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The Remarkable American Consumer

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The American consumer is a very persistent spending machine. It is American consumption growth running at higher than 4 percent annualized—well above its long-term average—that has kept the economy comfortably out of recession for the past six months as the housing slowdown has subtracted more than a percentage point from growth. Even with a substantial additional drag on the U.S. economy from other areas—inventory liquidation, weakening net exports, and rapidly rising gasoline prices—the American consumer's spending surge has still been enough to keep GDP growth in positive territory.

Durable American consumption growth is an immensely important factor for the world economy. It creates a reliable and persistent source of demand growth that accounts for over 70 percent of U.S. GDP growth and a substantial portion of rising demand for the exports of the rest of the world, including rapidly industrializing economies like China's.

The strain on the consumer as the principal support for maintaining growth is beginning to show, as growth in the first quarter of this year slipped perilously close to zero, at just 0.7 percent. Yet, even that disconcertingly low figure may not mean that a recession is imminent, provided that the U.S. consumer continues to supply just an average contribution to growth while the drag from housing, inventory disinvestment, and negative net exports subsides. If, alternatively, consumption slips, a recession is likely. Consumption is the key to the current growth outlook.

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Consumption Seldom Slips

It is testimony to the market's faith in the American consumer that the consensus expectation is for U.S. GDP growth to recover to around a 2 percent annual rate in the second quarter and to rise more rapidly in the second half of the year, assuming consumption growth will hold up at close to its long-run average of 2.5 percent to 3 percent. Growth pessimists, however, point out that consumption growth may falter because household savings rates are still negative, while household debt levels relative to income are unusually high. Additionally, gasoline prices have risen to a point at which they are subtracting more than 1 percent from disposable income.

Still, the odds are against those who bet against the American consumer. Perhaps that is why the Federal Reserve's own forecast is for growth to pick up in the second half of the year. The persistent strength of consumption is related to some unusual positive developments in the U.S. economy over the past twenty-five years, including faster-than-usual wealth accumulation and the evolution of a more elastic credit system, which have altered the relationship between consumption spending and income.

The consistency of American consumption growth is striking. Since the turmoil of 1980–82, when Paul Volcker was wringing inflation out of the U.S. economy, only two quarters have posted declines in consumption in the United States. That is two quarters out of ninety-seven. Those quarters were the fourth quarter of 1990 and the first quarter of 1991, during and after the Iraqi invasion of Kuwait, which coincided with sharply higher oil prices and a spike in geopolitical uncertainty. Those two lone quarters of negative consumption coincided with the last real recession—two consecutive quarters of negative GDP growth—experienced by the United States. While mid-2001 saw a mild recession by technical standards, it did not produce two consecutive quarters of negative GDP growth and there was not a single quarter of negative consumption growth.

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Consumption Grows While Saving Falls

The persistence of consumption growth since the early 1980s is even more remarkable (on the surface at least), in view of the fact that since 1982–85, personal saving as a share of disposable personal income has dropped from a range of 8 to 10 percent to minus 1.3 percent over the past year. The most rapid drop in the personal saving rate occurred between 1982 and about 2000, by which time the saving rate had fallen to what was then viewed as a dangerously low 2 percent. After hovering around 2 percent until 2003, the personal saving rate made another swoop down and has been in negative territory since 2003. It is, of course, the negative personal saving rate coupled with public sector deficits that has boosted American net borrowing from abroad to about 6 percent of GDP. That said, a negative saving rate and rising indebtedness to the rest of world have failed to dent the persistent rise in American consumption, due in part to the willingness of foreigners to lend to America at low interest rates the funds necessary for it to keep spending in excess of income.

The persistent strength of American consumption growth during the quarter-century since the early 1980s, and its partial financing by a progressive drop in the savings rate over the same period, suggests strongly that income growth is not the only factor that determines consumption growth.

The level of wealth, the accumulated assets of American households, has proven to be an important determinant of spending habits. The breakdown of the usual connection between savings and wealth accumulation has made many casual observers of American consumption behavior uncomfortable over the past twenty-five years. The most common way to accumulate wealth is to restrain consumption, boost savings, and thereby acquire assets. The traditional story of the evolution of an American family in the early post-Depression years saw households restrain consumption, save, accumulate financial wealth, and then, perhaps with the help of a loan equal to half the value of the house, purchase the major asset of most traditional American families—the primary residence.

Compare that model with a more contemporary one rising out of the late stages of the recent housing boom. During 2005 and early 2006, so-called subprime lending enabled households with virtually no accumulated assets to borrow 100 percent of the purchase price of residential real estate. Such easy credit led numerous, more adventurous households (many located in California and Florida) to buy multiple speculative real estate units, say, several condominiums, with no money down. These steps were, by the way, totally rational. If a lender is willing to lend 100 percent of the purchase price—even in a risky market—the borrower may as well take up the offer and exercise what amounts to infinite leverage on real estate speculation. Should he be unable to sell the speculatively purchased units, he need only walk away from the loan, leaving the subprime lender to suffer the loss.

Subprime lenders thought that they were invulnerable based upon having sold the subprime mortgages in tranches to the credit derivatives market. What tripped them up was the clause in the subprime lending contract specifying that if a borrower failed to make even the first payment on the loan, the loan reverted back to the subprime lender. During 2006, when weakening market conditions in Florida, California, and elsewhere caused many speculative borrowers to walk away from their loans without making even a first payment, subprime lenders were submerged in a cascade of bad paper that pushed many of them out of business.

Elastic Credit Markets

The contrast between the traditional "save-and-then-borrow-moderately" paradigm and the "borrow-it-all" subprime paradigm illustrates another factor operating on American consumption: American credit markets have become far more elastic, especially over the past decade. While some abuses, such as in the subprime sector, have arisen for American households that have, through rising asset prices, accumulated wealth at an unusual pace without saving, elastic credit markets have provided an important additional degree of freedom that enables most middle-to-upper-income households to maintain spending at a level close to income. In effect, the elastic credit market has turned the primary asset of American households, residential real estate, into a flexible line of credit. Home equity loans and mortgage equity withdrawal mirroring the rise in the value of residential real estate have contributed to a more stable American spending stream that has persistently risen relative to income.

The key reality is that the two major sources of household wealth—financial assets and real estate—have increased in value at an unusual pace. The fact that households own these assets has meant that they are better able to sustain consumption even when income growth slows or confidence slips.

It is worth noting that the elasticity of the credit system applies also to American corporations. Privatization and credit-financed leveraged buyouts (LBOs) essentially amount to a substitution of debt for equity on terms that enhance the value of the corporation. The debt issued to finance retirement of equity is then sold to global investors by dividing it into blocks of securities of different quality—risky to less risky. This process is carried out in what has come to be called the credit derivatives market. The full operation of that sector and its ultimate viability are still being determined. Suffice it to say for now that the LBO and private-equity booms are manifestations of the increasing elasticity of America's credit system that parallel the increasing elasticity of the credit available to American households.

The rising elasticity of America's credit system is an important factor to consider in a discussion of the persistent growth of American consumption. Paradoxically, it may also turn out that the same elevated credit elasticity forms the basis for the return of the American business cycle, which has been largely absent for the past twenty-five years. The fact that credit is so elastic—both for households and corporations—can lead to imbalances whereby, for example, too many houses and condominiums are produced because of credit-driven speculative demand. If the demand abates because, say, of a sudden contraction of credit, unwanted stocks of such real estate, like excessive inventories or an excessive stock of traditional capital, have to be worked off over a period of time. Furthermore, when stocks are being reduced, production of new units, say, of houses or condominiums, has to be sharply curtailed. The result, as we have seen since mid-2006, is a substantial drag on U.S. GDP growth—at a rate of more than a percentage point of GDP—from falling residential investment. Going forward, the biggest uncertainty facing the U.S. economy is whether such adjustments will spill over into consumption behavior. The Fed and the markets are betting they will not. We will probably learn the answer between now and next fall.

Wealth and Consumption

The other big factor underlying persistent American consumption growth and resultant stable GDP growth has been—as already noted—an unusually rapid pace of wealth accumulation over the past twenty-five years that is not tied to saving, per se. Between 1980 and the end of 2006, the real net worth of American households grew at about 4 percent per year, while overall income grew at about 3 percent per year. As a result, the ratio of household real net worth to annual disposable income rose from about 4.4 to 1 in the early 1980s to 5.7 to 1 in 2006. A peak ratio at about 6 to 1 occurred in 2000 after the spike in the American stock market.

The growth of wealth relative to income at a pace that boosts the wealth-to-income ratio—while personal savings as a share of disposable income is falling from about 8 percent to minus 1 percent—is a remarkable development. This conclusion holds, notwithstanding some measurement issues arising from the fact that about 15 percent of consumption consists of spending on durable goods, which, due to their ability to supply consumption services over time, contains some saving. That said, the consistently measured saving rate has fallen steadily, even accounting for the fact that the durables component of consumption means that it may be downwardly biased.

Measurement issues aside, the key reality is that the two major sources of household wealth—financial assets and real estate—have increased in value at an unusual pace. The fact that households own these assets has meant that they are better able to sustain consumption, even when income growth slows or confidence slips. A high wealth-to-income ratio helps to cushion consumption at times when income growth may be reduced or when the inclination to spend a given level of income is reduced by uncertainties such as the Gulf War, Hurricane Katrina, the 9/11 attacks, and other disasters. U.S. consumption has recovered quickly after these incidents, and, even immediately afterward, since the Gulf War consumption growth has not dropped below zero.

Exogenous Wealth Creation

What are the sources of what we shall call exogenous wealth creation—that is, wealth creation not driven by traditional savings and accumulation? Knowing the sources (which we cannot fully do) is important because this is the headiest form of wealth accumulation, that is, that tied simply to the ownership of appreciating assets rather than through restricted consumption and elevated savings. My favorite candidates for the causes of the broad exogenous wealth creation of the past quarter-century are two: the Great Moderation, or the more stable path of the U.S. economy since 1982, in which lower and less volatile inflation have been associated with less volatile growth; and innovations in the credit system that have contributed to the ability of households to manage income and spending decisions with lower holdings of highly liquid savings and more funds invested in less-liquid assets such as equities, bonds, and real estate.

Some circumstantial support for these explanations of exogenous wealth creation come from observing China—today's most rapidly growing emerging economy. There, wealth accumulation has, so far, been achieved the old-fashioned way. Households save up to 40 percent of income in order to accumulate assets in a volatile economy with a primitive credit system. Without well-developed government health and retirement systems, households must accumulate assets to provide for old age and medical costs. The credit system into which those assets can be invested is far less developed and far more risky, as the experience in China's stock market and credit markets over the past decade has shown.

China's growth rate and inflation rates are both higher and more volatile than those in the United States, contributing to the uncertainty that households in China must manage as they make decisions about savings and consumption. Chinese households want to get richer, and they are saving at an extraordinary rate in order to do so. The saving motive is reinforced by the uncertainty they face, which in turn is tied to economic volatility and poor facilities for wealth storage. The persistent exogenous wealth creation that Americans have been fortunate enough to experience since the early 1980s has not been as available in China, although it probably will begin to emerge.

Another insight into American consumption behavior and its relationship with wealth is gained by looking at the period before 1980. During that time, say, between 1960 and 1980, American wealth was growing at a rate of about 3.5 percent a year while income was also growing at a slightly higher rate. The wealth-to-income ratio, which reached about 5 percent in the early 1960s, had fallen to 4.2 percent in the mid-1970s after the massive exogenous shock of a quadrupling of oil prices imposed the equivalent of a heavy tax on American consumers while rendering obsolete much of the American capital stock that had been oriented toward cheap energy. Over the decades, when income was rising faster than wealth, American savings held in a range of 8 to 10 percent, peaking at about 12 percent in the highly uncertain period after the first oil crisis in the second half of the 1970s, when rising inflation and inflation uncertainty penalized growth and increased household concerns about being able to sustain consumption.

Looking Ahead

Interesting questions arise about the American business cycle and the sustainability of consumption growth in excess of income growth going forward. Now that the traditionally defined saving rate is virtually zero, can exogenous wealth creation and rising elasticity of the credit system contribute to a continuation of consumption spending in excess of income? We do not know the answer, but it seems unlikely that exogenous wealth creation will continue at the extraordinary pace of the past twenty-five years. The pace of productivity growth will provide a clue, with a steady, high level suggesting that exogenous wealth creation may continue, while lower productivity growth may signal declining wealth creation.

We have seen that the elasticity of the credit markets may have already been extended beyond viable levels in view of the difficulties in the subprime and lower-level mortgage markets. Indeed, the elasticity of the credit markets may replace inventory dynamics as a primary source of business cycle developments. Whatever the outcome, it will depend importantly on the continued resilience, or lack thereof, of the American consumer and, in turn, on the factors that affect the path of consumption over time.