

FINANCIAL TIMES

TUESDAY JUNE 20 2006

COMMENT

ZACHARY KARABELL and DAN CHUNG

Alive and well under a mountain of debt

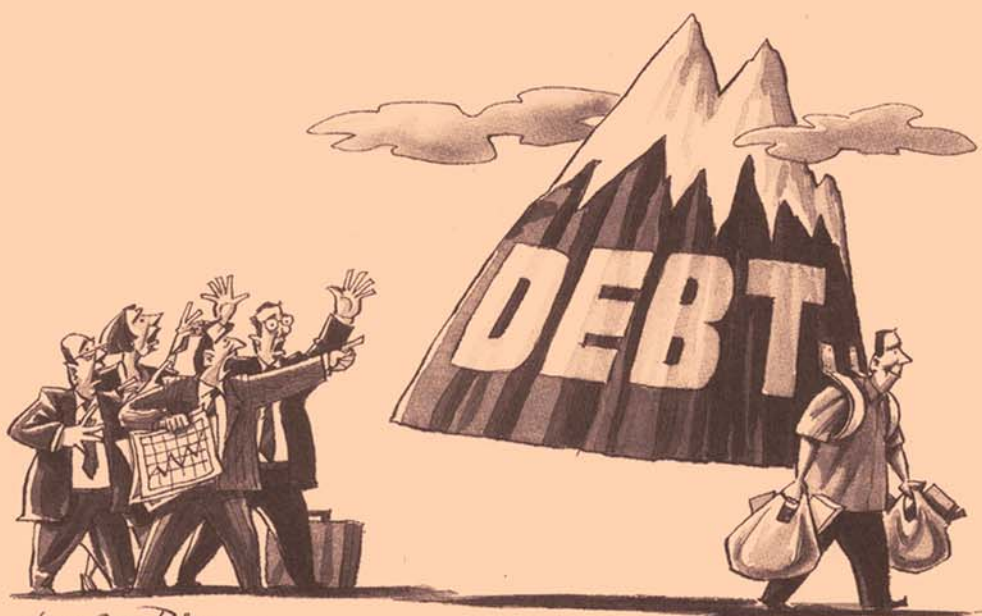
Remember the scene in *Monty Python and the Holy Grail* where two men push a wheelbarrow through a plague-afflicted village shouting: "Bring out your dead"? A family heaves a body on to the pile, whereupon it lifts his head and says: "But I'm not dead yet!" One man whacks him with a cudgel and says: "Now you are." That is the perfect metaphor for the American consumer on the one hand and strategists, commentators and economists on the other. They keep trying to bury the consumer under a mountain of debt, even though he is alive and kicking.

There is an understandable cultural prejudice against debt. For most of history, the risks outweighed the costs. If you calculated wrongly, you did not just go bankrupt: you lost your business, home and possessions. That is why Benjamin Franklin, as "Poor Richard", cautioned against

The amount that households spend to service their debt is manageable. The question is not how much debt but whether it is affordable.

debt. But times have changed. Low interest rates, securitisation and bankruptcy law have changed the nature of debt.

Our prejudice against debt no longer makes sense. In



Ingram Pinn

March, Federal Reserve chairman Ben Bernanke said as much when he suggested that the substitution of mortgage debt for credit card and automobile debt had been a rational decision by consumers to shift leverage into lower-rate obligations. But his assessment is at odds with attitudes on Main Street and Wall Street, especially in light of global agitation over inflation and excess liquidity.

There is no denying that the absolute amount of consumer debt is higher than ever. At the end of 2005 there was \$8,200bn (£4,500bn) of outstanding mortgage debt in the US, \$800bn of credit card debt and another \$2,500bn of assorted other debts includ-

ing automobile loans. That is a total of \$11,500bn.

Big numbers, yes, and big numbers are easily turned into a harbinger of crisis. But take the financial net worth of US households (which excludes the value of homes): \$26,500bn, a record high. With home value included, that rises to \$52,000bn – more than four-and-a-half times household debt.

The role of interest rates cannot be overstated. Even with the Fed tightening, the absolute level of rates is low by historical standards, so low that for all the refinancing and home-equity extraction we have seen, we can still see more. The average mortgage rate for a 15-year loan is around 6 per cent. In

2000, it was 7.72 per cent. Even though conventional wisdom says that consumers are tapped out, they can continue to use their homes as piggy banks. Even if rates go up another 50 basis points, it is likely that consumers will extract hundreds of billions of dollars in cash-out refinancing this year.

Furthermore, the amount that households must spend to service their debts is manageable. That should be the central concern: not how much debt, but whether it is affordable. In 2001, households spent 12.9 per cent of income to service their debts; by the end of 2005, that had risen to nearly 14 per cent. Again, the key issue is rates: if rates are at

or near a peak, debt-financed spending can continue. If not, we will face a credit crunch, especially since average incomes are barely rising.

Anyone who defends current levels risks being labelled as blind not only to structural imbalances but to the struggles faced by families who are taking on debt to meet basic obligations such as homes, medical costs and education. We are not making a judgment about the wisdom of individual consumers, about the struggles they face or about an American culture that overemphasises consumption and encourages excessive spending. We are making a structural argument that the economy can sustain far higher levels of con-

sumer debt than in the past. Even if more individuals face a credit squeeze, the system overall is in no jeopardy.

In addition, many consumers may be using debt more wisely than commentators give them credit for. The increasing array of financial instruments means that people can take on more debt when they are young and their career outlooks are improving.

The pluses in today's economy are evident: easy access to credit and goods and services at low prices. The negatives are also clear: little wage growth. The world is awash in labour, which combined with favourable demographics in the developing world, means that inflation should trend lower and rates

are more likely to be 2 per cent than 6 per cent in the coming years. Central banks can affect rates in the short term but global markets dictate the longterm outlook. If that is the case, and rates and inflation continue their decline, today's large debt numbers will look small by comparison.

Stripped of its stigma, debt is a neutral tool. Used prudently, it generates economic activity; taken on foolishly, it is a recipe for problems. The question is: what is the tipping point? Prudence, say the sceptics, dictates cutting back now. But is that prudence, or fear?

There are many things we do that become dangerous in excess. The goal, as Poor Richard told us, is modera-

tion. In a world of low rates and less structural risk, the definition of moderation – and risk – must change. The fear that debt arouses once protected people from stupid decisions but today it impedes a rational assessment of costs and benefits. Apocalyptic rhetoric may be good for politics but it is lousy for economics and does nothing to help us understand the world we live in. Poor Richard would not have approved.

Zachary Karabell is senior vice-president and chief economist and Dan Chung is president and chief investment officer of Fred Alger Management.