Consumer debt may trip up shaky financial markets

by Anthony K. Wikrent

Late last year, it was Orange County, California, and then the Mexican peso. In February, it was Barings PLC and derivatives markets in Singapore. In June and July, it was Daimler Benz and the cross-links between industrial companies and banks in Germany. In August, it was the pubescent banks of Russia. In September, it was the Japanese banking system. Now, it's the American consumer.

"It" refers to the latest cause of alarm over yet another leak in the rotting financial system, which threatens to unleash the raging flood waters of world monetary and financial disintegration. The newest hole gained front-page attention on Oct. 26, when reports of growing U.S. consumer loan delinquencies, and charge-offs by banks and other financial companies, sparked a nervous sell-off of banking and financial stocks that roiled the U.S. stock markets for days. The Money Store reported that 30-day overdue delinquencies on its lower-quality home equity loans had jumped over 1%, to 5.47% of all such loans outstanding. At the same time, the Mortgage Information Corp. of San Francisco was reporting that the overall delinquency rate for home mortgages, nationwide, had increased 11 basis points from the first quarter of this year, to 2.84%.

"Assuming that this is a fairly normal business cycle, then the consumer credit and loan problem will likely get much worse before it gets better," James Solloway, director of research at Argus Research in New York City, told the *Wall Street Journal*. Other signs to look at are the host of discount retail stores that have filed bankruptcy, such as Caldor's. The retail outlook for the all-important Christmas season, is increasingly being described in terms that would only delight a Scrooge. Even once-mighty K-Mart has fallen on hard times and is said to be seeking protection from its creditors.

As a result, nervous investors have sent bank and consumer credit company stock prices tumbling 10-25% in the past few weeks, leading sharp falls in the U.S. stock market twice in the last week of October.

Why all the fuss?

Why all the fuss about consumer spending? The fact is, that over the last decade, Americans have borrowed heavily to compensate for falling real incomes. Now, increasing numbers of Americans are unable to pay back their borrowings. And that threatens to further unravel parts of the financial derivatives markets, such as so-called "asset-backed securities," that are based on such things as home mortgages, or credit card receivables. Since the growth of the financial bubble proceeds by cannibalizing the productive economy, the consumer credit collapse reflects the principle, "the better it grows, the worse it gets." The indicative reproductive parameters of the physical economy have been declining at a "trend" rate of around 2% per year over the last three decades, while the claims of financial instruments have been increasing at around 40% per year. These two "trends," and the growing disparity between demands to be paid, and the ability to pay, cannot continue much longer.

The mortgage derivative market has already imploded, in February and May 1994, obliterating David Askin's Granite hedge funds, and General Electric's Kidder Peabody. But, what of credit cards? As the yahoos on Wall Street say, it's been a "growth industry." Credit card debt in the United States has tripled to more than $387 billion in the past 10 years. It is an extremely lucrative business for the banks, with interest rates of 16% or higher charged on credit balances. How lucrative this racket is, can be judged by the fact that credit card issuers mailed out 2.1 billion solicitations for new cards in 1994—an average of eight for every man, woman, and child in the United States. Only 1.5% of the solicitations responded and were approved for credit, but that is still 30 million new credit cards put into circulation, in one year.

Roughly 70% of U.S. credit card holders carry a balance on their cards, the average amount being $3,900, over four times the average $900 of 10 years ago. A front-page article in the Oct. 29, *Chicago Tribune* reported the following calculations: A cardholder with an average $3,900 balance, who makes only the minimum payment of $78 a month, would take 35 years to pay off the balance. And, at 18% interest, he or she would have paid $10,096 in interest, nearly three times the amount charged to the account.

Now, increasing numbers of consumers are unable to meet the interest payments on this debt, and credit card defaults are soaring. First National Bank of Chicago increased its accounting charge-off for delinquent credit-card receivables by 47% from a year ago, writing off $94 million in the third quarter. Houston-based American General Corp., an insurance company with a booming consumer-loan unit, took a $47 million third-quarter write-off, and warned that problem loans might rise in the fourth quarter. Charge-offs rose 31% at Chemical Bank, 23% at BankAmerica, and 22% at Citicorp.

Federal Reserve Board Governor Lawrence B. Lindsey warned, "What concerns me is we're seeing those problems, with unemployment at 5.6%. Normally, those types of problems are associated with a deteriorating business cycle [and] much higher unemployment rates."

"What we are seeing," Catherine Williams, of the Consumer Credit Counseling Service of Greater Chicago, told the *Chicago Tribune* on Oct. 29, "is the snowplow effect. Consumers have just been pushing the debt down the road, and the interest has been piling up. Now, they don't have the money to pay the bill."

The effect of derivatives

Why should a few billions, or even tens of billions, of dollars of consumer debt, be of such concern to financial markets that now measure trading volumes in the trillions of dollars? The answer is that the financial markets are all interconnected, thanks to the financial derivatives contracts developed over the past few years. For example, Citicorp might package together $750,000 of credit-card receivables, into a financial contract it sells for $1 million (since Citicorp's subsidiary, Citibank, can reasonably assume that it will be paid back almost $2 for every $1 charged by its credit card holders). In effect, Citicorp sells to someone else the payment streams on the Citibank credit cards, thereby immediately picking up the $250,000 "profit." The purchaser can expect a minimal return of around 10 or 20%, and can even hope for as much as 50%—provided that the credit card holders continue to pay off their balances, slowly, and at 16% or more.

Now, further assume that the purchaser of the Citicorp "asset-backed" security *borrows* the money to buy it, by putting up $1 million in U.S. Treasury bills as full collateral. Say Treasury bills are paying 5.6%, and the purchaser has to pay 6.0% for borrowing the fully secured $1 million loan. The purchaser appears to be losing 0.4%, but is picking up 10%, and perhaps as much as 50%, on the Citicorp contract. So, for giving up $4,000 in interest, the purchaser can pick up $100,000, for a net gain of $96,000. The net gain may even be as high as $496,000 (50% of $1 million, minus the $4,000 in net lost interest). And, all without using any of his own money, thanks to the *leverage* of borrowing.

Where does the "net gain" of $96,000, or more, come from? From the people who are slowly paying off their credit card balances, at 16% interest or higher. What happens if those people suddenly can't pay anymore; say, if they're faced with a choice between losing their credit card, and losing their house?

No wonder the *wunderkinder* of Wall Street are worrying over steeply rising consumer debt delinquencies.

Median earnings are falling

Realization actually seems to be flashing in lower Manhattan. In the Oct. 29 *Washington Post,* Robert Kuttner, in a signed commentary entitled "America Deserves a Raise," wrote, "In the years between 1947 and 1973, the median paycheck more than doubled, and the bottom 20% enjoyed the biggest gains. Since 1973, median earnings have fallen by about 15% and the bottom fifth have fallen farthest behind. More than 40% of all earnings gains have gone to the top 1%." A number of others have sounded the same warning, including economist Paul Krugman in the *New York Times* on Aug. 21, and Morgan Stanley chief economist Steve Roach, in the *Wall Street Journal* on Oct. 12. Roach was joined by David Wyss, an economist at DRI/McGraw Hill, a bastion of corporate establishment thinking, who said, "It's hard to avoid. The basic fact is that the bottom 60% are losing ground. The working poor are really caught."

It's not any humanitarian concern that is driving these statements; rather, it's something more like, "Perhaps we better give the proletariat more money, the better to extract from them the loot we need to keep our games going." Salomon Brothers economist David Shulman and his colleagues traced this out in a special "Equity Strategy" advisory in July. "The secular slowdown in the growth rate of consumption expenditures is consistent with the trend in income distribution," Shulman, et al., wrote, "Put simply, aggregate consumption spending is becoming more dependent on a narrower base of people. . . . As incomes become more concentrated, aggregate consumption spending becomes more dependent on asset prices . . . should asset prices start to fall [i.e., should the stock market cease to rise], the danger exists that a self-feeding decline in consumption spending could occur. . . . Thus, in our view, a drop in asset prices would be one of the elements necessary to tip the economy over into a full-fledged recession."