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As U.S. Economy Has Thrived, So Has Debt

Imbalances Make Greenspan's Legacy as Fed Chairman Unclear

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Beverly Wilmore is bracing for the tuition bills about to start rolling in after her 19-year-old daughter starts at Towson University this week. But she's not too worried -- she figures she and her husband can borrow against their four-bedroom Gaithersburg home, which has appreciated from $250,000 when they bought it in 2000 to about $400,000 now.

And as the home's value rose, two years ago the Wilmores refinanced their mortgage, cutting their monthly home-loan payments by hundreds of dollars, she recalled.

Like many families who caught the housing boom, the Wilmores now have more debt than before they bought their home, but they also are wealthier. "I'm thankful for the low interest rate," said Wilmore, 42, a special-education teacher.

The Wilmores are among the millions of Americans who have prospered during Alan Greenspan's 18 years as chairman of the Federal Reserve. They lived through nearly two decades of generally stable economic growth with low inflation, low unemployment and modest interest rates. Under Greenspan's watch, the economy thrived despite stock market crashes, international financial crises, terrorist attacks, wars and other shocks. No wonder, as Greenspan prepares to retire next week, economists have lauded him as the greatest central banker ever.

Still, his legacy will be judged not just by his record at the Fed, but also by the economy he bequeaths. And when he leaves office Jan. 31, Greenspan leaves a nation awash in debt -- record household debt and a record trade gap.

Many analysts say his low interest rate policies contributed to these huge imbalances, which threaten the economy he nurtured.

"The jury is out on his legacy in large part because of the debt" and the trade deficit, said Stephen S. Roach, chief economist at Morgan Stanley. "You will not be able to truly judge his accomplishments until we see how this plays out in the post-Greenspan era."

Creating Debt

Greenspan and his Fed colleagues agree that part of the growth in household debt and the trade gap is the

side effect of policies that helped steady the U.S. economy after the 2000 bursting of the stock bubble. The Fed's low interest rates encouraged consumers to borrow and spend on houses, autos and other goods, spurring economic growth for several years when businesses were cutting jobs and reluctant to invest. And it was no surprise that consumers spent much of their borrowed money on imports, causing the trade deficit to swell. But in the view of central bank policymakers, the alternative would have been worse -- a longer and more painful downturn.

Greenspan's Fed didn't do it alone, economists agree. Other factors helped fuel the borrowing binge, including global financial trends that have helped keep mortgage rates low and prompted lenders to extend more credit to more people.

The result is a prosperity built on borrowing, say many economists, pointing to a string of recent records and firsts:

· U.S. household debt hit a record $11.4 trillion in last year's third quarter, which ended Sept. 30, after shooting up at the fastest rate since 1985, according to Fed data.

· U.S. households spent a record 13.75 percent of their after-tax, or disposable, income on servicing their debts in the third quarter, the Fed reported.

· The trade deficit for last year is estimated to have swollen to another record high, above $700 billion, increasing America's indebtedness to foreigners.

"The economy's increasing reliance on unprecedented levels of debt is clearly unsustainable and extremely troubling," said Charles W. McMillion, chief economist with MBG Information Services, a financial analysis firm. "The only serious questions are when and how will current imbalances be addressed and what will be the consequences."

The Fed chairman told Congress in June: "I think we've learned very early on in economic history that debt in modest quantities does enhance the rate of growth of an economy and does create higher standards of living, but in excess, creates very serious problems."

Greenspan didn't define "excess," but economists see troubling possibilities: A sudden reversal in housing prices could trigger a recession if consumers cut back on spending and households have trouble paying their mortgages. The trade gap could swell to a point that forces a sharp fall in the dollar and surge in interest rates, also causing a recession.

Even without a crisis, the debt load will weigh on the economy simply because of the interest to be paid on it, which leaves less money to spend on other things and prevents living standards from rising as fast as they would otherwise, some analysts believe.

The Past Five Years

To understand how all this debt built up, recall how things looked in early 2001.

In January 2001, Beverly and Kevin Wilmore were excitedly overseeing construction of their home, looking forward to moving in with their two children the following year.

But from his office at the Fed's marble headquarters on Constitution Avenue NW, Greenspan saw that the

economy was sputtering. Stock prices had been sliding for nearly a year after peaking in early 2000 at the height of the tech boom. Retail sales had soured. Businesses were throttling back on production and investment.

On Jan. 3, 2001, Greenspan convened a conference call meeting of the central bank's top policymakers. They agreed to cut the Fed's benchmark short-term interest rate for the first time in more than two years, to 6 percent from 6.5 percent.

That action marked the beginning of an aggressive campaign by Greenspan and his colleagues to prevent the bursting of the stock market bubble from devastating the U.S. economy.

Greenspan had studied the Great Depression of the 1930s and believed it resulted largely from the Fed's mistakes in tightening credit after the 1929 stock market crash. He also had seen Japan's central bank ease credit too cautiously after that country's property bubble burst in the early 1990s, triggering a decade-long economic slump. He would do the opposite, dramatically easing credit -- by cutting interest rates -- to cushion the economy's landing.

The Greenspan Fed lowered its benchmark rate another 12 times over the next 2 1/2 years as the economy struggled to regain its footing, cutting the rate to 1 percent by June 2003, the lowest level since 1959.

The benchmark federal funds rate, the overnight rate on loans between banks, influences many other longer-term rates in the economy, including those on mortgages, car loans and business loans. Low interest rates encourage consumers and businesses to borrow and spend, stimulating economic growth.

The Fed's rate cuts had little effect on corporate America, which had overinvested in equipment, software and factories during the late 1990s boom; businesses retrenched, slashing both payrolls and spending plans, tipping the economy into recession from March through November of 2001.

But low interest rates worked like an intoxicant on consumers, who snapped up new cars and trucks with no-interest loans and seized on low mortgage rates to buy new homes and refinance old home loans. Those sales and refinancings freed up more cash to spend. Households used much of that extra money to pay off credit cards, student loans and other, higher-interest rate debt -- "cleaning up their balance sheets," in economists' terms. They also kept shopping through the recession, the terrorist attacks and the rocky economic recovery that followed.

The tonic worked. Household spending rose in 2001, 2002, and 2004, even as the wealth and income of the typical household fell or remained flat in the same period, according to an analysis by Moody's Economy.com. The recession was one of the mildest on record. The economy has been growing since November 2001 and was strong enough by mid-2004 for the Fed to start raising the benchmark rate.

Fed officials expected then that longer-term rates, such as mortgages, would rise as well, causing consumers to borrow less and save more.

But it didn't work out that way. For several reasons -- low inflation, economic stability and foreign investors pouring their savings into U.S. stocks, bonds and other assets -- long-term interest rates fell for a year after the Fed started raising the benchmark rate and have stayed relatively low.

Mortgage rates also fell, prompting homeowners to refinance repeatedly. Changes in the financial industry

made it easier for homeowners to tap their home equity through refinancing. Lenders provided adjustable-rate mortgages that enabled home buyers to pay higher prices while temporarily making low monthly loan payments.

The housing market kept booming. Consumer debt and spending kept climbing.

Living With the Debt

Many households are happy with the results. Homeownership climbed above 69 percent in late 2004, which means millions more people gained a store of wealth that can grow and be available in hard times.

And home values have skyrocketed, pumping up household wealth to a record $51 trillion in the third quarter, according to Fed data.

But household debt rose faster in recent years than wealth or disposable income, reaching an unprecedented 126.1 percent of after-tax income in the third quarter, double its 1980level.

All this debt isn't straining households so far. Late payments on credit card loans and other forms of consumer debt declined in the third quarter, the American Bankers Association reports. Although delinquency rates probably rose in the last three months of the year because of the delayed effects of the hurricanes, those rates are likely to fall this year because of the strong economy, said ABA chief economist James Chessen. "I think it will be a pretty good year for consumer debt and the ability to pay your loans," he said

These national figures combine all U.S. households, but debt tends to weigh most heavily on low-income families, other analysts note.

Many households with incomes below $50,000 a year, the bottom half of the income distribution, have mortgages at higher interest rates, plus car loans, student loans and credit card debt, said Mark Zandi, chief economist at Economy.com. "Their balance sheets are a mess," and they will have a harder time as interest rates rise, he said.

Indeed, U.S. households collectively spent more than their combined income in the second and third quarters of last year. The only way to do that is by selling assets, dipping into savings or borrowing.

When questioned on Capitol Hill in June about criticism that the Fed's strategy had helped inflate a housing bubble, Greenspan suggested that such imbalances were an acceptable price for avoiding another depression or a Japan-like economic stagnation.

"We knew that in the process of what we were doing -- that is, addressing the consequence of a very severe deflation of a [stock] bubble -- carried with it potential side effects," Greenspan said. "As best we can judge, things have turned out reasonably as we had expected, both positively and negatively, but in our judgment, the positive effects of the policy far exceeded the negative ones."

If Greenspan's strategy of raising rates in small, steady steps works, rising interest rates will cause the housing market to simmer gradually, households will save more, and the trade gap will narrow without great damage to the overall economy.

If so, Greenspan will go down in history with his reputation untarnished.

As Beverly Wilmore put it, as she recounted her family's recent experience, "We've prospered."

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