

Center for American Progress



Credit or Cash?

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Summary

On December 8, the Federal Reserve released a new report, *The Flow of Funds Accounts of the United States*, a quarterly statistical depiction of financial flows and holdings across the country. The report tells the tale of two economies: one drowning in debt, the other overflowing with so much cash that it doesn't know what to do with it.

For families:

- *Record debt.* Household debt is at a record high (121.2 percent) as a percentage of disposable income. This means that families are more burdened by their debt than ever before.
- *Record reductions in home equity.* Families have cashed out more home equity than ever before, \$113 billion in the third quarter alone. This means families are financing more of their consumption by reducing their home equity—a trend that is not sustainable without further wage growth.

For companies:

- *Highest cash holdings in nearly 40 years.* Corporate cash holdings totaled 6.2 percent of their assets in the third quarter of 2005. Cash holdings for the last four quarters are at their highest level since 1966.
- *Less investment.* Instead of using the additional resources generated by high profits for productive investments, corporations are using their money to spread the wealth to their shareholders. Typical mechanisms are dividend pay-outs and share repurchases that help to boost share prices. Fewer dividend pay-outs relative to corporate profits have been largely compensated for by higher share repurchases.

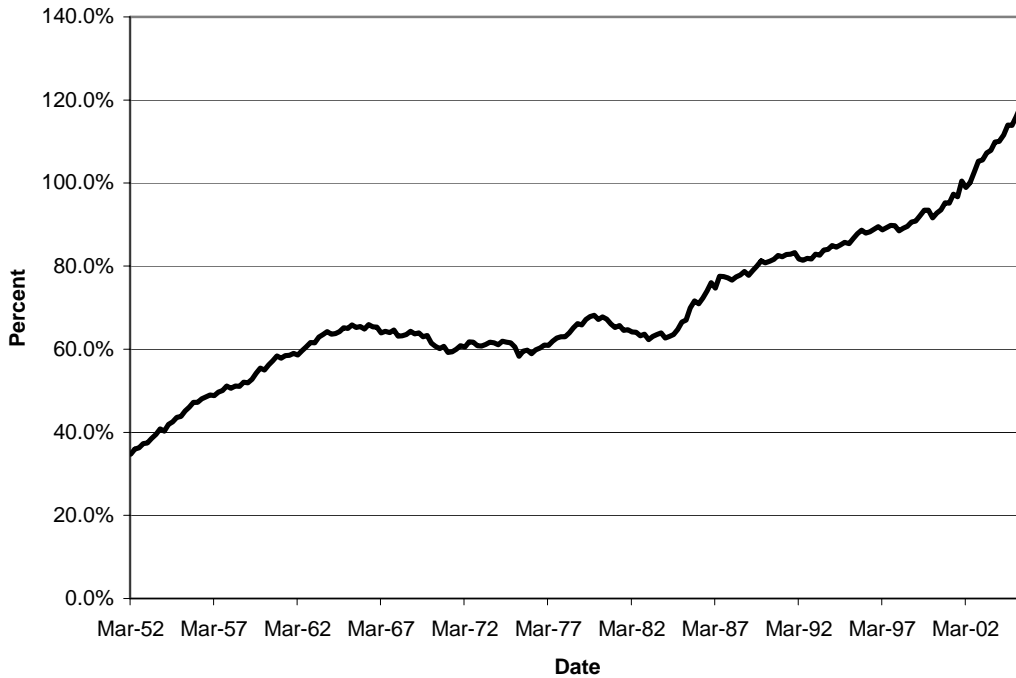
America's Two Economies

America's families continue to amass greater and frightening debt levels. In the third quarter, total credit market debt surpassed 120 percent of disposable income for the first time since the Fed started keeping record in the early 1950s (figure 1).

With low interest rates making it easier and easier for families to take on more debt, it should come as no surprise that debt levels continue to grow. The Federal Reserve also

reported its estimates for the household debt service burden, i.e. how much households have pay to service their debt out of their disposable income. According to these figures, families dedicated on average a record 13.8 percent of disposable income to servicing their outstanding debt in the third quarter of 2005. This is up from its last low point of 13.1 percent at the end of 2004. If the debt service burden had remained at the 2004 level, households would have had an additional \$14.9 billion at their disposal in the third quarter.

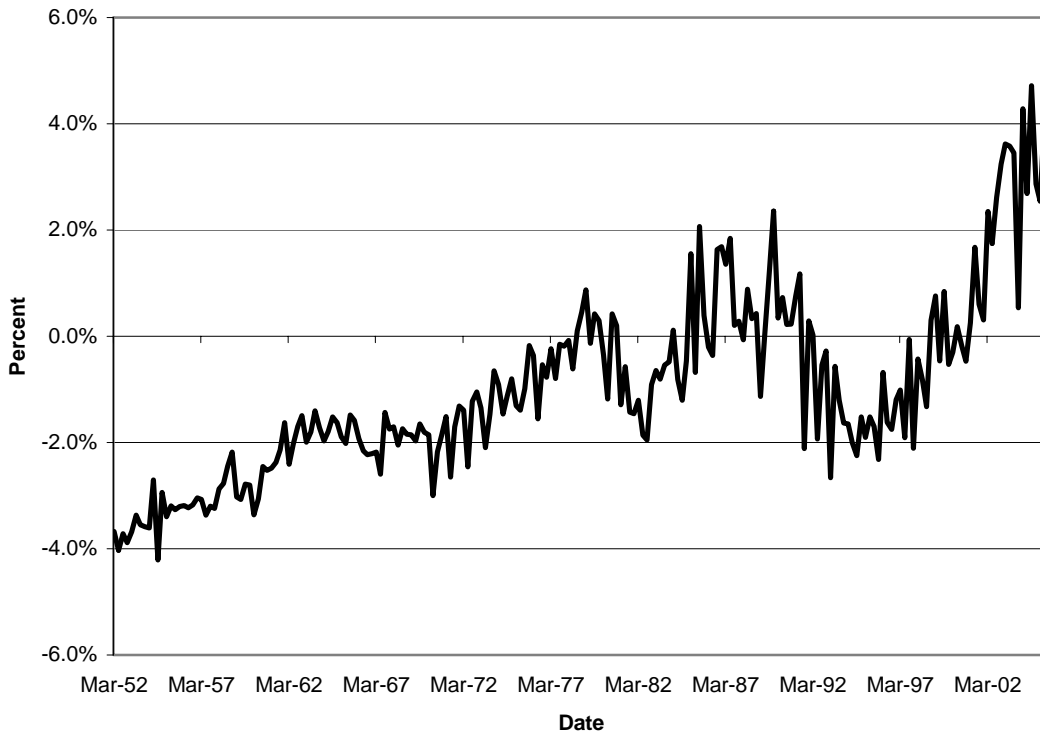
Figure 1: Household Credit Relative to Disposable Income



Notes: Author's calculations based on tables F.100 and L.100 from Board of Governors, Federal Reserve System, Release Z.1 Flow of Funds Accounts of the United States, Washington, D.C.: Board of Governors.

The rise in debt levels is largely due to a boom in home equity cash-outs. Families are borrowing more money against the appreciated values of their homes than they used to in order to pay for bigger homes or for renovations. In the third quarter alone, this meant that households had an additional \$111 billion available for consumption, the equivalent of a 5 percent raise in their disposable income (figure 2). This was the highest level of home equity cash-outs since the Fed started to keep records.

Figure 2: New Mortgages Minus Real Estate Investments



Notes: Author's calculations based on table F.100 from Board of Governors, Federal Reserve System, Release Z.1 Flow of Funds Accounts of the United States, Washington, D.C.: Board of Governors.

This dependence on mortgage debt to finance other consumption is not only worrisome because it drives household debt to new heights, but it also plays a crucial role in driving the economy forward. New household debt has been the Energizer Bunny of this business cycle. Unfortunately, this Energizer Bunny *cannot* keeping going and going. At some point, even the cheapest credit will have to be repaid. Unless households see significant employment and wage gains in the near future, their debt burdens will inevitably dampen their consumption and thus dampen economic growth.

If circumstances don't improve for the household economy, the corporate economy will soon be sharing the burden.

Corporations are not oblivious to the fact that much of the economic expansion since the start of the last recession in March 2001 has depended on households borrowing more money. It is likely one of the reasons why they have been so reluctant to invest as aggressively in new productive capacity as they would have a few years ago. Capital expenditures relative to corporate pre-tax profits, for instance, fell to their lowest level since the end of 1975, according to the data released by the Federal Reserve (figure 3).

Figure 3: Capital Expenditures Relative to Before Tax Profits



Notes: Author's calculations based on table F.102 from Board of Governors, Federal Reserve System, Release Z.1 Flow of Funds Accounts of the United States, Washington, D.C.: Board of Governors.

That is, corporations are using their high profit levels – the highest relative to assets since March 1980 – for uses other than productive capital. Where does that money go? For one, corporations are holding relatively large amounts of cash. Corporate cash holdings totaled 6.2 percent of their assets in the third quarter of 2005, slightly below the highest level since 1966 of 6.3 percent just a few quarters earlier (figure 4).

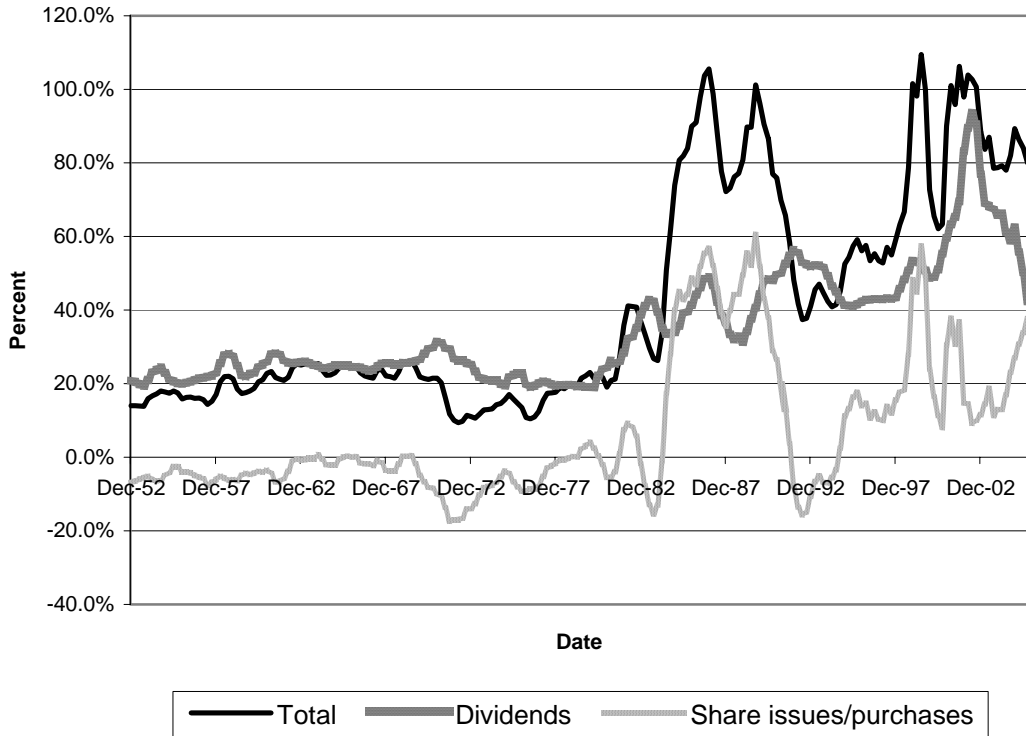
Figure 4: Liquid Assets as Share of Total Assets



Notes: Author's calculations based on table L.102 from Board of Governors, Federal Reserve System, Release Z.1 Flow of Funds Accounts of the United States, Washington, D.C.: Board of Governors.

In addition, instead of using the additional resources generated by high profits for productive investments, corporations are using their money to spread the wealth to their shareholders. Typical mechanisms are dividend pay-outs and share repurchases that help to boost share prices. Fewer dividend pay-outs relative to corporate profits have been largely compensated for by higher share repurchases (figure 4). As a result, America's corporations still used almost three-quarters of their before tax profits on these two items, with the lion's share of the benefit going to their shareholders.

Figure 5: The Use of Corporate Profits for Dividends and Share Purchases



Notes: All figures are 4-quarter averages. Author's calculations based on table L.102 from Board of Governors, Federal Reserve System, Release Z.1 Flow of Funds Accounts of the United States, Washington, D.C.: Board of Governors.

Going into 2006, it should be clear that this bipolar economy is not sustainable. The household economy will have to see larger income gains to support more consumption and to entice the corporate economy to use its funds to invest more in America's future and less in the portfolios of its shareholders.