Subprime problems signal trouble ahead, research shows

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If it seems as though sub-prime mortgage loans stirred up trouble in the financial markets, just wait until debt problems spill over onto household spending. According to economists Barry Cynamon and Steven Fazzari, America's love affair with consumption has been a big source of economic stimulus for a long time. But the party might be about to end. Americans' overextended wallets could trigger the most severe downturn in economic activity seen since at least the 1980s — and possibly since the Great Depression.

"For the past 25 years, America has experienced a period of rising consumer debt," said Fazzari, an economics professor at Washington University in St. Louis. "Up to now the high debt levels have had a positive influence on the economy. In fact, it was a stimulus to economic growth. But now it's likely to become a source of economic contraction."

While the sub-prime mortgage loans have caused a great deal of market volatility, the current situation could be a harbinger of difficulties ahead.

"Many people think that trouble in the housing market won't have that big of an impact on the overall economy because construction accounts for only 5 percent of the economy. They predict a soft landing from the current troubles," Fazzari said. "Our research suggests that we're facing a much more serious problem due to our consumption habits, that could have a much bigger impact.

"We're already seeing credit dry up in housing. But this may not affect just home building. Going forward, the inability to get home loans could affect consumer spending. It will become more difficult to shop at the rate we're used to, and at the rate the economy has come to depend on. Consumer spending accounts for 70 percent of the economy. That's a much bigger portion than construction, which means the potential impact is much greater."

Fazzari along with Cynamon, a WUSTL graduate who is now pursuing a Ph.D. at the University of Chicago, studied the impact American consumers have had on the economy over the past 25 years, as well as the impetus behind the people's spending and borrowing habits. Their analysis leads them to conclude that various factors are responsible for the increase in consumer debt during the latter half of the 20th century.

"We are social animals who learn behaviors from those around us, both 'real' people and the characters we identify with in the media. The media, as well as friends, family and co-workers, have a big influence on people's willingness to buy more," Fazzari said. "The message we all hear is that it's OK to spend more money, it's patriotic to buy more and that it's perfectly normal to take on debt to do so."

Combine that pressure with a loosening of institutional constraints to accessing credit, and you wind up with the current situation. The risk comes into play because with so much debt, the source of financial instability is now in the consumer sector.

"We're already seeing what happens to the markets from a weakened mortgage market. Many people who received loans who would not have qualified with previous credit standards are now unable to afford those loans as 'teaser rates' expire interest rates go up," Fazzari said. "What will people do when offers for new credit cards don't show up in the mail three times a week? People won't be able to simply pay off old loans with new lines of credit. They'll be forced to service their debt, if they can."

Source: Washington University in St. Louis