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Written Testimony of

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"How Is the Middle-Class Family Faring in Today's Economy?"

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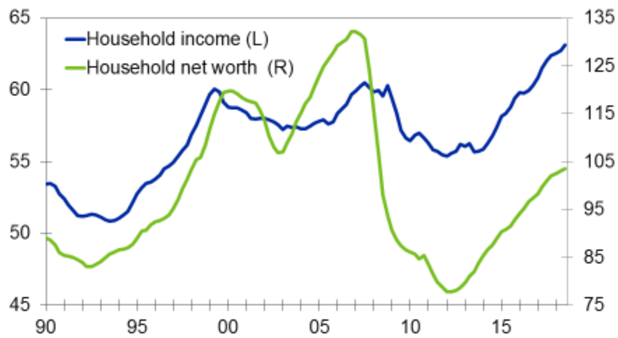
American middle-class families are struggling to manage their finances. Yes, the economic expansion is approaching its tenth birthday, which would make it the longest in the nation's history, and unemployment is low and still falling. But the middle class, burdened by heavy debt, continues to grapple with depressed incomes, low savings and stagnant wealth. Compared to high-income households, middle-class families have seen their share of the nation's income, wealth and spending decline for more than a generation.

Stagnant incomes

Real median household income has grown very slowly over the past two decades (see Chart 1). Median household income is arguably the most accurate measure of the typical American family's financial gains, with half of households having higher incomes and half having lower incomes. It also accounts for the impact of inflation.[i] Between the late 1990s and the middle of this decade, real median household income was largely unchanged. This was especially disconcerting because it came on the heels of several decades that had seen steady increases in median income.

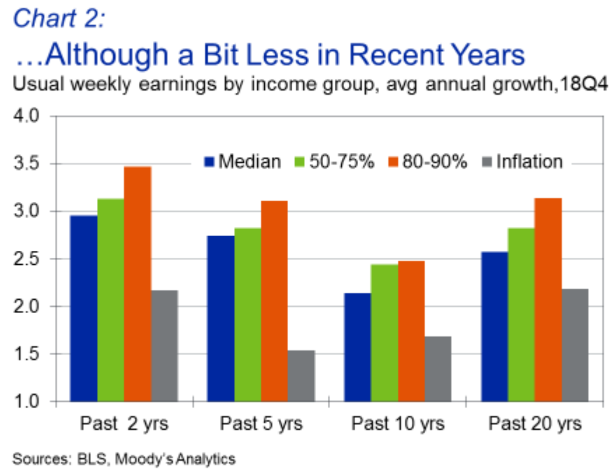
Chart 1:
The Middle Class Is Struggling…
Median household income and net worth, 18Q3 $ ths



Sources: Federal Reserve, Census Bureau, Moody's Analytics

Behind this poor performance were two recessions: the downturn in the early 2000s triggered by the bursting technology bubble in the stock market and of course the financial crisis that hit a decade ago as the housing bubble burst. Unemployment peaked at 10% in late 2009, and while it has steadily declined during the current expansion, the economy did not return to most estimates of full employment—around 4.5%—until summer 2017. This long stretch of underemployment undermined the finances of the middle class.

Real median incomes have improved in the very tight labor market of the past several years as unemployment fell below 4%. The usual weekly earnings of the median worker and upper-middle-class worker—those in the 50%-75% quartile of the wage distribution—have increased by close to 3% per annum over the past two years, which is well above the 2% rate of inflation (see Chart 2). However, such low unemployment has never been sustained. And since much of the recent economic growth has been temporarily fueled by deficit-financed tax cuts, particularly for wealthy households and large corporations, middle-class families cannot count on unemployment remaining this low for very long.



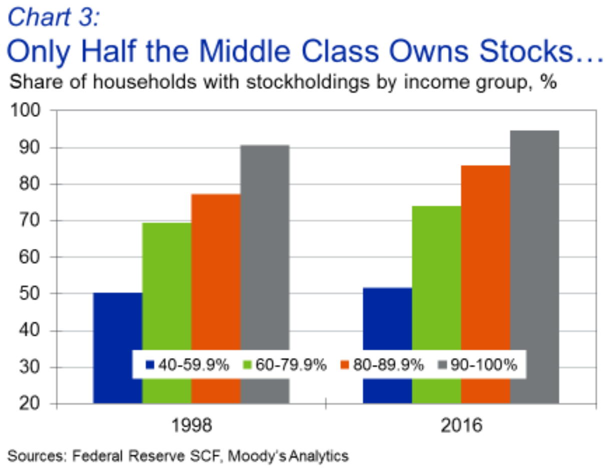
Broader secular forces, the most notable being the rapid pace of technological change, have also hurt middle-class finances.[ii] The advent of the internet and its incorporation into business activities since the mid-1990s have been especially hard on middle-paying occupations. In a metaphorical if not real sense, these jobs have been effectively coded-out. Many of those losing jobs and without requisite skills have been forced out of the middle class altogether. The economic gains from new technologies have been huge, but so have the costs for many Americans previously in the middle class.

Rapidly expanding global trade with the emerging world, ushered in by the North American Free Trade Agreement in the mid-1990s and the entry of China into the World Trade Organization in the early 2000s, also hurt the middle class.[iii] This is clearest in the large decline in manufacturing jobs, which are generally good middle-paying jobs. Laid-off factory workers also have had a tough time finding comparable jobs, particularly since those workers are generally older and less likely to relocate. However, the ill-effects of expanded global trade on the middle class have likely played out, with the emerging world becoming an increasingly large market for U.S. goods and services. Indeed, growing demand from the rest of the world for U.S.-produced wares will be an important source of future middle-class U.S. jobs.

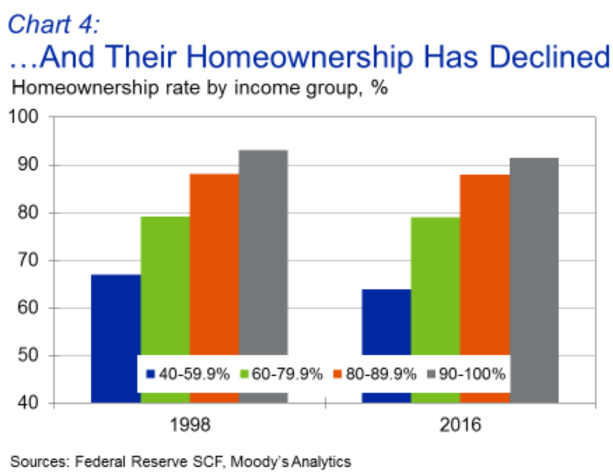
Less wealthy

The finances of middle-class Americans appear even shakier in light of the fact that they are no wealthier today than they were two decades ago. Median household net worth—the difference in value of what the typical American family owns and what they owe—has gone up and down with the wild swings in stock prices and housing values. But, after accounting for inflation, it is currently about where it was in the late 1990s (see Chart 1).

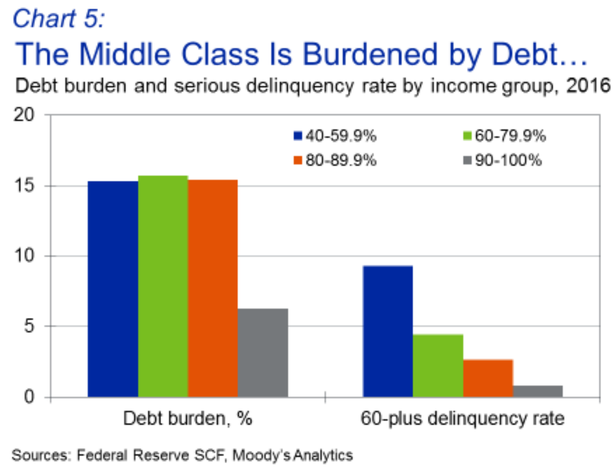
The big gains in the stock market over the past decade have benefited only half of households in the middle quintile of the income distribution (see Chart 3). Moreover, the half of families in this income group that own any stock, directly or indirectly through retirement accounts, have small stock portfolios, typically less than $20,000.[iv] In contrast, nearly all families in the top 10% of the income distribution own stocks, with a typical portfolio valued at approximately $400,000.



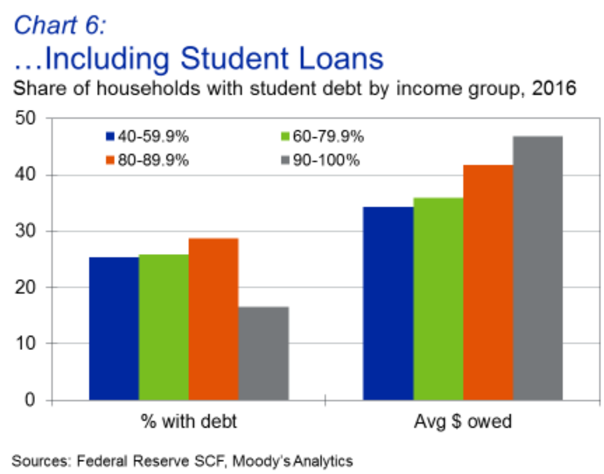
Homeownership is not quite as skewed, but less than two-thirds of families in the middle quintile own their own homes, compared with more than 90% of families in the top 10% of the income distribution (see Chart 4). Homeownership has declined across all income groups since the housing bubble burst, but it has fallen more for middle-class and lower-income families. High-income households have enjoyed consistent access to mortgage loans throughout much of this expansion, whereas middle- and lower-income households had difficulty qualifying for loans in the credit crunch that prevailed for several years after the financial crisis was quelled.[v]



Middle-class families are also having more difficulty managing their debt. For those in the middle quintile, about 15% of their income goes to making debt payments, and almost one-tenth of families in this income group have a loan with a serious delinquency of more than 60 days (see Chart 5). Those in higher-income groups are having an easier go of it, at least judging by their ability to make their debt payments on time. Those in the top 10% of the income distribution shell out only about 5% of their income on debt payments, and serious delinquencies among these families are rare.



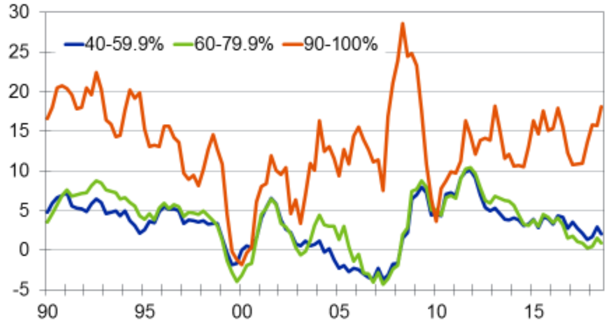
Student loan debt has increased significantly for those in the middle class. About one-fourth of families in the middle of the income distribution have at least one student loan, with a total loan balance of over $35,000 (see Chart 6). This is up sharply from a decade ago when one-seventh of families had a student loan, and two decades ago when only one-tenth of families had a loan. Prior to the financial crisis and housing bust, middle-class families had traditionally relied on home equity loans to finance their children's college education. This was no longer an option after the bust, and thus these families turned to student loans.



Saving shortfall

With constrained incomes and higher debt loads, it is not surprising that middle-class Americans are having trouble saving money. The personal saving rate—the share of after-tax income that is saved—is currently close to zero for families in the middle quintiles (see Chart 7). Since the late 1990s, the saving rate for these income groups has been negative as often as it has been positive. These families spent beyond their incomes throughout much of the 2000s, most likely by increasing their borrowing.

Chart 7:
The Middle Class Has Difficulty Saving
Personal saving rate by income group, %



Sources: Federal Reserve, Moody's Analytics

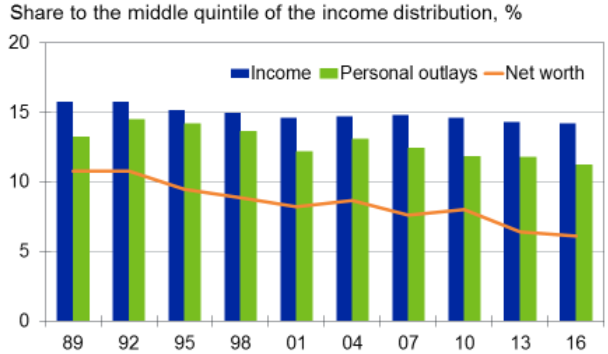
There is strong evidence that the financial crisis was most fundamentally due to the constrained incomes of middle-class families who turned to mortgage and other borrowing to maintain their spending.[vi] They were motivated to increase their borrowing because their incomes were not growing, and they were empowered to borrow by the very lax lending standards of the time. Ultimately these households could not manage their debt payments, and they defaulted. Poorly capitalized and illiquid lenders were overwhelmed by mounting losses, and the financial system effectively collapsed. Massive intervention by the Federal Reserve and lawmakers was needed to bail out failing institutions.

Even though the middle class continues to struggle and is unable to save, it remains a more cautious borrower. Lenders, for their part, are also much more circumspect in extending credit. Due to regulatory changes since the crisis, lenders are much better capitalized and more liquid. Risk management practices, such as bank stress testing, have also dramatically improved. Prospects for another financial crisis are thus very low, at least for the foreseeable future. Having said this, middle-class baby boomers now in their fifties and sixties may have their own personal financial crises as they retire, because many are financially ill-prepared.[vii]

Falling behind

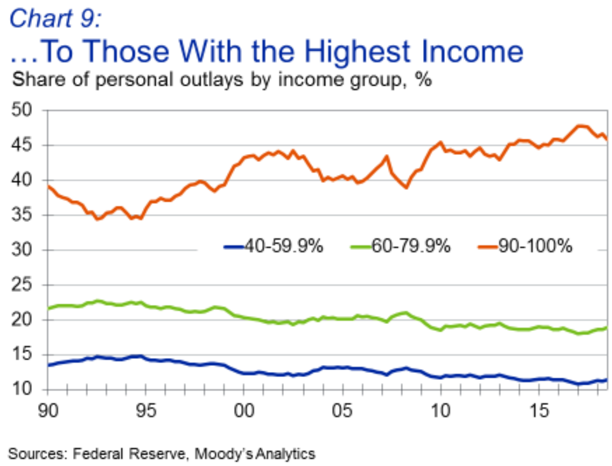
The middle class is also falling steadily farther behind those in the top of the income and wealth distribution. Those in the middle quintile of the income distribution, who by definition account for one-fifth of all families, take home well below 15% of overall income, and this share has steadily declined since the late 1990s (see Chart 8). Their wealth, which made up about 10% of overall wealth two decades ago, is now closer to 5%. That is, 20% of the population that makes up the middle of the income distribution, owns only about 5% of the nation's wealth.

Chart 8:
Middle Class Loses Financial Ground…
Share to the middle quintile of the income distribution, %



Sources: Federal Reserve SCF, Census Bureau, Moody's Analytics

Perhaps more important, these middle-class families account for only about 10% of total consumer spending—a share that has been declining steadily with no hint of stabilizing. The middle class is winning a shrinking piece of the nation's economic pie, which is going instead to those with the highest incomes. Not quite half of all consumer spending is currently enjoyed by those in the top 10% of the income distribution (see Chart 9). This is up from just over one-third of spending about a quarter-century ago.



Conclusions

America's middle-class families have had a tough financial go of it. Their incomes have improved as the economy has finally returned to full employment after the debilitating financial crisis. But this comes after decades of stagnation, and there are reasonable concerns that their recent economic gains are not durable, since they have been temporarily supported by massive deficit-financed tax cuts mainly for the wealthy and large corporations. Their balance sheets have strengthened along with rising stock prices and house values during much of this expansion, but they have had to dig themselves out of the deep financial hole created in the crisis, and even so, they are no wealthier today than they were two decades ago. Moreover, given that they do not have the financial wherewithal to save much, it is unclear how they will be able to build future wealth now that stock and house prices are no longer increasing as quickly. It is also galling that while the middle-class share of the nation's income, wealth and spending is already disproportionately small, that share continues to get smaller.

The Federal Reserve appears to be working to help address the plight of the middle class by letting the economy operate beyond full employment for longer than it might otherwise have allowed.[viii] While short-term interest rates have risen, they remain low by most historical standards, and given stable inflation that is near the Fed's target, policymakers have indicated they will remain patient when considering future rate increases. The tight labor market should continue to support stronger wage growth across all income groups.

Monetary policy can only go so far in helping the middle class, and lawmakers should also consider policy steps. It makes little sense to allow personal tax rates to increase for middle-income taxpayers, as they are slated to do under current tax law, but tax rates on high-income and wealthy taxpayers and large corporations should increase to pay for fiscal efforts to support the middle class. Particularly effective would be significant increases in infrastructure spending, which would quickly create many middle-paying jobs and open up development in stunted communities in the nation's inner cities and rural areas. Federal dollars to defray the costs of childcare, early childhood education, and higher education would also go a long way to help parents work, save more, and build the wealth needed in retirement. Of course, this will also provide our children with the skills they will need to win future high-paying jobs.

Our nation is only as strong as our middle class, and we are struggling. The causes are many. What is clear is that lawmakers must refocus economic policy onto what matters for the typical American family. The fortunes of the middle class and of the nation depend on it.

[i] The American middle class includes families that are in the middle of the income and wealth distribution. The median and the middle quintile of these distributions are most often used in this testimony to be representative of the entire middle class.
[ii] The impact of technological advances on middle-paying jobs is carefully considered in "Dances With Robots," Frank Levy and Richard Nurnane, Third Way, 2013.
[iii] A particularly good assessment of the significant labor market adjustments created by China's rapid economic ascent is provided by "The China Shock: Learning From Labor Market Adjustments to Large Changes in Trade," David Autor, NBER paper, January 2016.
[iv] Many of the statistics regarding the strength of the household balance sheet used in this testimony are from the Federal Reserve's triennial Survey of Consumer Finance. The most recent survey was conducted in 2016.
[v] The unusually tight mortgage underwriting standards that have prevailed since the financial crisis are evident in the Urban Institute's Housing Credit Availability Index.
[vi] This is discussed in "What Does Rising Inequality Mean for the Macroeconomy," Mark Zandi, in "After Piketty: The Agenda for Economics and Inequality," Heather Boushey, J. Bradford DeLong and Marshall Steinbaum, Harvard University Press, 2017.
[vii] Just how ill-prepared baby boomers are for retirement is shown in "Retirement Preparedness: Baby Boomers vs. the Silent Generation," The Sightlines Project, Stanford Center on Longevity.
[viii] This stands in contrast to the stated policy of "opportunistic disinflation," pursued by the Federal Reserve in much of the 1980s, 1990s and early 2000s when the Fed's principal goal was to reduce inflation. This policy is described in "The Road to Price Stability," Athanasios Orphanides, Fed working paper, May 2006.