William C Dudley: Remarks at the New York Fed's Economic Press Briefing on the Household Debt and Credit Report

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the New York Fed's Economic Press Briefing on the Household Debt and Credit Report, New York City, 12 February 2016.

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Domenico Giannone, Andrew Haughwout, Joseph Tracy and Wilbert van der Klaauw assisted in preparing these remarks.

Good morning and welcome to the Federal Reserve Bank of New York's Economic Press Briefing. I am pleased to have this opportunity to speak with you today about the economic outlook, with a focus on the household sector. As always, what I have to say reflects my own views and not necessarily those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.

According to the National Bureau of Economic Research, the current expansion began in July 2009, making it nearly seven years old. If we gathered this expansion and the 11 prior post-WWII expansions together for a family photograph, arranging them by age from youngest in front to oldest in back, this expansion would be standing third from the rear. The only two that lasted longer were the expansion that began in February of 1961, which lasted for nearly nine years, and the one that began in March of 1991, which lasted for ten years. Thus, the current expansion is already an elder statesman in the family of post-war U.S. expansions. This raises the question of whether this expansion has already entered its twilight years, with the risk of recession edging higher with each passing month.

As I have said before, expansions do not simply die of old age.[1] Rather, expansions end either because a significant inflation risk emerges that requires a sharp tightening of monetary policy, or the economy is adversely impacted by a large shock that cannot be offset by monetary policy in a timely manner. While the sample of post-war U.S. expansions is still too small for reliable statistical analysis, the evidence suggests that after an expansion's first few years its likelihood of ending is mostly independent of age, and depends mainly instead on the level of inflation. Since the possibility is low that a significant inflation risk would emerge over the near term, this means that the main danger facing the current expansion is the risk of large, adverse shocks.

Given that the labor market still appears to have some excess slack and inflation is below the Federal Reserve's objective, monetary policy is appropriately still quite accommodative despite the advancing age of the expansion. While this limits to an extent the degree to which monetary policy can aggressively respond to any adverse events, the good news is that the economy is more resilient to any shocks. Key sectors of the U.S. economy, such as the household sector, seem to be in good shape. The financial system is also clearly much stronger, with the banking system much better capitalized and with much larger liquidity buffers than in the years preceding the financial crisis.

In today's briefing, we will be focusing on the household sector. Given the importance of consumption to U.S. economic growth, the health of the household sector is critical for an assessment of risks to the outlook. Over the last several years we have devoted significant resources to better understanding the state of the household sector, and one outcome of this attention is our now well-known *Quarterly Report on Household Debt and Credit*. This report, and the data that underlie it, give us direct insight into the health of the household balance

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1 See William C. Dudley, ***The U.S. Economic Outlook and Implications for Monetary Policy***, Remarks at the Economic Leadership Forum, Somerset, New Jersey.

sheet. The assets and liabilities that families hold is a crucial determinant of the household sector's ability to help immunize the economy from shocks. We learned during the Great Recession the importance of household liabilities – in particular, mortgages, which make up more than two-thirds of the sector's total liabilities.

As you know, the early part of the 2000s witnessed a very substantial expansion in borrowing by households. This borrowing took many forms, but was particularly notable in mortgages and home equity lines of credit, and reflected the very high and unsustainable expectations of house price appreciation. Household debts peaked in 2008, at which point the sector's balance sheet was weak. Households were highly-leveraged, with many underwater on their mortgages. This was particularly the case for younger and lower- and middle-income households who, besides being more leveraged, were disproportionally affected by job loss and other income shocks, and had little experience managing debts – especially in times of stress. Consequently, delinquency, foreclosure and bankruptcy rates reached very high levels.

Beginning in 2008, households began a new phase to repair their balance sheets by paying down outstanding debt. During this "Great Deleveraging," which lasted five years, households reduced their overall liabilities by 12 percent or $1.5 trillion. House prices began to rise again in earnest in 2012, and by mid-2013 household deleveraging appeared to have come to an end. Net household borrowing resumed, and household debt has risen over 8 percent during the last couple of years. But, this recent period of credit expansion looks very different from the early 2000s, and I believe that the household sector today is in much better health. There are several reasons for my confidence.

Let me begin with the situation in the residential mortgage market, which plays such a dominant role in household finance and was such a problem the last time around. Currently, house price growth is running nationally at around 5 percent per year. But this time, households appear to be much more cautious in how they are responding to the rise in home values. Rather than borrowing against the rising equity in their homes, mortgage balances have instead essentially stabilized and remain well below their previous levels. As my colleagues will describe in more detail shortly, this stabilization reflects an increase in debt paydown due to a combination of lower interest rates, shorter loan terms and aging of mortgages. This trend is reflected in increased household saving and growing home equity, and we expect these trends to continue to help households rebuild their balance sheets over the near term, thereby further increasing the household sector's resiliency to shocks.

Low interest rates have also been important in driving the household debt service ratio to the lowest levels observed in our data. This means that households have more capacity with which to absorb any temporary adverse income shocks. One clear reflection of these improvements is the very significant decline in delinquency rates. At this point, the great majority of the bad debt from the boom years has been charged off and new foreclosures are at the lowest level we've seen in our data. The combination of charge-offs and tight mortgage underwriting standards over the last several years has shifted the stock of outstanding mortgage balances toward lower-risk borrowers, who are typically older with more stable incomes.

For all these reasons, the household sector looks much better positioned today than in 2008 to absorb shocks and continue to contribute to the economic expansion.

Now, before asking my colleagues to discuss some of these trends in more detail, let me note that my positive overview of the household sector comes with some caveats. First, these aggregate statistics can mask some important variations, and there are some local markets where, as in the prior boom, both house prices and mortgage growth are quite strong. Similarly, there exist substantial differences across households in their financial situation and their ability to improve their balance sheets. Borrowers with little equity, low credit scores and slow income growth face difficulties refinancing into low rate mortgages. As a result, this subset of the population has been less able to deleverage and still faces

relatively high debt service costs, which constrains their consumption, investment and saving behavior. So, even within what looks to be a stable overall mortgage market, there are some things that we must continue to monitor. Second, there are other difficult challenges that many households face, particularly with respect to a subject we've discussed on previous occasions – student loans. On balance, though, households are in a much better position today than they were in 2008. Now, I'd like to turn things over to our economists, beginning with Andrew Haughwout, who will provide a more detailed discussion of household sector finances.