
America's Debt Overhang

Growth or Austerity, and other Policy Choices

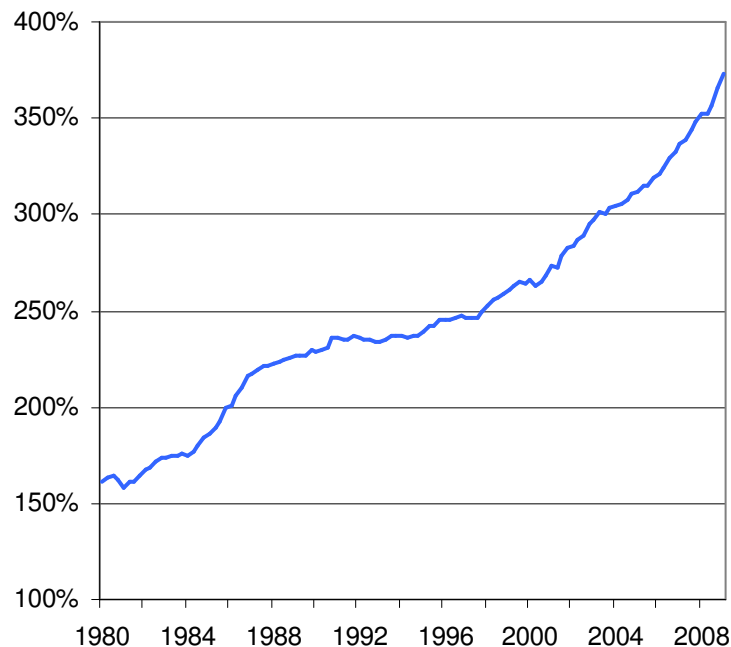
September 2009

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NEW AMERICA FOUNDATION

The Debt Overhang

Total U.S. Debt as a Percent of GDP



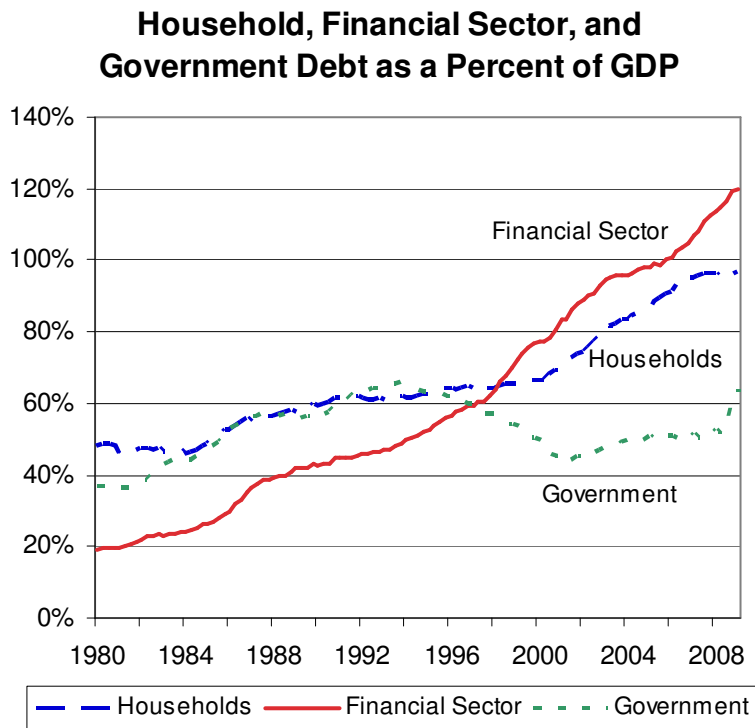
Source: Federal Reserve

The bursting of the housing and credit bubble has left the United States with a large debt overhang.

America's total debt is at a historical high of 373% of GDP.

America's debt as a percent of GDP has more than doubled since 1980, when it stood at 161%.

Household And Financial Sector Debt



Source: Federal Reserve

Household and financial sector debt has accounted for the lion's share of the increase in debt since 1980.

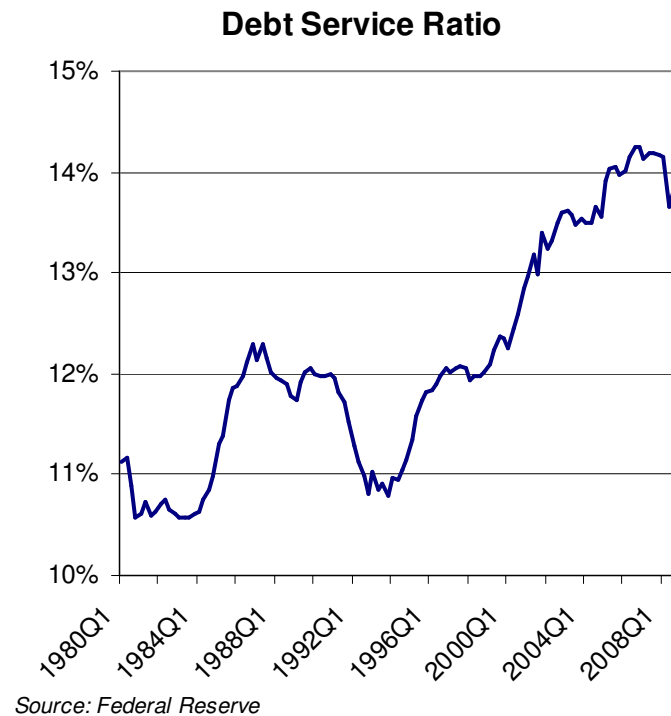
Household debt climbed from 48% of GDP in 1980 to 97% in the first quarter of 2009.

Financial sector debt rose from 19% of GDP in 1980 to 120% in the first quarter of 2009.

Household Debt-Servicing Burden

Despite low interest rates, the debt-servicing burden for households has increased, taking a bigger bite out of incomes.

The debt service ratio – the ratio of debt payments to disposable personal income – rose from 11.1% in 1980 to 13.5% in 2009.



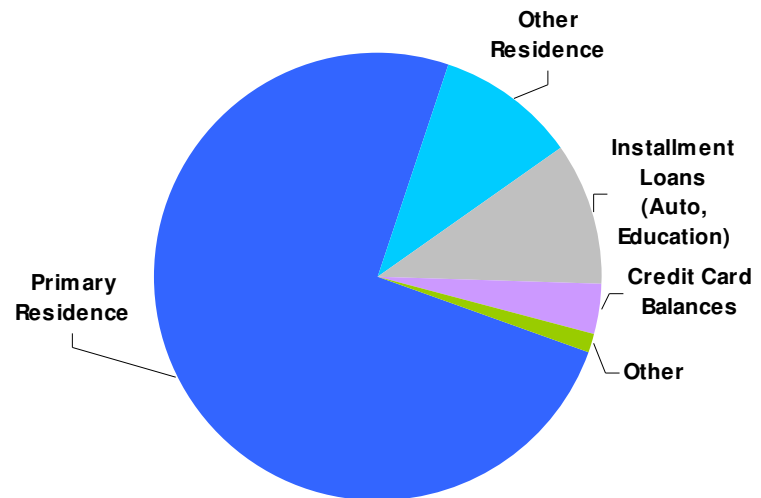
Household Leverage

Residential property accounts for 85% of household debt.

10% of household debt is in installment loans and 3.5% is in credit card debt.

Middle-income households hold more debt as a percent of their disposable incomes than upper or lower income households.

U.S. Debt by Type

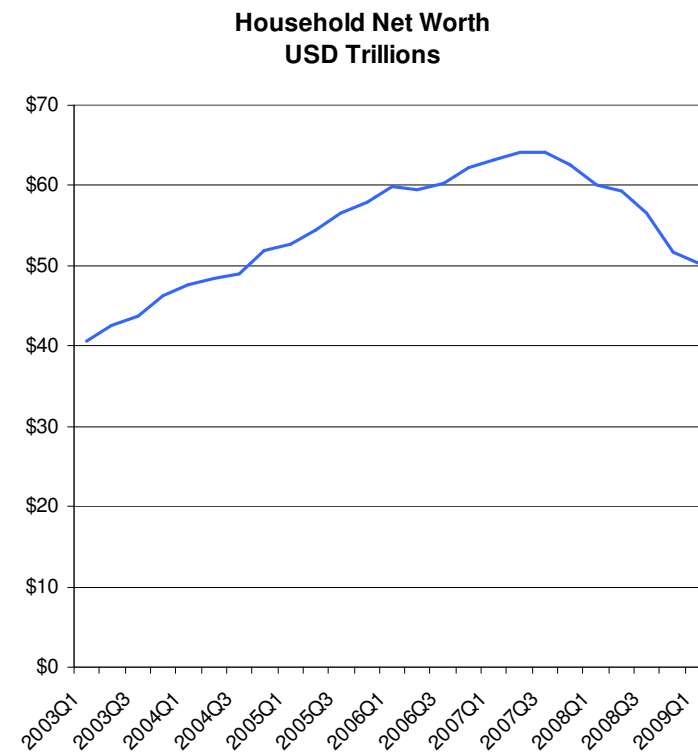


Source: Federal Reserve

Rapid Decline In Household Wealth

The net worth of U.S. households and non-profit organizations fell \$13.9 trillion from the second quarter of 2007 to the first quarter of 2009.

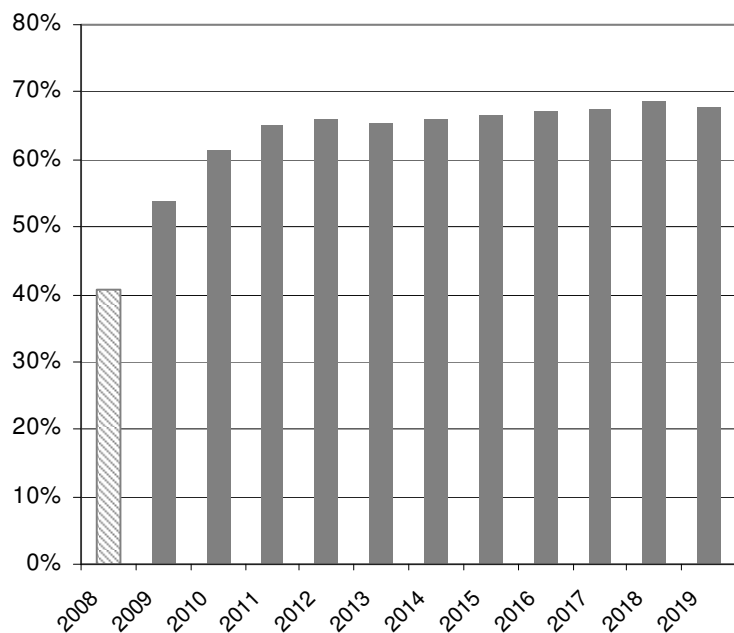
The ratio of household debt to financial assets has thus increased, making it more difficult for households to tap home equity and other assets to supplement incomes.



Source: Federal Reserve

Government Debt Is Now Rising More Rapidly

Federal Debt Held by the Public
as a Percent of GDP



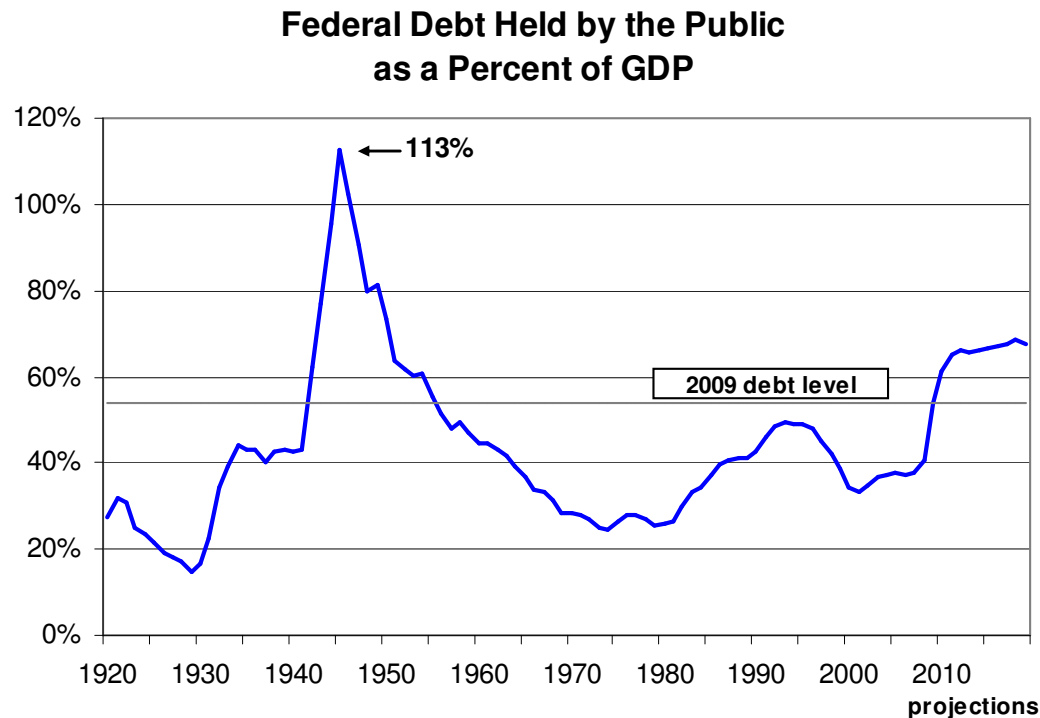
Source: Congressional Budget Office

Federal debt has increased because of falling tax revenues and the cost of government rescue programs.

Government debt will need to rise further to offset the effects of the deleveraging of the private sector.

Federal debt held by the public is projected to increase from 40.8% of GDP in 2008 to 68% in 2019, according to the CBO's baseline projection.

But Is Within America's Historical Experience



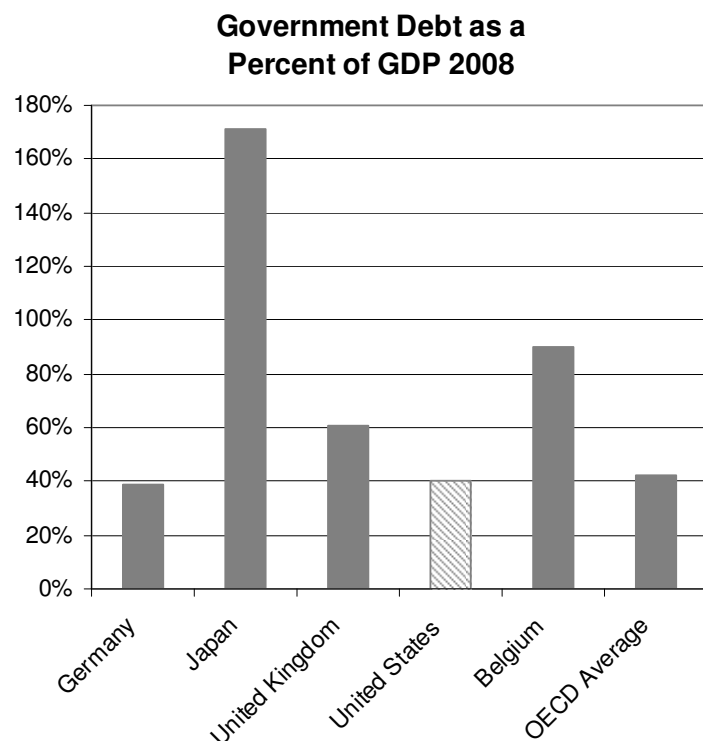
Source: Congressional Budget Office

In the period following WWII, federal debt reached a peak of 113% of GDP in 1945 and remained above the projected 2009 level until 1956.

“We’re looking at debt levels that a number of advanced countries, the U.S. included, have had in the past, and dealt with.”

**Paul R. Krugman
New York Times**

And Is Lower Than Other OECD Economies



Source: OECD, National Statistics

U.S. government debt is within acceptable international norms.

In 2008, U.S. government debt was slightly below the OECD average.

After the bursting of Japan's property bubble, its government debt increased from 47% of GDP in 1990 to 106% in 2000.

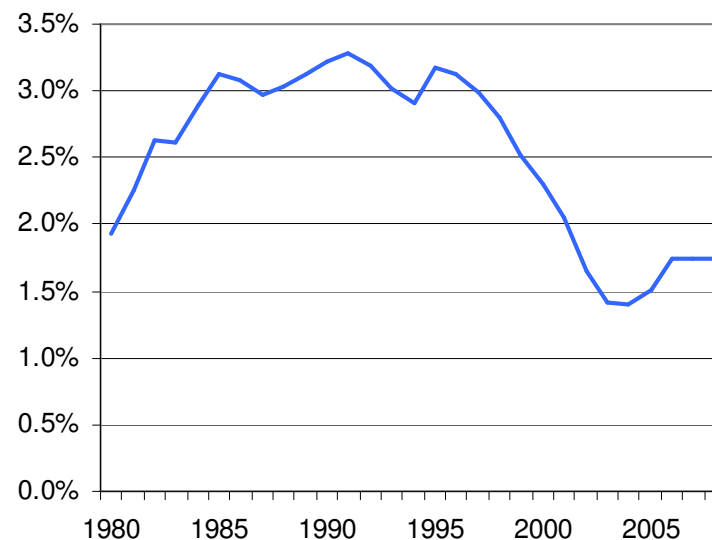
America's Federal Debt Servicing Remains Low

The debt-servicing burden on the federal debt is less than it was during the period from 1980 to 2001.

The debt-servicing burden in 2009 is 1.75% of GDP, down from 1.93% in 1980 and 3.28% in 1991.

It is lower because the government has been able to borrow recently at historically low interest rates.

**Net Interest Payments
as a Percent of GDP**



Source: Congressional Budget Office

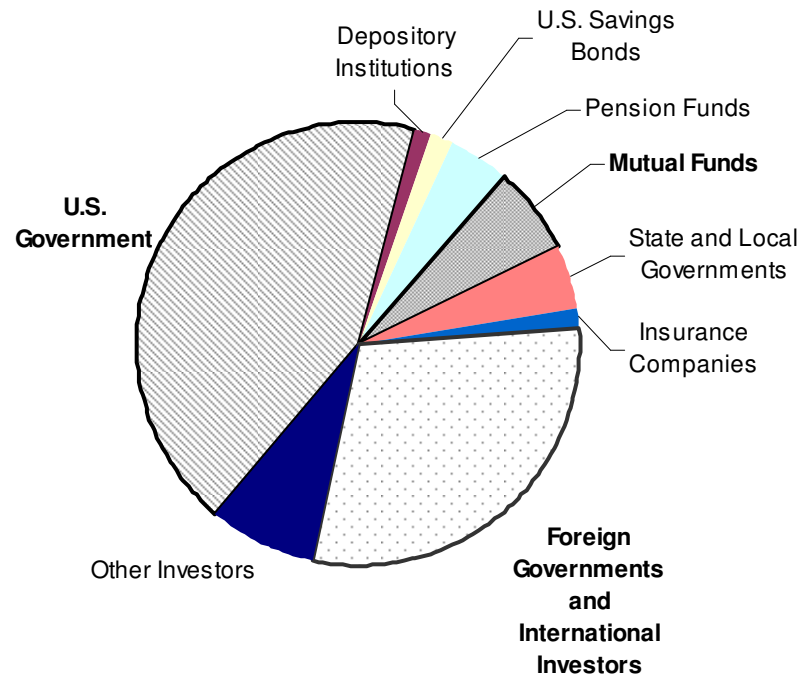
Ownership Of U.S. Government Debt Is Widely Distributed

The three largest holders of U.S. Treasuries are the U.S. government (43%), foreign governments (29%), and mutual funds (6%).

Top Three Holders of Treasury Securities	
U.S. Government	43%
Foreign Governments	29%
Mutual Funds	6%

Excluding U.S. government holdings, foreign governments and international investors hold 52% of Treasury Securities. China accounts for 23.5% of total foreign ownership.

Estimated Ownership of U.S. Treasury Securities
March 2009



Source: U.S. Treasury

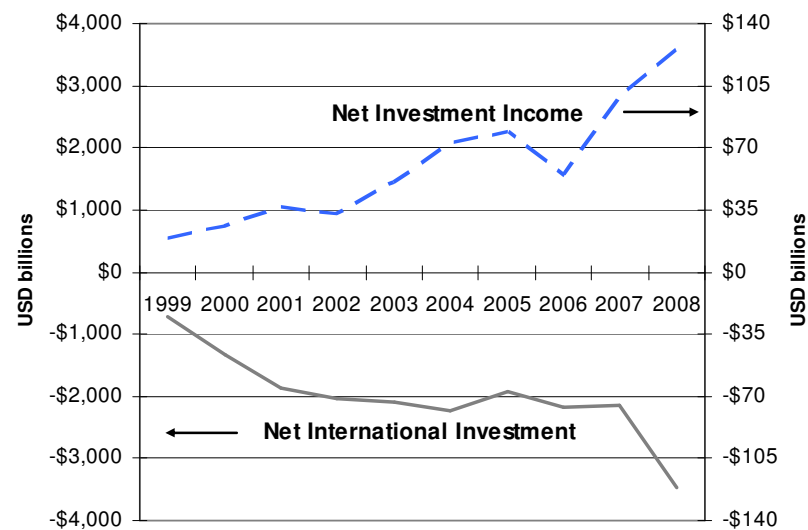
America's International Debt

America's international debt has increased because of persistently high current account deficits.

America's net overseas investment position has deteriorated \$2.75 trillion over the past decade.

But, the U.S. has continued to run a positive net investment income balance – because we earn more on our overseas investments than foreigners earn on U.S. assets.

Net International Investment Position and Balance on Investment Income



Source: Bureau of Economic Analysis

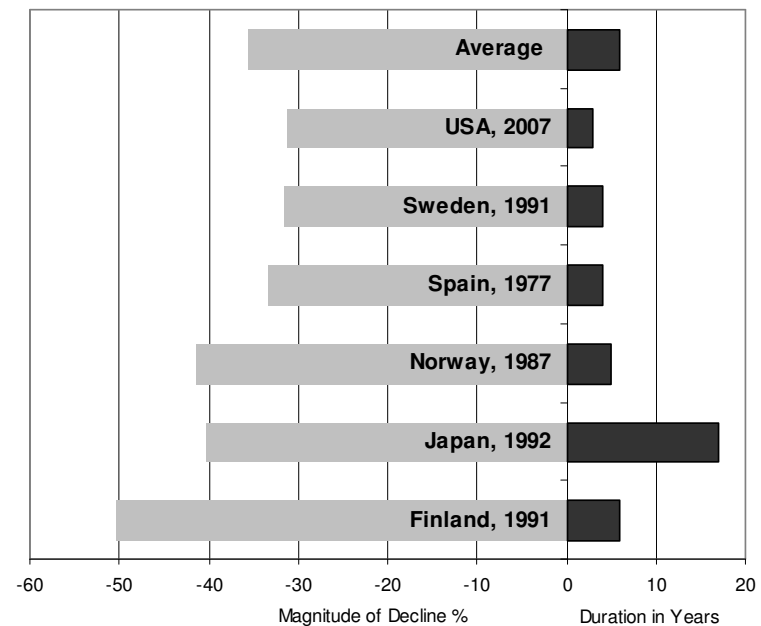
Deleveraging Takes Time

Economies are slow to recover from financial crises, according to a study by Carmen Reinhart and Kenneth Rogoff.

On average:

- Housing prices decline 35.5 % over roughly six years.
- Recessions after financial crises last 1.9 years.
- Equity prices collapse 56% over 3.4 years.
- Unemployment rises 7% over nearly 5 years.
- Government debt increases by 86% during the three years following a financial crisis.

Real Housing Price Cycles and Banking Crises



Source: Rogoff and Reinhart, "Banking Crises: An Equal Opportunity Menace"

Why We Must Deleverage The Private Sector

A sustainable recovery, in which private investment and consumption drive growth, is not possible until the private sector has repaired its balance sheet.

Financial institutions must increase their capital in order to resume the scale of earlier lending to creditworthy borrowers.

Households need to increase their savings in order to pay down debts before they can increase consumption on a sustained basis.

“The restoration of normal credit creation should not be expected until the economy has adjusted to the disappearance of shadow bank credit, and until banks have created the capacity to resume lending to creditworthy borrowers.”

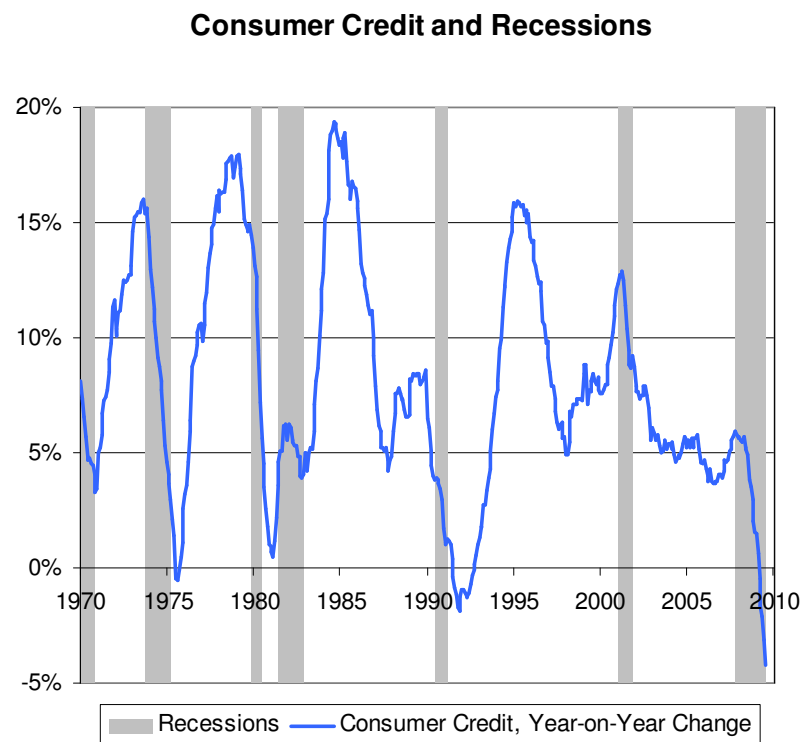
George Magnus
Senior Economic Adviser
UBS Investment Bank

Banks Are Improving Capital Ratios By Lending Less

The drying up of consumer credit has been more severe than in any previous recession.

Consumer credit fell by \$21.6 billion in July, the largest drop since the government started to keep records in 1943.

Previous recoveries have benefited from an expansion of consumer credit, but banks are still tightening credit.



Source: Federal Reserve

IMF: Banks Need More Capital

As of April, the IMF estimated that U.S. banks would need capital injections of \$275 billion to return to pre-crisis leverage ratios.

To reach leverage ratios from the middle of the 1990s, banks would need \$500 billion in capital injections.

Given the questionable quality of the assets on their balance sheets, banks will probably need to make more provisions for bad debts from mortgages, commercial real estate, auto and personal loans, and credit cards.

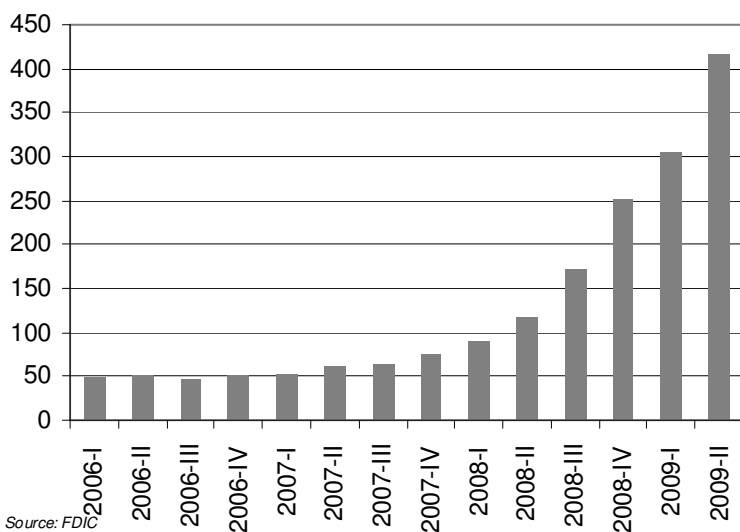
“It is proving difficult to effectively implement measures that fully address the problem of impaired assets on banks’ balance sheets, leaving banks vulnerable to a further deterioration in the quality of these assets if the global downturn is deeper, and more prolonged, than projected.”

IMF Global Financial
Stability Report Market
Update - July 08, 2009

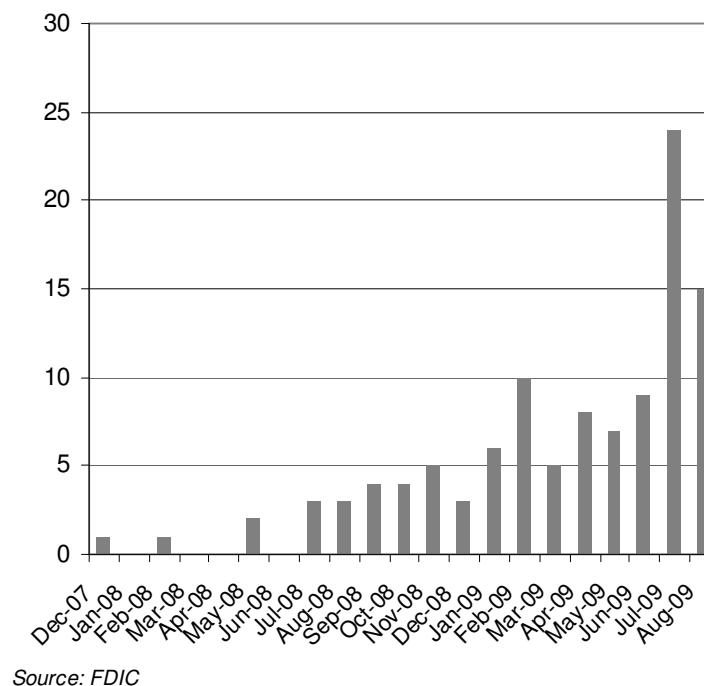
More “Problem” Institutions, More Bank Failures

The number of “problem” financial institutions is at a 15-year high and increasing.

“Problem” Institutions



FDIC Bank Failures per Month



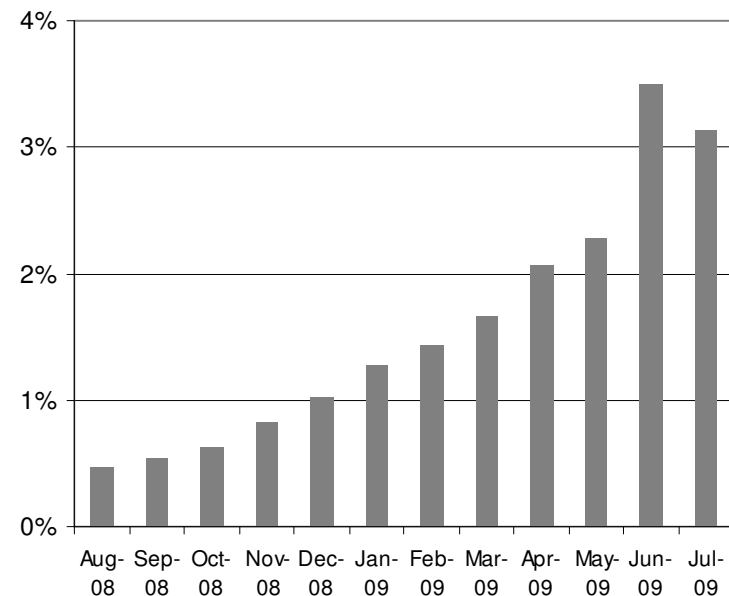
Commercial Real Estate Exposure

At the end of the first quarter of 2009, banks held \$1.8 trillion of outstanding debt associated with commercial real estate.

The May stress tests found that banks would suffer \$53 billion in losses on their commercial real estate holdings. Deutsche Bank estimates losses could be \$115 – \$150 billion, not including losses on Commercial Mortgage-Backed Securities (CMBS).

Commercial real estate prices have fallen 36% and are likely to continue falling as vacancy rates remain high, unemployment rises, and the market for CMBS deteriorates.

Percent of Commercial Mortgage-Backed Securities (CMBS) in Delinquency



Source: Realpoint

Options For Financial Sector Balance Sheet Repair

(Other than by Reducing Lending)

1. Profit inflation.

A steep yield curve enables banks to borrow cheaply and lend at higher interest rates.

“Even a banker can make money with a steep yield curve.”

Larry Kudlow
CNBC

2. Private equity issuance.

Banks can issue more equity, thereby increasing their capital.

4. Bank consolidation.

Stronger banks can take over weaker banks.

3. Debt-for-equity swaps.

Bondholders can be asked to trade debt for equity, reducing a bank’s debt load and increasing its capital.

5. Public recapitalization.

The U.S. government can inject more capital into banks.

How Much Must the Household Sector Delever?

The debt-to-disposable income ratio for U.S. households is currently 127%.

- To reduce the debt-income ratio to 115%, households must eliminate \$1.75 trillion of debt.*
- To reduce the debt-income ratio to 91% (1990-2000 average), \$4.35 trillion of debt must be eliminated.*

*Assumes constant incomes

Source: Bank of America Merrill Lynch



Source: Federal Reserve, Bureau of Economic Analysis, Department of Commerce, Bank of America Merrill Lynch

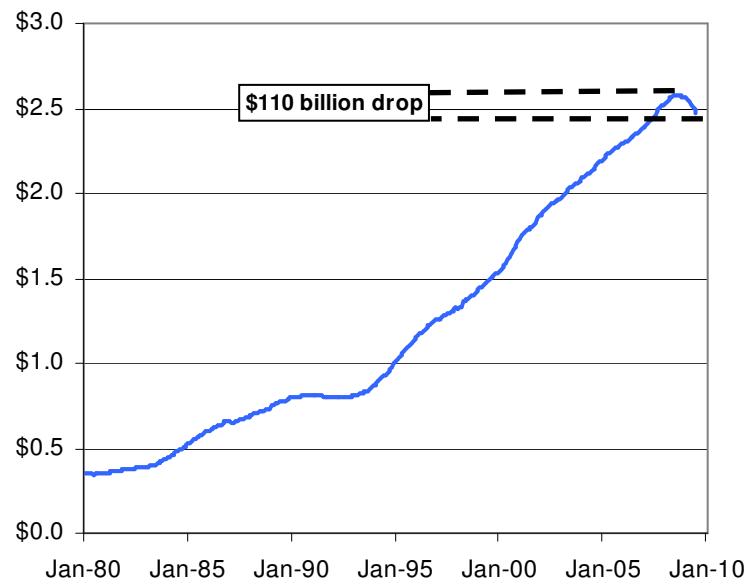
Household Deleveraging Has Barely Begun

Since consumer credit peaked in 2008, Americans have cut just \$110 billion worth of credit, leaving much more deleveraging to come.

“At the end of the first quarter of 2009, the ratio of gross household debt to GDP was a mere 2% lower than at the end of 2007.”

Martin Wolf
Financial Times

Total Consumer Credit Outstanding
USD Trillions



Source: Federal Reserve

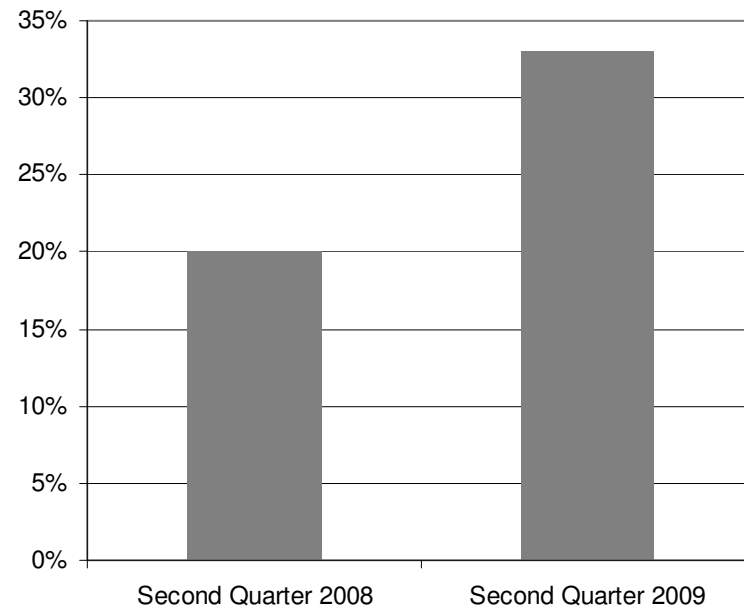
And More Problems Lie Ahead

Mortgage resets — many from low initial teaser rates — will not peak until 2010.

Many households therefore will face rising mortgage payments, putting additional upward pressure on already high foreclosure rates.

Even foreclosures for prime fixed-rate mortgages are on the rise. In the first quarter of 2009, 5.7% of prime fixed-rate loans were overdue or in foreclosure, up from 3.2% a year earlier.

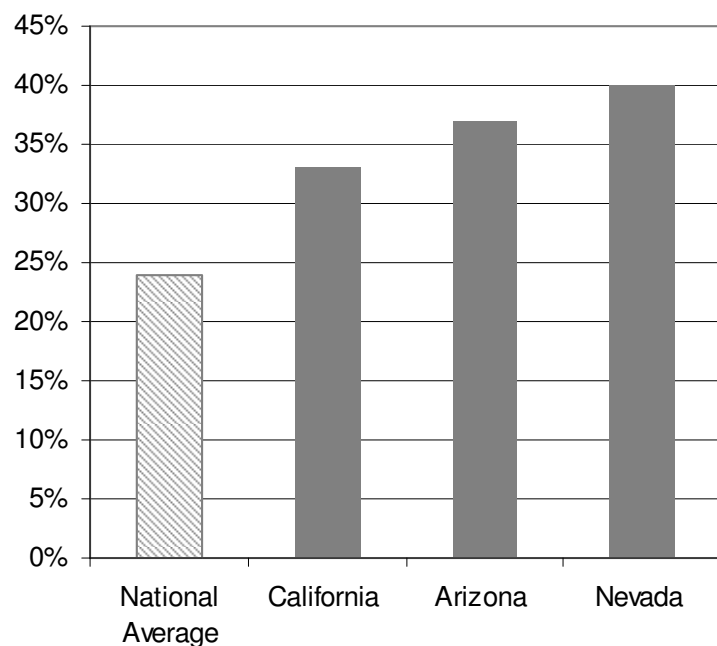
Prime Fixed-Rate Mortgage Foreclosures as a Share of Total Foreclosures



Source: Mortgage Bankers Association

U.S. Homeowners Underwater and Sinking

Underwater Mortgages as a Percent of Owner Occupied Homes



Source: Moody's Economy.com

Roughly one quarter of U.S. homeowners are underwater.

Today 24% of mortgage holders owe more on their homes than their homes are worth.

Deutsche Bank estimates this number will increase to 48% by the first quarter of 2011.

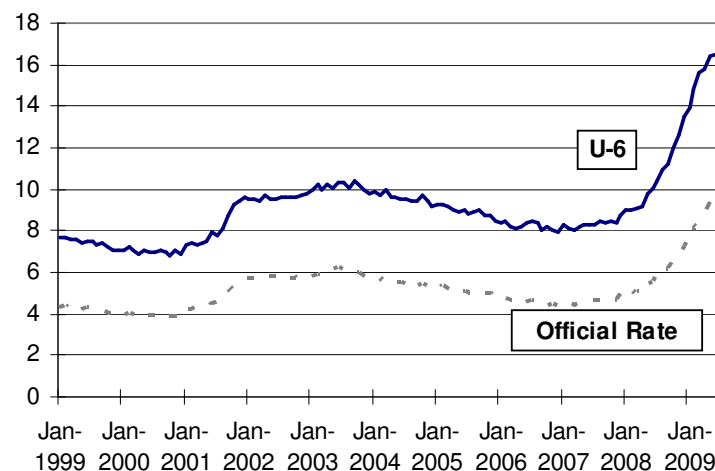
Households Will Be Hit Further By Rising Unemployment

Housing prices have shown some improvement recently, but are not likely to stabilize as long as unemployment is rising.

“The economy is now moving from a bubble housing crisis to an unemployment housing crisis. According to a study by the New York Times, 60 percent of the mortgage defaults this year will be set off primarily by unemployment, up from 29 percent last year.”

“Not Out of the Woods”
New America Foundation

Unemployment Rate and Broader Measure of Unemployment (U-6*)



*Total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all marginally attached workers.

Source: Bureau of Labor Statistics

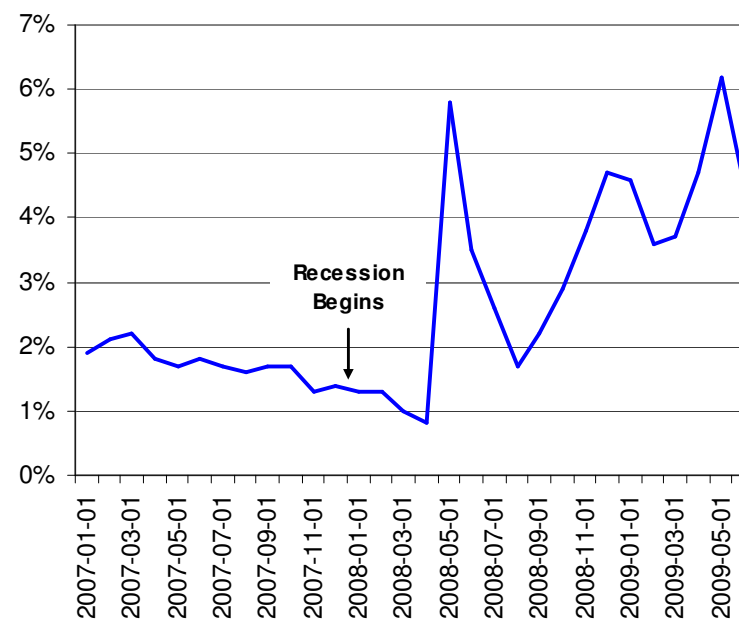
Household Deleveraging Depends On Higher Savings

Since the beginning of the recession, households have increased their savings.

The personal savings rate has increased from 1.4% to 4.6% since the beginning of the recession.

The savings rate will need to revert to pre-bubble levels of 6% to 8% in order for household debt to decline significantly.

Personal Savings Rate Since the Beginning of the Crisis



Source: Bureau of Economic Analysis

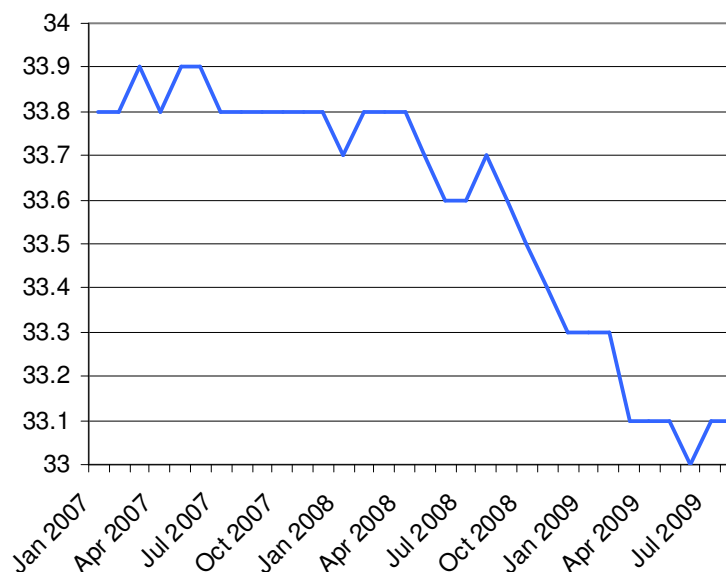
Deleveraging Would Be Facilitated By Rising Incomes

But, increasing savings will constrain consumer demand unless employment, wages, and weekly hours also increase.

If consumption is to remain at current levels and the savings rate is to return to pre-bubble levels, personal disposable income would have to increase by more than 2%.

Household deleveraging therefore depends on rising wages or increased government transfers.

Average Weekly Hours Of Production Workers



Source: Bureau of Labor Statistics

Other Household Deleveraging Options

Bankruptcy

The Bankruptcy Abuse Prevention and Consumer Protection Act passed in 2005 has made bankruptcy more difficult for many households and businesses.

Mortgage Relief

The current homeowner relief program has had limited effect to date. New measures will therefore be needed.

Targeted Debt Relief

Other than the debt relief granted to the auto and the financial sectors, few other sectors have benefited from debt relief.

Proposed Relief for Student Loans

Under the “Debt Swap” plan proposed by Senator Sherrod Brown, the federal government would give out-of-school adult borrowers with high cost private student loan debt the ability to refinance \$8,000 in debt into low-cost, unsubsidized, federal Stafford student loans.

This would save over \$2,000 in interest payments over the life of a typical student loan.

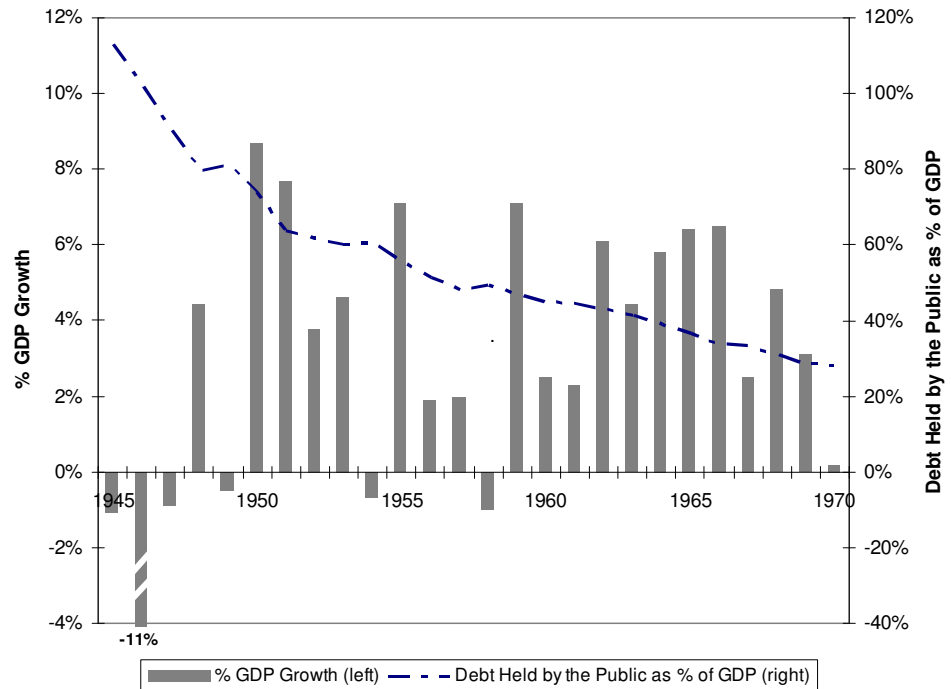
Can We Grow Our Way Out of Debt?

Our experience after WWII suggests we can.

Federal debt held by the public declined from 80% of GDP in 1948 to 28% in 1970.

The growth rate averaged 3.9% during this period, outstripping almost continuous government deficits.

Public Debt and GDP Growth, 1945-1970



Source: Congressional Budget Office, Bureau of Economic Analysis

But We Need A Growth Strategy For Today's Private Sector Debt Overhang

Government will need to lever up in order for the private sector to delever.

Public investment (along with global demand) will need to offset weaker demand from consumption and private investment to spur growth.

Economic growth is needed to increase incomes and wages in order for households to increase their savings and pay down debt.

“Budget deficits have an important role to play in facilitating the deleveraging process of the private sector so that it does not cause a massive economic contraction.”

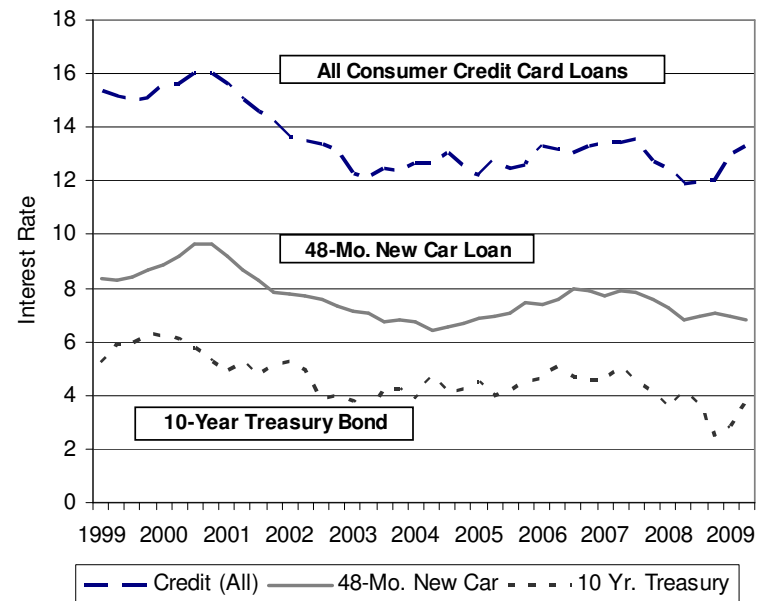
Thomas Palley
Schwartz Economic Fellow
New America Foundation

Servicing Public Debt Costs Less Than Servicing Private Debt

Facilitating the reduction of private sector debt by increasing government debt to stimulate economic growth would:

- Reduce the overall debt-servicing burden because interest rates on government debt are lower than interest rates on private sector debt.
- Distribute the burden of debt more evenly and more fairly.
- Relieve stress on U.S. banks and put more risk onto foreign debt holders.

Interest Rates on Consumer Loans and Government Debt



Source: U.S. Treasury, Federal Reserve

Government Sector Debt Has Room To Grow

The government debt-servicing burden remains less than it was in 1991 because of low interest rates.

Overall U.S. borrowing has declined and is expected to grow slowly in the future, allowing the government to issue more debt without the fear of driving up interest rates.

The global demand for U.S. Treasuries remains high because of the role Treasuries play in providing liquidity to the nation's financial system and because of the principal reserve currency role of the U.S. dollar.

“Markets should not focus just on government issuance, but look at the bigger debt picture.... Government debt may be ballooning but corporate and household debt is shrinking. So the total stock of debt in the economy is not rising.”

Dhaval Joshi
RAB Capital

A Public Investment Deleveraging And Growth Strategy

