Why is the Consumer Still so Resilient?

The Fed has lifted the funds rate a cumulative 525 basis points since March 2022 to 5.50%, its highest reading in 22 years. Despite tighter monetary policy, consumers continue to spend. Real consumption is up 2.3% over the past four quarters. What gives?

For most households, interest costs have not yet appreciably increased because they locked in financing when rates were low. Instead, it is new borrowers that are suffering from the high cost of credit. Eventually, this will work to slow the economy, but this process can take time.

Low financing costs are illustrated in the chart below. It shows the Fed’s household financial obligations ratio versus the effective household borrowing rate. The former is the broadest measure of interest payments as a share of disposable personal income, and the latter is a weighted average share of borrowing for automobile loans, credit cards, mortgages and personal loans.

Debt service payments are low even though borrowing costs are high. Through Q1 2023 the household financial obligations ratio was 14.3%, which is down from 14.5% in the previous quarter. While the current obligations ratio is up sharply from its Q1 2022 low (12.6%), the series, remarkably, is no higher than where it was when the Fed began tightening (14.3%).

Meanwhile, Fed hiking has pushed the effective household borrowing rate up 350 basis points to 8.50%, which is its highest reading in over two decades. The reason aggregate households are not paying more to borrow is because many locked in low auto and mortgage financing in 2020 and 2021. While personal loans and credit card rates are up sharply, combined they still account for a relatively low share of total borrowing.

However, this does not mean the economy is out of the woods — far from it. Newly formed households face significantly higher financing costs, which will weigh on marginal consumer purchases. But it does mean the full effects of tighter monetary policy will take longer to play out.

Sources: FRB, Haver, SMBC Nikko
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