

Applying the Concept: Using Debt to Smooth Consumption

If we were to take a look at the balance sheet of a typical household, we would find both assets and liabilities. Household assets are things like checking and savings account balances, retirement savings, cars, appliances, home equity and the like. Liabilities might include a home mortgage, a car loan, and credit card debt.

Over the past quarter of a century the U.S. financial system has changed dramatically. Not only has the internet revolutionized trading in financial markets, but consumer credit has become easier to get. Households today can borrow in ways that simply did not exist in 1980. Someone contemplating the purchase of a home can shop among dozens of types of mortgages offered by dozens of brokers. Homeowners are deluged with offers for home equity loans – loans that are collateralized by the value of the house in excess of the outstanding mortgage. Then there are the nearly daily offers for credit cards. Someone intent on borrowing can obtain tens of thousands of dollars of consumer credit relatively easily.

While this explosion of credit and debt in America has allowed some people to spend far too much, so that they cannot pay back what they owe, the reality is that the primary purpose of this debt is to allow individuals to consume now and pay later. That is, it allows people to smooth consumption even when income is variable.

We use credit in two ways. First, it allows us to make large purchases without having to save the full amount of purchase first. Auto loans and mortgages are examples. Without a mortgage, very few young people could afford to own a home. Second, having the ability to borrow also means that someone who loses their job and has no savings, they will still have something to eat and a place to sleep until they get a new job. Availability of credit allows people to keep their purchases of consumer goods and services – their consumption – smooth, despite fluctuations in income.

Figure A shows that as household debt has risen, consumption has become smoother. The figure shows that as the ratio of total household debt to income (the black line) doubled from 60 percent in 1970 to 120 percent in 2004, the standard deviation of consumption growth (the red line) fell

by half from 3 percent to 1½ percent. The correlation of these two series is a remarkable -0.87. Borrowing allowed individuals to smooth their consumption, consuming more than their income some of the time and less others. And remember core principle #5: Stability improves welfare. The use of loans allowed households to reduce the consumption instability, a form of risk, created by fluctuations in income.

