

The Outlook for Consumer Spending and the Broader Economic Recovery

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Testimony before the U.S. Congress Joint Economic Committee
October 29, 2009

Chair Maloney, Vice Chairman Schumer, Ranking Members Brady and Brownback, and members of the Committee, I appreciate the opportunity to appear before you today to discuss the outlook for consumer spending and the broader economic recovery.

The Outlook for Consumer Spending

I will begin with the outlook for consumer spending on goods and services, as it is the largest component of GDP, and it played an important role fueling the economic expansion earlier in the decade. The available information suggests that the fundamental determinants of consumption will support only moderate growth in consumption over the next couple of years.

One factor that will probably restrain consumption will be tepid growth in households' labor income. As you know, the sharp decline in aggregate demand for output has led to one of the largest percent declines in employment since the Second World War. Payroll employment has fallen by more than 7 million since the recession began, and, although the rate of decline has abated in recent months, we are unlikely to see substantial gains in employment in the near future. When labor demand picks up again, firms are likely to increase workers' average hours—which fell noticeably during the downturn—before increasing the number of workers they employ. Firms tend to pursue this strategy because raising hours is less costly and easier to reverse than hiring new workers if the recovery proves transient. Of course, longer workweeks would increase workers' earnings, but the magnitude of this response is also likely to be muted.

If employment and average hours worked rise only slowly, labor income could advance rapidly only if compensation per hour rose rapidly. However, compensation has been moving up quite sluggishly in recent quarters, and, with the unemployment rate at its highest level since the early 1980s, it is likely to continue to do so.

Of course, one caveat to this perspective is that household income is not independent of consumer spending. If, for example, the other fundamental determinants of consumption were to change in a favorable way, then consumer spending would likely grow more rapidly, which would, in turn, feed back into greater strength in income. However, as conditions stand now, the most likely outcome is for lackluster income growth over the next couple of years.

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Under current law, consumption will also be restrained by a significant increase in tax payments over the next few years, as several key tax provisions expire. First, the temporary higher exemption limits for the Alternative Minimum Tax (AMT) are scheduled to expire at the end of 2009; if allowed to do so, many more taxpayers will be subject to the AMT. Second, the tax cuts provided by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), along with the Making Work Pay tax credit enacted in the American Recovery and Reinvestment Act (ARRA), are scheduled to expire by the end of 2010.

Moreover, additional forces should damp consumption relative to after-tax income. Compared with the situation prior to the crisis, saving is likely to represent a markedly higher share of after-tax income, and consumption is likely to represent a markedly lower share of after-tax income.

The most powerful of these forces is the massive declines that we have seen in household wealth. In the years leading up to the financial crisis, the saving needs of many households were met by substantial capital gains on homes and on holdings of corporate equities. However, the sharp reversals in the prices of these assets over the past couple of years have changed the picture dramatically. I recently studied data from surveys of household finances done in 1962, 1983 and then every three years since 1989. I estimated that recent declines in asset prices have reduced the ratio of non-pension wealth to income for the median household below the levels seen over the past quarter-century and similar to the level seen in the early 1960s.² Households above the median have been left with about as much wealth relative to income as their counterparts in the late 1980s and only slightly more than their counterparts in the early 1960s. Meanwhile, households at the 25th percentile have seen their wealth-to-income ratio fall to the level recorded in the early 1960s, and households at the 10th percentile have negative wealth for the first time in at least half a century.

The recent declines in wealth should have the opposite effect of the earlier increases in wealth—they will likely induce households to reduce their consumption and increase their saving in order to rebuild their wealth. Indeed, the weight of evidence from statistical studies over the years suggests that one fewer dollar of wealth leads to a permanent decline in the level of household consumption of about three to five cents, although this range does not encompass the conclusions of every researcher. For the most part, the evidence in these studies also suggests that households move toward their new lower levels of spending gradually over a period of one to three years.

² See Karen E. Dynan, “Changing Household Financial Opportunities and Economic Security,” forthcoming in the Fall 2009 issue of the *Journal of Economic Perspectives*. The comparison is based on data from 1962 Survey of Financial Characteristics of Consumers; the 1983, 1989, 1992, 1995, 1998, 2001, 2004, and 2007 Surveys of Consumer Finances; and an imputation of the wealth of respondents to the 2007 Survey of Consumer Finances as of the end of 2008. Since the end of 2008, movements in home prices and equity prices have had opposing effects on household wealth.

Applying the results of these studies to the declines in wealth that households have seen over the past couple of years, I estimate that wealth effects should damp consumption growth this year by between 2 and 3½ percentage points and hold down next year's consumption growth by between ½ and 1 percentage point. In doing this calculation, I assumed that household wealth rises at about the same rate as disposable income through the end of next year. The negative wealth effects could be even larger if stock prices turn down again or house prices continue to fall (a topic to which I will return later in my remarks).

The personal saving rate will probably also be boosted by factors beyond wealth. Earlier this decade, many analysts came to the view that the economy had entered a "Great Moderation," a marked long-run reduction in economic volatility. The experience of the past couple of years has presented a substantial challenge to that view. Many households have likely revised upward the amount of risk they see in their economic environment. Accordingly, one would expect households to reduce their spending so as to raise their precautionary savings.

Part of this increase in precautionary saving may occur as a reduction in borrowing. Households have just had a vivid lesson about the risks associated with high leverage, and many will be more reluctant to take on large amounts of debt to fund spending.

Households' borrowing to finance consumption is also likely to be crimped by a more restrictive supply of credit. Since the financial crisis and economic downturn began, lenders have sharply reduced their willingness to extend credit to households. With unemployment rates remaining very high in coming quarters, lenders are likely to continue to see heightened risk in lending to households for some time to come. Further, the supply of credit seems unlikely to return to the levels seen earlier this decade even after the economy returns to full strength, as lenders, like households, have probably marked up their expectations of economic volatility over the long run. Regulatory actions should serve to reinforce the greater restrictiveness of lenders; indeed, the Federal Reserve and Congress have already taken steps to restrict some types of mortgage lending and certain practices among credit card lenders.

All told, I expect that consumer spending will move up at a modest pace in coming quarters because of weak income growth as well as higher saving and lower borrowing. Although this outlook contributes importantly to my expectation of a relatively weak overall recovery, I should note that higher household saving and lower household borrowing have the important positive aspect of leaving the economy in a more solid and more sustainable position. At the household level, the restructuring of balance sheets will leave households less vulnerable to disruptions to their incomes and to unexpected spending needs. At the national level, higher saving will help to correct what many analysts believe are unsustainable imbalances in trade and capital flows between countries.

The Outlook for the Broader Economy

Turning to the broader economy, I share what seems to be the consensus view that we are not likely to see the rapid snapback in activity that has followed many previous downturns. As with consumer spending, the most probable outcome seems to be a moderate expansion of economic activity over the next couple of years.

To be sure, the consensus view may not turn out to be correct. Two years ago, for example, most analysts did not foresee the deep recession that we have experienced. Similarly, the recovery could well be stronger or weaker than most forecasters now expect.

That said, although the economy appears to have reached a turning point, none of the major components of private aggregate demand seem poised for a sharp recovery. As I have just described at length, consumer spending is unlikely to expand robustly over the next year or so. Indeed, consumer spending has rarely led the way out of downturns in the past. All recoveries are different, of course, but, on average, the saving rate has tended to move sideways after the economy hits bottom, implying that consumer spending has generally increased as rapidly as income and overall economic activity.

In the housing sector, the long contraction appears to have come to an end, with residential construction, home sales, and home prices all showing signs of firming in recent months. Indeed, homes are much more affordable than they were a few years ago, with national home prices now down more than 30 percent from their peak in 2006 and interest rates on conforming mortgages roughly 1.5 percentage points below their average over the past decade. However, a strong rebound in construction seems very unlikely. The stock of unsold new homes remains very high, particularly when measured relative to sales. In addition, housing demand will likely be held back for some time by the weak financial situations of many households. Moreover, many households that are not qualified for government-supported mortgages—either with backing from the government-sponsored enterprises or through the Federal Housing Authority or the Department of Veterans Affairs—are finding it extremely difficult to obtain a mortgage.

One downside risk to this already soft outlook stems from the foreclosure crisis. In 2008, lenders initiated more than 2-1/4 million foreclosures, up from a pace of 1-1/2 million in 2007 and an average of less than 1 million over the preceding three years. With various foreclosure moratoria expiring in early 2009, the rate at which foreclosures were initiated shot up to an annual pace of 3 million.³ Foreclosure starts generally affect housing markets with a substantial lag, as the foreclosure process can take many months or even years to complete. Thus, although improvements in economic conditions and this year's government initiatives to prevent foreclosures may damp the foreclosure start rate, the rate at which distressed properties are coming to market is likely still building. We lack good estimates of how large the influx will be and how it will affect the housing market,

³ See Larry Cordell, Karen E. Dynan, Andreas Lehnert, Nellie Liang, and Eileen Mauskopf, "The Incentives of Mortgage Servicers and Designing Loan Modifications to Address the Mortgage Crisis," in Robert W. Kolb, ed., *Lessons from the Financial Crisis* (forthcoming).

but one cannot dismiss the possibility that these properties will depress housing construction and home prices yet further.

Business investment in equipment and structures is likely to be held down by the large amount of excess capacity. Falling demand for manufactured products over the past two years has left capacity utilization in that sector extremely low relative to historical norms. Outside of manufacturing, the financial sector, which traditionally has invested heavily in high-tech equipment, has shrunk markedly and is likely to stay much smaller than its pre-crisis size. More broadly, weak demand for output should damp business investment in many sectors. Business spending on structures is likely to be particularly sluggish, amid high vacancies in the office sector and very tight financing conditions for firms that do wish to start new projects.

Business investment in inventories is probably contributing to growth in the second half of this year. The sharp reduction in demand for goods led businesses to liquidate their holdings of inventories at a staggering rate in the first half of the year. But, with the recent stabilization of demand, the pace of destocking should be slowing, and, at some point, firms will begin to rebuild inventories. This pattern appears to have been boosting production of late and should continue to do so for several quarters. However, inventory investment cannot be counted on as a source of sustained growth as its effects on production tend to be neutral once inventories are brought in line with sales.

Foreign growth has picked up of late, particularly in many Asian nations. This recovery has led to an increase in demand for U.S. exports. However, imports have also turned around with the firming of domestic demand. On balance, net exports appear to be contributing little to the U.S. recovery at this point.

In sum, economic activity is on track to expand over the next couple of years but only at a modest pace. As a result, the economy is unlikely to see full employment for many years, prolonging the current economic distress for millions of households.

Policy Options

In light of the expected slow pace of the recovery, many policy analysts and other observers are considering possible policy actions to spur demand for output and employment. Some of these policy actions would be broadly stimulative, while others would have narrower, targeted effects.

As I noted earlier, under current law, households' disposable income will be reduced by the expiration at the end of this year of the higher exemption limits for the Alternative Minimum Tax and the expiration by the end of next year of the 2001 and 2003 tax cuts and the Making Work Pay tax credit. According to the Congressional Budget Office (CBO), these developments will depress disposable personal income in 2011 by a projected \$300 billion or nearly 3 percent.⁴ Pushing back the date at which these provisions expire would provide more support for consumer spending.

⁴ See Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2009.

That said, policymakers should be mindful of the long-term need for fiscal discipline. Even with the expiration of these tax provisions, CBO projects that U.S. budget deficits will be more than 3 percent of GDP five to ten years from now and that federal debt held by the public will be rising relative to GDP. High budget deficits reduce saving and investment and, in turn, damp economic growth; they also risk inducing a crisis in which the holders of U.S. debt lose their appetite for that debt. Thus, while it may make sense for Congress to take steps that reduce taxes on households in the short run, it is imperative that policymakers form a plan to bring revenues back in line with spending over the longer run.

More targeted policy changes can generally be divided into those that bolster job creation and those that provide other relief to households that have suffered job losses. In the former category, additional aid to state and local governments would reduce the need for cutbacks in employment by those governments and by related private-sector entities. Even if one thinks that state governments should restrain their activities and employment over time, the abrupt cutbacks enforced by falling tax revenue in this recession have not served the broader economy well.

As another strategy for encouraging job creation, some analysts have proposed offering tax credits for firms that hire new workers. Designing and implementing effective tax incentives for hiring is difficult, however. One challenge is that, in the dynamic U.S. job market, many firms are creating jobs even in tough economic times. Therefore, a tax credit for all job creation tends to distribute money to many firms that would have done that same hiring anyway. On the other hand, restricting a tax credit to employment increases that would not otherwise have occurred is hard.

With regard to initiatives that provide other types of relief to households that have suffered job losses, several possibilities would help households sustain their spending and thereby bolster the overall recovery. For example, the efforts that Congress is making to extend unemployment insurance for those who are scheduled to exhaust their benefits by the end of this year would be helpful. Likewise, an extension of the subsidy of COBRA health-insurance premiums for laid-off workers would also be helpful.

Policymakers could also adopt policies to help homeowners who have lost their jobs meet their mortgage obligations. The Administration's loan modification program, the Home Affordable Modification Program, should help many borrowers for whom a moderate permanent adjustment to mortgage payments would make those payments sustainable over the long run. However, the program is not well-suited to cases where homeowners have suffered large temporary declines in income, because the required modifications will often be too costly to qualify for the program.⁵ Nor do costly permanent modifications make sense for these cases, as they should not be needed once the

⁵ For more discussion of the Home Affordable Modification Program and its limitations, see Larry Cordell, Karen E. Dynan, Andreas Lehnert, Nellie Liang, and Eileen Mauskopf, "Designing Loan Modifications to Address the Mortgage Crisis and the Making Home Affordable Program," Federal Reserve Finance and Economics Discussion Series Paper No. 2009-43, October 2009.

homeowners have found other jobs. Instead, temporary assistance for meeting mortgage obligations would help support the spending of laid-off workers, and, by making mortgage default less likely, reduce the downside risks to the housing outlook that I noted above.

Another way to support the housing market would be to extend the first-time homebuyer tax credit, which is scheduled to expire on December 1st of this year. This approach would likely spur some new home sales. However, as my colleague Ted Gayer at the Brookings Institution has argued, the tax credit may be a costly way to accomplish this goal, as most of the homebuyers expected to receive the credit would probably have bought homes without the credit. In addition, to the degree that the tax credit simply shifts additional households from renting to owning, it does not address the fundamental problem of oversupply in the housing market.⁶

Conclusion

Recent economic data point to a decided firming of economic activity. A great deal of uncertainty surrounds the question of the strength and speed of recovery, but the most likely course for the economy seems to be gradual expansion. Consumer spending on goods and services, the largest component of aggregate demand for output, is likely to be held to a modest upward trajectory over the next of couple years by weak income growth, higher saving, and lower borrowing. Likewise, the fundamental determinants of other major components of private demand appear to be supportive of only moderate growth in these categories. Policymakers have some options that would bolster the recovery and increase the speed with which the economy returns to full employment; considerations of such actions should be mindful not only of the short-run benefits but also of the potential long-run costs, particularly in terms of the budget deficit.

Thank you very much.

⁶ See Gayer, Ted “Should Congress Extend the First-time Homebuyer Tax Credit?” at http://www.brookings.edu/opinions/2009/0924_tax_credit_gayer.aspx.