Household Interest Payments Soaring on Back of Higher Rates

The Fed has lifted interest rates by 525 basis points since March 2022, to 5.5% at present. This is the fastest, most aggressive hiking cycle since 1981-82. In response, interest payments have risen sharply, as illustrated in the chart below. Monetary policy has not lost its potency. A slowdown in consumer spending is coming.

The aggressive and rapid increase in the fed funds rate has pushed up household non-mortgage interest payments as a share of disposable personal income to its highest reading since April 2008, when the economy was in recession. The ratio stood at 2.53% in July 2023, the latest datapoint, up from only 1.62% in February 2022 when the funds rate was close to zero.

In the recent past, when the ratio moved into the 2.8% to 3% range, it marked an economic tipping point. For example, the ratio topped out at 2.82% in December 1989, 3.05% in November 2000 and 2.86% in June 2007. Downturns began within the next 12 months thereafter. If short-term rates stay at their current reading, interest expenses are likely to go higher as floating rate debt resets. This is what happened after the Fed stopped raising rates in May 2000 and June 2006. And, if the Fed raises rates in November as some investors expect, interest payments as a share of income will go even higher. But there is another factor to consider.

Student loan repayments begin next month after a three-year hiatus, and they effectively act a huge tax increase on that subsector of the economy where the marginal propensity to consume it quite high. Based on our analysis, we estimate that US households will pay almost $12 billion per month in interest (and principle) or roughly $140 billion per annum. This is worth approximately three-quarters of a percent on annual real GDP growth, which is sizeable.

The bottom line is that rising interest payments will continue to sap household purchasing power and act as a significant headwind to consumer spending, which accounts for 70% of expenditures-based GDP. Unless monetary policy becomes much less restrictive and soon, recession remains the base case.
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