The End of the Consumer Age

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I. INTRODUCTION

The Great Recession has halted a remarkable quarter-century shopping spree by American consumers. From the middle of the 1980s through 2007, the share of disposable income spent by U.S. consumers rose rapidly (figure 1). While many commentators wanted to slap American consumers on the hand for their profligate ways, this behavior provided strong demand and contributed much to the good U.S. economic performance relative to most other developed countries. Furthermore, the absence of deep drops in the consumption rate during recessions mitigated negative demand shocks, such as the dramatic drop in capital expenditures that followed the bursting of the late-1990s high-tech bubble. Robust consumption helped create macroeconomic conditions that became known as the Great Moderation: compare the deep dips in the consumption rate during the severe 1974-75 and 1981-82 recessions with its tame behavior in what has been labeled “mild” downturns in 1990-91 and 2001. As we argue in Cynamon and Fazzari (2008), the “consumer age” was a source of growth for the U.S. economy for nearly a quarter century.

This story has a dark side, however. While spending grew robustly across the income distribution, outside of the top quintile, incomes were stagnant (see the chapters in this volume by Palley and Setterfield). The result was rapid growth in debt-to-income ratios in virtually all income groups. In our 2008 article we identified a “risk of collapse” from rising financial fragility in the household sector. By mid 2010, it is clear that what appeared as a risk several years ago became reality. In contrast to the recessions of 1990-91 and 2001, consumption dropped sharply as credit markets seized up and home prices plummeted. The decline in real personal consumer spending from its peak in January, 2008 to May, 2009 was the largest drop since 1980. Consumption and household debt dynamics were obviously central to the macroeconomic forces that led up to the Great Recession. Furthermore, an understanding of these behaviors is necessary to understand the future path of the U.S. economy and to design effective policy.

This chapter explores the source of the dramatic rise of American consumption. While the conventional life-cycle consumption theory models the household as an atomistic agent and seeks an explanation from a familiar cast of macroeconomic variables, such as, wealth, taxes, and interest rates, our theory models the households as a fundamentally social agent guided by norms of behavior. Thus, while conventional theory strives to explain the behavior of consumers considering prices and budget constraints in a literal way, our theory incorporates an understanding of consumers as agents embedded in a world of social cues. Furthermore, conventional theory models the household as an agent that understands the true, objective probability distributions that determine future outcomes. In contrast, a central part of our explanation is the recognition that households make spending and financial choices in an environment of uncertainty.

We argue that the life-cycle model has serious limitations for our attempt to understand modern American consumption over the past two decades and the associated evolution of the household balance sheet. According to our perspective, and in contrast to the standard life-cycle model, consumption preferences are endogenous and evolve through time. Drawing on research from social psychology and marketing, we start from the premise that individuals make many of their choices based on their identity. That identity is formed by their experiences and the people with whom they associate, it evolves over time, and it is co-determined along with a package of
social norms that dictate what one ought to do. The influence of identity is present in individuals’ economic lives as well and informs their views on what they and others should and should not buy (consumption norms) and how they should handle their finances (financial norms). Contrary to conventional models, our theory starts from a premise that social interaction feeds through social norms to have important effects on the way individuals choose to consume.

Endogenous preferences in our framework are produced by group interactions, the media, and other social influences. Consumers of recent decades lived in a social structure that encouraged greater spending and experienced rapid financial innovation that fundamentally transformed the way that they could finance that spending. Innovations in consumer finance combined with historically favorable circumstances, such as falling interest rates, greatly expanded the access to debt for American households during the consumer age. Through the lens of the life-cycle model, this change has potential benefits, as it enhances the ability of households to smooth consumption relative to income fluctuations. But the heavy use of financial markets by consumers also introduces the possibility of behaviors not anticipated in models of narrow intertemporal optimizers with full information.

Behavioral patterns based on social norms, and related to those that drive consumption preferences, also contributed significantly to the household debt explosion. In a world of uncertainty, borrowing did not necessarily correspond to a careful plan for repayment consistent with forward-looking intertemporal budget constraints and a full understanding of the systemic implications of the new modes of behavior. Our argument is not that American consumers borrowed more simply because they could borrow more in the new institutional environment, but that changing social norms made it seem normal to consume more (as opposed to desirable to spend more—which is always the case) as well as normal to borrow in order to finance that consumption (which was certainly not always the case). With rapidly changing technology and a proliferation of new products—both financial and electronic, experience became a less reliable guide to sensible choices. People were encouraged to take on more debt by the fact that they observed others borrowing in new ways and it seemed to working out well for them.

Section IV discusses the macroeconomic implications of these behaviors. We argue that strong consumption growth over the past two decades provided an important source of Keynesian demand stimulus that enhanced growth and mitigated the severity of recessions, especially the recession of 2001. The associated build up of household debt, however, led to the conditions that eventually brought the American consumption boom to an end and quickly pushed the economy into the Great Recession. We interpret these developments with Hyman Minsky’s financial instability theory, developed primarily for business investment. Minsky’s work identifies the systematic character of aggregate debt-financed expansions that sow the seeds of their own destruction as greater leverage leads to financial fragility.

The final section of this chapter considers the forces that will shape American consumption in the aftermath of the Great Recession. The housing bust and associated financial crisis make further increases in the indebtedness of U.S. households relative to their income unlikely; indeed, many analysts argue that consumers must repair their collective balance sheets in coming years by paying down debt, raising the saving rate. While such an outcome seems prudent in conventional terms, it raises the question of what source of demand growth can replace the debt-financed spending of the consumer age.

II. MODELS OF HOUSEHOLD BEHAVIOR
A. HOW HAVE ECONOMISTS UNDERSTOOD CONSUMPTION?

Figure 1 documents the rise in the share of disposable income Americans spent on consumption from the middle 1980s through the beginning of the Great Recession. To explain this remarkable change, mainstream economists would first look to the workhorse life-cycle model of consumer behavior. According to this model, forward-looking households form a lifetime plan to optimally allocate current assets, current income, and all expected future incomes to consumption. Financial behavior emerges implicitly from the optimal plan. Borrowing and saving simply reflect a misalignment between the optimal consumption path and the income path. Households borrow if current income falls short of optimal current consumption. The plan will work out in the end, with all debts discharged, unless there is an unanticipated change in the “fundamentals.” And these fundamentals arise from objective probability distributions that are fully understood by the decision makers.

The life-cycle model has great difficulty explaining the significant increase in the share of income Americans consumed over the past two decades. Among the most prominent implications of the model is the demographic prediction that consumers borrow early and late in life when incomes tend to be low relative to lifetime averages, and save during peak earning years. Of course, the period of rising consumption rates corresponds to the transition of the massive baby-boom generation into their peak earning years which the model predicts should reduce the share of income consumed. Parker (2000) discusses this problem, among others, including the possibility that rising asset wealth explains higher spending out of income. He argues that higher wealth explains, at most, 20 percent of the rise in the consumption rate through the late 1990s. Moreover, the detailed timing and distribution of changes in wealth and consumption since that time do not align well. Wealth-to-income ratios have not risen since the late 1990s (the Flow of Funds household net worth-to–income ratio was almost identical in 1998 and 2006) while the expenditure rate has jumped by an additional two percentage points.

While the discussion of consumption in Keynes (1936) introduces a richer set of considerations than the mainstream life-cycle model, his analysis does not provide much insight into the source of the American consumption boom. Keynes viewed consumption as mostly “passive” responding to income changes. And, although Minsky’s perspective provides important insights into the emergence of financial fragility that every chapter in this volume places at the center of the Great Recession, his microeconomic analysis focused almost exclusively on investment and asserted that the “behavior of consumption [is] secondary” (1986, page 191).

B. UNCERTAINTY

Some economists have argued that all models are false and that the quality of a model is best measured by the quality of the predictions it makes rather than the extent to which the story that animates the model itself corresponds to our understanding of the true process that the model is meant to help us understand (Friedman 1953). We agree that every model is incomplete by design: the only truly complete model of any phenomenon we observe in the universe is the
entire universe itself. That said, the key to good modeling is the choice of what to include in the model to get the best incremental gain in understanding of the phenomenon in question.

We believe that the life-cycle model is fundamentally incomplete for explaining the dramatic American consumer spending and finance behaviors leading up to the Great Recession. We come to this conclusion not because it is a poor description of what is actually happening (i.e. no real person makes their spending and saving decisions by solving a dynamic program explicitly or even unconsciously) but because we think that the key abstraction that makes a dynamic programming context possible—assuming that there is either complete certainty or that uncertainty is limited to variation in outcomes of known probability distributions—fails to guide our understanding to the issues of greatest importance. Crotty (1994, p. 131) explained this well when he wrote: “[e]xpectations and confidence formation are complex, institutionally contingent, and nondeterministic psychological and social processes that can never be fully or permanently captured by any fixed mathematical formula.” The information needed to even approximate the solution to the relevant dynamic programming problem simply does not exist, and that means that the household must be using a fundamentally different process—with fundamentally different decision drivers—than the ones that take center stage in the life-cycle model.

The reason that uncertainty largely undermines basis of the life-cycle model is that, as Hicks once wrote, people “do not know what is going to happen and know that they do not know what is going to happen,” (see Davidson 1987, page 149). Most of the time people make decisions without knowing the key variables that ought to be involved in making the decision let alone forecasted values of those variables. When uncertainty strikes it is a source of stress. As Crotty (1994, page 120) writes, “because they are fully human, agents have a deep psychological need to create the illusion of order and continuity even where these things may not exist.” So how do humans, who have an intrinsic tendency to dislike uncertainty, respond when they are faced with choices knowing that they lack the information and/or understanding to make the best decision? As Keynes wrote:

Knowing that our own individual judgment is worthless, we endeavor to fall back on the judgment of the rest of the world which is perhaps better informed. That is, we endeavor to conform with the behavior of the majority or the average. The psychology of a society of individuals each of whom is trying to copy the others leads to what we may strictly term a conventional judgment (1936, 214-5).

This quotation anticipates the idea of an information cascade, introduced by Bikchandani, Hirschleifer, and Welch (1992), which explains how rational actors who observe other actors’ actions but not their information can create an equilibrium of herd behavior (which in this context turns out to be sub-optimal). Each actor observes the action of the preceding actors, concludes that the action must be optimal, and then takes it.

C. SOCIAL REFERENCES AND HOUSEHOLD CHOICES

How do individuals make spending and financial decisions in a world of uncertainty? The core of our answer could not be more simple: when one is unsure of how to behave, look at the behavior of others for guidance. For decades, social psychologists have studied the effect of group identity on human behavior. Festinger (1954) studies social reference groups and argues that humans have a fundamental drive to evaluate their opinions and abilities, through comparison to those who are similar on relevant dimensions. Tajfel (1972) suggests that behavior
is determined in part by group prototypes that reflect social values and act as guides for action, rather than solely by atomistic preferences. Within the marketing literature, reference groups are defined as social groups that are important to a consumer and against which he compares himself. More recent reference group research is based on conformity and social comparison theory (see Folkes and Kiesler 1991 for a review). Individuals look to similar others who appear to validate one’s self-concept and associated cognitions and behaviors. Hogg (2000) suggests that the deep motivation for people to identify with groups may stem from a desire to reduce at least the perception of uncertainty.

From this perspective preferences are not given exogenously, as assumed in most mainstream economic theory, but rather created through time as the household is continually buffeted by events and social interaction. Households learn consumption patterns from their social reference groups. By analogy to the economic theory of the firm, households learn “technologies” from their reference group to “produce” utility using specific consumption goods as “inputs” (as in Becker 1965). Reference groups—virtual or real—are an important source of information: first, they introduce an individual to new products so that choices are influenced by one’s reference group; second, they provide experience and knowledge in how to appreciate, enjoy (and consequently desire) new products.

Consider a simple example. Think of the preference for good wine not as an innate characteristic of individual utility but rather as a learned behavior conditioned by one’s social reference group. An individual with a working class reference group is unlikely to sit around the table at expensive restaurants bantering with friends and sommeliers about tannins, complexity, oakiness, etc. If the enjoyment “technology” for good wine is not typically part of a person’s social reference group, it may be difficult for that person to appreciate wine qualities. Should an individual experience a large rise in income, he will have the means to begin dining at places, and with other people, that take their wine seriously. The association with higher income households in the new reference group will “teach,” at least implicitly, the person in the new social situation about the joys of fine wine and change his preferences.

Individuals not only learn utility producing technologies from their social reference groups, they also compare their consumption standards to the reference group. Positional and status perceptions induce comparisons with other individuals (Frank 1997, Schor 1998). Frank, in particular, forcefully argues that people define their self image and self worth by what they consume and possess relative to those in their reference group.

In addition, “habit formation,” a concept that is becoming more important in both microeconomic and macroeconomic research on consumption, is implied from this way of understanding household preference.¹ Once individuals learn new enjoyment technologies from their social reference group, they will not forget them. To extend the example discussed above, once you learn to appreciate good wine you do not forget the associated pleasures, even if your economic situation deteriorates. Thus, household preferences are path dependent and the relevant references for current decisions include both the social circumstances in which an individual is situated at any point in time, what one might call her cross-sectional reference, and the individual’s personal history, or her time-series reference.

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¹ See Duesenberry’s (1949) “relative income hypothesis.” Recent references include Campbell and Cochrane (1999), Fuhrer (2000), and Morley (2007)
We define the *consumption norm* as the standard of consumption individuals consider normal based on his group identity.² The norm provides a conceptual sufficient statistic for social and habitual influences on consumer choice that evolve through time. It guides choices in a world of uncertainty. To the extent that the utility function is viewed as exogenous, as is typical in most analysis of consumption with the standard life-cycle model, it abstracts from the dynamic social context of preferences. We argue that the consumption norm is a powerful behavioral force that cannot be ignored as we try to understand modern consumption behavior.

Social references and the associated norms affect financial decisions as well as spending decisions. Indeed, in the financial sphere, uncertainty is likely to be particularly important as households must confront complex intertemporal implications of their decisions that depend on systemic macroeconomic conditions. Changing institutional structures interact with social norms to define what practices are responsible and sensible. For example, borrowing for a home with 20 percent down and a fixed-rate mortgage was consistent with the financial norms of the 1960s and the 1970s. But few people in that era would re-finance their mortgages to get cash for a new car or a vacation. When home equity loans with tax advantages became available in the late 1980s, borrowing against one’s home for non-housing consumption became more common. In the 1990s, innovations in the mortgage markets reduced transaction costs and cash-out refinancing became more common. Initially, these actions were responses to changes in available financial products. We argue, however, that what households consider normal behavior also evolved along with these changing practices.

We argue that behaviors driven to conform to (possibly evolving) consumption and financial norms are more than just preferences. Rather, they fulfill a need of individuals to participate fully in social life, something humans seem programmed by evolution to pursue vigorously. Recent magnetic resonance imaging of brain responses in the context of a social conformity experiment show that the “opinions of others can easily affect how much we value things. … [S]ocial influence on the value of an object is associated with the magnitude of the ventral striatum response to receiving it. This finding provides clear evidence that social influence mediates very basic value signals in known reinforcement learning circuitry” (Campbell-Meikeljohn, et al.). This behavior assuages the fundamental uncertainty of the complex modern environment in which Americans must make spending and financing choices. These choices were consistent with social conditions prevailing when they were made, but they could not account for the aggregate financial fragility that they were creating, a theme we return to below.

### III. EVOLUTION OF HOUSEHOLD BEHAVIORAL NORMS IN THE CONSUMER AGE

#### A. SOCIAL PRESSURES THAT RAISE DESIRED SPENDING

That consumption levels should rise in a growing economy is no surprise, as rising incomes allow individuals to support higher standards of living, but consumption rose faster than disposable income from the middle 1980s until just recently. One simple explanation is that

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² Schor (1998) also uses the terms “social norm” and “consumption norm” in a similar context. She writes (page 9), that “the very term ‘standard of living’ suggests the point: the standard is the social norm.” Akerlof (2007) defines norms as individuals’ views about how they and others should or should not behave.
while good economic times allow individuals to spend more habit formation prevents symmetric reductions during downturns.

In addition, new opportunities for consumption can cause higher growth of spending relative to income. The drive for profit requires enterprises to grab consumer attention by introducing innovative products. Through marketing, modern firms incorporate new and better stuff into consumption norms. Some things that were “luxuries” decades ago become standard. Some parts of today’s consumption norm for most of American society did not even exist a couple of decades ago. In the language developed in the previous subsection, households learn how to use the new products to produce satisfaction in new ways. Some of these items become necessary for individuals to fully participate in the evolving social structure (think of cell phones and internet access, for example, or, in an earlier period, television and radio). Product innovation is always an objective of entrepreneurial capitalism, but there is no reason for it to proceed at the same rate over time. We believe that integration of semi-conductor technology into consumer products has been particularly effective in raising the rate of consumer product innovation in the past quarter century, and it has accelerated the growth in consumption norms that created social pressure for spending to rise faster than income.

The mass media have become a central part of the learning process that shapes consumption choices through time. Greater media saturation obviously encourages more consumption. In addition, advertising targets consumers with the means to pay for the products it hawks. When promoting new products, marketing often targets upper middle class consumers where there is a reasonably dense population of potential buyers with discretionary income. But this advertising takes place in the mass media, and it therefore extends its reach to households with incomes lower than the target audience. The media present compelling and influential lifestyle models. Because of these models, part of the relevant social reference changes from actual peers and neighbors to fictional characters created for entertainment and marketing. In this context, the consumption behaviors demonstrated, while possibly portrayed as perfectly “normal,” are unconstrained by income and wealth and may therefore be completely inconsistent. As Schor (1998, pages 80-81) points out, one’s reference neighborhood used to consist largely of friends and family who lived in close proximity, and who likely had similar incomes and group identities. But media saturation greatly widens the “neighborhood.” Spending ambitions are not determined by one’s immediate neighborhood and social circles only; one is also bombarded with consumption cues from the mass media.

If marketing is biased toward higher income consumers with discretionary spending power, rising economic inequality also contributes to an increase in desired spending that outpaces income growth. To illustrate this point, suppose that the median advertising message targets households with income at the 80th percentile. The message influences all income groups, however. As the income gap between the marketing target group and the median-income household rises, the pressure to spend “beyond one’s means” rises across much of the income distribution. Median households will not be able to afford the standard of living of the 80th percentile, but they will do what they can, pushing the propensity to consume out of disposable income higher, and, as discussed below, increasing household indebtedness.

These trends are magnified by “positional externalities” in consumption, emphasized prominently in the work of Robert Frank who compares the evolution of consumption norms to an arms race. Frank (1997, page 1840) writes “[t]he things we feel we ‘need’ depend on the kinds of things that others have, and our needs thus grow when we find ourselves in the presence
of others who have more than we do. Yet when all of us spend more, the new, higher spending level simply becomes the norm.”

B. CONSUMER CREDIT: CHANGING INSTITUTIONS—CHANGING ATTITUDES

The desire for higher consumption alone is not sufficient to explain the striking upward trend in consumption relative to income. Consumers must be able to pay for their spending. Until the early 1980s, the household experience with credit was largely limited to home mortgages and the finance of consumer durables, primarily cars. These loans were collateralized and required substantial down payments. But things have changed dramatically in recent decades. Credit cards now provide a line of unsecured credit to most households, albeit with substantial interest costs. Innovations in housing finance have greatly increased the ability of home owners to borrow at tax-subsidized interest rates for any kind of consumption through equity credit lines or cash-out refinancing.

One important reason for these developments is new information technology that makes it easier to obtain information on prospective borrowers. Standard models of credit rationing rely on the lender's inability to distinguish between “good” and “bad” borrowers. Such models generate outcomes in which lenders ration credit if they cannot distinguish the quality of borrowers. However, if lenders can distinguish between borrowers, they finance those they identify as good risks at low interest rates and the bad ones at high interest rates. If new credit reporting technologies make distinguishing between good and bad credit risks easier at the micro level, credit should have become more accessible. But in a world of uncertainty, one cannot expect such decisions to account for the transformation of aggregate financial fragility that took place with these new practices, a macroeconomic setting in which historical data became increasingly less relevant at the underlying structure of consumer finance changed.

Tax law changes have also affected the market for household debt. In particular, the Tax Reform Act of 1986 eliminated the income tax deduction for most categories of interest expense, but famously retained the deductibility of home mortgage interest. Initially, home equity credit lines became a simple way to shift interest payments on traditional consumer debt, car loans for example, from a non-deductible to a deductible expense. But once the home equity line is in place, it becomes much easier for home owners to borrow for any purpose, including non-durable expenditure: institutional change transforms financial norms.

In addition, mortgage refinancing to exploit interest rate movements has become much more common (Hurst and Stafford 2004, Wray 2007). It is not surprising that falling interest rates would boost consumption as households refinance and their debt service payments decline. But the long-term trend of lower nominal interest rates since the early 1980s made refinancing “normal” and introduced new financial practices that households in an earlier era would not likely considered as responsible financial behavior. Most obviously, “cash-out” refinancing has encouraged households to exploit the benefits of a lower mortgage interest rate with a large upfront cash infusion rather than a reduction in monthly debt service payments.

Changes in attitudes, likely stimulated by increased borrowing activity, have also played a role in the transformation of household finance. The vast majority of adult household decision makers from the end of World War 2 to the 1970s either had to confront the financial challenges of the Great Depression themselves or had parents who managed household budgets during this bleak period. These people have an aversion to consumer debt. The Depression is two
generations removed for baby boomers, however, and they have been much more willing to borrow aggressively to get what they want (see Malmendier and Nagle, 2007). Again, this phenomenon spreads through social reference groups. When the behavior of one’s neighbor suggests that a home equity credit line can easily finance a vacation or home improvement, the social stigma associated with debt begins to erode. The dramatic rise in the consumption-income ratio corresponds to the period in which the baby-boom generation, with its relatively relaxed attitude about debt, has become the dominant force in American consumption.

These arguments resemble a claim that household liquidity constraints have relaxed (see Carroll, 1992, for example), but there is a subtle difference. In a conventional life-cycle consumption model with liquidity constraints, households have a feasible, optimal plan that they would follow in the absence of constraints, but the constraint prevents current consumption from reaching this desired level. When greater access to credit relaxes the constraint, households raise debt and consumption toward the level derived from the optimal plan. These actions can be understood by looking at a representative household in isolation, without reference to broader social forces. In our context, in contrast, we view consumption and debt choices as driven to an important extent by social interaction. A family, in isolation, might choose a more conservative financial path, but the influence of neighbors, both those who have a physical presence and those whose lifestyles are piped in through the media, drives both consumption and debt higher.

This behavior may be myopic relative to the results of a standard life-cycle model with liquidity constraints, perhaps myopic in the sense of the time-inconsistent behaviors (e.g. hyperbolic discounting) found in behavioral economics research. The social influences on household finance also reflect the uncertainty households face about the future. They are not really sure what kind of financial plan is feasible, but there is a perceived “safety in numbers.” If others borrow heavily to consume a lot now, both higher consumption and the higher debt necessary to finance it seem like the “thing to do.”

Regardless of the underlying reasons, a quick look at aggregate household financial statistics demonstrates the dramatic rise in consumer debt. Figure 2 shows total household and mortgage debt outstanding (Federal Reserve Flow of Funds data) as a share of GDP. This ratio has been rising for decades, likely due in part to financial innovations in household lending. The ratio shows some acceleration in the mid to late 1980s, roughly the beginning of the consumption boom. The growth in debt accelerates dramatically after 2000, entirely due to the rapid rise in mortgage debt. Something new is happening in recent years.

In our view, the standard life-cycle model, with its narrow focus on consumption smoothing subject to a hard intertemporal budget constraint, does not adequately describe household spending and borrowing decisions in the past quarter century. We argue instead that, in the context of uncertainty, households base their decisions on a wide variety of evolving social cues about consumption and financial behavior. With financial innovation and greater access to debt, the year-by-year budget constraint became much softer. Families likely did not have a detailed plan for how they would service their debts in all states of the world that could arise from well understood probability distributions. Rather, households mimic the behaviors they

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3 For formal analysis, see Laibson (1997). More intuitively, consider the case of Benjamin Franklin Baggett who filed for bankruptcy in 2003. “We came to rely on credit as part of our income. … I looked at $1,000 on my credit card as disposable income.” (“Extra Credit: Lagging Behind the Wealthy, Many Use Debt to Catch Up,” Wall Street Journal, May 17, 2005, page A1).
observe around them, from both real people and media models, assuaging their uncertainty in the perceived comfort of acting like others in. It may have been unrealistic for households to believe that the favorable macroeconomic trends that were necessary for them to validate their financial positions would continue indefinitely, which included falling interest rates, easier lending terms, and rapidly appreciating home prices.\(^4\) But such a systemic perspective lies outside of the information that the typical household uses to make critical financial decisions. Families can observe their neighbors, but they cannot be expected to appreciate the complex macroeconomics of emergent financial instability.

A similar point likely applies to lenders. Their relaxed credit standards may have created excessive systemic risk, but the short-term environment made risky loans very profitable for a while. Managers and investors see the money that can be made in the short run, but they do not adequately perceive macroeconomic risks that emerge in new ways compared with earlier financial disturbances. It is these risks that we now turn to explore.

### IV. ConsuMPTION, DEBT, AND U.S. MACROECONOMIC PERFORMANCE

What are the macroeconomic implications of these developments in the modern American consumer culture? The basic message is simple: the trends described above were a significant source of strength for the economy for over two decades. But they also set systematic forces in motion that spawned the Great Recession and threaten an extended period of stagnation going forward.

#### A. MILD RECESSIONS AND STRONG AGGREGATE GROWTH (FOR A WHILE)

According to the Keynesian macroeconomic theory that is the foundation for all the analysis in this book, strong consumption creates substantial macroeconomic stimulus. One outcome was a change in the dynamics of recessions in 1990-91 and 2001 compared with recessions in 1974-75 and 1981-82. The conventional wisdom was that U.S. recessions since the early 1980s were “mild,” contributing to the view that the U.S. economy had experienced a “Great Moderation,” at least prior to the collapse in late 2008. Consider figure 1 again. The ratio of personal outlays to disposable income obviously collapsed in both the 1974-75 and 1980-82 periods, significantly magnifying the severity of economic weakness. During the early 1990s recession, the growth of the consumption-income ratio that started in the mid 1980s took a pause, but there was virtually no decline. In 2001, the consumption-income ratio continued to grow in spite of the dramatic collapse of the late 1990s bubble in technology stock prices and the fallout from the September 11, 2001 terrorist attacks.\(^5\) Strong consumption spending greatly attenuated the declines in aggregate demand from the middle 1980s through 2007, which helped to contain recession dynamics.

\(^4\) Minsky (1986) uses “validate” to describe the process of meeting contractual debt service obligations. Also see Wray (2007).

\(^5\) Also see Kotz (2008). The unusual nature of this phenomenon is noted by Burhouse (2003): “consumer spending and borrowing patterns during and after the 2001 recession departed significantly from historic norms. U.S. households in 2002 continue to spend and borrow at a record pace even as personal bankruptcy filings reached record levels.”
But short-run macro performance in recessions does not tell the whole story, and as we consider the way forward after the Great Recession, the dynamics of consumption during recessions may not be the most important part of the link between consumption spending and macroeconomic outcomes. In our view, the American consumption boom was an important engine of demand-led growth for U.S. economy over the longer term. According to mainstream macro theory, high demand growth affects macro performance only at short-run frequencies relevant for business cycles, a few quarters to a couple of years. In the long run, however, supply-side forces are supposed to explain growth as wage and price adjustments, or enlightened monetary policy, offset demand factors and the economy converges to full employment. Over a longer horizon, therefore, mainstream theory predicts that growth is limited by potential output. Yet, there is little evidence that the U.S. economy faced supply constraints at the margin for most of the years since the beginning of the consumption boom. Inflation was on a downward trend from the early 1980s. Unemployment tested multi-decade lows in the late 1990s with no adverse effects on inflation. Potential output has stayed ahead of demand, and that demand growth, which was dominated by consumption spending, has been the proximate cause of output growth over a relatively long period of time.

B. RISING HOUSEHOLD DEBT AND THE SEEDS OF THE GREAT RECESSION

Figure 2 summarizes the unprecedented rise in household debt that accompanied the consumption boom. High consumer indebtedness was critical to the forces that made the Great Recession the most severe economic downturn since the 1930s. The financial Keynesian theory of Hyman Minsky provides a framework for analyzing the dynamics of these phenomena. This perspective emphasizes the two-sided character of debt-financed spending. In the growth phase of the aggregate business cycle, the creation of debt boosts demand that provides economic stimulus. But Minsky argues that as debt continues to grow during the boom phase of the cycle the financial system will become more fragile. The Keynesian link between higher borrowing, rising spending, and income creation validates the decision to increase lending. But that validation systematically encourages even more aggressive financial practices. Again, uncertainty is central to this process. No one knows how much financial stress the system can bear. Financial success influences conventional expectations about appropriate financial practices (financial norms) and fragility rises further. The basic logic of this process implies that the system expands until it breaks in a financial crisis, when finally the more aggressive practices cannot be validated any more.

While Minsky’s theory identifies a deep family resemblance across financial cycles, the specific form of any particular cycle depends on unique historical circumstances. Minsky’s writings, although they mention consumption and household debt, focus primarily on business finance and investment. We propose that innovation in consumer finance and the associated evolution of household financial norms over recent decades has shifted the locus of financial instability to the consumer sector. These themes are developed elsewhere in this volume.

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6 Furthermore, in mainstream theory, high consumption actually reduces the growth of potential output, because lower saving reduces the capital stock and labor productivity.
7 Criticism of the mainstream view that flexible wages and prices eventually eliminate demand effects on output and employment has been a major theme of the alternative Keynesian literature. See Fazzari, Ferri, and Greenberg (1998) for a survey of some of these contributions.
8 See, in particular, Minsky (1985, pages 37-50).
particularly the chapters by Wray and Kregel. Here, we want to emphasize the correspondence between, first, the result from the previous subsection that strong consumption cushioned recessions and contributed to strong secular growth in the U.S. over recent decades and, second, the rising financial fragility of the household sector. These are two sides of the same underlying phenomenon: the consumption boom sowed the seeds of its own destruction.

The consumption boom was financed by borrowing that led to Minskyan financial fragility. Indeed, since income growth was anemic over this period for most of the income distribution, debt growth was the only way to finance such a boom (**cite Palley and Setterfield chapters; others?). Wray’s chapter in this book describes the emergent financial fragility in detail as well as the particular conditions that triggered the collapse, beginning in 2007. The abrupt shift from the finance-led boom to contraction led to historic declines in both consumer spending and residential investment.

Real personal consumption expenditures peaked in January of 2008 and fell 1.9 percent to a trough in May of 2009.9 This decline was the most severe since a 2.6 percent fall at the beginning of the 1980 recession. It is about double the decline of the worst drop during the Great Moderation period (September, 1990 through March, 1991). If one focuses on durable consumption, which clearly depends to a much greater extent on financial conditions than total expenditure, the Great Recession peak comes earlier than one might expect, in August of 2005. After a modest decline, durable spending plummets after mid 2007 to a trough also in May of 2009. The peak-to-trough decline in real durable consumption of 18.7 percent is roughly the same as the most severe drops in the postwar period (19.4 percent from April, 1973 through January, 1975 and 19.1 percent from June, 1978 through December, 1981).

In percentage terms, the decline in residential investment has been breathtaking. From the peak in the fourth quarter of 2005 to the trough (so far) in the second quarter of 2009 the construction of new homes fell 56 percent. The only period that comes close to matching this debacle in postwar U.S. history is the third quarter of 1978 through the third quarter of 1982 when mortgage rates exceeded 15 percent. Even in those remarkably turbulent times residential investment decline from peak to trough by less than the recent experience (45 percent).

While the stunning decline in percentage terms of housing investment dwarfs the fall in personal consumption, the latter is much larger. Together, we very roughly estimate that each category is about half a trillion dollars below what would have been predicted by the pre-recession trends. There has also been a big decline in business investment. But, in strong contrast to the 2001 recession, this decline seems to have been induced by the household sector. Business investment did not peak until the second quarter of 2008.

This narrative for the Great Recession is fundamentally Keynesian: the common engine of the consumption-housing boom and the subsequent collapse is demand. But it is misleading to think of these forces as demand “shocks.” The Minsky framework illuminates the systematic dynamic character of debt-financed demand. It can be a powerful source of growth, but it leads, sooner or later, to collapse. One cannot understand the Great Recession outside of the household finance boom that preceded it.

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9 The figures in this paragraph refer to three-month moving averages of monthly data to smooth out random volatility.
C. CONCLUSION: HOUSEHOLD FINANCE AND SPENDING IN THE AFTERMATH OF THE GREAT RECESSION

Does the Great Recession mark the end of nearly a quarter century run of strong growth fueled in large part by American consumer spending and the associated explosion of indebtedness? From the middle 1980s to 2007, the specific historical conditions in the U.S. created a remarkably good environment for high consumption and rising household debt. These conditions included falling energy costs, large tax cuts, a stock market boom, a historic decline in interest rates, a home price boom, and financial innovation that opened new doors for consumer lending. In classic Minsky fashion, however, these favorable conditions encouraged more aggressive financial practices until they reached a breaking point, a particular point in time that the popular press has called the “Minsky Moment.” With falling home prices and retrenchment in mortgage lending, conditions reversed.

Where does the U.S. economy go from here? It seems impossible to expect a reprise of the debt-fueled consumption boom evident in figures 1 and 2. Borrowers and lenders have been decimated by the crisis. At the least, norms of lending have changed for the medium term, if not consumption and borrowing norms. Therefore a significant source of U.S. (and global) demand growth for the past quarter century has disappeared. There seems no obvious replacement going forward. Absent a dramatic new technological development, business investment is likely to be sluggish in the face of historic excess capacity. Government spending could be a source of growth, but the 2010 political rhetoric in the U.S. has reacted to the early stages of the Great Recession with calls for “fiscal responsibility.” We seriously doubt that the American government will act on this rhetoric in any significant way by tightening fiscal policy while the economy remains mired in stagnation, but the current political culture seems like it will prevent the federal government from leading demand upward as the household sector retreats. Even defensive fiscal measures such as the extension of expiring unemployment benefits have been shot down recently. Furthermore, state and local fiscal policy is a deepening disaster. Some American policymakers spin fantasies about rising exports. But who will buy more American goods? Japan and the Eurozone are even more aggressive about pursuing fiscal austerity than the U.S. China and other developing countries in Asia are doing relatively well, but these countries have an export-led growth model that is unlikely change over the next few years.

The period from the summer of 2009 through the first half of 2010 might be labeled a retreat from panic when aggressive monetary policy, automatic fiscal stabilizers, and some discretionary fiscal policy stopped the freefall that began after the September, 2008 failure of Lehman Brothers. Inventory dynamics and some rebound of discretionary consumption as fear of another Great Depression receded created some growth. The mainstream analysis called a bottom to the recession. Following conventional wisdom based on the typical patterns of business cycles in the second half of the 20th century, recovery should follow, even if the severity of the decline implies that true recovery will take a long time. But without the American consumers’ willingness and ability to further lever up their collective balance sheets the source of demand growth for even a sluggish recovery remains a mystery. The way forward is likely to disappoint. The result could include further financial panic and the dreaded “double dip.” But even in the best case the economy will need to find an alternative demand growth model, as discussed elsewhere in this book, to replace our quarter-century consumer age.
REFERENCES


Figure 2 - Household Debt (Share of Disposable Income)