The ugly reality of lowering debt by default

by Nin-Hai Tseng, reporter September 28, 2010: 2:35 PM ET

FORTUNE -- There have been at least a few seemingly positive signs of progress during this anemic economic recovery: U.S. households are spending less. They're saving more. Debt is steadily falling.

But don't be fooled by the cheery headlines. The trend toward fiscal discipline might sound uplifting, especially at a time when many have learned all too painfully that they spent too much in the years leading up to the financial crisis. But dig a little deeper and you'll find that even the best economic news is masking something ugly.

It turns out that many households aren't exactly tightening their wallets and using all their saved cash to pay down debts. They're simply defaulting on them.

Total household debt fell by $77 billion during the three months ending in June, but nearly half of that decline stemmed from bank charge-offs of residential mortgages, credit cards and other consumer loans, according to Capital Economics Group. In a recent report, the London-based economic research consultancy found that this isn't necessarily a new development. Household debt has fallen every quarter since the beginning of 2008, leaving it $473 billion below the peak, which is the equivalent of reducing debt at every household by $4,200.

Shedding away debt - however it's done - is critical to the overall health of the economy. But the wave of households de-leveraging by default is worrisome. And many Americans are using their new savings to buy up U.S. Treasuries instead of devoting it all toward paying down debt. During the past year, households bought 42% of the new Treasury debt issued, equal to about $616 billion and far more than the $432 billion absorbed by foreign investors.

This will probably prolong the de-leveraging process further, say analysts at Capital Economics. Until households can meaningfully shed off debt, it will likely be one of the key factors stalling economic growth and the job market as many companies wait for GDP to pick up significantly before hiring more workers.

Cutting plastic or cutting credit card bills?

The wave of defaults on mortgage loans is no surprise, given the rise in foreclosures and the fall in housing prices. But perhaps even more troublesome is the increase in consumer defaults on credit card debt. It's been widely reported that debt levels on credit cards have fallen - at one point surprisingly dropping below the level of outstanding student loans, according to an August story in *The Wall Street Journal*.

But consumers haven't exactly discovered a newfound sense of frugality. In 2009, outstanding credit card debt dropped by about $93.2 billion compared with the previous year, according to a report from CardHub.com, a credit card comparison website. This might sound like good news, but the reality is that the majority of the drop -- $81.6 billion -- is due to Americans defaulting on their debt.

So the real decrease is much smaller - about $11.6 billion - and much of that came during the first quarter when many people used tax returns to pay down card debt. At this rate, CardHub.com predicts consumers in 2010 will actually accumulate at least $26.2 billion more in credit card debt over last year.

"It's alarming," CardHub.com CEO and founder Odysseas Papadimitriou says. "We cannot revert to pre-recession debt levels."

Household debt might generally be falling, but at what cost? Those who default, depending on the size of the loan, take sizeable hits to their credit background, which could impact the terms of future loans.

So while consumers' debt burdens might technically be less today than they were just a few years ago, at least on paper, the burden is still quite heavy on the minds of consumers. ■

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