James McAndrews: The economy and the household debt and credit report

Remarks by Mr James McAndrews, Executive Vice President and Director of Research of the Federal Reserve Bank of New York, at the household debt and credit press briefing, New York City, 28 February 2013.

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Good morning and welcome to the New York Fed. I am pleased to have this opportunity to talk with you about some of the exciting research we are doing here at the Bank. This morning my remarks will focus on national economic conditions and then I will introduce our special presentation today on household debt and credit conditions. What I have to say reflects my own views and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.

National economic conditions

It has been three and one half years since the end of the "Great Recession." But, the pace of this expansion so far remains very sluggish compared with previous post-World War II business cycles: the level of real gross domestic product (GDP) in the fourth quarter of 2012 was only around 2½ percent above its previous peak in the fourth quarter of 2007. To put this into perspective, at this point in time following recessions in 1973, 1981, 1990 and 2001, the level of real GDP ranged from 14 percent to 18 percent above the previous cyclical peak. After falling by 3.1 percent in 2009, growth in real GDP averaged 2.4 percent in 2010, 1.8 percent in 2011 and 2.2 percent in 2012, a consistent but sluggish pace.

This sluggishness has been quite evident in the labor market. After falling by 421,000 per month in 2009, payroll employment grew by 85,000 per month in 2010, 175,000 per month in 2011, and 181,000 in 2012. To put these numbers in perspective, the trend rate of growth of the civilian non-institutional population is around 200,000 per month. The unemployment rate has declined from a peak of 10 percent in October of 2009 to just under 8 percent recently, due largely to the fact that the labor force participation rate has declined by considerably more than would be suggested by underlying demographic trends. Fortunately, long-term unemployment, defined as those unemployed for 15 weeks or longer, has declined from nearly 9 million in the first quarter of 2010 to about 6.6 million in recent months – a decline of 28 percent. The median duration of unemployment has declined from 23 weeks in the second quarter of 2010 to 16 weeks recently.

Nonetheless, as of January there were still about 3.2 million fewer jobs than at the end of 2007. The unemployment rate remains elevated, despite a significant decline of the labor force participation rate. And the ratio of employment to population in January was lower than it was at the end of the recession, indicating that employment growth has not kept pace with population growth.

Since the end of the Great Recession, overall inflation has averaged near the 2 percent longer-run objective of the FOMC. The rate of overall inflation in each of the past few years has been somewhat variable, reflecting sharp swings in energy and commodity prices that largely have been driven by conditions outside of the United States. While swings in commodity prices can cause fluctuations in expenditures for consumers that can be difficult for them to manage, these swings tend to be transitory and self-correcting. For these reasons, most economists prefer to gauge underlying inflation pressures by monitoring movements in prices that are less transitory. These include, but are not limited to, the core measures of inflation that exclude food and energy components. Based on the personal consumption expenditures deflator, or PCE, measure of consumer price inflation, which is more comprehensive than the more widely known consumer price index, or CPI measure,

the core inflation rate was 1.4 percent over the 12 months through December, below the 2 percent level that the Federal Open Market Committee (FOMC) has stated as its inflation objective, consistent with its mandate of price stability. The latest CPI indicates that inflation remained similarly subdued in January. Measures of longer-term inflation expectations have remained stable.

Sluggish improvement in labor market conditions, subdued inflation, and well-anchored inflation expectations, were noted as the primary factors underlying the FOMC's decision, at its January meeting, to continue to pursue a "highly accommodative" policy stance. That stance combines an exceptionally low policy interest rate – the federal funds rate in a range of 0 to 25 basis points – with forward guidance indicating that this range would be appropriate at least as long as the unemployment rate remains above 6½ percent, inflation is projected to be no more than 2½ percent between one and two years in the future, and inflation expectations remain well anchored. Moreover, to support a stronger economic recovery, the FOMC is purchasing Treasury securities at a rate of $45 billion per month and agency mortgage-backed securities (MBS) at a rate of $40 billion per month, and has stated its intention to continue purchasing assets until it sees substantial improvement in the outlook for the labor market, conditional on ongoing assessment of benefits and costs. Combined, these actions are intended to ease financial conditions and thereby help to establish a self-sustaining economic expansion.

Turning to recent developments, incoming data on the U.S. economy have been mixed of late. Based on the advance estimate, real GDP declined slightly in the final quarter of 2012, which was below the consensus expectations of an increase of around one percent. In addition, in January payroll employment rose by just 157,000, below the 200,000 average monthly gain in the fourth quarter, and the unemployment rate edged up to 7.9 percent.

Offsetting these soft indicators, we see evidence beneath the surface that private demand firmed in the final months of 2012 and has been reasonably well maintained thus far this year. Taking into account price changes, the January retail sales data were reasonably strong. Consumer spending, particularly for durable goods such as motor vehicles, has clearly strengthened. Light-weight motor vehicle sales in January were well above the average pace of the first quarter of 2012. This stronger durable goods spending reflects some improvements in labor market conditions, consumer confidence, household balance sheets and access to credit.

Another major plus for the economy entering 2013 is the housing market, with upward trends evident in housing starts, home sales and home prices. To see why this is so important, in 2009 residential investment was a 0.4 percentage point drag on growth of GDP, while in 2013 it is likely to provide a boost to growth on the order of 0.5 percentage point – a swing of nearly a full percentage point. Business investment in equipment and software, another component of private final demand, strengthened in the fourth quarter, and orders for nondefense capital goods have moved higher in recent months. Indicators of the U.S. manufacturing sector have begun to look a bit brighter as well, with the ISM manufacturing index at its highest level since last April. Survey-based indicators of manufacturing activity also have begun to improve in several other major economies around the world.

Of course the quickening pace of auto, home, and capital goods sales and orders, all interest-sensitive goods, is consistent with the highly accommodative stance of monetary policy, which not only lowers interest rates but enhances credit availability as well.

Along with these positive economic developments, there has been a notable increase in risk appetite among financial market participants over recent months, although there was some pull-back and volatility this week following the election results in Italy. From their recent lows in mid-November, equity prices in the United States are up around 10 percent. Credit spreads also have narrowed. Clearly, a perceived decline of downside risks has contributed to the improved tone in financial markets. Notably, in the United States the full fiscal cliff was avoided and the risk of a debt ceiling crisis has been taken off the table at least for the next

few months. In addition, the market showed greater confidence in the policy responses to the Euro area fiscal and banking crisis, although policy challenges remain. Overall, while still tentative, I see signs of reduced headwinds and possibly greater monetary policy traction.

However, several factors lead us to remain cautious about the outlook. First, in the past three years enthusiasm at the beginning of the year has given way to gloom by midyear. Second, households are still adjusting to increased tax burdens that began on January 1, which reduces disposable incomes significantly for many households. It remains to be seen what the split between lower household spending and lower saving will be, but we currently anticipate that consumer spending will weaken some in this quarter. Indeed, anecdotal reports suggest that consumer spending during the month of February was adversely affected by the increase in taxes. Third, while we avoided the full fiscal cliff back in early January, there remain several vexing fiscal policy issues on the immediate horizon that, depending on how they are resolved, could adversely affect the economy. Indeed, at this time it looks like the sequester will go into effect on March 1. If it remains in effect for the full year, estimates from forecasters suggest that the sequester could reduce projected real GDP growth for 2013 by about ½ percentage point, which would be on top of the ¾ to 1 percentage point drag coming from already-implemented fiscal policy actions.

Presentations on household debt and credit

Our special topic today is household debt and credit. Over the last several years, researchers at the New York Fed have put considerable effort into improving public understanding of consumer debt and credit conditions. Consumer debts occupy the intersection of Main and Wall Streets, and are thus of great interest to the public. In addition, of course, by most accounts the financial crisis grew out of the mortgage market – the largest and most important form of consumer debt. So to better inform the public and policymakers, New York Fed economists have developed a series of quarterly reports and topical studies on consumer debts.

We will have two presentations. In the first, Wilbert van der Klaauw will provide an overview of fourth quarter and full year 2012 developments in household debt and credit; much of what Wilbert will describe is covered in our Quarterly Report on Household Debt and Credit. The quarterly report has documented the enormous rise in consumer delinquencies and defaults as the housing bust and the Great Recession unfolded, and, over the last several years has provided an in-depth look at a very large reduction in household debt – the largest we have ever witnessed. Since the third quarter of 2008, its peak, household debt has fallen by $1.3 trillion – about 10 percent – mostly because of declining mortgage balances.

This morning we are releasing our latest quarterly report – for the fourth quarter of 2012. The report shows some clear signs of healing in consumer debt markets. First, and perhaps most interesting, the data indicate that the recent improvement in the housing market was accompanied by a slight increase in the level of household debt. While it is too soon to conclude that a trend has been established in which households are beginning to increase their debts again, there are signs that the four-year long contraction is slowing. Consumer delinquency rates continue to slowly recover as well, with overall delinquency rates now back to pre-recession levels – around 8½ percent – but still well above the 3–5 percent rates that prevailed in the first half of the 2000s.

During this long period of consumer retrenchment, only one form of consumer borrowing – student loans – consistently grew, and educational debt has now become the largest form of consumer debt, after mortgages. Student loans are widely held – roughly 39 million people have student loans, including a third of people in their 20s and 30s. For many of these families, educational debt is the tool that allows them to obtain higher education in spite of its large up-front cost. And higher education is, of course, the key to higher wages and a better standard of living. Nonetheless, student loans are not well measured or widely understood.

In the second presentation Donghoon Lee will describe the latest trends in the continuing growth in student loan debt and delinquencies, and their implications.

Thank you. I will now ask Wilbert to give an overview of developments in household debt and credit conditions.