between 40 percent and 45 percent before the crises. That number fell to about 30 percent in 2009. The percentage of consumers accumulating new debt at the end of 2013, however, was well below pre-crisis numbers.

The percentage of increasers is a useful tool for analyzing overall conditions, but it doesn't distinguish between consumers with high credit scores and low credit scores.

PERCENTAGE OF CONSUMERS INCREASING DEBT RELATIVE TO YEAR EARLIER, BY CREDIT QUARTILE



Gray bars denote NBER recession dates.

Braxton and Davig delved deeper into the data and found that a larger share of consumers with low credit scores recently increased outstanding debt while there was little change in the percentage of consumers with the highest credit scores who took on more debt.

This doesn't mean low-credit-score consumers are outspending consumers with high credit scores. On average, consumers with high credit scores, who increase their debt, do so by larger dollar amounts than consumers with low credit scores, Braxton said.

Consumers with low credit scores are largely increasing debt through automobile loans. The consumers borrowing for automobile loans increased from 7 percent in the third quarter of 2010 to nearly 12 percent in the fourth quarter of 2013.

Low-credit-score consumers also modestly increased credit card debt and consumer finance and retail borrowing during the same period. Mortgage debt, however, continued to decline for consumers with the lowest credit scores.

The bottom line, Braxton and Davig said, is that consumers with high credit scores remain cautious about taking on additional debt.

What the data does not precisely take into account is student loan debt. Unlike private loans, the federal government issues a majority of student loan debt–75 percent–and it does so without factoring in repayment risks or monetary values of students' degrees.

Delinquency rates on student loans, while slightly higher than home mortgage delinquency rates, are unequal in one important way: borrowers cannot seek bankruptcy protection from the debt under federal law. And chronic delinquencies can lead to wage garnishment, tax refund interception, the inability to borrow and other financial consequences.

Although average student loan debt has increased, the increase in total outstanding debt, $1 trillion in 2013, has come largely from an increased number of borrowers. Some economists consider student loan debt a human capital investment that will increase a person's net worth in the labor market and help the economy in the future.

But personal debt is different. Banks provide credit to consumers and businesses that can pay back loans. The federal student loan program directs funds based on need and desire.

If student loans make up a majority of rising personal debt burden, some economists think it could raise concerns for the U.S. economy in the long run.

Kevin Wright, Editor

FURTHER RESOURCES

"Consumer Debt Dynamics: An Update"
By John Carter Braxton and Troy Davig
http://www.kansascityfed.org/publicat/research/macrobulletins/mb14Braxton_Davig0218.pdf