Asian Credit Union Forum 2009

Background Notes

Lessons on the Value Of Thrift

(Ronald T. Wilcox, Professor of Business Administration, teaches Marketing Intelligence and Investor Behavior and Imperfect Markets at The Darden School of Business, University of Virginia.)

One of the common explanations for the current housing crisis, and the subsequent sub-prime mortgage mess is that the U.S. was inundated with cheap money from overseas, a world “savings glut” that depressed interest rates and facilitated reckless lending. There is a great deal of merit to this argument. There can be little doubt that U.S. interest rates were made low by the inflow of foreign capital, and that this contributed to consumers headlong rush into debt. It also helped create the business environment in which some of the more exotic, and risky, lending instruments looked safer than they were.

But this explanation is often put forward as the whole story when in reality it is a glass half full.

Americans also contributed to the current economic demise by having insufficient savings. Yes, there was a lot of capital (savings) sloshing around the economy, but precious little of it was coming from the bank accounts of U.S. households. If Americans would have had more savings, some of that savings would have been used to put down payments on houses. Instead of the millions of homes sold with essentially no money down many of these homes would be owned by people with equity stakes right from the beginning. Why does this matter? It matters because if you have a 20% equity stake in your house and prices fall you are a whole lot less likely to walk away from your house, allowing it to be foreclosed upon, than someone who has no stake and finds themselves with negative equity when prices fall. Giving up on nothing is easier than giving up on something. The housing market collapse has fed its downward spiral with this nothing, the savings that never happened, the down payments that never existed.

History teaches that countries that go through tough times save more money. We are about to learn thrift the hard way.

In the wake of an unprecedented $700 billion bailout plan passed by Congress, many are asking, “How did this happen?” While there is plenty of blame to go around—much of which rests with reckless politicians and avaricious profiteers—many of us still don’t fully comprehend exactly what has happened. All most of us know is that the stock markets are all over the place and there is real potential for a widening financial crisis.

At the heart of our present crisis is the simple issue of lending money to folks whose credit history and ability to repay said loans was dubious at best, i.e., subprime mortgages. This was compounded by the institutionalization of these defective lending practices through government-backed guarantees issued by Fannie Mae and Freddie Mac, the two government-sponsored enterprises that played a critical role in the current crisis.

Economics are not so much the source of this debacle as is a fundamental shift in values, namely, away from the historic Christian virtue of thrift. A concept that is almost anathema today, thrift exalts the prudent use of money and goods. If you look carefully you will see that the same “values” present in the subprime mortgage crisis are institutionalized throughout America’s current economic structure.

Historically, Americans were supported by a large number of institutions that encouraged savings and judicious spending. Local retail banks, credit unions, building and loan associations, savings and loans, savers’ clubs, and the like represented a cooperative, nonprofit banking tradition designed to serve the small saver. These institutions represented a pro-thrift sector of the financial service industry, which offered small, short-term loans to creditworthy Americans. In addition to encouraging savings, these institutions were also governed by strict rules for lending that limited the amount of debt consumers could carry.

If you wanted to buy a home, you had to first accumulate savings, apply to a local lender, document your creditworthiness, subject yourself to the bank’s scrutiny, and usually make a down payment. The federal government set limits on interest charges and, as social historian Barbara Dafoe Whitehead points out, “some forms of thriftlessness were outlawed entirely. Lotteries were illegal in all states, [and] usury laws prohibited predatory interest rates…” (Barbara Dafoe Whitehead, “A Nation in Debt: How we killed thrift, enthroned loan sharks and undermined American prosperity,” The American Interest Online, September 28, 2008). Whitehead observes, these “authoritative institutions play a role in guiding individual choices and in setting cultural norms” (Ibid.).

By contrast, the pro-thrift institutions of the past have been increasingly supplanted by new “authoritative institutions…setting cultural norms” that encourage thriftlessness. Instead of institutions committed to the principles of thrift, the market is now flooded with predatory institutions and parasites who prey on the naïve, desperate, and irresponsible, such as “subprime credit card issuers, mortgage brokers, rent-to-own merchants, payday lenders, auto title lenders, tax refund lenders, private student-loan companies, franchise tax preparers, check cashing outlets and the state lottery” (Ibid.). God, who has compassion on the poor, calls this “oppression” and describes it as an “abomination” (see Ezek. 18:13).

The average American today is bombarded by a large number of institutions (and messages) that actually discourage savings and promote impulsive, often foolish, spending, contributing to the highest level of consumer debt in history. As to the scale of this problem, “there are more than a billion [credit] cards in the hands of U.S. consumers” (Ibid., emphasis mine). Between 1989 and 2001, “credit card debt almost tripled, from $238 billion to $692 billion” with much of that coming from young, unemployed college students, “56 percent” of whom “have four or more cards” (Ibid.). Opportunistic payday lenders provide “fast cash” to more than 15 million lower income wage-earners each month at the equivalent annual percentage rate of 300 to 400 percent.

Since 1973, there has been a 500 percent increase in per capita spending on state lotteries—taking in more than $57 billion in 2006. Studies demonstrate that low-income households spend the most, as a percentage of their total income (approximately $645 annually), on lottery tickets. Dr. Whitehead reported that the Tax Foundation estimated "that if that household were to invest the same amount in stocks every year for forty years, it could expect to have $87,191 [in 2006 dollars]"
A major factor in the proliferation of these modern day moneychangers was the deregulation of interest rates—a violation of consciously Christian financial principles. In 1965, every state had usury limits on consumer loans. Since then, "seven states have completely deregulated interest rates…and at least 35 states allow lenders to charge the equivalent of more than 300 percent APR on a typical payday loan." In short, "state usury limits have increased from 36 percent in 1965 to 521 percent in 2007" (Ibid.).

With such extraordinary profits available (and now legal), everyone from payday lenders to major credit card companies saw the potential in supplanting the virtue of thrift with the promise of instant gratification through debt. And many Americans, who are equally culpable, bought it hook, line, and sinker! "Borrow today what you do not have to buy what you cannot afford" became the mantra of the consumer culture replacing the old adage, "neither a borrower nor a lender be."

Here again, the church has an opportunity to bear witness to life under the reign of God by living free from bondage to excessive consumption and consumer debt. Tragically, too many Christians are driven by the same idolatry that propels so many Americans into excessive consumption and debt.

The banks are just handing out money on credit cards like there's no tomorrow… It's quite terrifying to think that the average household… now has three months of their disposable income on a credit card balance," says one analyst.

It's not just fringe lenders but also big banks which have pushed unaffordable credit. *"We lent to whoever we could and as much money as they wanted,"* admits a former bank credit salesman

Additional Observations

PROFESSOR ROBERT SHILLER, ECONOMICS, YALE UNIVERSITY:

Both the housing boom and the dot-com boom occurred close in time, it was the same people, it was driven by the same sense of economic possibility and it was like a gold rush. You know when they discover gold, people go out staking their claim. That was the dot-com boom and now people, it's remarkable, think they've found gold in their own backyard, all they've got to do is buy a house and so, it's a remarkable delusion I think that has developed. Just buy a house and you'll be rich, amazing, I don't know how we got here, but we're here.

What we now have is a very, very serious dislocation in the lubricant of the financial system, which is credit. Now the analogy I always use is like a car engine: credit is the actual oil in the engine. Now there's a big crack and the oil's all flowing out of the engine, so the whole engine is ceasing up. So we're getting effects everywhere and I don't think we've seen the worst of the effects because it's going to be a rolling contagion where things happen in one market, then another, and they keep feeding back on themselves.

And the other thing we haven't seen as yet, which is the really, really long term effect, is on the real economy, because so far it's been a financial market crisis. Eventually it will affect things like GDP growth, employment, investment and how people spend money. Once that occurs what we're going to see is a new order of this particular contagion. That's what makes it much worse.