Debt load makes many Americans vulnerable

NEW YORK (AP) - Buy now, pay later: It's been the mantra of American consumers for decades. The results are obvious in the ballooning balances on credit cards and mortgage loans, and in the mushrooming U.S. trade deficit, which reflects the nation's nearly insatiable appetite for cheap, imported goods.

Low interest rates, especially since the end of the 2001 recession, have fed the debt beast at home, allowing American consumers to accumulate nearly $11 trillion in debt as they buy more homes, more cars, more clothes, more dinners out. At the same time, foreign investment in the United States is helping to keep the dollar strong, which holds down prices on those imports that Americans covet.

But what would happen if interest rates suddenly weren't so benign, or if foreign governments, corporations and individuals stopped investing so heavily in America? Some analysts fear such actions could trigger doomsday scenarios in which the bills come due and Americans can't pay, with devastating consequences for the entire economy.

The Associated Press asked some experts to discuss what could burst the debt bubble in three areas that appear most vulnerable, and to offer a rebuttal from the perspective of people who believe that while the country may be in debt, it's not in danger.

CREDIT CARD CRUNCH

The tool that has made it ever so easy for Americans to buy and buy and buy is the credit card. And buy they have.

Outstanding balances on credit cards have risen to more than $800 billion, or some $7,200 per U.S. household. That's the equivalent of three plasma TVs, or 24 iPod digital music players, or more than 1,200 Big Mac meals.

It's more than double the indebtedness of a decade ago — and it doesn't include an additional $1.3 trillion in debt for cars, appliances and personal loans.

With the savings rate hovering near all-time lows, most consumers don't have reserves, and so they're vulnerable to an economic shock.

What if interest rates suddenly shot up, say 3 percentage points or 4 percentage points, requiring burdened borrowers to greatly increase the amounts they have to pay each month on their debt?

"It would undermine the housing market, and could quickly result in credit problems that would affect the entire (American) financial system," says Mark Zandi, chief economist at Economy.com, a forecasting firm in suburban Philadelphia.

Such an event isn't beyond the realm of possibility if global investors, for instance, lose confidence in the U.S. economy and quickly shift their money elsewhere, or if a terror attack riles financial markets.

Some American borrowers already are in trouble, contributing to a sharp rise in bankruptcy filings. Howard Dvorkin, head of Consolidated Credit Counseling Services Inc. in Fort Lauderdale, Fla., warns that many more could be capsized soon.

As the Federal Reserve continues to push interest rates higher, the rates on many of the nation's cards are going up in lockstep. Meanwhile, banks are raising minimum payments, in some cases doubling them. And starting in October, a new bankruptcy law will make it much harder for consumers to be relieved of their debt.

"You'll see creditors get more aggressive at collecting debt, the reason being that they can," Dvorkin says.

That will turn many borrowers into "the walking wounded," struggling to keep up with card payments and limited in what they can buy — a massive drag on the U.S. economy.

Robert Manning, a humanities professor at the Rochester Institute of Technology and author of "Credit Card Nation," fears the rising debt burdens will have a tremendous social impact, too.

"We're looking at the possibility that millions won't be able to retire, that they'll have to work well into their '70s as they juggle their debt, he said.

THE REBUTTAL:

Skeptics don't see a big economic shock in the offing, arguing that doomsayers have warned for years that the sky is falling. Economy.com's Zandi says interest rates are most likely to go up at a measured pace, giving most consumers time to adjust to higher payments, and they may see their credit limits cut.

Still, much of the debt in recent years has been taken on by lower-income and lower-middle-income families, who borrowed aggressively to maintain their standard of living as wages stagnated. "Going forward it will be harder for them to maintain their spending — and their living standards," Zandi said.

Since the U.S. economy counts on consumer spending for two-thirds of its output, that translates to "living with slower growth" in the future, he said.

MORTGAGE MANIA

Americans have taken on more than $8.8 trillion in mortgages to buy homes and apartments, up an astounding 42 percent since the 2001 recession. By most reckoning, this is "good" debt because consumers are investing in appreciating assets — and they get a tax break on interest payments to boot.

The fast run-up in prices in recent years has made many homeowners feel wealthy, so they can ramp up day-to-day spending.

But wait: Millions of Americans have taken advantage of low rates in recent years to refinance their mortgages, with as many as eight in 10 in some quarters taking on larger loans so they can cash out some of their equity, according to mortgage giant Freddie Mac in McLean, Va.

And wait again: Borrowing against home equity rose to a record $715 billion last year, and it's projected to rise more this year, according to SMR Research in Hackettstown, N.J.

Why does that matter? Because the more home equity Americans tap now, the less they'll have in reserve for retirement or for emergencies.

The run-up in home prices — what Federal Reserve Chairman Alan Greenspan has described as "froth" — increasingly looks like a bubble.

"The bigger bubble is actually in the financing of homes," says economist Ed Yardeni of Oak Associates in Akron, Ohio. "Mortgage lenders have loosened their lending standards. Rather than telling a lot of would-be buyers, particularly in places like California, that they don't qualify, they're coming up with all sorts of so-called innovative alternative financing."

So millions are buying homes with no down payments. Or they have adjustable-rate mortgages or interest-only mortgages or optional payment mortgages.

What brings such a great party to an end?

"Interest rates going up just 2 percent would do it," says Peter Morici, a business professor at the University of Maryland in College Park. That, he says, would suppress prices, lower sales and put a real squeeze on those who were marginally qualified to buy because their payments would suddenly go up.

"Some people will lose their homes," Morici says. "Many people will just be hurting."

One mortgage insurer, The PMI Group, Inc. of Walnut Creek, Calif., believes the party is closer to last call in some cities than in others.

PMI's most recent quarterly survey found that the risk of home price declines has increased in 36 of the nation's 50 largest markets, with the danger greatest in Boston, New York's Nassau and Suffolk counties and the California cities of San Diego and San Jose.

"What we're seeing in the riskiest areas — especially California and the Northeast — is that home prices are going up faster than local incomes, so homes become less affordable," a PMI Group report says.

THE REBUTTAL:

Doug Duncan, chief economist for the Mortgage Bankers Association trade group in Washington, D.C., acknowledges that there may be "tiny bubbles," particularly in areas such as Las Vegas and along both coasts, where speculators are rushing in to buy property and flip it quickly for a profit.

Yet he believes most buyers see their homes as a place to live or to retire, with appreciation as "the frosting on the cake."

Duncan also believes Fed is sensitive to the potential impact higher rates could have the housing market. "The Fed has to be asking the question, 'If there's decline in equity in the housing sector, to what extent does that affect overall consumption?'" he says.

That argues for more of the plodding, quarter-point interest rate hikes the Fed has favored for the past year, not a rapid run-up in rates.