Consumer Spending and the Economy

By *HALE STEWART* September 19, 2010, 2:22 pm
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The U.S. economy is predominantly driven by consumer spending, which accounts for approximately 70 percent of all economic growth. But if consumers are to continue to drive the economy, they must be in a sound financial position; if they become overburdened with debt, they are not able to maintain their position as the primary driver of economic growth. To that end, consider the following table which shows the total amount of household debt (all consumer loans and mortgages), total nominal gross domestic product, total nominal disposable personal income, the ratio of household debt to G.D.P. and the ratio of household debt to total disposable personal income. All numbers are in billions:

Year	Total Household Debt	GDP	Disposable Personal Income (DPI)	Household Debt as a percentage of GDP	Household Debt as a percentage of (DPI)
1975	734	1,638	1,187	45%	62 %
1980	1,396	2,788	2,003	50%	70%
1985	2,278	4,218	3,073	54%	74%
1990	3,581	5,801	4,254	62%	84%
1995	4,841	7,415	5,457	65%	89%
2000	6,987	9,952	7,327	70%	95%
2005	11,743	12,638	9,277	93%	127%
2009	13,602	14,119	11,035	96%	123%

The table clearly shows that over the last 30 years, the typical U.S. consumer has increased both his total amount of debt and the percentage of that debt relative to overall G.D.P. and disposable income. While there is no bright line rule for "too much debt" in an economy, it is fair to say that at some level, the total amount of debt — and the percentage of debt to key economic numbers such as G.D.P. and disposable personal income — becomes so large that it forces consumers to slow their spending on other items in order to start devoting a larger amount of their income to paying down debt.

This observation is hardly new. In fact, it is largely based on the writings and observations of Irving Fisher, whose 1933 paper, The Debt-Deflation Theory of Great Depressions, provides a tremendous amount of insight into current situation of U.S. consumers. Mr. Fisher observed that slight misallocation of economic resources were generally not responsible for depressions. He noted that, "Any of them [traditional business cycle dis-equilibrium events] may suffice to explain small disturbances, but all of them put together have probably been inadequate to explain big disturbances."

As a present example of the previous point, the wheat market specifically and the grain markets in general are currently experiencing what Fisher called "dis-equilibrium" – an economically unbalanced situation where supply and demand are not perfectly equal. Earlier this year, the Russian wheat harvest was severely damaged by fires throughout Russia, eventually leading the

Russian government to ban all wheat exports. These events led to an increase in wheat prices because of the decrease in available product. While disquieting, the wheat market "dis-equilibrium events" were not serious enough to cause a depression. Instead, two interrelated and regular economic events occurred: the overall market experienced a period of higher prices caused by a decrease in product and new supplies and suppliers started to emerge.

The recent events in the wheat market are indicative of numerous events that occur throughout a market economy on a regular basis; too much of one product is produced, leading to lower prices to clear excess merchandise or too little of a product is produced, inviting new companies and producers to enter the market. However, Fisher argued even large numbers of these events occurring at the same time are typically not severe enough to cause a depression. What really caused depressions was "over-indebtedness to start and deflation following after that."

Fisher argued when an economy has too much debt, it becomes susceptible to the following chain of events. An event occurs which creates a "mild gloom that shocks the conscience." In other words, a news event occurs which lowers consumer confidence, leading investors to sell assets to start to pay off debt. As asset prices fall, investor confidence is lowered further as others see the value of their investments drop. This leads to further selling, lowering prices further. At some point, consumer's net worth drops to a point where they slow down their purchases, lowering business profits, which eventually leads to lay-offs, further exacerbating the downward cycle.