FTA Revenue Estimation & Tax Research Conference

Household Financial Stability and Economic Growth

October 9, 2013

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A New Research Initiative: Center for Household Financial Stability

Center for
HOUSEHOLD
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Researching Family Balance Sheets to
Strengthen Families and the Economy

- **What is the state of families' balance sheets?**
  - **Survey of Consumer Finances**
  - **Financial Accounts of the United States**
  - **Experian/New York Fed Consumer-Credit panel**
- **Why does it matter for families and for the economy?**
- **What can we do to improve them?**

www.stlouisfed.org/household-financial-stability/

- **Research**
  - ***2012 Annual Report*: The state of American balance sheets**
  - **Who was hurt most in the crisis?**
  - **Why did vulnerable families have risky balance sheets?**
  - **Why did young families lose so much wealth?**
  - **What is the current status of older families?**
- **Conferences and events**
  - **Financial-Access Forum (Oct. ' 12); Student Loans (Nov. '13)**
  - **Research Symposia (Feb. 2013; May 2014)**
  - **Rebuilding-Wealth Roundtable (Urban Institute, Oct. '13)**
- **Updates and monitoring tools**
  - ***In the Balance* briefs**

What is the State of American Families' Balance Sheets?

- **Largest household-wealth loss since the Great Depression: $16 trillion**
- **Main balance-sheet components**
  - **Equity shares**
  - **Housing**
  - **Other assets**
  - **Liabilities continued to rise until Q3.2008**
- **Demographic dimensions**
  - **In percentage terms, biggest losers were:**
    - **Young families**
    - **Less-educated**
    - **Minorities (African-American, Hispanic)**

Recovery of Average Wealth Loss: 76 Percent

- **Average inflation-adjusted household wealth loss, Q1.2007 (peak) through Q1.2009 (trough)**

-$153,000

-22.2%

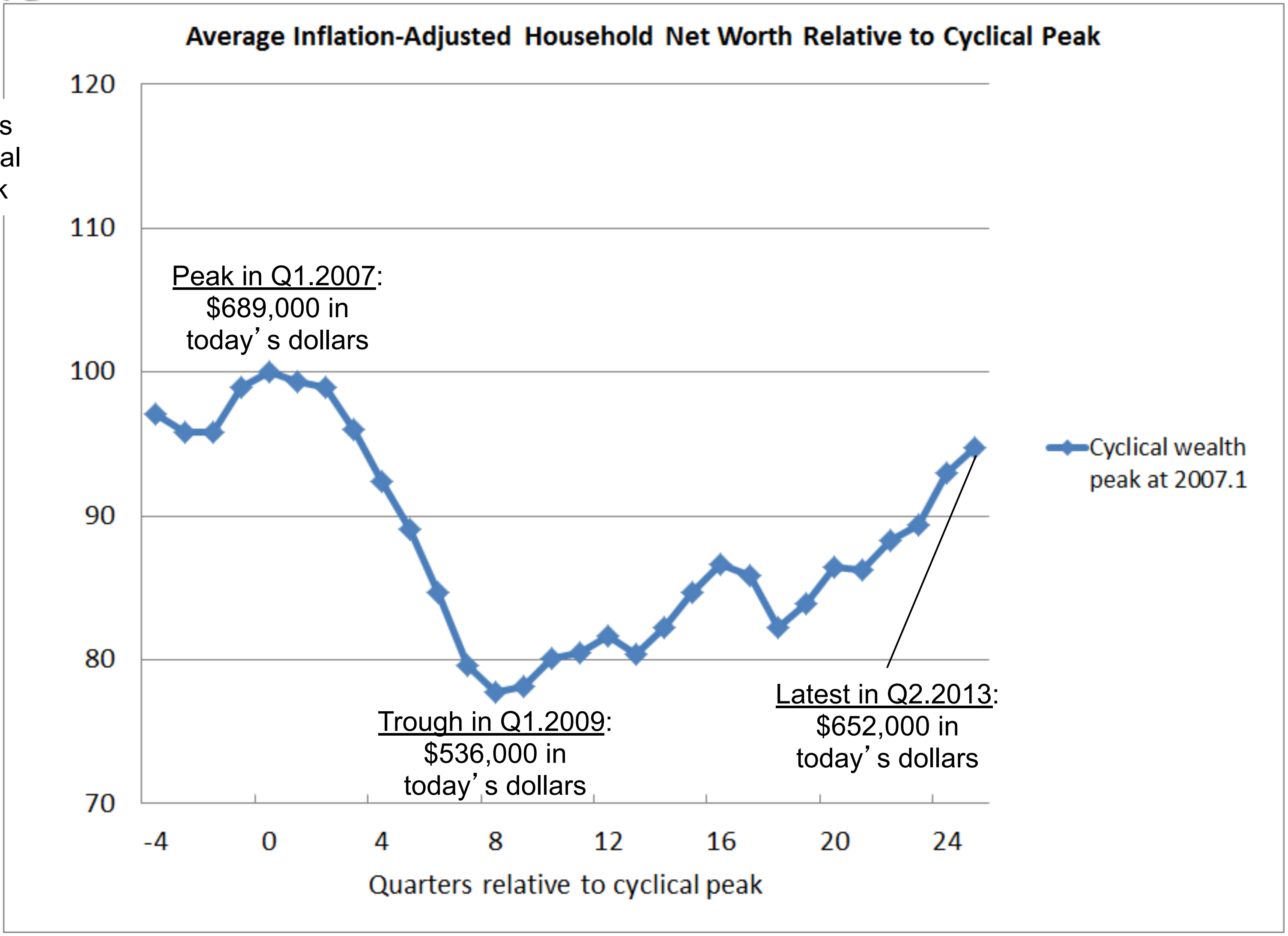
- **Average inflation-adjusted household wealth regained, Q1.2009 (trough) through Q2.2013 (latest)**

+$117,000

+21.8%

Average Real Household Wealth Hasn't Returned to Peak of 2007

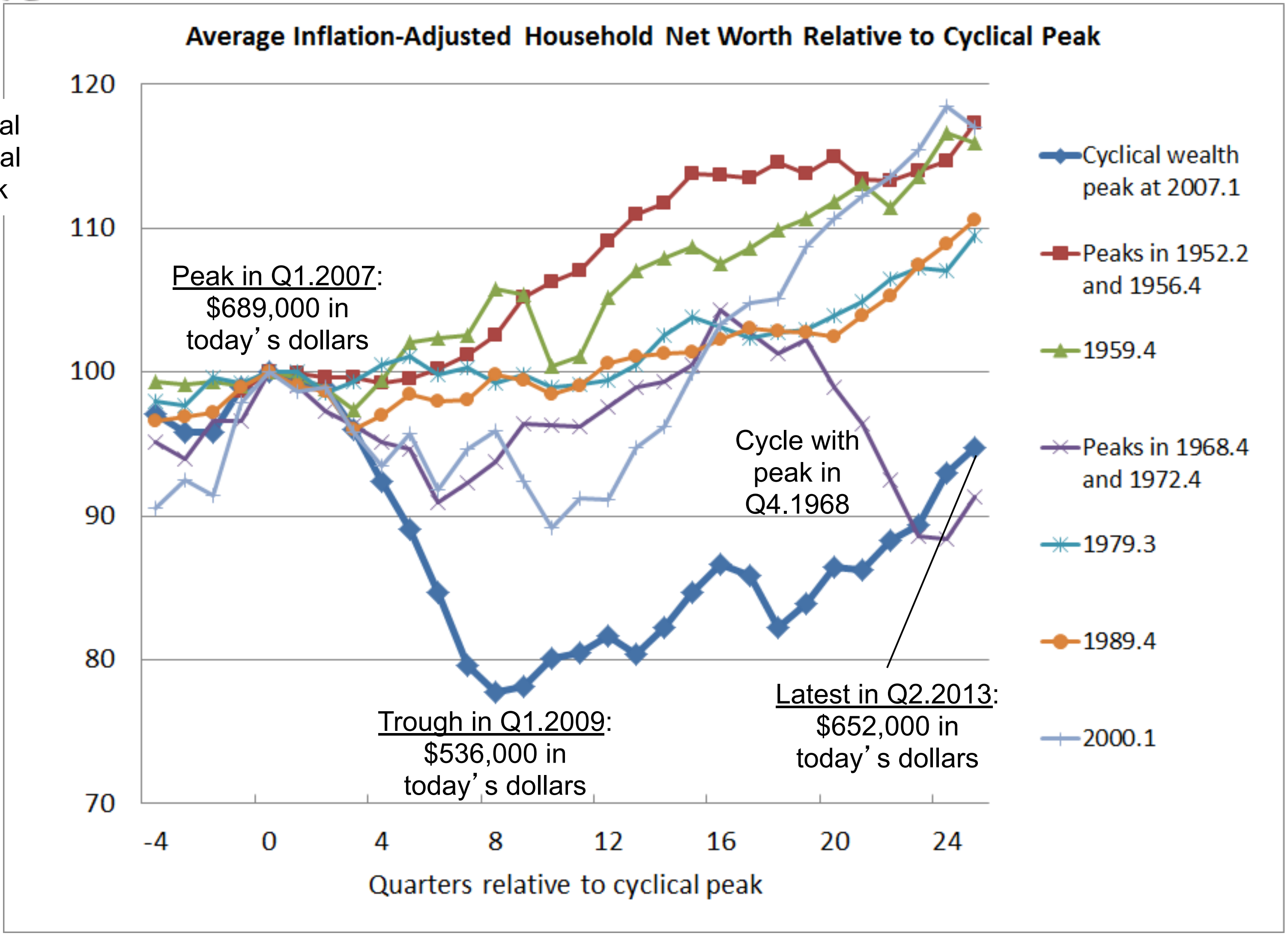
Index equals 100 at cyclical wealth peak



Sources: Federal Reserve Board, Bureau of Economic Analysis, Census Bureau

Wealth Loss During 1968-75 Cycle Also Was Protracted

Indexes equal 100 at cyclical wealth peak



Sources: Federal Reserve Board, Bureau of Economic Analysis, Census Bureau

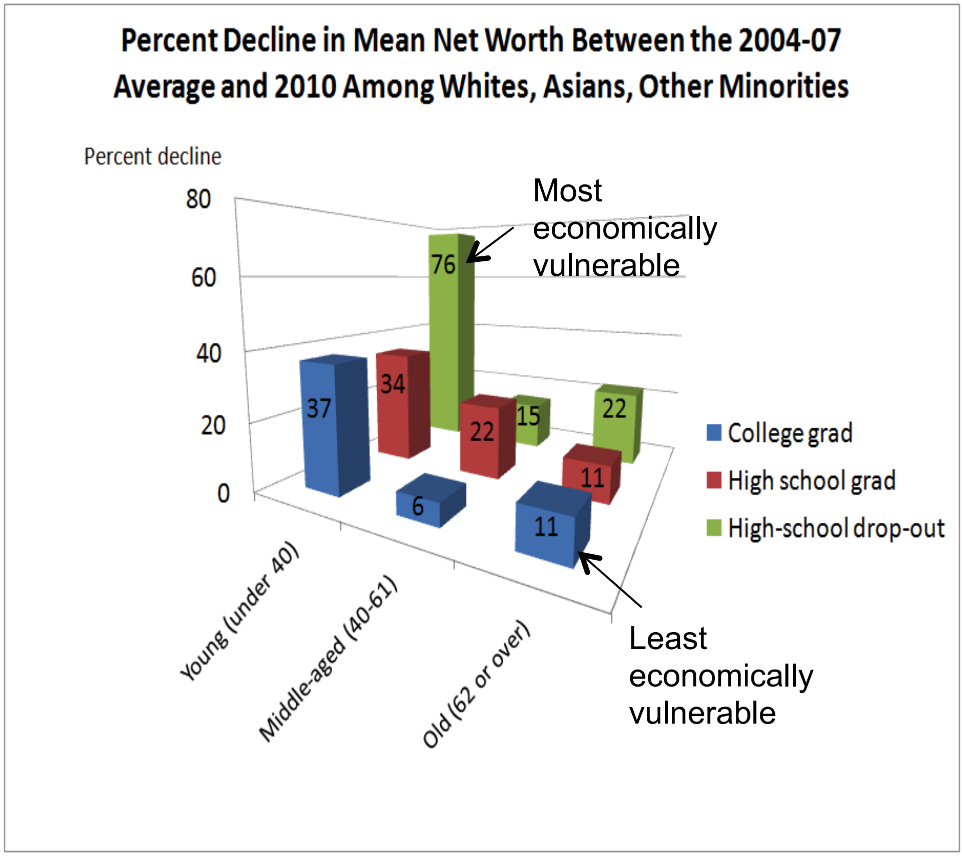
Economically Vulnerable Groups Suffered Very Large Wealth Losses

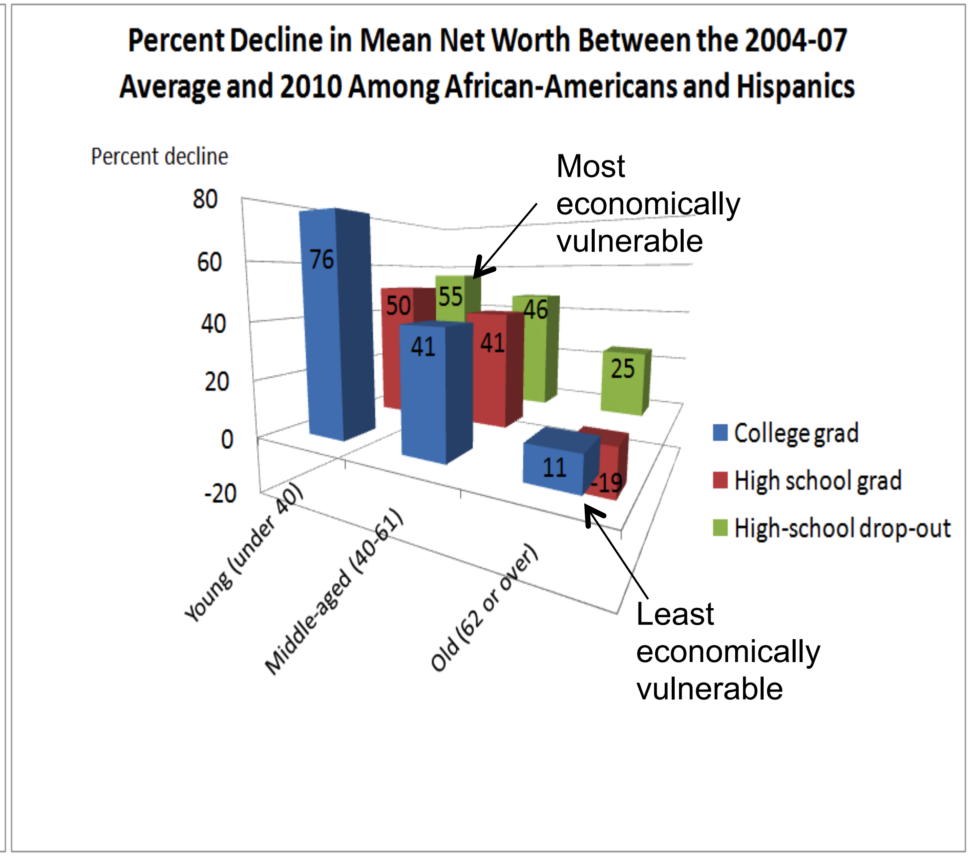
- **Wealth losses during the crisis (2010 wealth vs. 2004/07 average, inflation-adjusted)**
  - **Overall: -10%**
  - **Young (<40) families: -41%**
  - **Less-than HS families: -28%**
  - **Minority families: -31%**

- **Groups with smaller average losses**
  - **Older (62+) families: -4%**
  - **College grads (2- or 4-yr): -9%**
  - **Whites and Asians: -6%**

Source: Federal Reserve, Survey of Consumer Finances

Wealth Loss During the Crisis





Source: Federal Reserve, Survey of Consumer Finances

Wealth Recovery Continues

- **By balance-sheet item**
  - **Equity shares fully recovered**
  - **Housing still off 25% in real terms**
  - **Other assets remain below peak**
  - **Liabilities falling but still high**

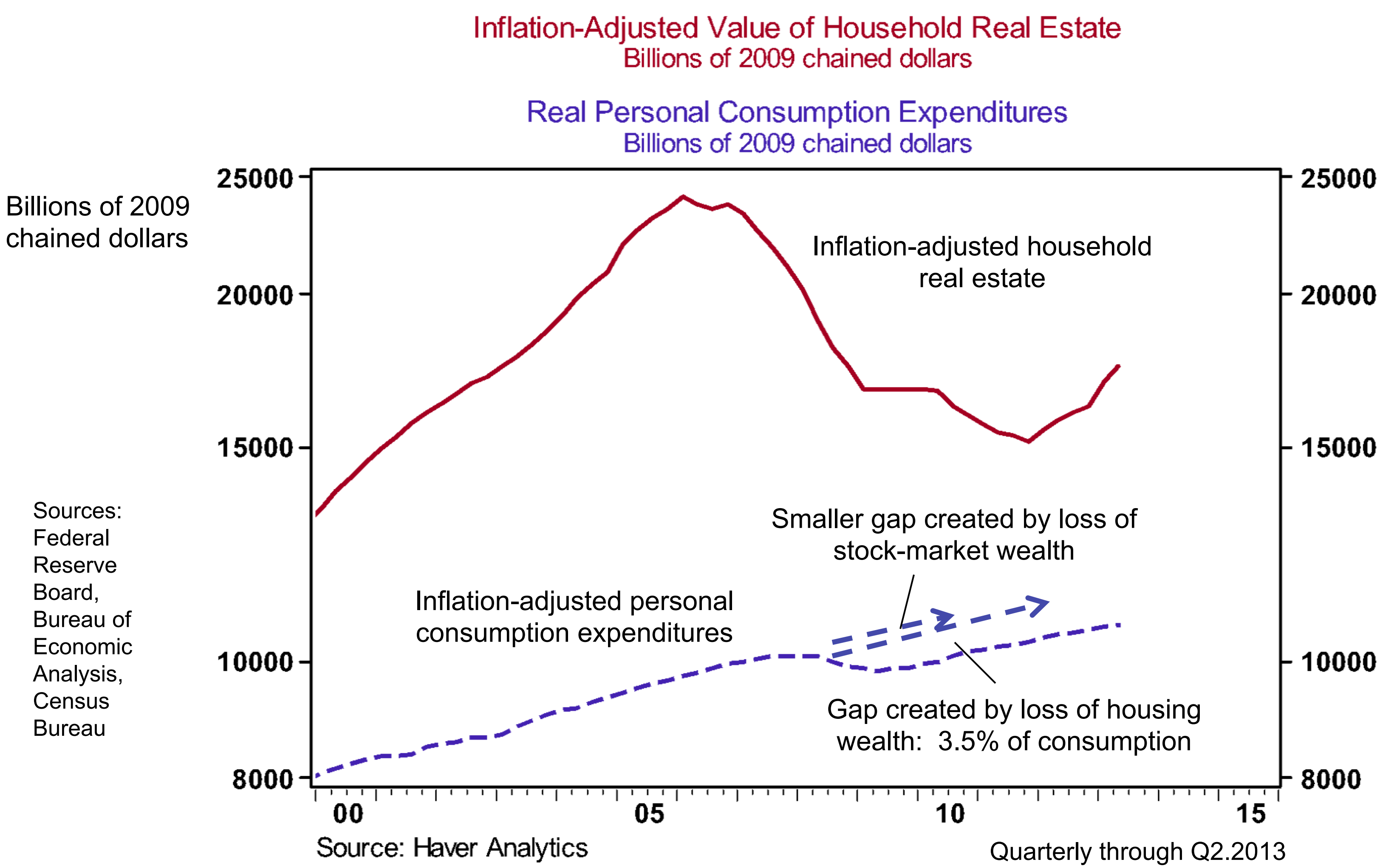
- **By demographic group**
  - **Biggest gainers owned stocks and businesses, had little debt: Mainly college-educated whites and Asians over 40**
  - **Biggest losers had only housing and lots of debt, and are recovering very slowly if at all**

Why Does it Matter for Families and the Economy?

- **Families**
  - **Strong balance sheets can buffer income shocks**
  - **Wealth predicts health outcomes, community stability, and children's success**
  - **Economic mobility**

- **The economy**
  - **Wealth effects**
  - **Leveraging and deleveraging effects**

Case, Quigley, and Shiller (2013): Housing Wealth Effect Reduced Consumer Spending



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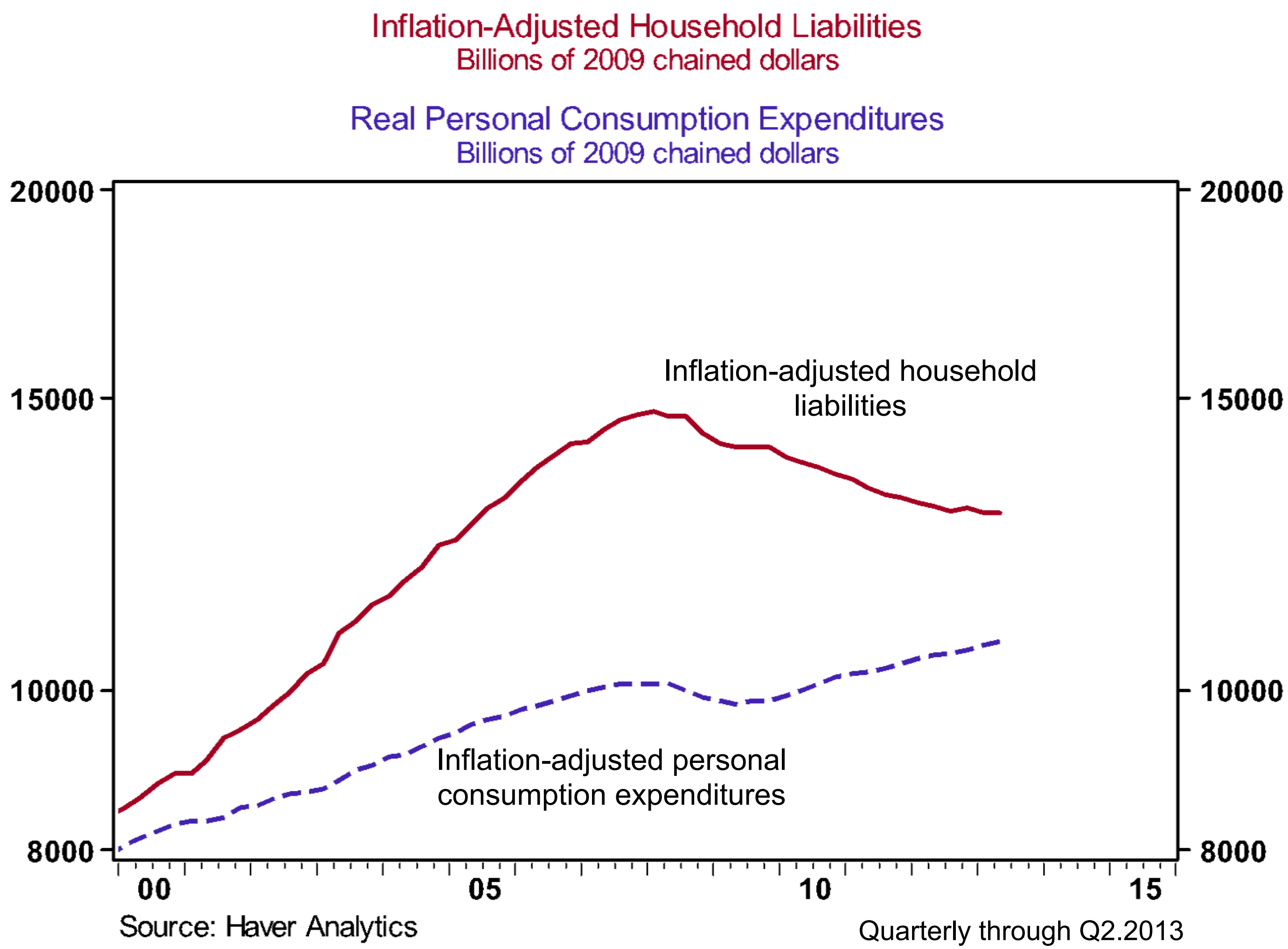
Dynan and Edelberg (2013): Debt Overhang Slows Deleveraging Households

Billions of 2009 chained dollars



Sources: Federal Reserve Board, Bureau of Economic Analysis, Census Bureau

What Can We Do to Improve It?

- **Research**
  - **Demographic drivers of financial fragility**
  - **Balance-sheet failures**
  - **Wealth-building successes and failures; for example homeownership**
- **Events**
  - **Research symposia**
  - **Practitioner "best-practice" events**
- **Policy**
  - **Help Federal Reserve leaders understand the role of household balance sheets in economic growth**
  - **Public policy advocacy not the Fed's job, but we partner with advocates**

For More Information

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Previous Presentations

- **Micro view**
- **Macro view**

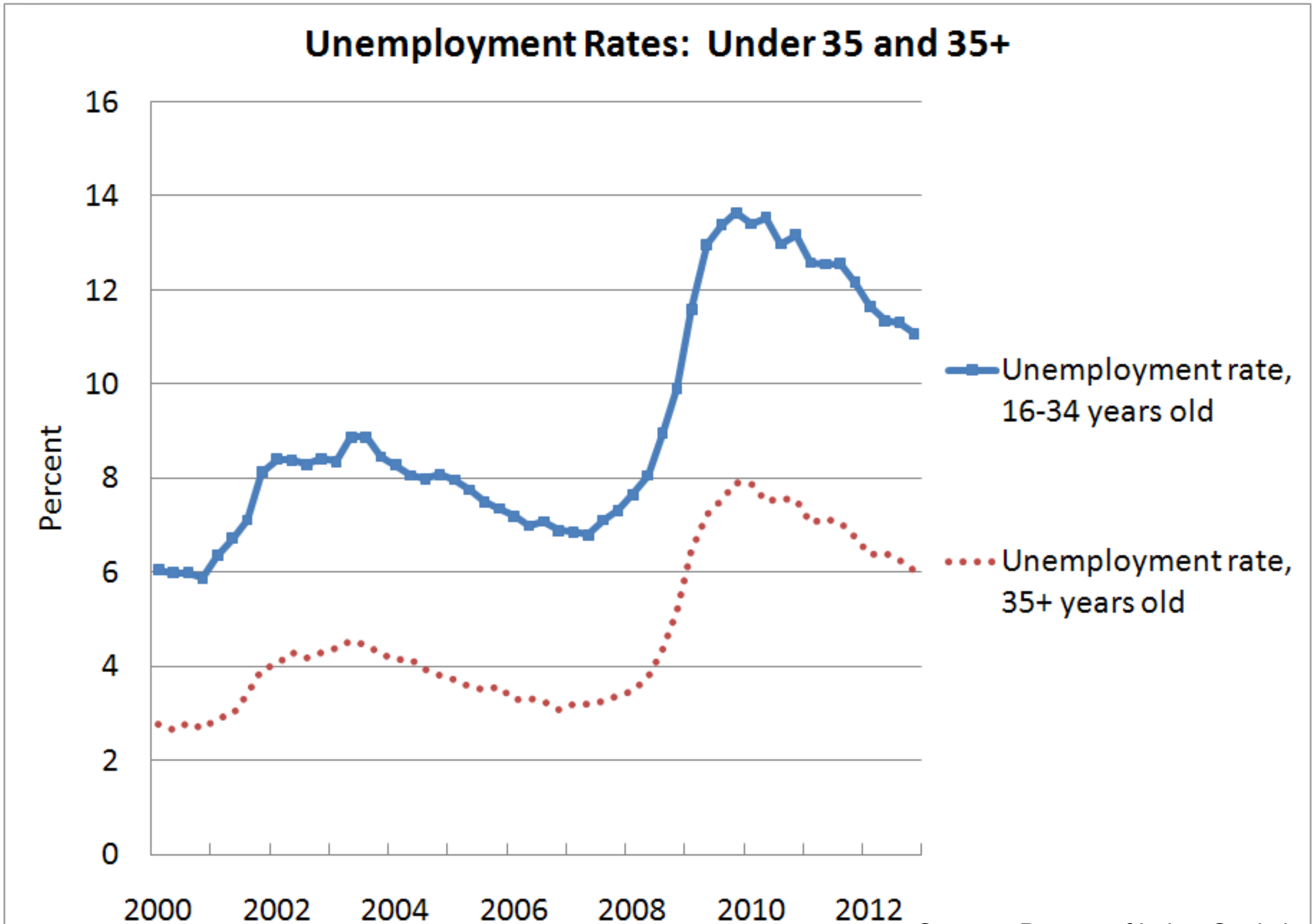
The Micro View: Economic Vulnerability and Financial Fragility

- **Evidence from the Survey of Consumer Finances: Economically vulnerable families were more likely to have risky balance sheets in 2007, then suffered larger percentage wealth losses during the crisis.**

- **Shouldn't a family's balance sheet be used to dampen its economic risk, rather than amplify it?**

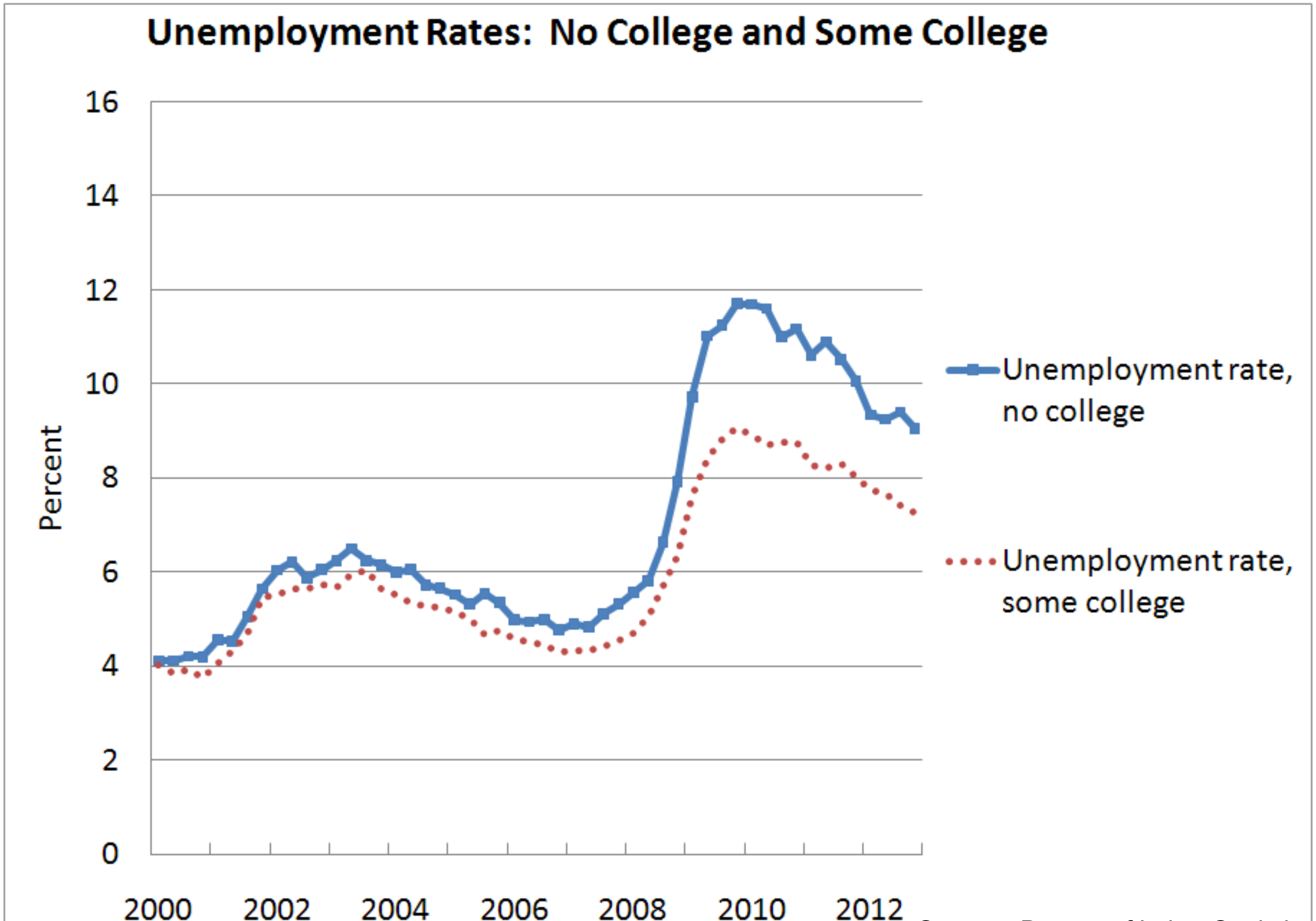
- **Which interventions are most likely to break the link between economic vulnerability and financial fragility?**

Economically Vulnerable Group: The Young



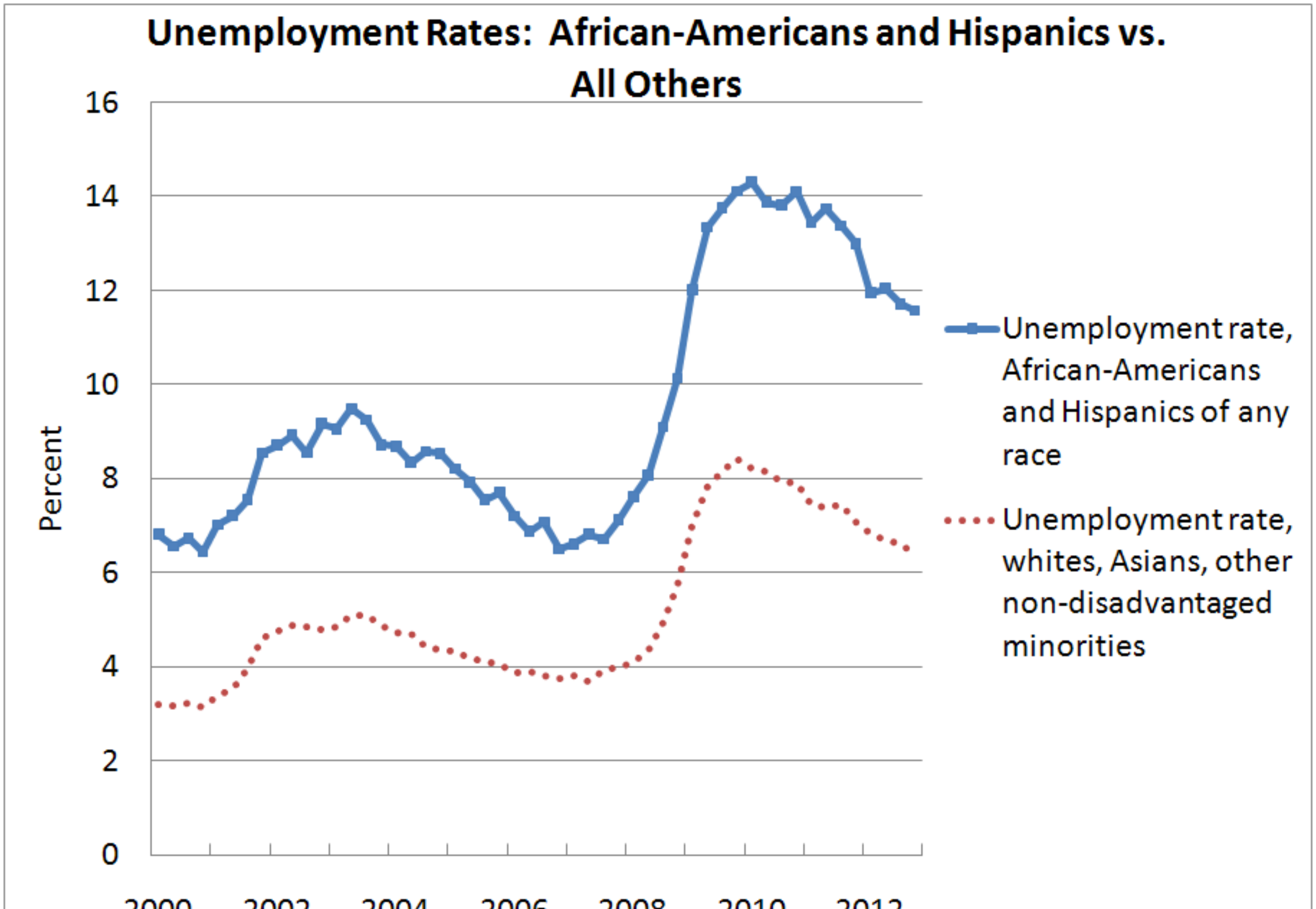
Source: Bureau of Labor Statistics

Economically Vulnerable Group: Less-Educated



Source: Bureau of Labor Statistics

Economically Vulnerable Group: African-Americans and Hispanics



Source: Bureau of Labor Statistics

Economic Vulnerability and Financial Fragility

- <u>Economic vulnerability</u>: Susceptibility to job and income losses
- <u>Financial fragility</u>: Risky financial behavior and risky balance sheets
  - <u>Fact</u>: They are positively correlated in the population across demographic sub-groups
- Why don't economically vulnerable families take <u>less</u> financial risk to hedge their consumption risk?
- <u>Our explanation</u>: They're driven by common factors—youth and inexperience, low human capital, and the legacy of discrimination

Economically Vulnerable Groups Suffered Very Large Wealth Losses

- **Wealth losses during the crisis (2010 wealth vs. 2004/07 average, inflation-adjusted)**
  - **Overall: -10%**
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  - **Minority families: -31%**

- **Groups with smaller average losses**
  - **Older (62+) families: -4%**
  - **College grads (2- or 4-yr): -9%**
  - **Whites and Asians: -6%**

Source: Federal Reserve, Survey of Consumer Finances

Economically Vulnerable Groups Had Risky Balance Sheets Going into the Crisis

Demographic Influences on Balance Sheets

Demographic group	*Marginal effect of belonging to a demographic group on:*		
	Safe and liquid assets relative to annual income		
Young families (< 40 years old)	-16 percentage points		
High-school drop-out families	-16		
African-Americans and Hispanics	-20		

Source: Emmons and Noeth (2013), based on Survey of Consumer Finances

Economically Vulnerable Groups Had Risky Balance Sheets Going into the Crisis

Demographic Influences on Balance Sheets			
Demographic group	*Marginal effect of belonging to a demographic group on:*		
	Safe and liquid assets relative to annual income	**Share of assets invested in housing**	
Young families (< 40 years old)	-16 percentage points	+13 percentage points	
High-school drop-out families	-16	+9	
African-Americans and Hispanics	-20	+14	

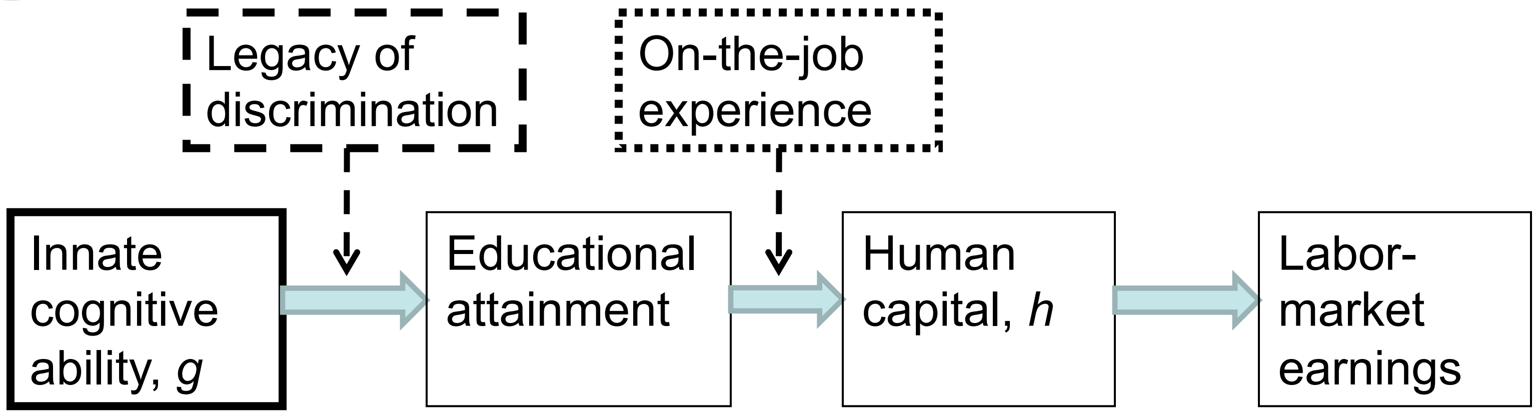
Source: Emmons and Noeth (2013), based on Survey of Consumer Finances

Economically Vulnerable Groups Had Risky Balance Sheets Going into the Crisis

Demographic Influences on Balance Sheets			
Demographic group	*Marginal effect of belonging to a demographic group on:*		
	Safe and liquid assets relative to annual income	**Share of assets invested in housing**	**Ratio of total debt to total assets**
Young families (< 40 years old)	-16 percentage points	+13 percentage points	+32 percentage points
High-school drop-out families	-16	+9	-4
African-Americans and Hispanics	-20	+14	+7

Source: Emmons and Noeth (2013), based on Survey of Consumer Finances

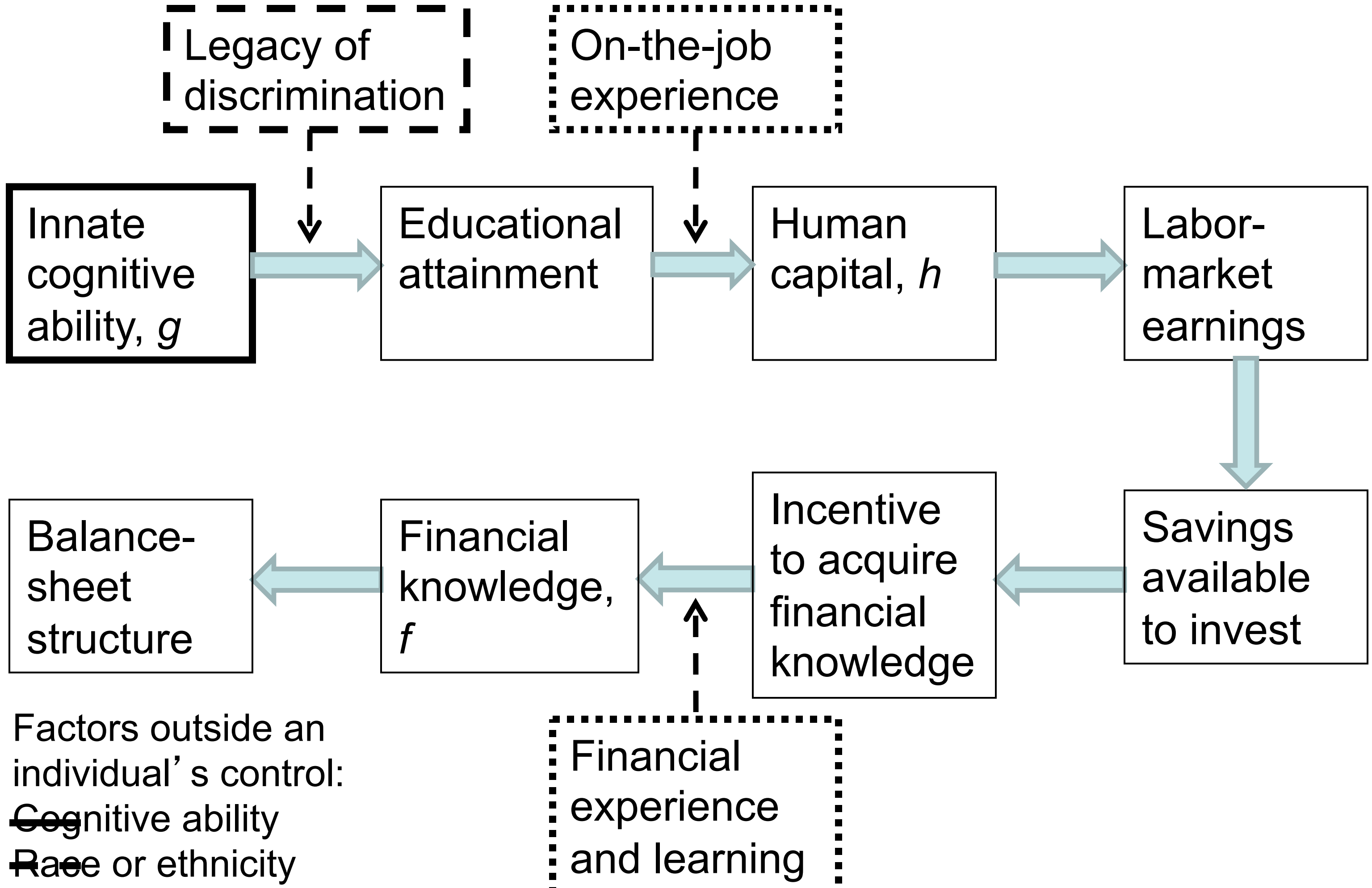
Our Model of Earnings Determination...



Factors outside an individual's control:

- Cognitive ability
- Race or ethnicity
- Age

… And Balance-Sheet Coice



Factors outside an individual's control:
~~Cog~~nitive ability
~~Rac~~e or ethnicity
~~Age~~

Key Implications

- **Economic vulnerability and financial fragility co-exist because they have common causes, including one or more of the following:**
  - **Being young and inexperienced**
  - **Low human capital**
  - **Historically disadvantaged minority**
- **What's new and counter-intuitive?**
  - **New: Endogenous acquisition of financial knowledge interacts with human capital (and all of its determinants)**
    - **See Lusardi, Michaud, Mitchell (2013)**
  - **Counter-intuitive: Balance sheets of groups with the most economic risk amplify their risk, rather than dampening it**

Risky Financial Behavior and Risky Balance Sheets

- **We define risky financial behavior to include:**
  - **Low saving rate**
  - **High-cost financial services**
  - **High debt-service-to-income ratio**

- **We define risky balance sheets to contain:**
  - **Low ratio of safe and liquid assets to income**
  - **High housing concentration**
  - **High balance-sheet leverage**

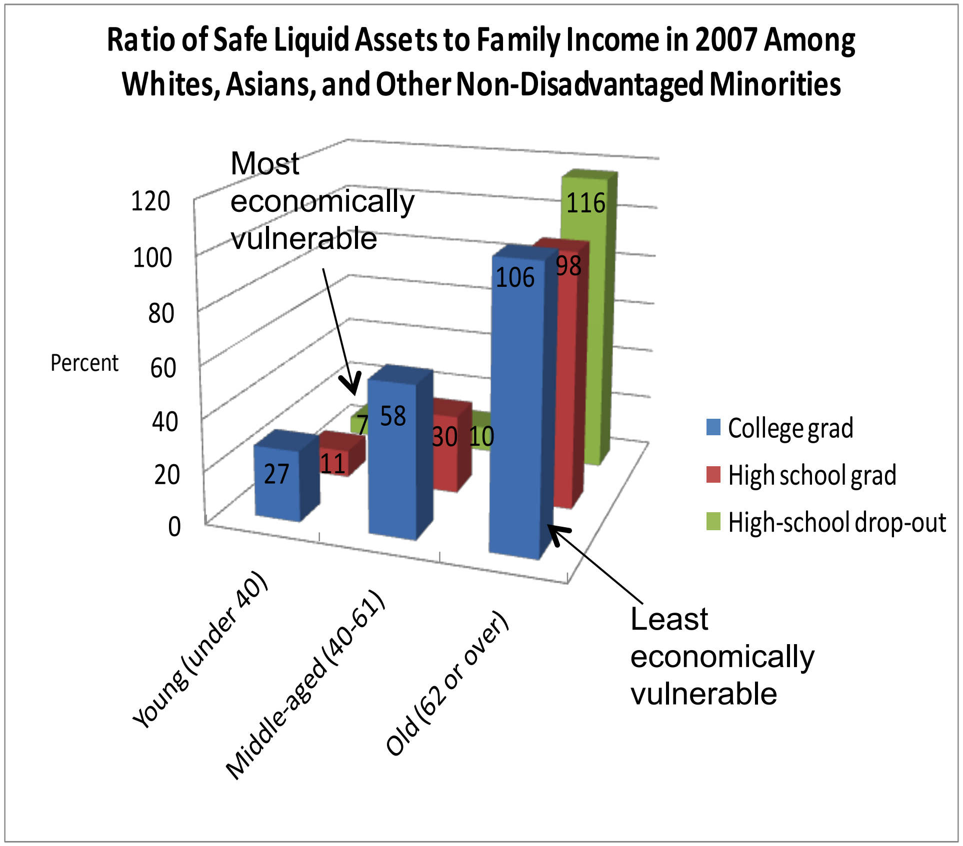
1) Ratio of Safe and Liquid Assets to Annual Income Before the Crash

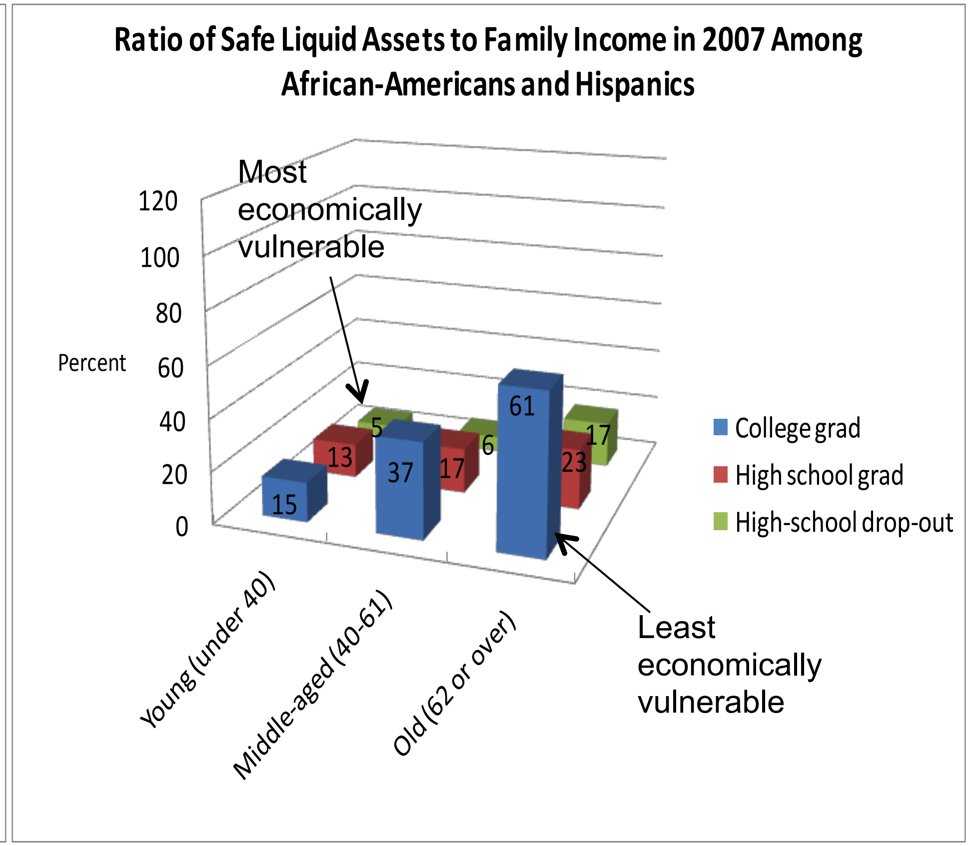
- **All families, average 2004/2007 safe-assets-to-income ratio**
  - **Overall: 56%**

- **Economically vulnerable groups**
  - **Young (<40) families: 20%**
  - **Minority families: 19%**
  - **Less-than HS families: 54%**

- **Less-vulnerable groups**
  - **Older (62+) families: 126%**
  - **Whites and Asians: 61%**
  - **College grads: 63%**

Ratio of Safe and Liquid Assets to Income





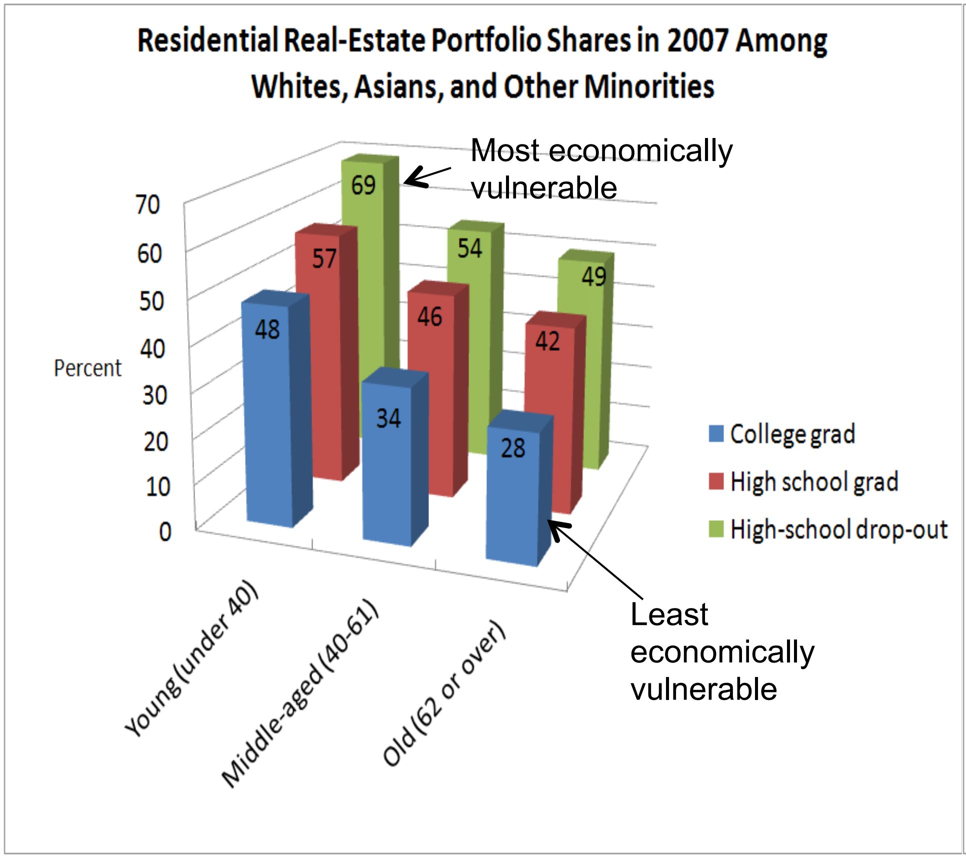
2) Share of Total Assets in Residential Real Estate Before the Crash

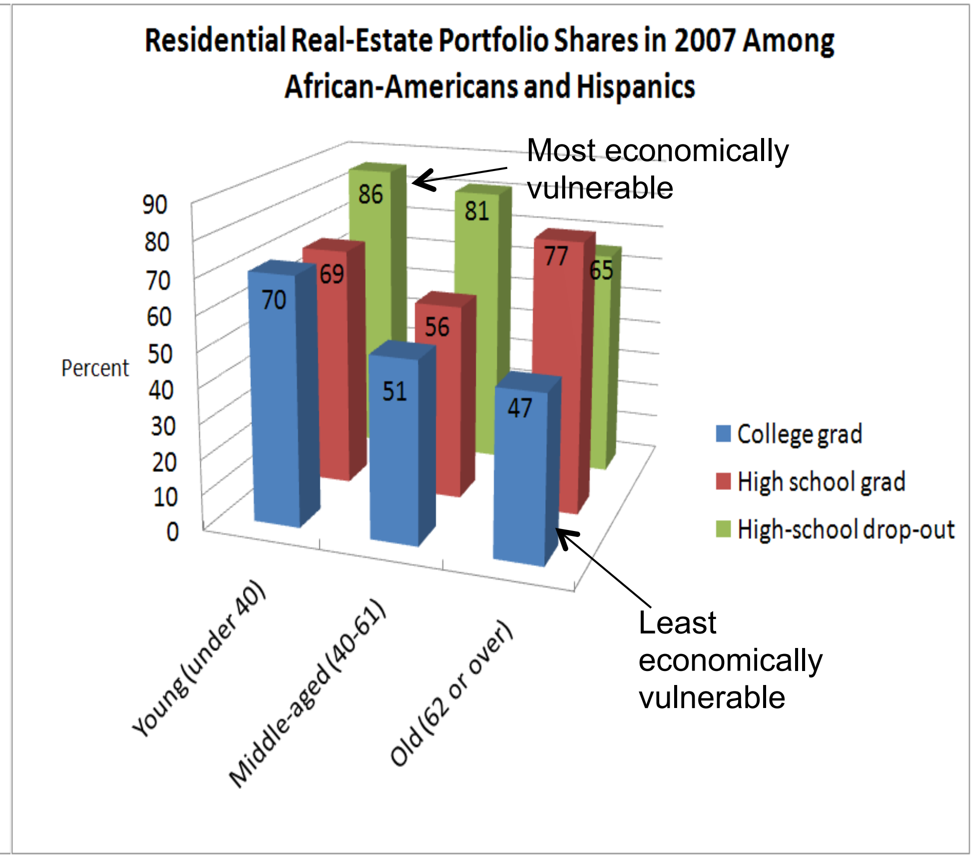
- **All families, average 2004/2007 RRE portfolio share**
  - **Overall: 39%**

- **Economically vulnerable groups**
  - **Young (<40) families: 54%**
  - **Minority families: 58%**
  - **Less-than HS families: 59%**

- **Less-vulnerable groups**
  - **Older (62+) families: 34%**
  - **Whites and Asians: 37%**
  - **College grads: 35%**

Residential Real-Estate Portfolio Shares





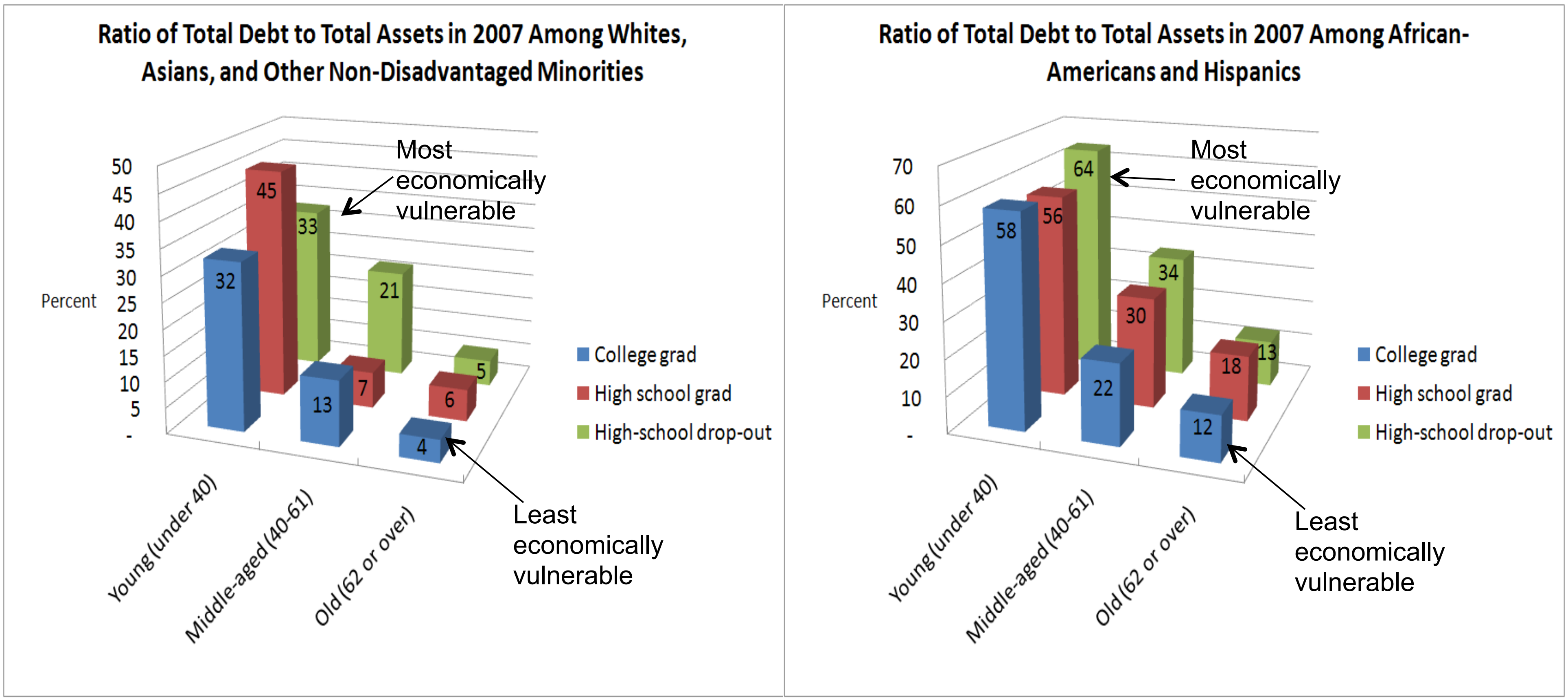
3) Ratio of Total Debt to Total Assets Before the Crash

- **All families, average 2004/2007 debt-to-assets ratio**
  - **Overall: 15%**

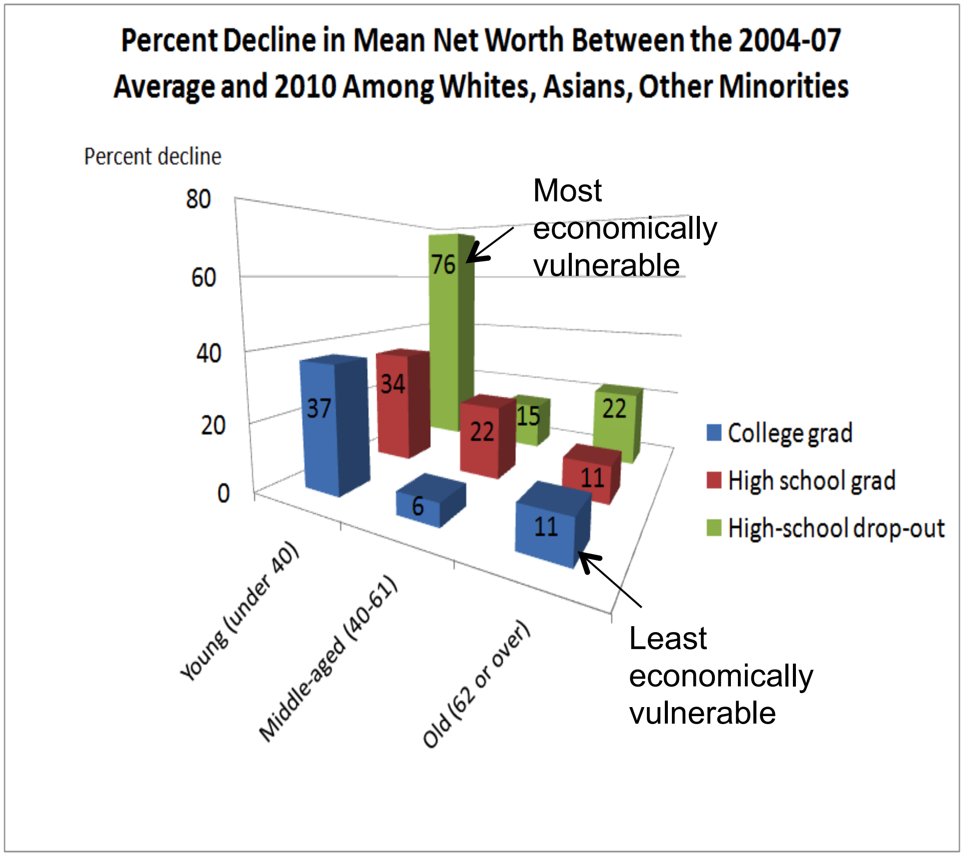
- **Economically vulnerable groups**
  - **Young (<40) families: 39%**
  - **Minority families: 31%**
  - **Less-than HS families: 16%**

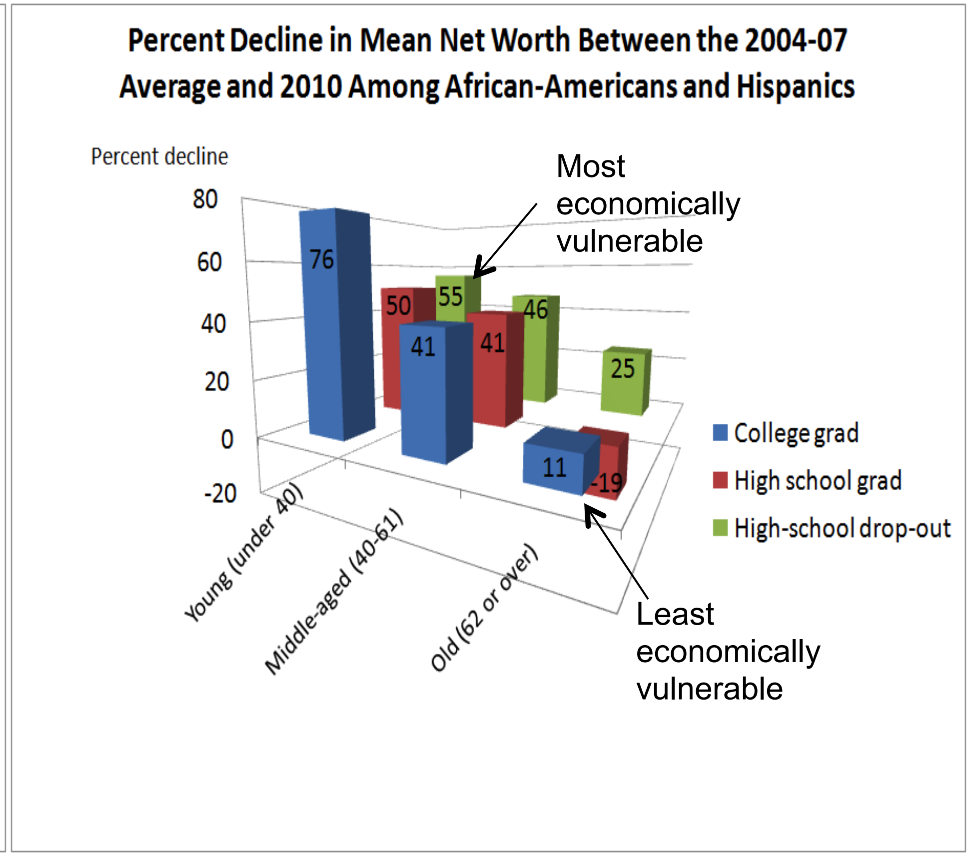
- **Less-vulnerable groups**
  - **Older (62+) families: 5%**
  - **Whites and Asians: 14%**
  - **College grads: 13%**

Ratio of Total Debt to Total Assets

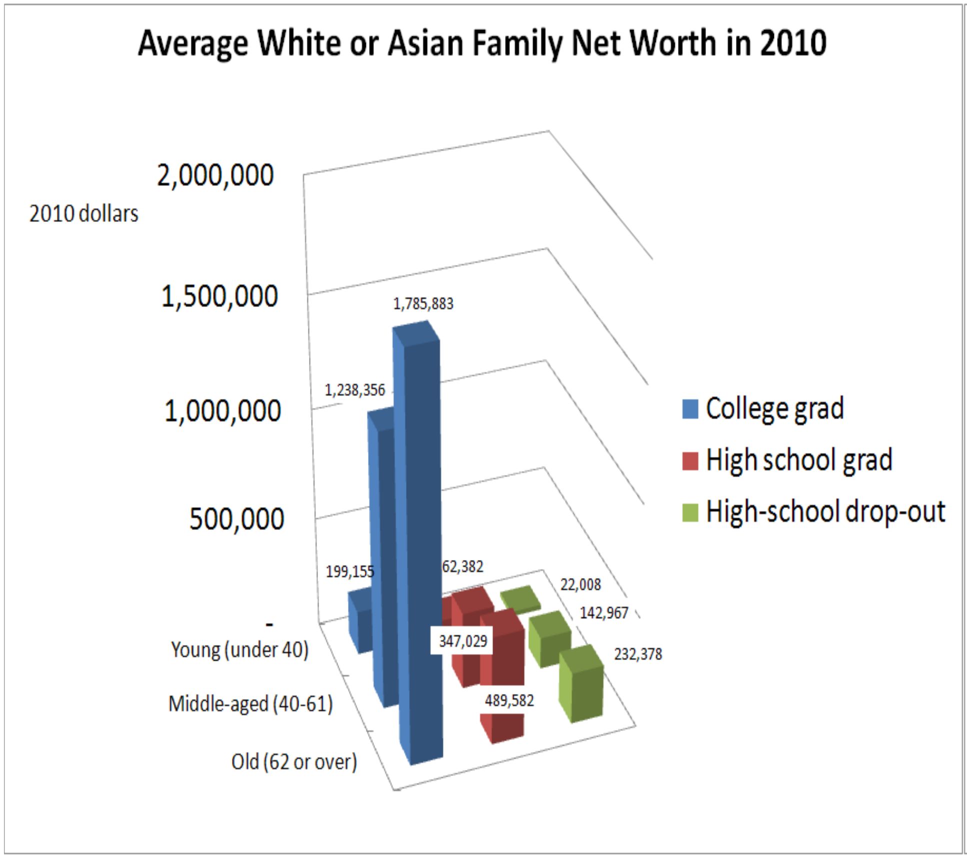


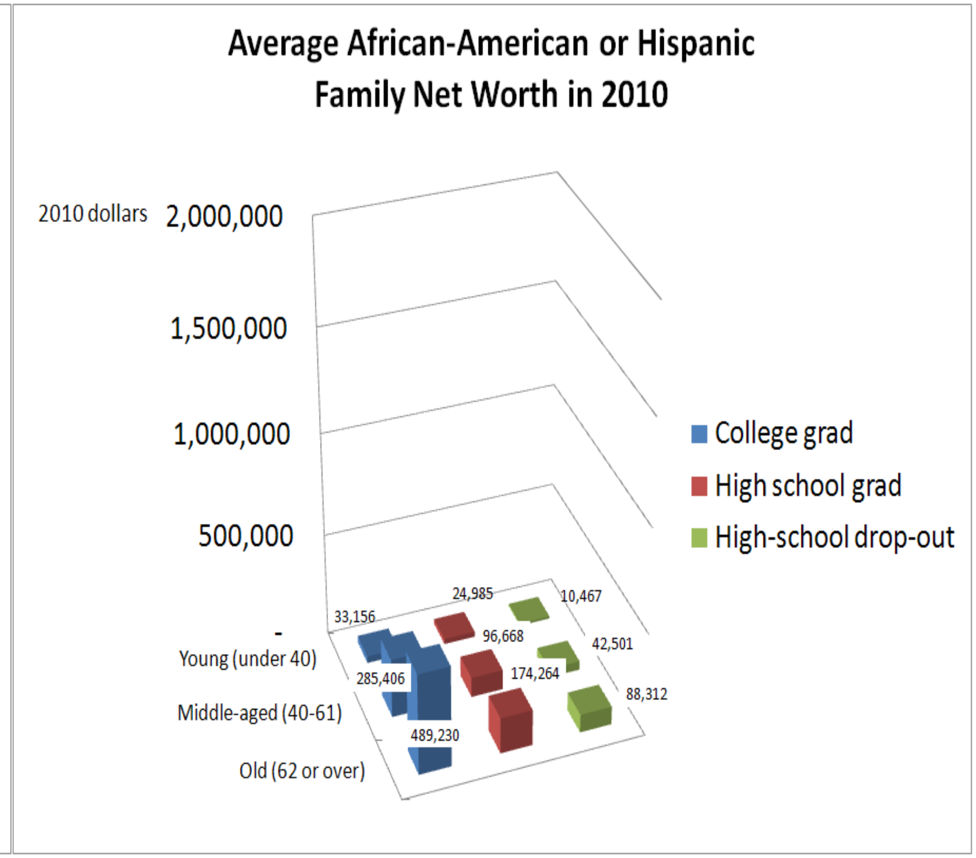
Wealth Loss During the Crisis



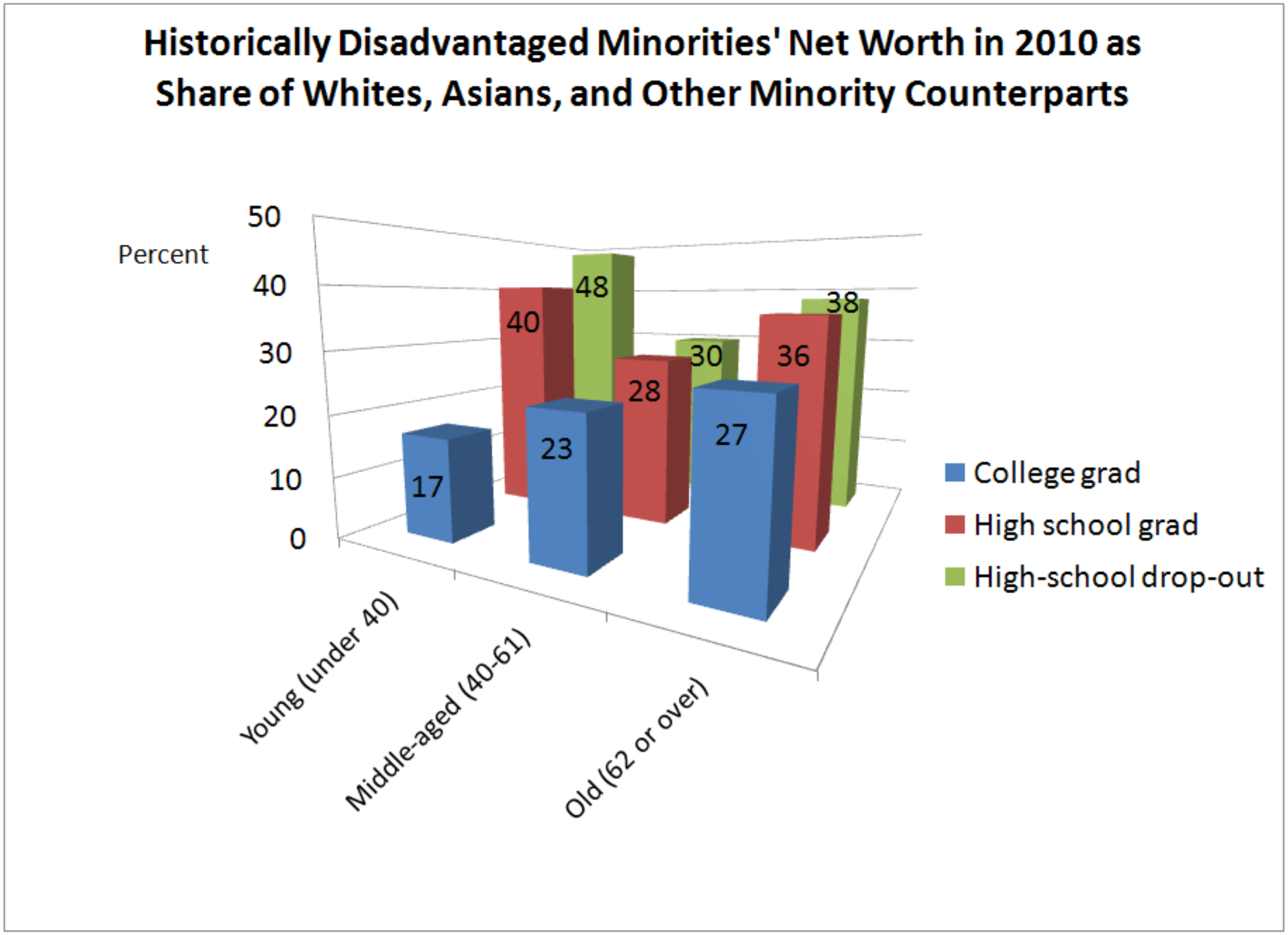


Wealth in 2010: Pre-Crisis Disparities Re-inforced by Crisis Losses





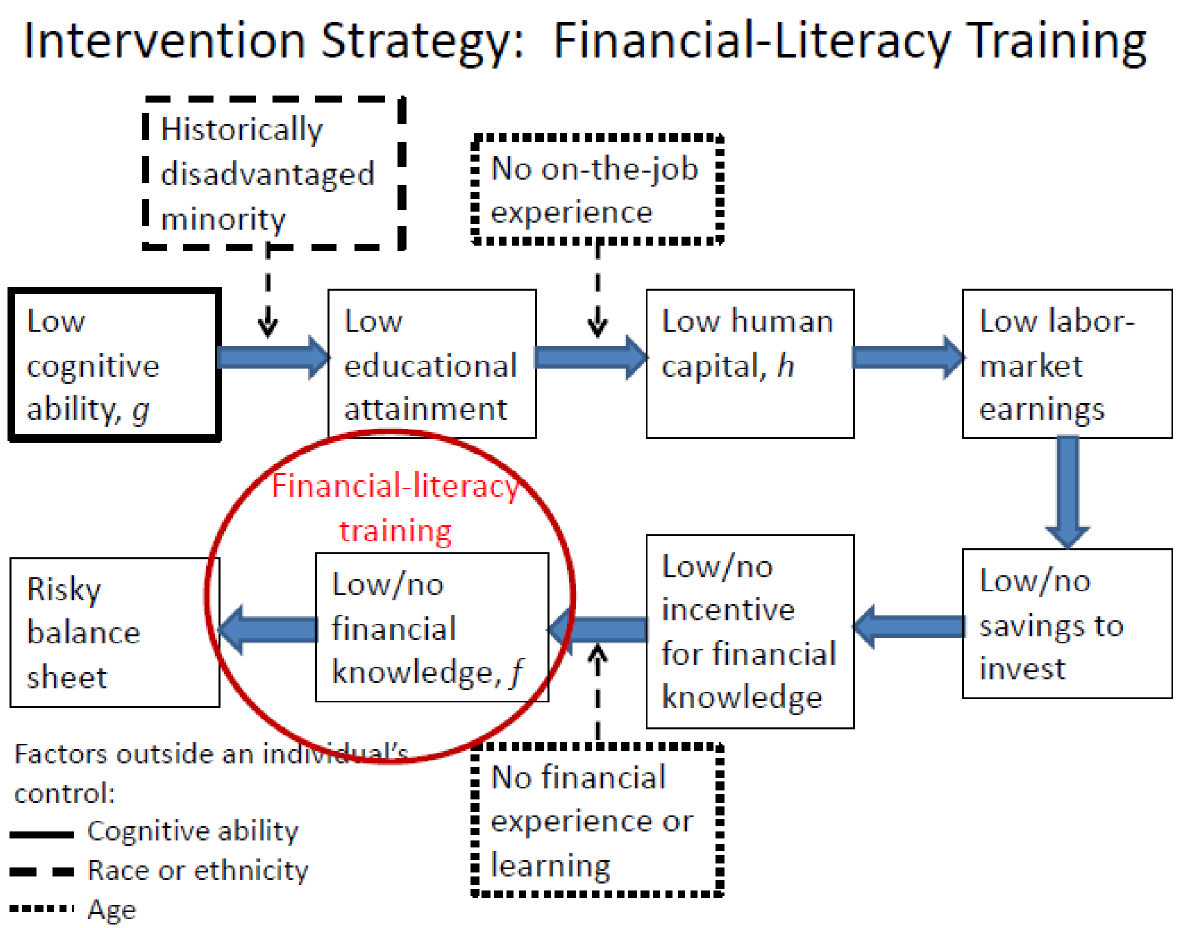
Ratio of African-American or Hispanic Wealth to Non-Minority Wealth



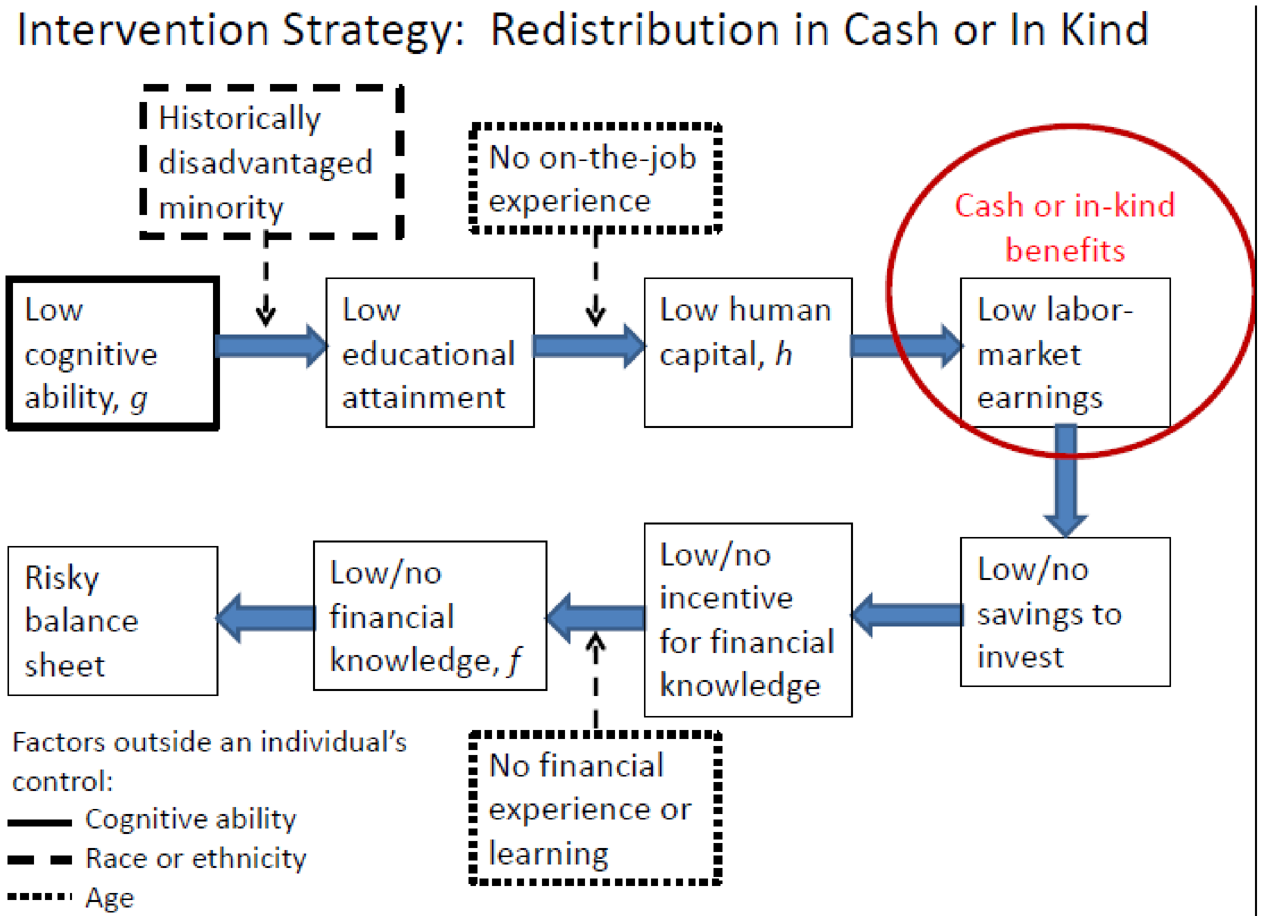
Can We Break the Link Between Economic Vulnerability and Financial Fragility?

- **Financial-literacy training**
- **Cash and in-kind benefits**
- **Individual-Development Accounts (IDAs)**
- **Early-childhood enrichment**

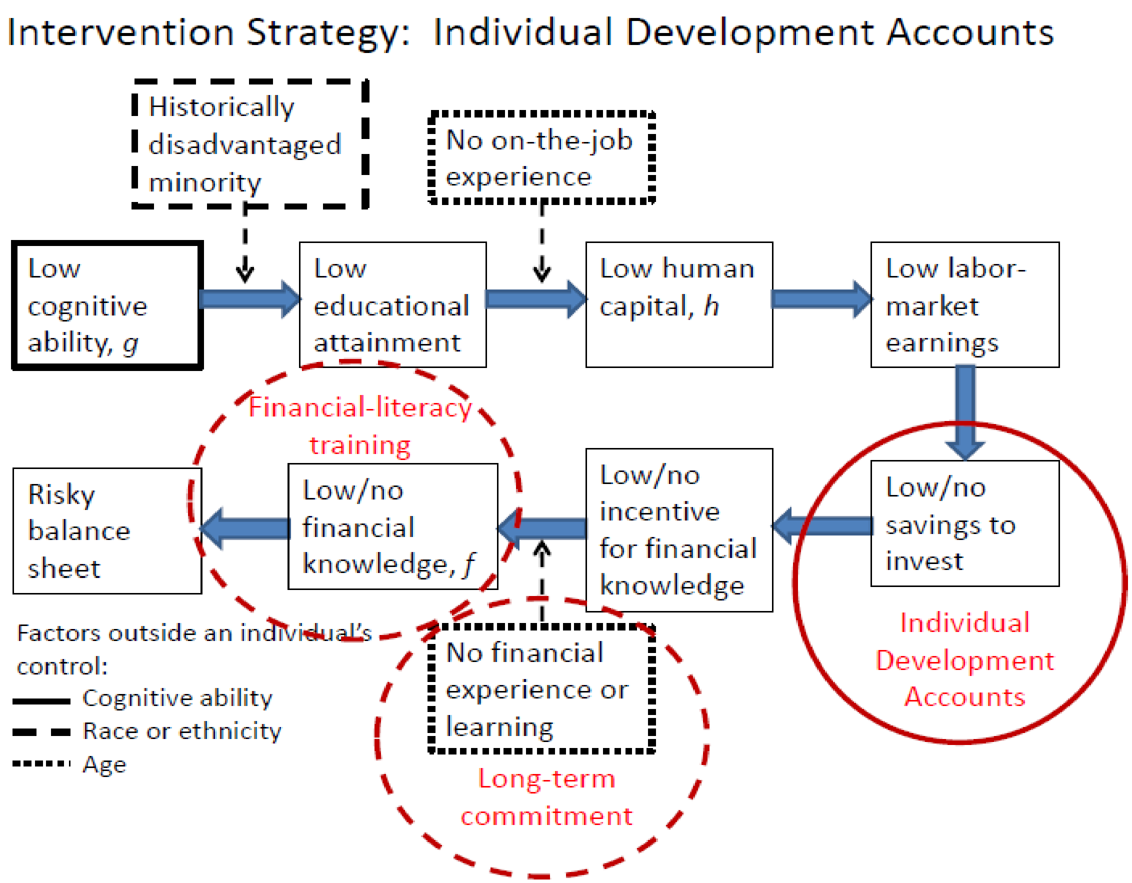
Adult Financial-Literacy Education Comes Too Late



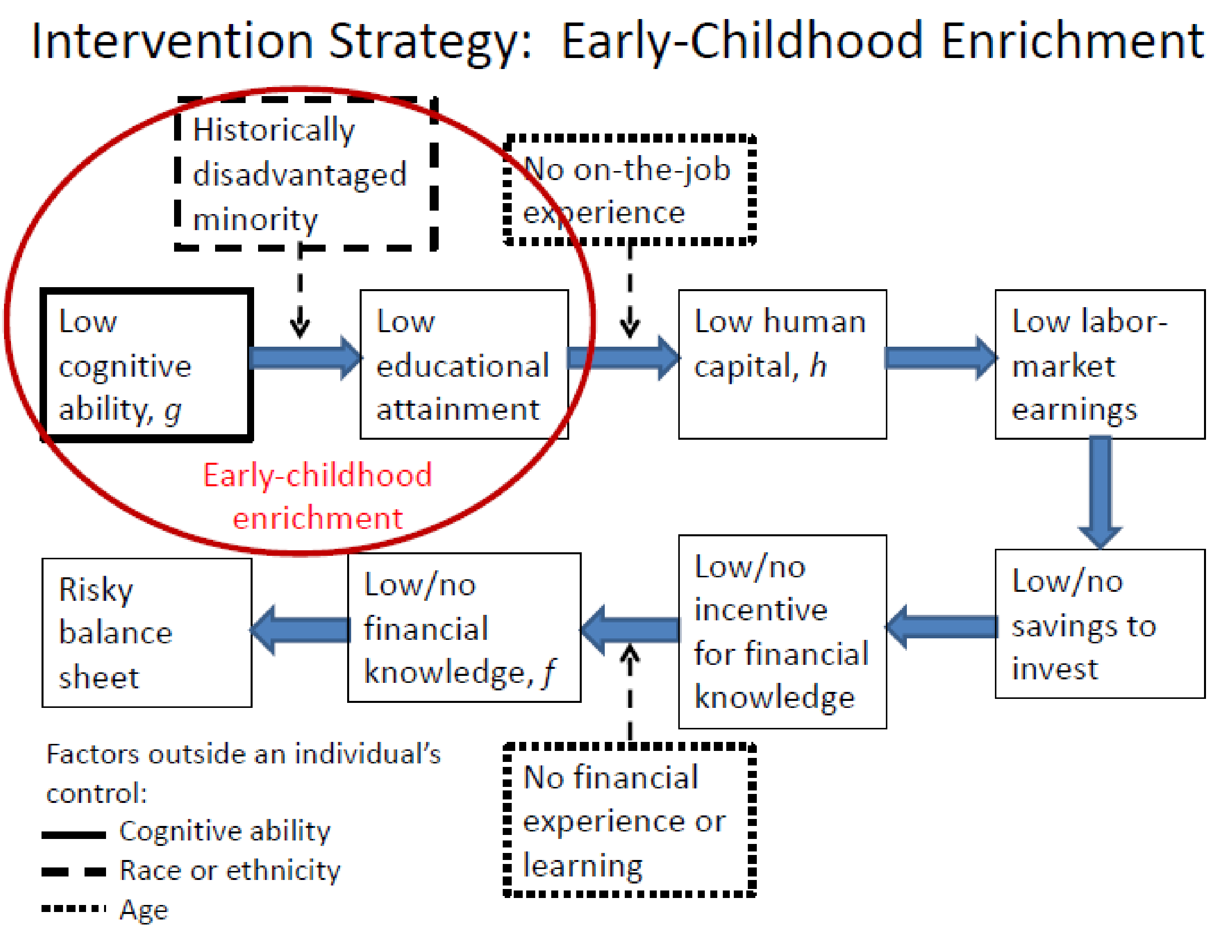
Cash and In-Kind Benefits May Not Translate into Financial Knowledge



Individual Development Accounts Intervene at Several Points



Early Childhood Interventions Target Human Capital



Why Did Economically Vulnerable Families Enter the Crisis With Risky Balance Sheets?

- **Economically vulnerable families were more likely to have risky balance sheets in 2007, and then to suffer large percentage wealth losses during the crisis.**

- **Common causes drive both:**
  - **Youth and inexperience**
  - **Low level of human capital**
  - **Legacy of discrimination**

- **Interventions should target human-capital formation and experience-based learning.**

The Macro View: Household Wealth and the Economy

- **How much wealth did the average household lose? How much has been rebuilt so far?**
- **What assets contributed the most to wealth losses and subsequent gains?**
- **Did wealth losses and deleveraging slow the recovery?**
- **If households are still rebuilding wealth, why is the saving rate so low?**

Recovery of Average Wealth Loss: 76 Percent

- **Average inflation-adjusted household wealth loss, Q1.2007 (peak) through Q1.2009 (trough)**

-$153,000

-22.2%

- **Average inflation-adjusted household wealth regained, Q1.2009 (trough) through Q2.2013 (latest)**

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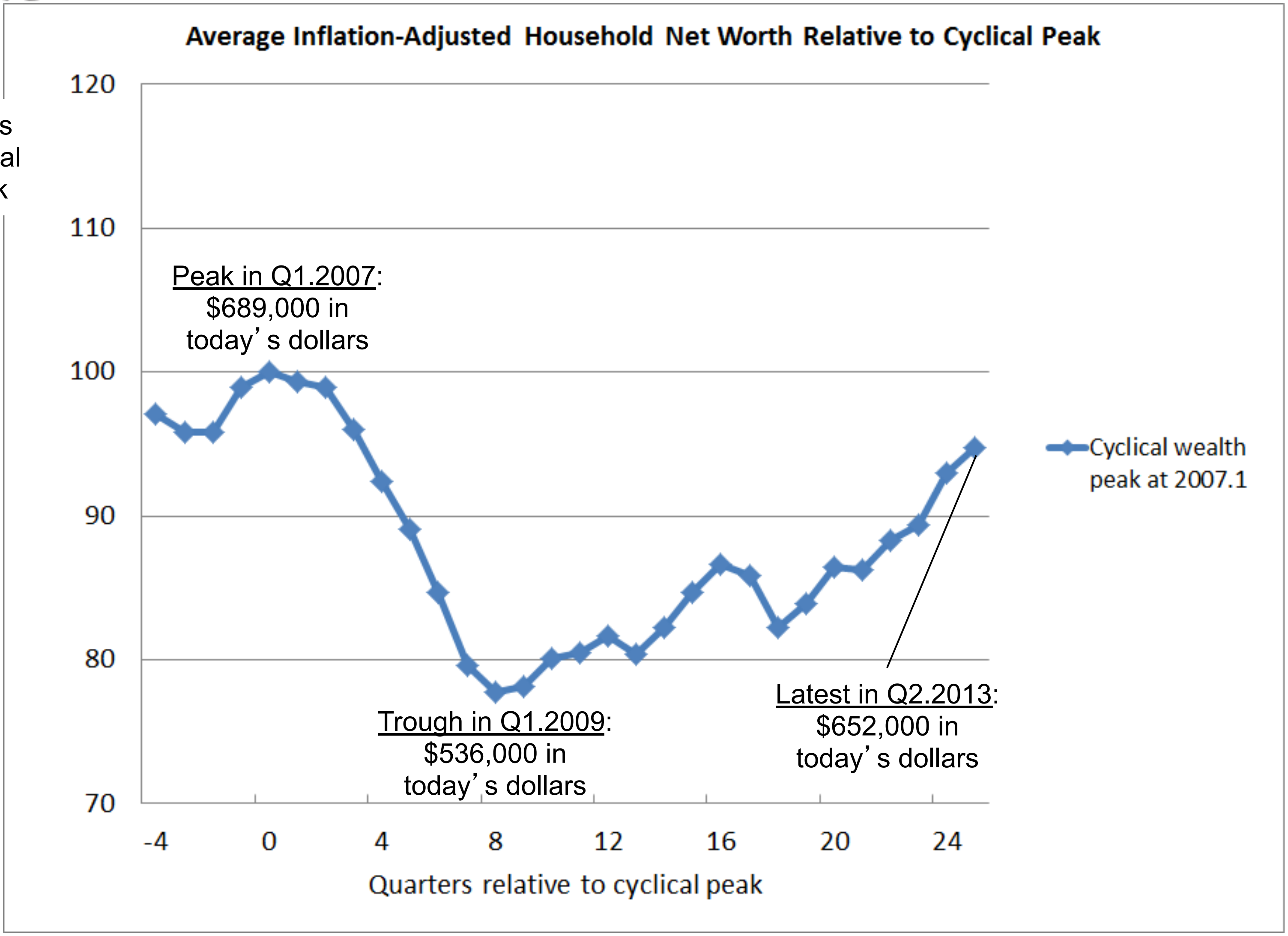

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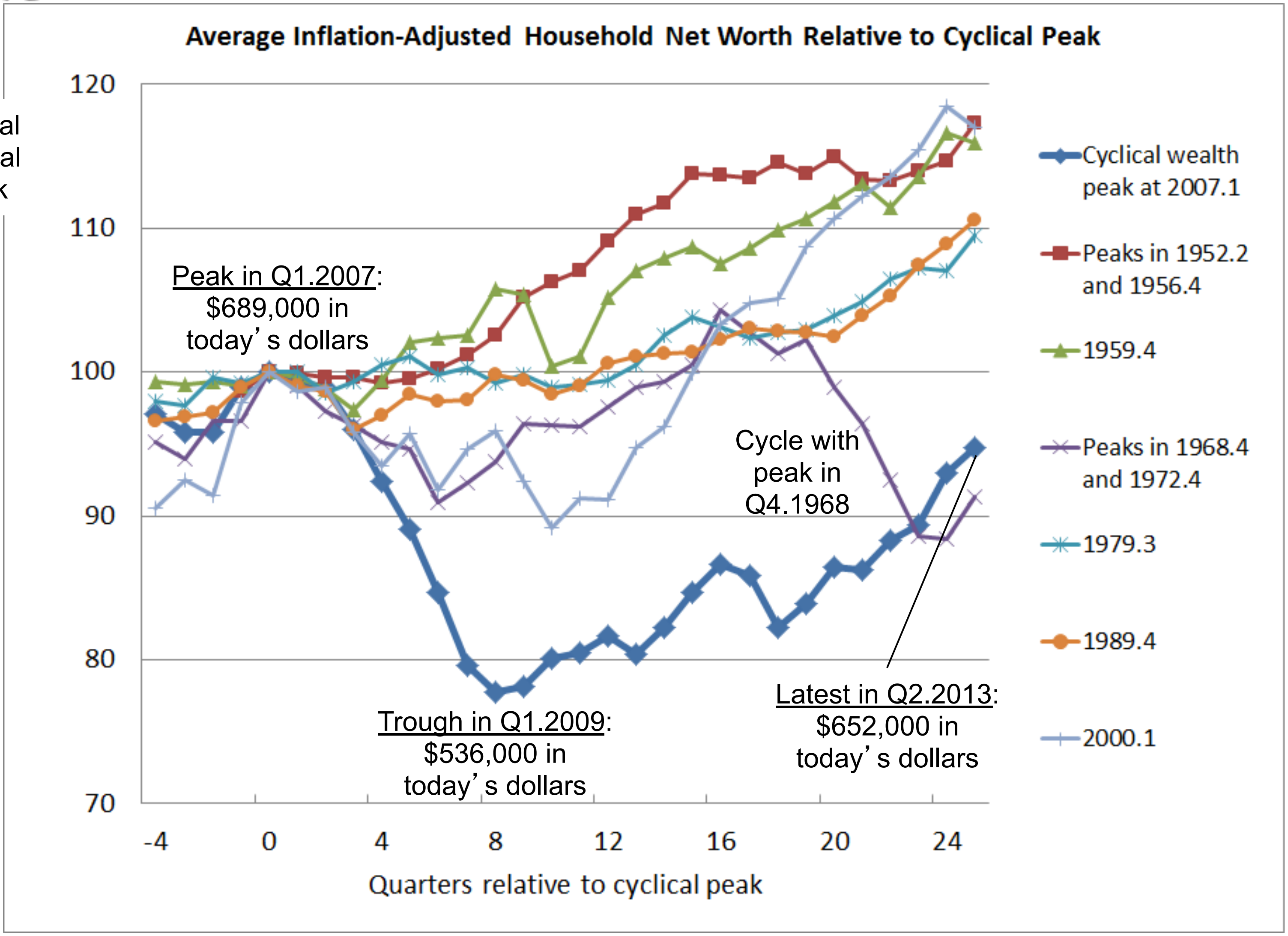

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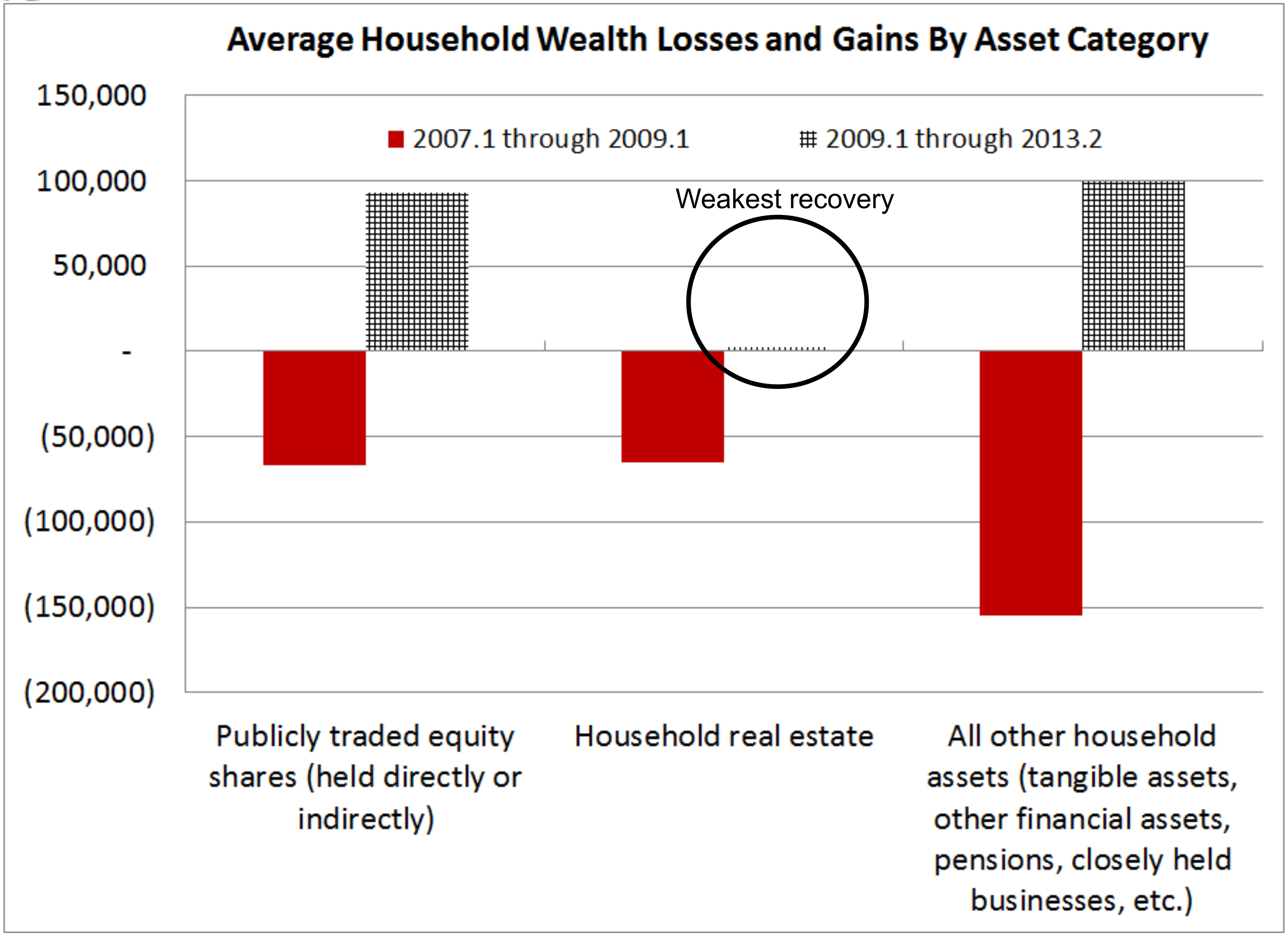
Composition of Household Wealth Losses and Recoveries

- **Composition of gains and losses by asset type**
  - **Losses**
    - **Same order of magnitude in dollar terms on stocks, houses, and "all other assets"**
  - **Recoveries through Q2.2013**
    - **Stocks at 113% of pre-recession peak**
    - **Other assets at 93%**
    - **Household RE at 70%**

Wealth Changes By Asset Type: Measured at Peak and Trough of Total Net Worth

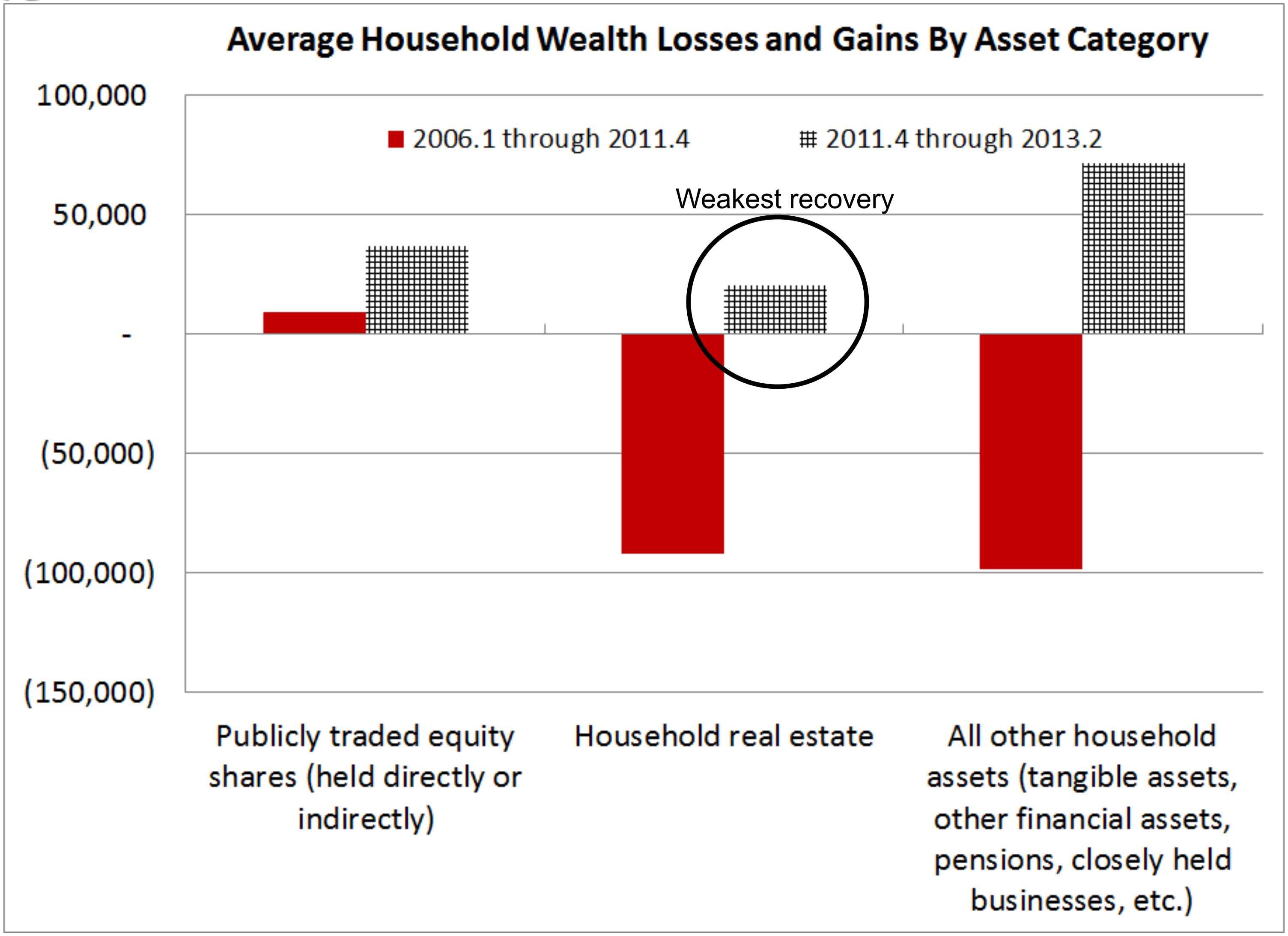
Q2.2013 dollars



Sources: Federal Reserve Board, Bureau of Economic Analysis, Census Bureau

Wealth Changes By Asset Type: Measured at Peak and Trough of Housing Values

Q2.2013 dollars



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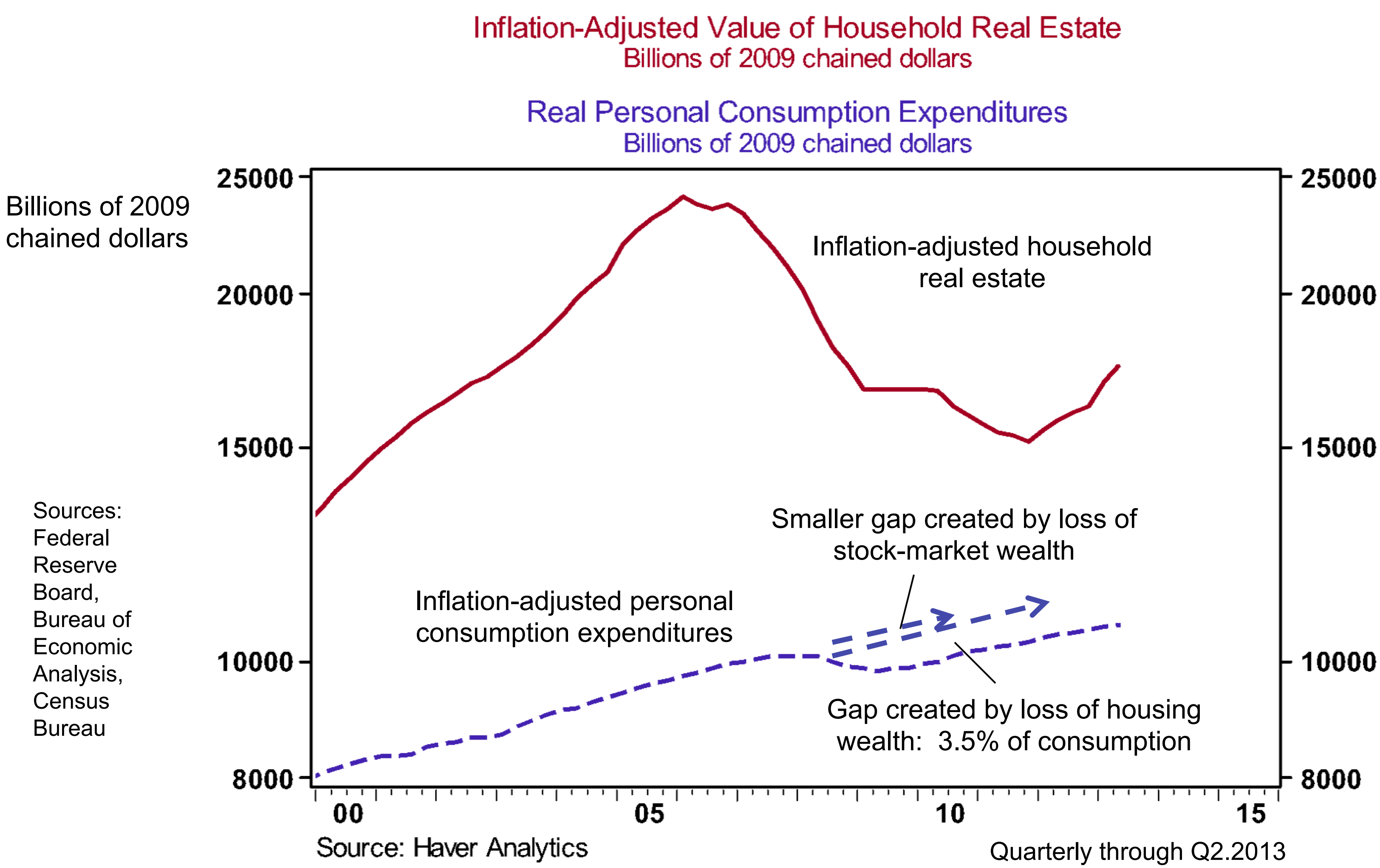

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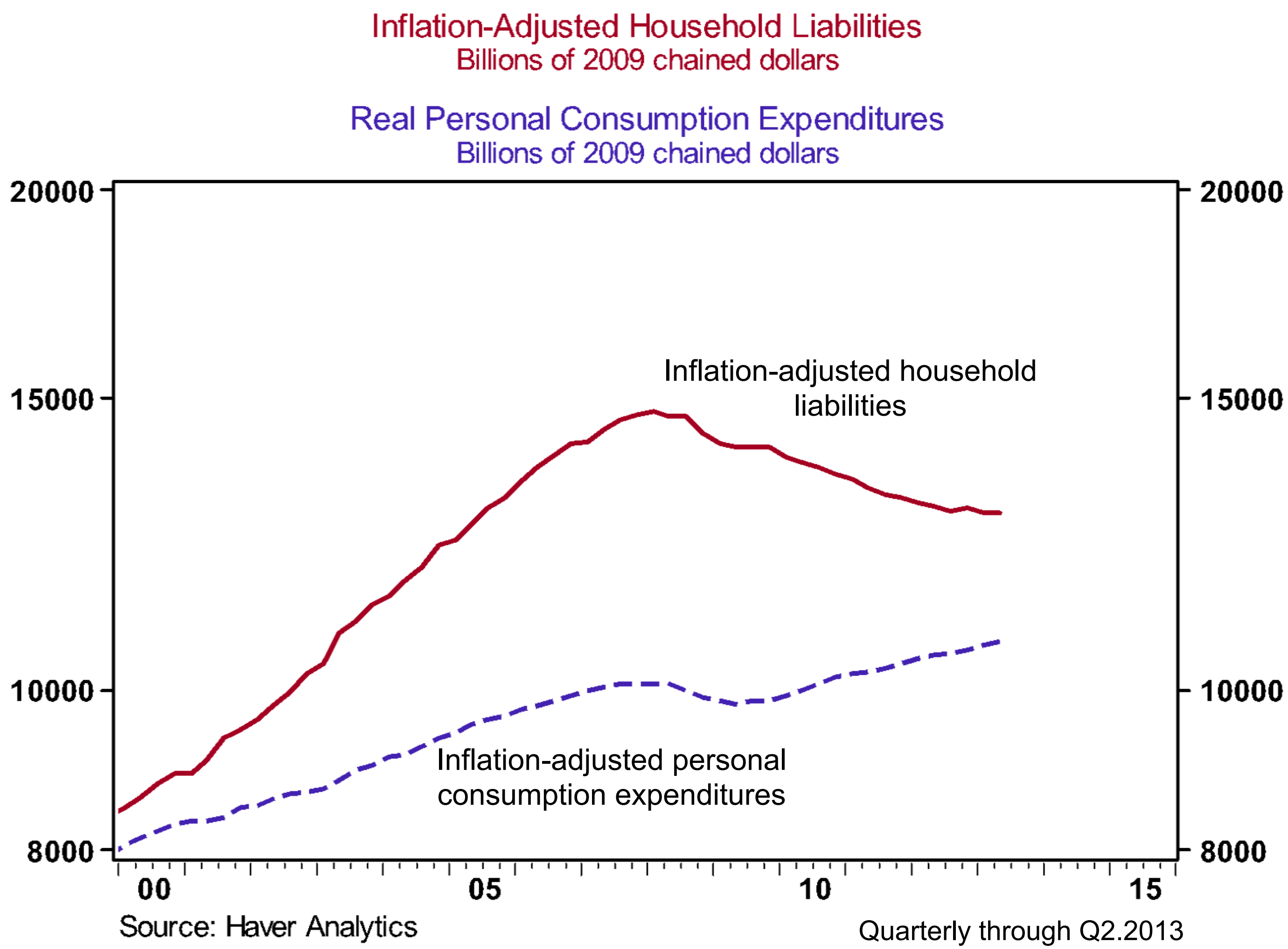
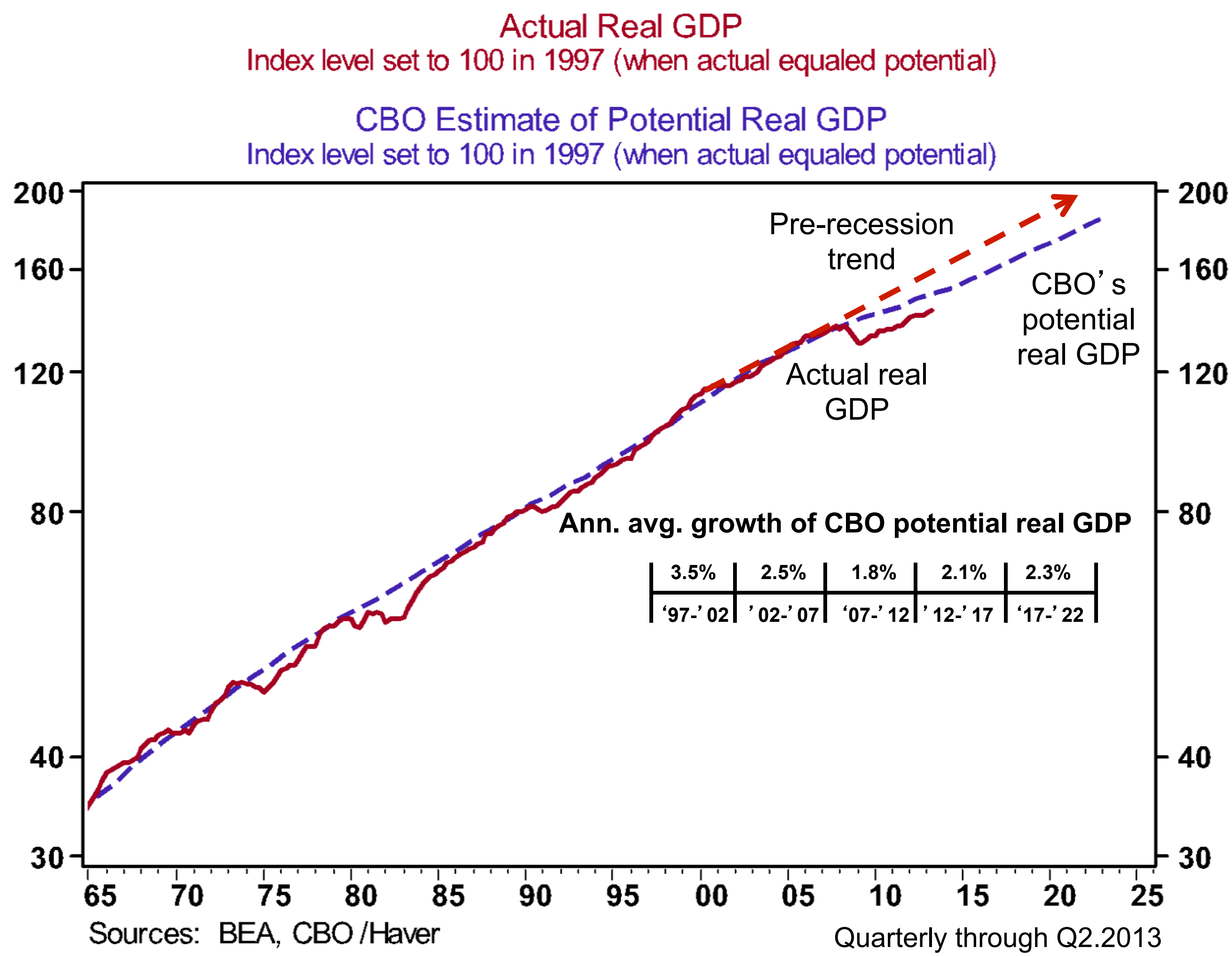


Sources: Federal Reserve Board, Bureau of Economic Analysis, Census Bureau

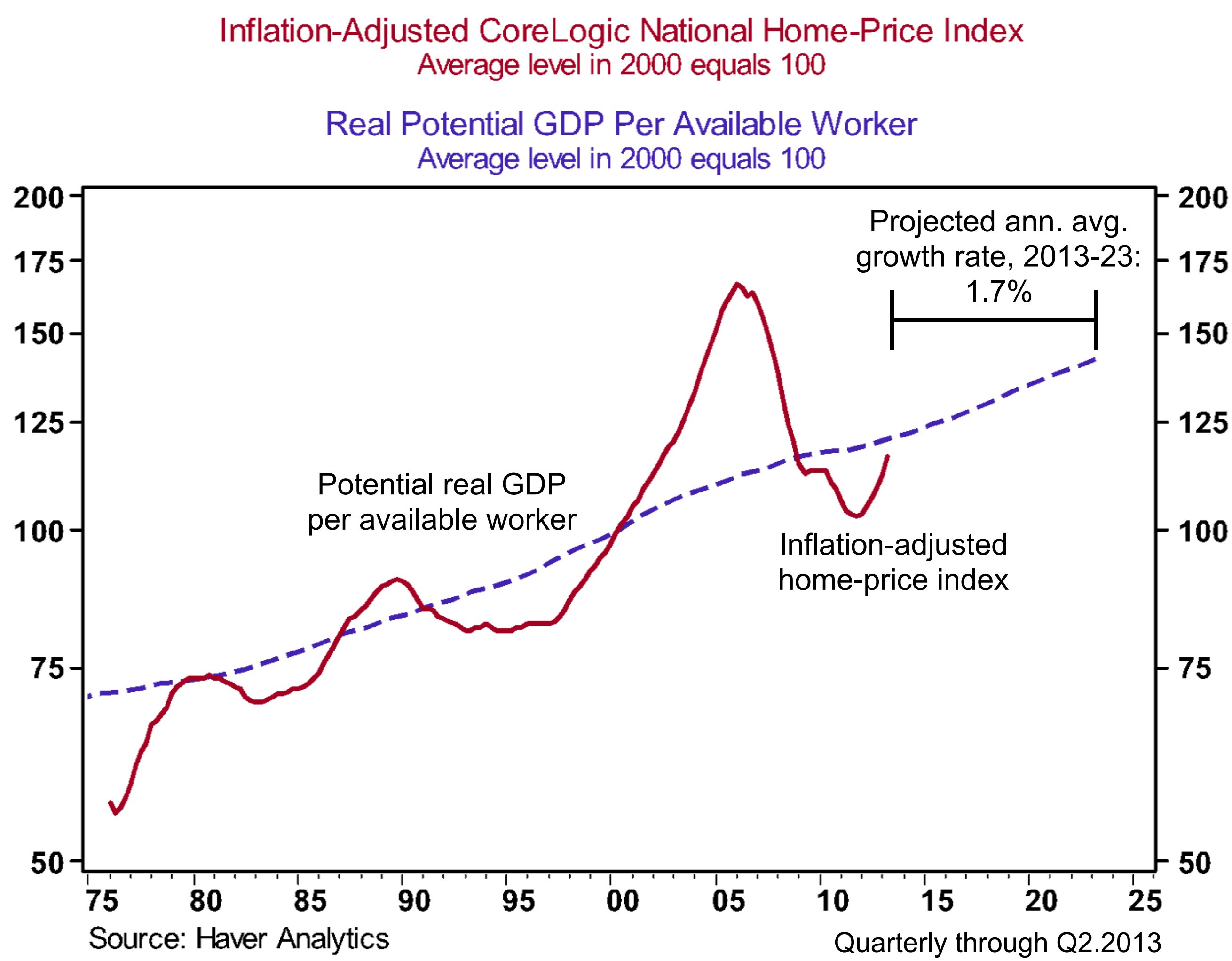
Much If Not All of Recession Output Loss Now Seen as Permanent

Index levels equal 100 in 1997



Sources: Bureau of Economic Analysis, Congress-ional Budget Office

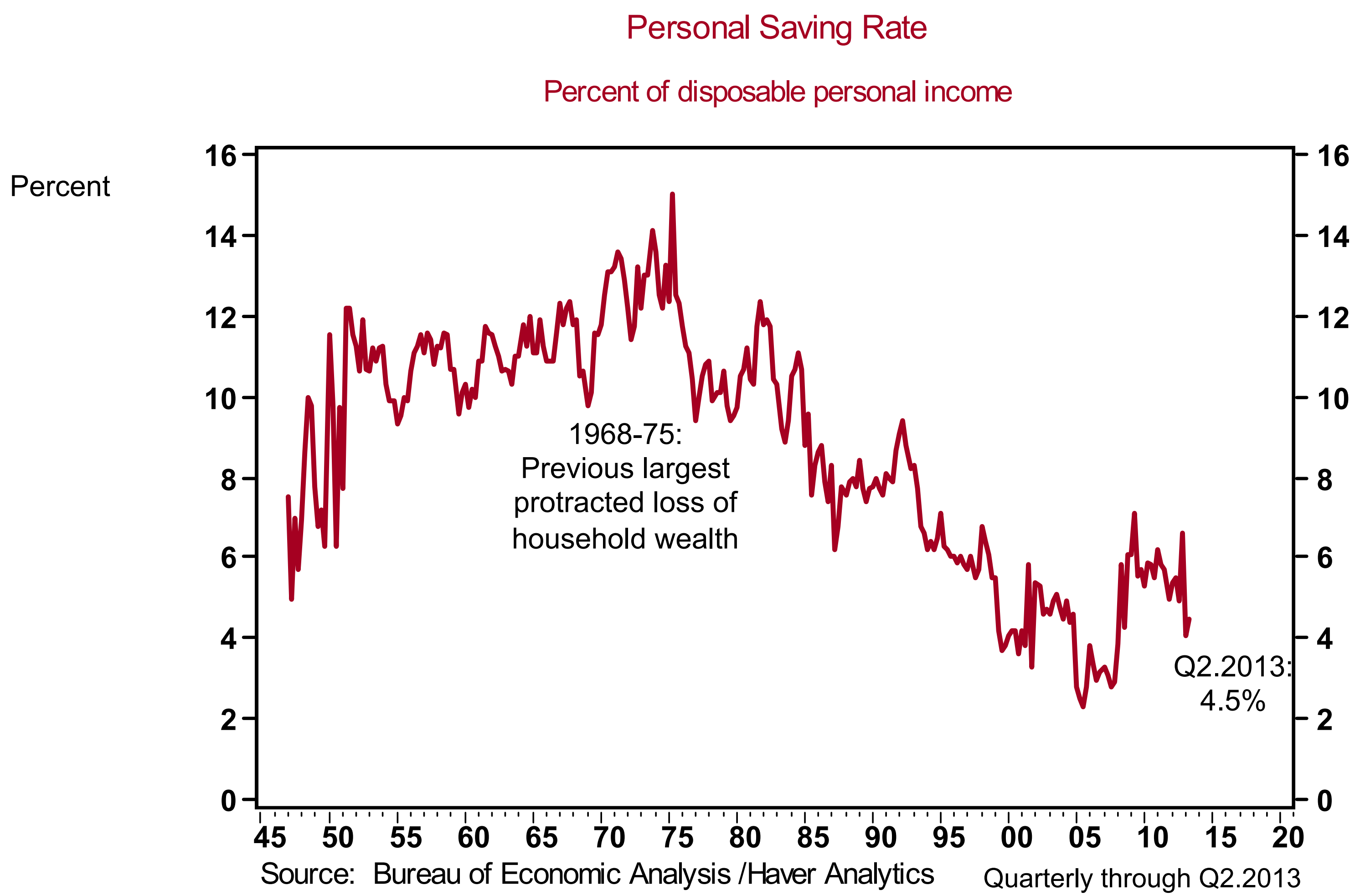
Real House Prices May Not Return to 2006 Peak for Decades



Index levels equal 100 in 1997

Sources: CoreLogic, Bureau of Economic Analysis, Congress-ional Budget Office

A Wealth Puzzle: If HHs are Rebuilding Wealth, Why Isn't HH Saving Rate Higher?



Household Wealth and the Economy: Is Wealth Rebuilding Finished?

- **Housing probably had the biggest effect on consumer spending and is slowest asset to recover.**
- **Household deleveraging continues.**
- **Slower projected economic growth suggests incomes and house prices unlikely to increase much.**
- **The typical family faces stagnant income and house prices, and still may have too much debt—it's not easy to rebuild wealth!**

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