Americans teetering on $14 trillion debt pile

By Emily Kaiser - Analysis

WASHINGTON (Reuters) - Free-spending U.S. consumers who bought everything from homes to groceries on borrowed money are running out of credit, and paying the bills will cost the world's biggest economy and its trading partners dearly.

The housing bust has exposed just how much Americans were relying on rising home values to pad spending and replace traditional savings. During the five-year real estate boom that ended in late 2006, household wealth expanded, retail sales grew faster than income, and savings dwindled.

But as banks restrict access to mortgages, auto loans and credit cards, consumers are altering their spending behavior so rapidly that companies cannot adjust fast enough.

Banks that eagerly handed out credit cards during the good times are reducing credit limits and setting asides billions of dollars to cover losses as customers miss payments.

U.S. automakers are warning of a near collapse in demand because would-be buyers are unable or unwilling to get loans.

Stores are bracing for the worst holiday season sales performance in at least 18 years.

Meredith Whitney, the Oppenheimer & Co analyst who was among the first to warn that banks needed to raise huge amounts of money to offset mortgage losses, worries that cuts to credit limits will constrain already cautious consumers, reinforcing a vicious cycle of bank losses and economic decline.

"If you lose your job, if you get sick, if any unforeseen event happens, that's your slush fund," Whitney said at the Reuters Global Finance Summit in New York.

"If all of a sudden you lose your slush fund (or it) gets cut dramatically -- and it will -- everything about you changes, and you become more guarded as a consumer. You could be absolutely fine in every other area of your life, but getting your credit line cut changes your whole outlook."

Over the past decade, American households have piled on $8 trillion in debt, an increase of 137 percent, twice the gain seen in the size of the economy. At $14 trillion, the debt load is now roughly equal to the entire economy's annual output.

Much of the increase comes from home mortgages, which have expanded by $6 trillion since 1998, but it also reflects higher balances on credit cards and auto loans.

Despite the expanding debt burden, investors around the world poured money into securities backed by mortgages and credit card receivables for much of this decade, keeping borrowing costs low.

Thanks to the easy credit, U.S. consumers kept increasing their spending throughout the housing run-up, easily exceeding wage growth. Retailers opened hundreds of new stores to fill newly constructed shopping centers. Imports soared, swelling the reserves of exporters such as China. U.S. household savings dwindled to almost nothing.

All of that is changing as the world grows wary of offering more credit to overextended Americans. As defaults jump, banks are now having trouble finding buyers for any investments tied to U.S. household borrowing.

RESTORING FAITH

The Treasury's decision, announced on Wednesday, to use some of its $700 billion rescue package to back consumer lending is likely to fall short until investors have faith that Americans are good credit risks.

That means paring the $14 trillion of debt, but there is no consensus on exactly how much households ought to borrow.

This much is clear: the portion of income that consumers save has steadily declined over the past 30 years from around 10 percent to near zero, and that trend will be reversed.

Economists think the saving rate will rise to somewhere around 5.0 percent in the next couple of years. Based on current household income, that would work out to around $500 billion less for consumers to spend, or about six weeks worth of U.S. retail sales on average.

What is most worrisome for the economy is that the reversal is occurring so quickly. Anxious households have already slashed spending, and banks worried that savers will yank deposits are clamping down even harder on credit.

Whether it is declining demand for cars from Japan, Chinese furniture or clothes from Central America, the slowdown in U.S. spending is casting a shadow over the world economy.

China has pledged a $586 billion stimulus to support growth as exports slide.Europe appears headed for a recession. Even emerging economies that had little exposure to the banking crisis are struggling with slower growth.

WORSE TO COME

Next year may be worse. Credit agency Fitch Ratings expects deeper credit card losses in 2009, and they could reach record highs. Card issuers are trying to cut losses while they can.

"You're seeing a lot of pre-emptive strikes from banks," said Joseph Beaulieu, an retail sector analyst at Morningstar in Chicago.

"You're seeing banks cut credit card limits and home equity lines of credit across the board. You're seeing credit card companies close unused accounts because they don't want someone to max out a card they haven't used in two years."

Credit card debt grew at a modest 1.2 percent annual rate in September to $971.4 billion, well below the 7.4 percent increase recorded in 2007, according to data from the U.S. Federal Reserve. The Fed's survey of loan officers showed that banks tightened lending standards in the last three months.

"It used to be that if you had a heartbeat and applied for a card, you'd get a $10,000 credit line," said Curtis Arnold, a consumer advocate and founder of CardRatings.com. "Those days are long gone."

It is a difficult cycle to break. As credit dries up, consumer spending slows, which forces companies to cut more jobs and more people to default.

How bad it gets depends on how many more jobs are lost as the U.S. economy slumps into a recession that could be the deepest since the mid-1970s. If unemployment climbs another two percentage points to 8.5 percent, as many economists expect, that would mean about three million more people out of work -- and likely struggling to pay credit card bills and mortgages.

Retailers have already suffered plenty of pain.

Several large chains have filed for bankruptcy protection, including the second largest electronics retailer Circuit City Stores Inc. Construction of new retail space is on a pace to decline by 37 percent this year.

Even companies that appear to be survivors haven't gone unscathed. Brad Anderson, the chief executive of Circuit City's biggest competitor, Best Buy Co Inc, said his company simply could not react fast enough to the "rapid, seismic changes in consumer behavior" in the past couple of months.

(Additional reporting by Jonathan Stempel in New York)

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