Testimony of Diane C. Swonk
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Hearing on Innovative Ideas to Strengthen & Expand the Middle Class
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Chairman Wyden, Ranking Member Hatch and distinguished members of the Committee: My name is Diane Swonk. I am Chief Economist and Senior Managing Director for Mesirow Financial in Chicago. I thank you for the opportunity to testify. As an economist, I spend much of my time studying data on the labor force and calculating implications for the U.S. economy in terms of spending and investment. This testimony takes a closer look at the challenges still facing the majority of American consumers. In it, I pay special attention to the unevenness of improvements in incomes and balance sheets across income strata, and how that is impacting both the pace and the composition of consumer spending. The middle class, in particular, remains a laggard and even if conditions do improve in 2014, this tide we call a subpar recovery is still unlikely to lift all boats. Those who have their incomes and fortunes tied to financial market gains, an extremely small percentage of households, are expected to continue to do substantially better than the majority of Americans.

The Bifurcation of Consumer Spending

Recent Taxes Changes and the Effects on Wages and Other Income

Real disposable income growth has been tepid since the onset of the recovery. Gains in 2013 were particularly weak. Several factors contributed to that weakness. Tax hikes on higher income households coupled with the expiration of the payroll tax holiday reduced after-tax incomes. The threat of higher taxes prompted wealthier households to shift income from 2013 into the end of 2012. That precipitated a drop in income at the start of the year. Wages remain stagnant while the composition of employment gains has been less than stellar.

The expiration of the payroll tax holiday, added to cuts in unemployment insurance and many food subsidies, has been particularly hard on lower and middle income households since the turn of the year. Grocers have complained that low and middle income households are spending significantly less, particularly on packaged foods. Hence, the decision by the mid-market grocery store chain, Dominick's in Chicago, to close its doors on December 31, 2013.

Prospects for 2014 are better, as the pace and composition of employment gains are both expected to improve once we get past distortions created by unusually harsh winter weather. Wages are expected to remain relatively stagnant, however, given the ongoing slack in labor markets.

Income and wealth inequalities have intensified. Median incomes continued to fall in 2012 (the most recent year for data) and remain well below the 1999 peak,[1] while the wealth lost in the crisis has been recouped but is concentrated in the top 7% of households.[2] Recent housing price appreciation has alleviated some of the distribution problems in recent years. The equity held in homes, however, remains below the levels hit prior to the crisis in 2006, which means that the majority of Americans who rely on the family home as the primary asset are still trying to regain ground lost to the recession.[3] Moreover, the surge in foreclosures and short sales and the drop in home ownership rates have disproportionately hit low and middle income households, many of whom took on loans that they never should have qualified for in the first place.

High Long-term Unemployment

This is all in addition to the increased stress that middle and lower income households are enduring in response to the cumulative problems associated with persistently high unemployment and a low level of labor force participation. The percentage of young adults living at home (more than 31% of 18-34 year olds) has risen fairly dramatically in recent years,[4] along with the percentage of households with several generations of families living together.[5] The drop in the labor force participation rate among 35-44 year olds[6] is particularly disturbing; it suggests that we are sidelining people who under "normal" circumstances would be in their prime "earning and learning" years.

No one knows exactly what the long-term effects of those losses will be but our experience from the deep recessions of the 1980s is not encouraging. Long-term unemployment, particularly among men in their prime earning years, permanently reduced their earnings relative to a comparable group of unionized workers who escaped layoffs. It also reduced the educational attainment and earning potential of their sons relative to counterparts who stayed employed. (Louis Jacobson, 1993)[7]

Improvements in Debt Uneven

On the brighter side, aggregate debt-to-disposable income levels have fallen to early 2003 levels; default rates on credit outstanding have fallen; and, recent surveys by

[1] (Carmen DeNavas-Walt, Issued September 2013)
[2] (Richard Fry, April 23, 2013)
[3] (Board of Governors of the Federal Reserve System, Issued March 6, 2014)
[4] (United States Census Bureau, Current Population Survey, 2013)
[5] (Livingston, Issued September 4, 2013)
[6] (Toossi, December 2013)
[7] (Louis Jacobson, 1993)

the Federal Reserve suggest access to consumer credit is easing. The recent loan officer survey showed an easing of mortgage credit, while credit available to consumers on credit cards expanded in 2013. All is relative, however, as the hurdles to obtaining a mortgage remain extremely high. Also, the recent expansion of credit available to credit card users has been concentrated among the most credit-worthy of borrowers, who appear to need it least. Credit card balances remained almost unchanged over the last year, despite a sharp increase in credit available to those who still have credit cards.[8]

Debt service burdens have also dropped precipitously, which should be providing some offset to stagnant wage gains when it comes to spending. Improvement, however, is concentrated among homeowners; financial obligations as a share of disposable income for renters, who are increasing, have actually risen in recent years.[9]

Defaults on credit have also fallen fairly dramatically. The exception is student loans, which have not only grown dramatically but are going bad at an accelerated pace.[10] This is limiting the current and potential pool of first-time home and vehicle buyers. The number of first-time homebuyers dropped to 26% of existing home sales in January, well below the 40% norm, despite a persistently high level of affordability.[11] This is one of many reasons that home sales have slackened in recent months. Existing home sales are the largest single trigger to additional consumer spending.

Home equity lines of credit also remain weak but are likely to pick up as we move into 2014.[12] Recent housing price appreciation makes it easier for many to qualify for home equity lines of credit. This is just one of many reasons those who own a home are opting to repair and remodel their current homes rather than sell to trade up and risk not qualifying for a new, larger mortgage.

Separately, payday loans have returned. With the collapse in the shadow banking industry, pawnshops are substituting for banks; layaway plans have returned to serve customers who have lost access to credit; and discounts, particularly in the apparel industry, are close to the all-time highs hit during the height of the financial crisis in 2008. (Promotions by low-end and mid-market retailers during the 2013 holiday were particularly aggressive.) Crowd lending is also picking up, with lenders like Lending Club matching investors and borrowers online. The high returns those lenders are achieving, however, is a red light to anyone who has watched consumer credit markets closely.

[8] (Board of Governors of the Federal Reserve System, January 2014)
[9] (Board of Governors of the Federal Reserve System, December 13, 2013)
[10] (Federal Reserve Bank of New York , February 18, 2014)
[11] (National Association of Realtors, Housing Affordability Index , Issued February 12, 2014)
[12] (Federal Reserve Bank of New York , February 18, 2014)

Confidence. Consumer confidence has gradually improved but remains well below the highs hit prior to the crisis and differs widely by income strata. Those earning over $50,000 a year are significantly more confident about the economy than those earning less than $50,000 a year. This reflects the differences in financial stress that have emerged across income levels in the wake of the crisis; it is simply easier for higher income households to absorb the costs associated with kids who never leave home or return home after college than it is for lower income households, especially in light of the rise in incomes and net worth in the wealthiest of households.

Implications for Consumer Spending

Consumer spending picked up, but remained suppressed relative to previous recoveries in the second half of 2013. Consumer spending is expected to remain more buoyant in 2014than it was earlier in the recovery. The wealth that was accumulated over the last year has been slow to materialize in spending but should play at least a marginal role in spurring gains for the wealthiest of households and some upper middle income households. Gains are expected to remain extremely uneven, however, with lower and most middle income households still reaching for value and moving down the retail food chain, while luxury retailers and service providers expand. More of the spending we see will be on big-ticket items such as vehicles, appliances, furniture and remodeling, as that is where pent-up demand is the greatest.

Unusually harsh winter weather exacerbated the pressure on big box retailers, apparel stores and restaurants in recent months. Consumers either hibernated, which took a toll on mall traffic as temperatures plummeted and storms raged or (if they could afford to) migrated to sunny vacations and ski resorts. The early surge in demand for travel to Disney World was so great that the amusement park was able to raise ticket prices in February, four months earlier than in 2013.

That said, the stress we are seeing on retailers who serve low and middle income households relative to those at the very high end clearly goes beyond weather disruptions. In response, the bulk of consumer spending is expected to remain concentrated in a small number of wealthy households. The bifurcation that we have seen in both spending and the type of businesses that win and lose is expected to continue:

- Spending at grocery stores is expected to remain constrained, with competition intensifying. Big box discounters have gained market share relative to more traditional stand-alone grocers but still have little pricing power. Whole Foods, which serves more affluent customers, is trying to restructure stores, offer more discounts and shed its image as a high-priced grocer. This is at the same time that competition is growing among higher-priced specialty grocers such as Fresh Market and Mariano’s, a new entrant in Chicago, that is taking over many of the stores vacated by Dominick's and adding more hires per store; its CEO has said he wants Mariano's to be the "Nordstrom of the grocery world," with enhanced service and one-stop shopping.)

- Spending at luxury retailers has come back, while department stores are failing and losing market share to the big box discounters, outlet malls and online discounters. Moreover, those who serve the most affluent of buyers have increased prices and upped their offerings of high-end merchandise; it is not uncommon for luxury retailers to sell out of purses with price tags in the thousands of dollars, before they even hit the shelves in New York.
- Spending at high-end restaurants is picking up with an influx of both wealthier and/or business clients, while spending at family restaurants is being squeezed. This is forcing mainstream restaurants to offer "value" menus and, more recently, adopt new technologies to lower labor costs; Applebee's is just one of many mainstream restaurants switching to tablet computers that customers can use to order food directly, instead of relying on wait staff. Moreover, stresses in lower and middle income households appear to have finally reached fast-food chains, which are also offering more value-priced menus and looking at ways to reduce labor costs with new technologies.
- Demand is on the rise for boutique hotels catering to the demands of the wealthiest clientele.
- Vehicle sales have come back but the average price of a vehicle is rising, as producers are increasingly chasing more affluent buyers. (The popularity of the Tesla, which has a base price of more than $70,000, is just one example.) The upswing in home values and equity prices will only exacerbate this trend, as we have yet to see the wealth effects on spending associated with the most recent surge in household net worth.
- Homebuilders, who were hurt by competition from the nearly-new market at the onset of the recovery, have almost abandoned building homes for first-time buyers and moved upscale to attract all-cash buyers and those who can still qualify for mortgages with the stricter requirements. Indeed, the premium in prices for new[13] compared to existing homes[14] has reached all-time highs in the last year, as builders chase price instead of volume in the single-family home market. This has spillover effects on the kinds of appliances, furniture and fixtures that are used in that construction as well.
- Multifamily construction is also on the rise,[15] as apartment vacancies have plummeted and rents have risen in recent years. Increased demand for homes in urban areas with close access to jobs and mass transit, however, is pushing up construction costs and forcing developers to appeal to higher

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[13] (U.S. Department of Commerce and U.S. Department of Housing and Urban Development , February 26, 2014)
[14] (National Association of Realtors, Existing Home Sales , February 21, 2014)
[15] (U.S. Department of Commerce and U.S. Department of Housing and Urban Development, February 19, 2014)

rather than lower income renters. The result will likely exacerbate the shortage of affordable housing for lower and middle income households.

Summation

The Great Recession and subpar recovery that followed both revealed and exacerbated income and wealth inequalities in the U.S. Those shifts have had a profound effect on both the pace and composition of consumer spending and are not likely to reverse any time soon. Most consumers measure their living standards by the pace at which they can accumulate goods and services, rather than just the level that they have achieved; both have deteriorated for the majority of Americans. This will have long-reaching consequences for confidence in the economy, willingness to invest in long-term assets and the potential for economic growth.

Thank you for the opportunity to testify. I would be pleased now to answer any questions the Committee may have.

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