An Update On The U.S. Debt Supercycle: Where Are We Now?

Until Debt Us Do Part

Major credit boom-bust cycles are highly destructive, leaving a debilitating legacy of weakened borrower and lender balance sheets, bruised consumer and business confidence, and impaired financial intermediation. The sluggish recovery in the U.S. economy is a testament to this reality and a key issue is timing when conditions will return to some degree of normality. The challenge in answering this important question is having a sense of what level of debt will represent a new equilibrium.

It is virtually impossible to identify a “normal” or “ideal” level of private sector debt. During the past six decades, private sector debt grew faster than nominal GDP in almost every non-recession year. As a result, the outstanding level of private debt rose from 53% of GDP in 1951 to a peak of 179% in 2007. It currently is still a lofty 159% (Chart 1). Debt levels – especially in the household sector – rose far beyond what could reasonably have been predicted. Indeed, as long ago as the 1960s, there already were concerns that consumer debt had reached dangerous levels.

When a rising trend has gone on for so long, there is tendency to extrapolate it into the future. However, it is not appropriate to assume that the household debt-to-income ratio will continue to trend higher in the future. There are good reasons why the ratio rose steadily throughout the post-WWII period:

- There was huge pent-up demand for housing and consumer durables after the war ended, leading to strong credit growth during the 1950s. Moreover, private sector debt burdens began the period at a very low level.

- The decline in interest rates from the extremely high levels of the early 1980s meant that borrowers could afford to carry more debt.

- Financial deregulation beginning in the 1980s, and innovations such as securitization, resulted in a general easing of credit conditions with banks becoming much more willing to lend.
The Federal Reserve was very tolerant of rapid credit growth and chose not to lean against what was obviously a growing housing bubble in the first half of the 2000s. Former Chairman Alan Greenspan had a particularly laissez-faire attitude in the misguided belief that markets would be self-policing with regard to credit overshoots.

The above tailwinds behind credit growth have largely ended. There may now be some pent-up demand for housing but consumer debt burdens remain elevated and the homeownership rate is not likely to return to earlier highs for the foreseeable future. Meanwhile, the financial regulatory pendulum has swung toward more vigilance, and constraints on lending imply that credit conditions will remain much tighter than in the past two decades. Finally, it seems reasonable to assume that consumer attitudes are no longer so complacent toward high debt levels. The destruction of so much housing wealth will likely have a lasting impact on consumer psychology.

In sum, the trend in the ratio of consumer debt to income is likely to be flat or even downward sloping in the years ahead. This suggests that deleveraging has a long way to go.

**Assessing The “Right” Amount Of Consumer Debt**

It is common to use the ratio of debt to income or to GDP as a measure of debt burdens. The assumption is that income or GDP are reasonable proxies of the ability to service the debt. However, this measure is open to some challenges. Specifically:

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**CHART 1**

**An Enormous Overshoot In Private Sector Debt**

<table>
<thead>
<tr>
<th>Year</th>
<th>Private Sector Debt</th>
<th>Household Debt</th>
<th>Business Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>1970</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>1980</td>
<td>75%</td>
<td>75%</td>
<td>75%</td>
</tr>
<tr>
<td>1990</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>2000</td>
<td>125%</td>
<td>125%</td>
<td>125%</td>
</tr>
<tr>
<td>2010</td>
<td>150%</td>
<td>150%</td>
<td>150%</td>
</tr>
</tbody>
</table>

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The ratio mixes a stock variable (debt) with a flow variable (income), and ignores the asset side of the balance sheet.

The ratio is not a perfect measure of debt serviceability because it does not take account of the level of interest rates.

Given these points, how should we assess the current level of U.S. consumer debt? In Chart 2, we show consumer debt relative to assets and the picture is not very different to that of debt relative to income. Overall debt levels relative to household sector assets are below their peak but remain at a historically high level. The problems are concentrated in mortgage debt, which is running at 60% of the value of household real estate assets compared with a pre-crisis average of around 40%. And because around one-third of homeowners have no mortgage, the position of mortgage holders is much worse than the aggregate data suggest. According to Zillow Inc., about 31% of mortgage holders were underwater with their mortgages in the second quarter.

Non-mortgage debt as a percentage of non-real estate assets is not at a troubling level, although it should be noted that most of this debt is used to finance consumption not asset purchases. Overall, using debt-to-income ratios does not seem any worse than using debt-to-asset ratios as a way to scale debt burdens.

The dramatic decline in borrowing costs has certainly made it easier to carry current high debt loads. Fed estimates show a steep drop in the household sector’s debt servicing payments as a percent of income in recent years (Chart 3). They are no higher today than in the mid-1980s,
even though debt burdens have risen dramatically over the period. However, there is a caveat.

The household sector has slightly more interest-earning financial assets than liabilities ($13.8 trillion versus $12.8 trillion in 2012 Q1) and a drop in interest rates is an overall negative in income flow terms. While debt-servicing costs have fallen by 3.1% of disposable income in the past five years, interest receipts have dropped by 3.9% of income.

Measuring the overall impact of falling rates on households is complex because the ownership of assets and liabilities is skewed heavily toward the wealthy. Those with lots of debt and few interest-paying assets are obviously huge beneficiaries of lower borrowing costs, assuming that they have been able to refinance their mortgages. Those with a lot of interest-earning assets and little debt are worse off, and that is a particular problem for the elderly.

While current low borrowing costs ease the burden of debtors, we should not lose sight of the reason why interest rates are low: the economy is weak and consumers face both high unemployment and eroding real wages.

In sum, there is no getting away from the fact that the current level of U.S. household debt is still far above what should be considered normal levels. That leads to the obvious question of where it might settle.

As noted earlier, it is not appropriate to simply extrapolate the previous trends in debt-to-income or debt-to-asset ratios and assume that a return to those trend lines will represent the new equilibrium. Even if the trend did remain...
upward sloping, one should expect an overshoot to be matched by a period of undershoot.

Estimating the timing of a return to a “normal” debt-income ratio requires making assumptions about the trends in income and debt growth, and a new target level for the ratio. In order to simplify the process, we assume that nominal household income will grow at 5% a year, and that the level of outstanding debt remains totally flat. On that basis, the debt-to-income ratio would return to its current upward-sloping trend line by the end of 2014. However, as we noted, it does not seem reasonable to keep extrapolating this past trend. If the ratio were to return to its average of the 1990s, then it would take until the end of 2018 to return to that level, assuming zero debt growth over the period. Obviously, if debt levels continued to contract (as opposed to staying flat), then the deleveraging process would end more quickly, but that likely would be more disruptive for the economy and financial system.¹

What About The Business Sector?

It is widely agreed that the business sector is in good financial shape, but the picture is not quite as simple as assumed. The first point to note is that debt levels are at historically high levels relative to business GDP (Chart 4). This is true for both the non-financial corporate sector and for unincorporated businesses.²

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¹ It is important to note that it is the pace of deleveraging that matters for economic growth. Thus, as long as consumer deleveraging occurs at a steady rate then the rate of overall economic growth will not be curtailed.

² Unincorporated businesses account for around 28% of non-financial business GDP.
The non-financial corporate sector’s financial liabilities do not look quite so alarming relative to assets, but unincorporated businesses are not in as good shape as the corporate sector. The net worth of unincorporated businesses relative to GDP is above that of the corporate sector, but close to a historical low.

High levels of business debt would be less of a problem if they had been used to finance strong growth in productive investment. But that has not been the case. As shown in Chart 5, growth in the real private non-residential capital stock has slowed dramatically over the years, reflecting the fact that new investment has barely been enough to offset depreciation.

While many companies are sitting on large piles of cash, the data challenge the notion that the overall business sector is in great financial shape. The corporate sector is in better health than unincorporated businesses and that matters when it comes to the stock market. But, from the perspective of deleveraging pressures throughout the economy, the total business sector is more important. The state of business balance sheets helps to explain why capital spending growth and hiring have not been as strong as might have been expected given the strength of corporate profits.

**The Financial Sector Has Deleveraged**

The balance sheets of both lenders and borrowers were compromised during the credit bubble, with the investment banking sector leveraging itself to the edge of extinction. The inevitable collapse in
the value of securitized products subsequently led to a lot of forced deleveraging throughout the financial sector. This can be seen by the drop in the ratio of financial debt to the financial sector’s GDP (Chart 6). Although this ratio remains high by historical standards, there has been good progress in balance sheet repair.

The remaining two major independent investment banks – Goldman Sachs and Morgan Stanley – have undergone major deleveraging in recent years. Just before the crisis broke, Morgan Stanley’s tangible assets represented a stunning 40 multiple of tangible equity capital. The equivalent Goldman Sachs number was 35 (Chart 7). Those ratios have since plunged as a result of asset reductions (tangible assets have fallen by 38% for MS and 20% for GS from their 2007 peaks) and a significant rebuilding of equity capital.

Commercial banks also have made progress in balance sheet restructuring. For the industry as a whole, total assets and total loans relative to tangible equity capital have declined sharply, reflecting a major rebuilding of equity capital (Chart 8). Tangible equity climbed from $892 billion to $1,216 billion between 2008 Q1 and 2012 Q1. However, the small to mid-size banks are in better shape than the very large ones.

The leverage ratios of JP Morgan, Citibank and Bank of America have not improved by as much as the overall sector. Moreover, the derivatives exposure of these large banks has not fallen much since the crisis broke (Chart 9). The derivatives exposure of the large U.S. banks remains very high relative to capital.

The financial sector still faces many challenges including increased regulation and oversight, slow growth in assets and lingering bad loan problems. Nonetheless, the Fed’s aggressive pump priming will continue to support the financial sector, facilitating an ongoing rebuilding of balance sheet strength.

Public Debt: The Next Pressure Point

The above discussion paints a mixed picture for overall private sector deleveraging. Households and unincorporated businesses still have far too much debt, while banks and other corporations are in reasonable shape. The key point, and one that we have emphasized in previous reports, is
that the Debt Supercycle in the private sector reached an important inflection point in 2007. Consumer debt burdens finally reached a long-awaited breaking point, marking the end of their multi-decade uptrend. At the same time, the overly lax regulatory and oversight regime that helped foster an extraordinarily loose lending environment came to an end.

The effective end of the Debt Supercycle in the private sector had the potential to cause tremendous economic and financial instability and it is not a surprise that the authorities responded with aggressive monetary and fiscal stimulus.

The Fed’s actions broke the vicious self-feeding spiral of falling asset prices, debt defaults and collapsing economic activity, but have not been able to reignite a major new credit upturn. With consumers no longer prepared to borrow and spend with wild abandon, the government stepped in to fill the void. The Debt Supercycle moved into what we have labeled its final inning, with government debt soaring dramatically in the past few years. Thus, if we look at the overall level of U.S. non-financial debt to GDP, it has not fallen much at all (Chart 10).

The record-low levels of Treasury yields and the resilient dollar show that markets currently are unconcerned with the U.S. fiscal trends. But, this will not always be true. The long-run fiscal trend is grim, largely reflecting demographic pressures on health care and, to a lesser extent, Social Security. Projections from the Congressional Budget Office suggest the ratio of federal debt to GDP could breach 100% by the middle of next decade, assuming the tax cuts, due to expire at the end of this year, are extended. And the debt ratio will keep rising steadily in future decades.
The solution to U.S. fiscal trends is fairly straightforward in theory: entitlement programs and the tax system need drastic reforms. Social Security and Medicare should be means tested and the tax base needs to be broadened with the many loopholes being closed. In practice, carrying out these reforms will be very difficult politically, because they will be unpopular with voters and fiercely resisted by special interest groups. Thus, it probably will require intense market pressures to force change, as currently is the case in the euro area.

The U.S. Debt Supercycle truly will be at an end when the markets force a major retrenchment in U.S. fiscal policy. That likely will occur within the next several years. If the next Administration has not at least begun a serious debate about major fiscal reform by the midpoint of its term of office, then the markets are likely
to start exerting pressure. The next major financial crisis will be when the markets attack the U.S. in the way they currently are attacking peripheral Europe.

**Concluding Thoughts**

The Great Recession of 2007-09 will be remembered as a defining moment in economic and financial history. It was a time when many of the prevailing assumptions and ideas that guided the behavior of consumers, businesses and policymakers were seriously challenged and, in some cases, completely overturned. For example, the complacency and dangers of the prevailing laissez-faire approach to financial regulation was laid bare and central bankers were forced to acknowledge that low and stable consumer price inflation was not enough to guarantee prosperity. Meanwhile, we finally reached the point where gravity took hold over consumer debt levels.

The end of the Debt Supercycle was bound to be traumatic for the economy, but prompt and forceful policy stimulus softened the blow. The Debt Supercycle was extended at the cost of a dramatic worsening in the government’s balance sheet. This too will have to be addressed at some point in the next several years and in that sense, the Debt Supercycle is in its final stages. Regardless of the election results in November, the Debt Supercycle is careening toward a conclusion.

The end point need not be catastrophic. Perhaps politicians will find the courage to reform spending programs and taxes before markets lose their patience. That would be extremely bullish, although the odds seem slim given the increasingly fractious and partisan nature of U.S. politics.

The end of the Debt Supercycle does not mean that overall credit will contract. There always will need to be some credit growth to finance business investment and purchases of homes and consumer durables. But, it will be a healthier economic and financial environment where the growth in debt and incomes are more closely aligned.

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