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Consumer spending: past and present

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Like capital investment, consumer spending has a significant role in driving economic growth. In free market economies like that of the United States, consumer demand drives the allocation and distribution of economic resources. In 2015, consumer spending generated more than two-thirds of U.S. gross domestic product and accounted for 1.5 percentage points of the 2.0 percentage-point average growth in GDP over the past 5 years. Higher incomes, lower interest rates, increasing wealth, and composition of wealth (liquid versus illiquid assets) may lead to increased consumer spending. Additionally, the prevalence of consumer credit and the ability of consumers to leverage housing wealth can also precipitate increased consumer spending. Higher interest rates often prompt consumers to save or reduce debt levels, thereby restraining their spending.

In their article titled “Increased credit availability rising asset prices help boost consumer spending” (*Economic Letter*, Federal Reserve Bank of Dallas, April 2016, http://www.dallasfed.org/assets/documents/research/eclett/2016/el1603.pdf), John V. Duca, Anthony Murphy, and Elizabeth Organ analyze the determinants of consumer spending during the boom years of the mid-2000s, during the downturn of the Great Recession, and in the years that followed. The authors assert that increased access to consumer and mortgage credit, along with increased asset prices, were key factors that led to the consumption boom years of the mid-2000s. The authors cite debt accumulated during the boom years, along with a reduction in the availability of credit and asset prices, as the reason for a bust in consumer spending during the Great Recession. Since the end of the recession, the authors indicate that significant reductions in household debt, renewed access to consumer credit, and resurgent asset prices have bolstered consumer spending and are likely to continue to do so.

According to the authors, the ratio of consumer spending to income increased dramatically from the early 1980s to the mid-2000s, peaking at almost 97.5 percent in 2005. The ratio fell during the Great Recession, reaching a trough at 92.5 percent in 2012, and raising concerns that the savings rate would remain at elevated levels and dampen spending. Since 2012, the ratio has risen to around 95 percent, where it has persisted over the last few years. The authors stipulate that increased access to consumer credit helped elevate consumer spending relative to income from 1980 to 2006. While access to consumer credit decreased during the Great Recession, it has increased in subsequent years and is now greater than it was prior to the Great Recession.

Household wealth also plays a role in enabling consumer spending. The authors indicate that, during the early to mid-2000s, household wealth rose substantially. Specifically, rising home prices caused wealth-to-income ratios to increase from 530 percent in late 2003 to 650 percent in mid-2007. This, in turn, led to a significant increase in consumer spending. The conventional estimate of the wealth effect—what the authors define as "the impact of higher household wealth on aggregate consumption"—was found to be $3 in additional spending for each $100

increase in wealth. The wealth effect of rising liquid assets, such as bank deposits, was even greater—almost $9 for each $100 increase in wealth.

The authors explain that the housing wealth effect increased steadily, from approximately 1.3 percent in the early 1990s to a peak of about 3.5 percent in the mid-2000s. Rising home values and housing wealth effects bolstered consumption during the subprime and housing booms. Throughout the Great Recession, higher mortgage debt, lower home prices, and lower home equity led to increased savings and a drop in consumer spending. Since the mid-2000s, the housing wealth effect has been cut in half, and is back to the mid-1990s level.