Reducing Debt

You've probably heard the word "deleveraging" in recent years. If you are like most Americans, you had probably never heard the word prior to the credit crisis. And why would you? For the past thirty years Americans have been busily leveraging their family balance sheets, adding debt at what proved to be a reckless rate. Reducing debt—or deleveraging—was simply not in our vocabularies as a country.

My, how times have changed. With the notable exception of the Federal government—which continues to add debt at an alarming rate through deficit spending—debt in virtually all other sectors of the American economy is in decline. Non-financial businesses have largely already completed the process of deleveraging, though the financial sector still has quite a way to go, as do American households.

Most of us would agree that, while it is painful in the present, the reduction of debt is ultimately a good thing. Deep down, most Americans have a mistrust of debt, as well they should. Though credit is the lifeblood of an economy, it can be dangerous if used to excess. And the housing bubble of the mid-to-late 2000s was certainly one of those times. As a country, we got stung—hard. But now, by tightening our belts and paying down our debts, we are laying the groundwork for a solid future, right?

Well, maybe not. Writing for CNN, Nin-Hai Tseng reports, ***"It turns out that many households aren't exactly tightening their wallets and using all their saved cash to pay down debts. They're simply defaulting on them."***

As Tseng continues, total household debt fell by $77 billion during the three months ending in June, ***"but nearly half of that decline stemmed from bank charge-offs of residential mortgages, credit cards and other consumer loans.***

"Household debt has fallen every quarter since the beginning of 2008, leaving it $473 billion below the peak, which is the equivalent of reducing debt at every household by $4,200."

Taking another look at the numbers, Tseng reports that credit card debt outstanding fell by $93.2 billion in 2009—which would, at first glance, sound like excellent news. Alas, a full $81.6 billion of that amount was due to cardholders defaulting on their debts. Only $11.6 billion was due to actual debt repayment.

Taking this "easy way" to reduce debt has its appeal, of course. But it comes at a cost, doing long-term damage by lowering credit ratings and impairing a debtor's ability to borrow in the future.

There are a couple points we can take away from all of this. First, the banking and credit system, though stabilized, is not out of the woods yet. New loans are not being made as quickly as in past years, while older loans continue to default. The result is that the percentage of bad loans of the total of all loans outstanding is likely to remain elevated for quite some time.

The second point is that, while defaults are making the deleveraging process appear quicker than it really is, Americans really are paying down their debts. Money is tight these days, and Americans don't have a lot of idle cash sitting around to pay their debts; if they did, they probably wouldn't have had the debts to begin with. Nevertheless, they are indeed doing it, even if their progress comes in fits and starts. By simply not accumulating new debts, the old ones will slowly disappear through attrition.

The Baby Boomers will be the primary drivers of the deleveraging process. At this stage of their lives, most Boomers have little need of new debt. If they buy a new home, it is likely to be smaller and more modest than what they currently own. They will eventually need new cars; but they are not likely to drive them as many miles as their previous cars. And as for furniture and appliances? Sure, Boomers will need to buy the occasional washing machine replacement—and may do so on credit—but they certainly won't be doing so en masse.

The Echo Boomers and Gen X are still in debt accumulation mode, of course, but they lack the spending power of the Baby Boomers. The Echo Boomers are too young to have that power and the Gen X is just too small in number. Just as the Boomers defined the consumer culture of the past 30 years, they will also define the culture of frugality that should characterize this decade.

Sincerely,

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