Federal Reserve Bank of San Francisco

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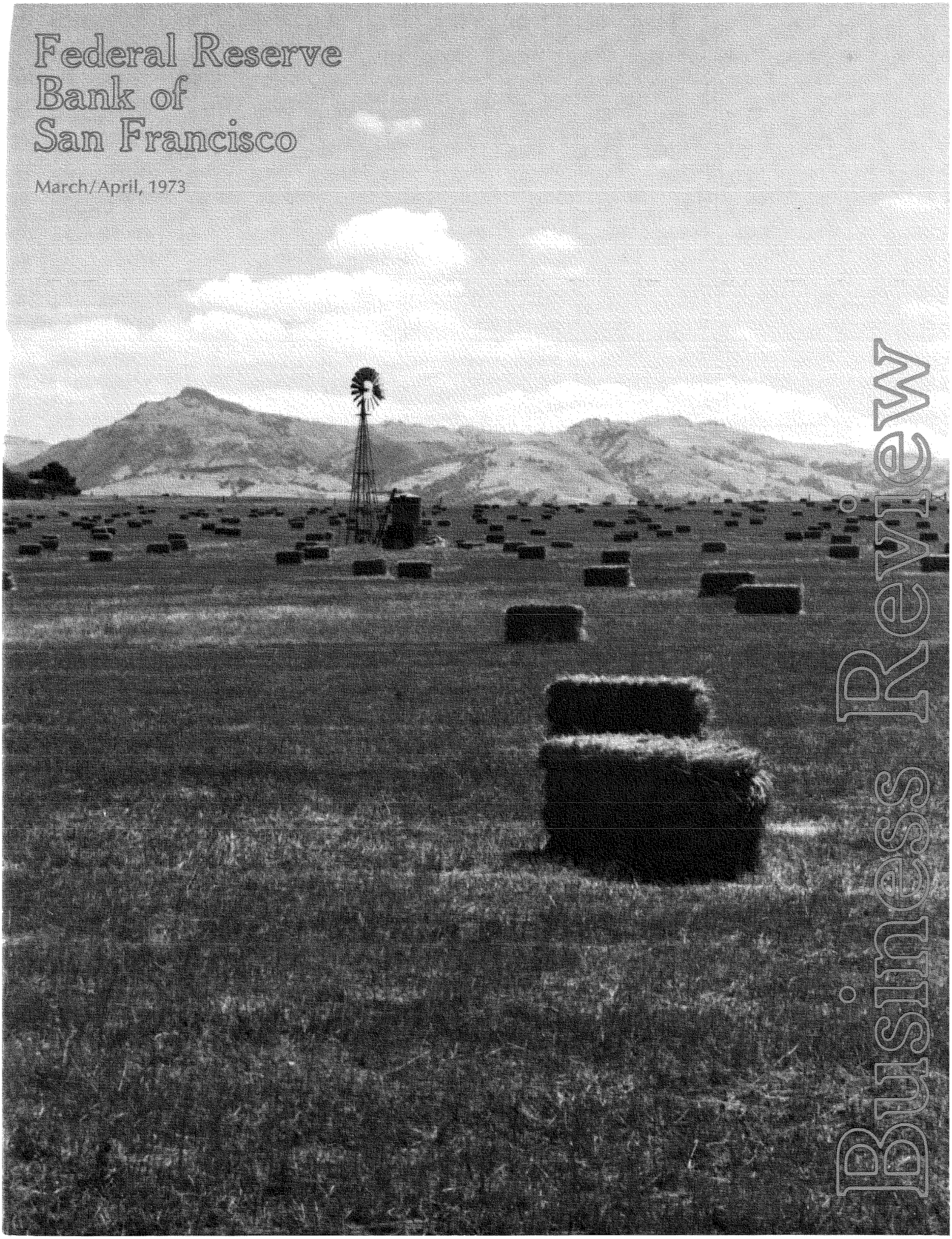


Business Review

Buying on Time

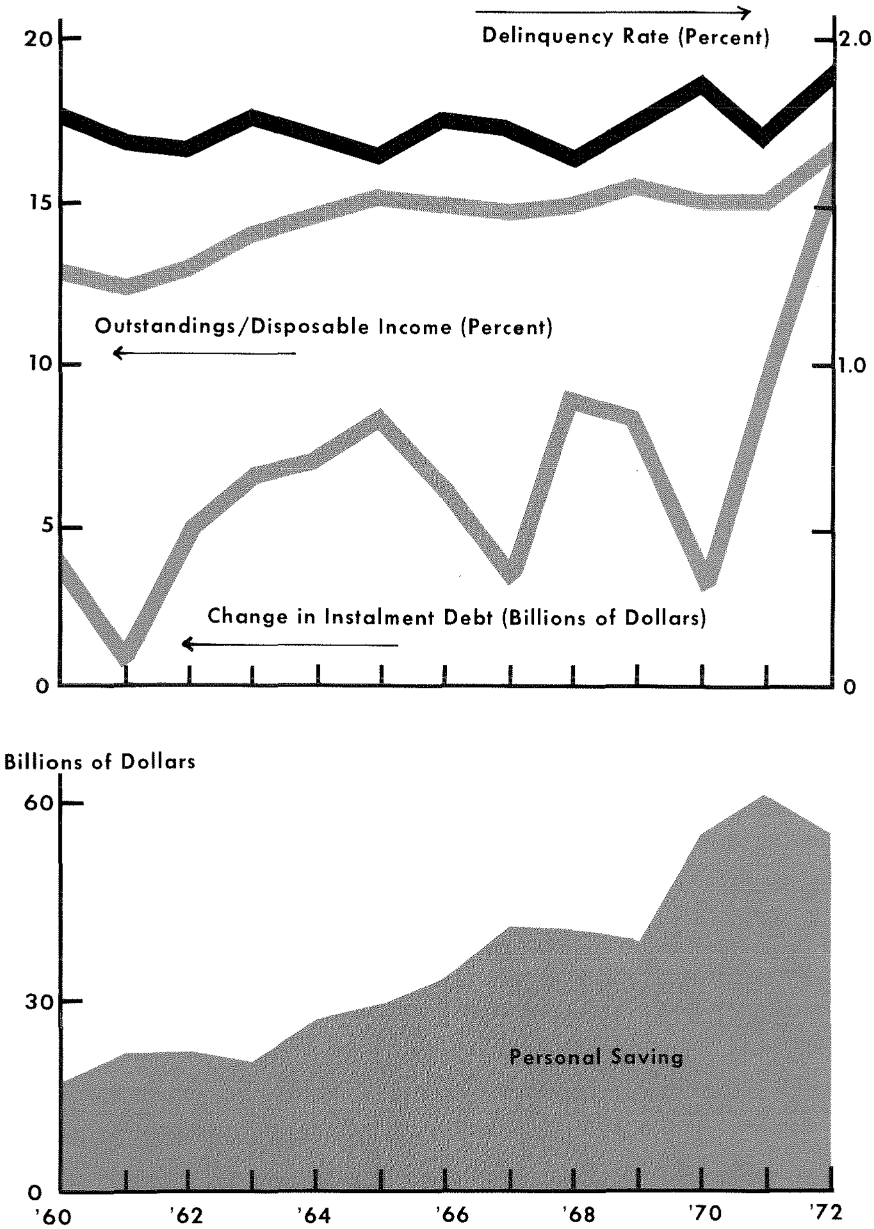
Consumers have been borrowing (and buying) recently as though credit cards were going out of style. In a remarkable display of borrowing, they added more than $16 billion to their instalment debt last year, and even accelerated the pace in late 1972 and early 1973. Net credit additions had ranged between about $5½ billion and $9½ billion annually throughout the entire 1963-71 period, except for the business slowdowns of 1967 and 1970, so the 1972 performance was indeed remarkable —and perhaps unsustainable.

Paradoxically, the vast expansion in credit usage has paralleled a continued strength in consumer saving. Personal saving last year ($55 billion) was off significantly from the 1971 peak ($61 billion) —but it equalled the 1970 figure, which in turn was one-third higher than that of any earlier year. In fact, the 1972 figure would have approached the 1971 peak if there had been no extra withholding of Federal income taxes, since this is causing taxpayers to receive some of last year's income this spring instead of when earned in 1972.

Several worrisome elements must be incorporated in the credit picture. In particular, the burden of instalment debt, measured by the ratio of outstanding instalment credit to disposable personal income, increased from 14.0 to 15.0 percent in the past year alone. (This ratio had risen rapidly in the first two decades following World War II, from 1.4 percent in 1945 to 14.0 percent in 1965, but it subsequently tended to level off.) Also, the delinquency rate (for accounts unpaid for 30 days or more) averaged 1.88 percent last year, the highest level of the past two decades, after some years with practically no trend.

Strong gains everywhere

Last year's buying spree was fueled by the strong expansion, of 12 percent or more, in each of the major instalment credit categories listed in Federal Reserve statistics. Moreover, since 1960, auto credit outstanding has far more than doubled, while other consumer-goods paper and personal loans have far more than tripled in volume. At the end of 1972, auto paper remained dominant, with $44 billion outstanding, but other goods paper and personal loans were approaching in importance, with $40 billion and $37 billion, respectively. The smaller category of repair and modernization loans accounted for $6 billion more.



Burden of debt rises as consumers take on massive amounts of new debt—yet they also continue saving at near-record levels

Noninstalment loans, growing at a slower pace over time, still exceeded $30 billion in outstandings at the end of 1972. In addition, several other credit sources not included in Federal Reserve statistics were also available to support the spending boom. Life-insurance policy loans, as estimated by the Institute of Life Insurance, approached $18 billion last year after more than tripling since 1960. Another source practically nonexistent a decade ago—mortgage credit available for non-real estate purposes—probably exceeded $25 billion last year, according to Conference Board figures.

Autos—and other things

To a large extent, the present credit boom can be attributed to the consumer's renewed love affair with the automobile. During the sluggish 1969-70 period, auto sales trended downward, and credit usage for auto financing declined. Then came a sharp turnaround, generated mostly by the economic-policy stimulus of August 1971. New-car sales jumped to a record 10.8 million last year—and the industry now is talking of 11.5 million sales this year. This has meant an upsurge in credit usage, since about two-thirds of new-car sales involve credit financing. Extensions of auto credit surged from $29.8 billion in the 1970 recession year to $34.9 billion in 1971 and $40.2 billion in 1972.

The auto boom today, like that of the mid '50s, has been supported by an easing of credit terms—specifically, by some lengthening of usual contract maturities. Two decades ago, the usual maximum maturity for new-car contracts was only 24 months, but then came a breakthrough, so that today more than four of every five contracts are written for 36 months. In the past several years, however, some banks and finance companies have been selectively granting 42- or 48-month contracts, and that practice could spread further. In one variation, buyers hold down their monthly payments by agreeing to a final "balloon" payment, which would be paid off through refinancing or through proceeds from the sale of the car.

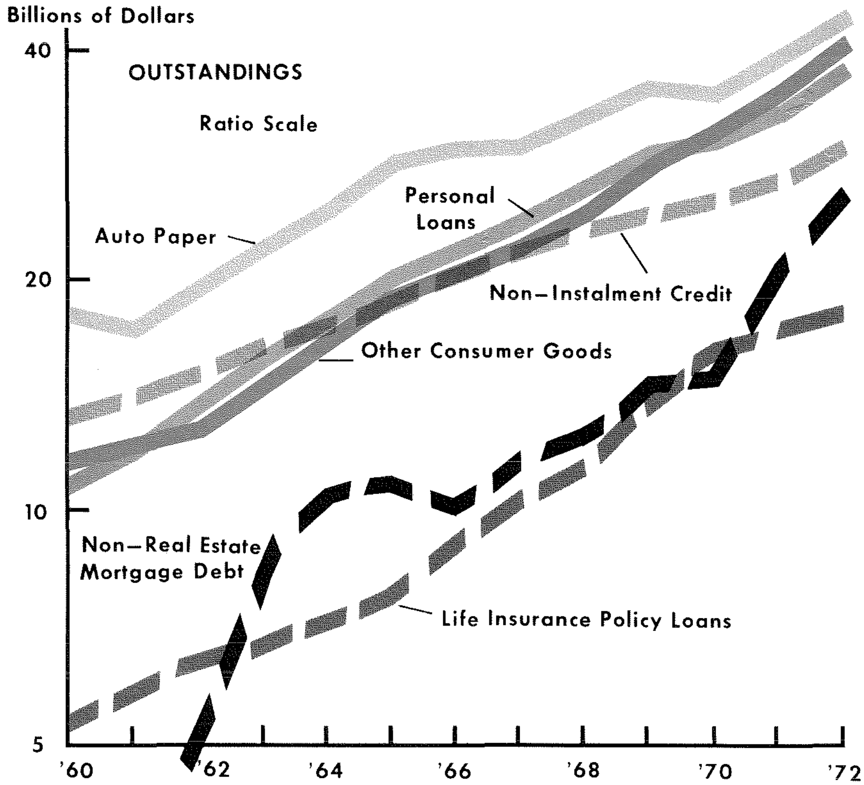
Young adults spark the buying (and borrowing) boom

The rapid growth of personal loans has reflected the widening number of uses for this type of credit—including payment for medical and educational fees, travel, taxes, insurance premiums, and debt consolidation, to name only a few such uses. The rapid growth of consumer-goods paper has reflected not only auto sales but also a number of other uses —mobile homes, boats, furniture, appliances and whatever else can be financed by the ubiquitous credit card. Although the fastest proportional growth came in the late '60s, commercial-bank credit-card outstandings rose 20 percent last year alone to exceed $5 billion at year end.

The mobile-home industry logically is tied to the shelter market, but the bulk of the financing shows up in the consumer-credit statistics; outstandings at banks and finance companies jumped 25 percent in 1972 to more than $8½ billion at year-end. (Mobile homes are financed largely by intermediate-term instalment credit, typically on the basis of seven-to-ten-year maturities.) Credit usage has been spurred by the relatively low prices of mobile homes, relative to conventional housing, and (in tight-money periods) by the greater availability of financing for mobile homes than for conventional dwellings. Moreover, despite the relative inexpensiveness of mobile homes, the trend to larger and more elaborate units has meant a greater need for credit.

Cyclical sensitivity
Developments of the past several years highlight the cyclical sensitivity of instalment credit. Changes in credit and changes in economic conditions tend to move in tandem, with credit advancing briskly in business expansions but growing slowly or actually declining during business slowdowns. (Indeed, the net change in credit is considered a leading indicator of business activity.) The consumer's willingness to incur new debt, after all, depends on his confidence that current and future income levels will be sufficiently large to cover required payments without strain. At the same time, the spending of stepped-up borrowings tends to generate higher levels of income.

Thus, during the recessions of the past quarter-century, instalment credit for autos and other goods either declined or else advanced at a more subdued rate than formerly. Likewise, in each subsequent recovery period, when consumers had reason to become optimistic about the future, credit in these categories advanced sharply and helped feed the business expansion. On the other hand, personal-loan usage advanced at a more stable pace over time.



Households finance spending through auto paper and other consumer-goods paper, but also through other forms of debt

Commercial-bank dominance
Commercial banks have become increasingly dominant in the consumer-lending field over time. Between 1960 and 1972, their share of total outstandings rose from 39 to 47 percent, as bank-held paper almost quadrupled to $60 billion. In particular, their share of the giant auto market jumped from 46 to 61 percent, and their share of the market for other goods similarly rose from 24 to 40 percent. In contrast, the bank share of personal loans held at about 34 percent in both 1960 and 1972.

Within the other-goods category, banks accounted last year for over two-thirds of the credit-card market shared with oil companies and other lenders, and for a like proportion of the mobile-home market shared with finance companies. But savings-and-loan associations, formerly a negligible quantity, are now permitted to finance mobile homes, and they will undoubtedly become an important factor in that market over time.

The finance-company share of the consumer-credit market has declined for a number of years, largely because of their loss of auto financing to banks and credit unions. Between 1960 and 1972, their share of auto credit outstanding was cut in half, to 23 percent. This development was accentuated by the credit crunch of 1969. Beset on the one hand by the high price and restricted availability of funds in the commercial-paper market, and on the other hand by the relatively small increase in finance charges on auto contracts, finance companies then turned to more lucrative types of financing, such as business loans, personal loans and mobile-home paper.

The market—near-term

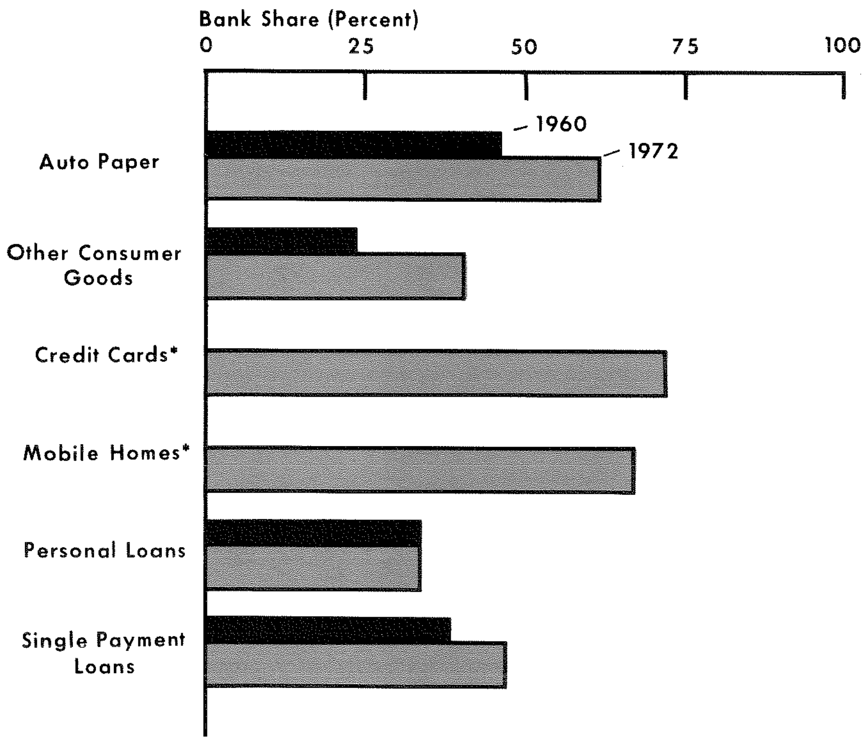
The shape of the market in 1973 could well be influenced by the earlier experiences of lenders and borrowers—for instance, the experiences of the late '60s. Financial institutions then seemed less willing to make heavy commitments of funds to consumers, especially since they were caught between the rising cost of funds and the statutory (or informal) ceilings on consumer-loan rates. At the same time, households suffered a significant slowdown in the growth of liquid-asset holdings, and thus tended to postpone taking on new debt burdens. To the extent these factors are repeated in 1973, credit usage could taper off.

The aftermath of the overwithholding phenomenon of 1972 also could lead to some easing of borrowing pressures. Consumers responded in a similar way to both the 1968 intended tax increase and the 1972 unintended (overwithholding) tax increase. In each case, consumers adjusted their finances by substituting credit for income—not by drawing down stocks or reducing the rate of addition to financial assets. In other words, households substituted credit dollars for the missing dollars in their take-home pay, and thereby maintained a heavy buying pace while salting away substantial amounts in savings.

The refunds now reaching consumers—representing a reversal of 1972's unintended tax increase—will help make it possible for consumers to sustain their recent buying patterns without borrowing further. At the same time, consumers' willingness to take on more debt may be reduced because of the cautious attitude induced by the recent worsening of the inflationary problem. The general effect thus could be an easing of consumer borrowing pressures.

The market—long-run

The shape of the consumer-credit market in the longer run could well be influenced by the trends set a quarter-century or more ago. The pattern of instalment-credit growth—measured in terms of the ratio of outstandings (or extensions) to disposable income—consisted of a sharp upsurge in the first decade or so following World War II, and of a much slower growth in the more recent past. Whether the recent upsurge is simply a cyclical phenomenon or is the beginning of an accelerated trend is still an unanswered question.



*Included in other consumer goods paper

Banks increase their share of total outstandings from 39 to 47 percent, with emphasis on consumer durable-goods financing

Consumer demand for credit is based upon the growing demand for consumer durables as incomes rise, upon the demand for a larger number and wider range of durable goods as leisure increases and tastes change, and upon the demand for new and improved products as technology provides them. Another important factor is the willingness of lenders to finance changing consumer preferences—for services as well as for commodities—and to finance ever-widening circles of customers.

More importantly, the "life cycle" has been a major determinant of consumer borrowing behavior over time. According to this thesis, most instalment borrowing is done by young households who need credit to build up their basic stock of cars, furniture and appliances, while little borrowing of this type is done by older households. (A University of Michigan survey shows that 73 percent of all households under the age of 35—twice the proportion of those over 55—still have unsatisfied consumption needs.) Thus, there was a massive upsurge in credit demand following World War II, based upon the sharp increase in the number of new households (as well as older households deprived of goods during the years of depression and war), and supported by the ample availability of income and assets to provide downpayments for big-ticket purchases.

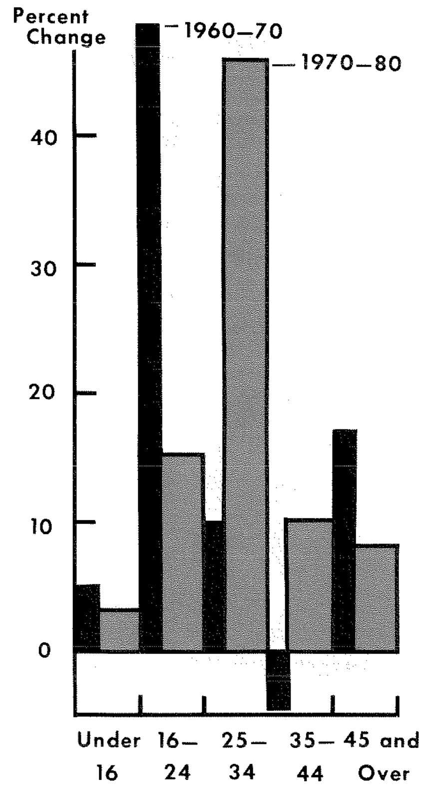
Demand factors

The first postwar decade saw not only the sharpest percentage increases in purchases of big-ticket items, but also the sharpest rise in credit usage for financing such items. A shift in consumer attitudes had much to do with this. After World War II, there occurred a substantial increase in the proportion of households—especially younger households—that considered credit usage to be socially acceptable. This trend has continued in later years, but at a slower pace because of the dwindling number of potential converts. Also, the sharpest decline in loan maturities occurred in the first postwar decade, thereby contributing to a stronger acceleration of outstanding loans in that decade than in the subsequent period. Widening usage of credit has stimulated a process of **embourgeoisement**, which permits blue-collar workers to adopt middle-class living standards previously available only to more affluent white-collar workers. This process is likely to continue further, especially in view of the millions of lower-income individuals anxious to adopt similar consumer standards. And as the process continues, credit demands will expand.

Whatever weight should be given to other factors, the life-cycle explanation alone should stimulate credit demands immensely during the present decade. The number of persons in the 25-34 age-bracket will increase by 11½ million in the present decade—a 46-percent increase, as against the 10-percent gain of the preceding decade. Moreover, there may be an extra bulge in household formations in this group at the present time, because of the large number who were in the service or remained in school during the late '60s. Other age brackets which are less active borrowers will increase at a much slower pace during the 1970s; those aged 35 to 44 will increase by 10 percent, and the 45-and-over bracket will gain only 8 percent, while the 15-to-24 year-olds will increase by 15 percent.

Supply factors

Future usage of instalment credit also will be influenced by developments on the supply side of the business, such as legal reforms, changing lenders' views about loan risks, and increasing competition among lenders. Expansion may come about, for example, if thrift institutions gain the legal authority to make consumer loans, or if lenders ease their own rules regarding the people (and the things) that they will finance, and if competing credit-card networks continue to spread throughout the nation. And as indicated above, if lenders should validate the obviously large consumer demands of lower-income groups, a substantial increase in total credit usage would ensue. Already, in fact, some lenders make loans to welfare clients.



Young-adult population boom supports boom in borrowing

Western Borrowing

Consumer borrowing at Twelfth District banks grew irregularly for the better part of a decade but then jumped 23 percent in 1972, so that instalment loans outstanding reached $9.7 billion at the end of the year. This increase helped finance a comparable upsurge in durable-goods purchases last year. Yet, consumer borrowing at banks elsewhere increased more rapidly over the decade, so that the District share of total outstandings dropped from 16.9 percent in 1963 to 16.2 percent in 1972.

Long known as pioneers in the field of consumer finance, District banks continued to offer a wide range of services over the past decade. However, they shifted their emphasis somewhat, becoming less active than other banks in auto financing and more active in financing other consumer goods. Between 1963 and 1972, their share of bank-held auto paper declined from 19.1 to 16.2 percent, while their share of other consumer-goods paper rose from 16.2 to 18.5 percent. (Last December, they held 22.7 percent of credit card outstandings.) They accounted for 13.5 percent of personal loans outstanding in 1963 and for 13.1 percent in 1972.

During the last several years, Western households have shown even more willingness than their counterparts elsewhere to assume more debt, at least in the form of bank-held consumer paper. In 1970, bank extensions of consumer instalment credit amounted to 6.2 percent of disposable personal income for both the West and the nation, but by 1972 the ratio reached 8.2 percent for the West as against 7.5 percent for the nation. In most earlier years, the bank-held consumer-debt burden was lower for this region than for the nation.

If all of the 85 recommendations found in the recent report of the National Commission on Consumer Finance were to be written into law, the consumer-credit market might continue to grow as rapidly as it has in the past several decades. In the area of competition, the Commission would permit thrift institutions to allocate as much as 10 percent of their assets to consumer lending, would modify restrictions on branch banking, and would permit banks to compete with finance companies in the high-risk (and thus high-interest) small-loan market. In the area of consumer protection, the Commission would outlaw such devices as wage assignments, confessions of judgment and balloon payments—and outlaw also the use of the "holder in due course" doctrine, which entitles banks and other lenders to collect from debtors even where faulty merchandise is involved.

The basic purpose is to ensure that credit "is available to every credit-worthy applicant on a nondiscriminatory basis." To help achieve this goal, the Commission suggests that current ceilings on interest rates might be lifted further—possibly to as much as 42 percent on the first $300 of any transaction. This conclusion was not unanimous, however, since one Commission member (Congresswoman Leonor Sullivan) argued that credit is already amply available; "in fact, the evidence is convincing that large numbers of Americans obtain far more credit than their economic situations would justify."

Increased burdens?

The factors outlined above suggest a strong expansion of instalment credit in coming years, but the question remains whether consumers will be able to service the increased burden. The ratio of debt repayments to disposable income rose to 16.0 percent in 1972 after hovering around 15.5 percent for five straight years, and the burden should increase because of the sharp 28-percent increase in extensions between 1970 and 1972 alone. Yet it should also be remembered that consumers can pay their debts out of savings as well as income, especially in view of the 25-percent increase in liquid asset holdings between 1970 and 1972.

For that matter we should remember the considerable growth over time in the household sector's auxiliary assets, such as health and other insurance, unemployment compensation, pension funds and the like. These security-providing secondary assets alleviate some of the strains on the household budget and help ensure that liquid assets are available for the repayment of consumer debt if necessary.

The consumer-credit market is not likely to witness again the very rapid expansion of the early postwar period, unless lenders are willing to take the risks of widening eligibility and easing credit terms even faster than they already have. Even so, the continuing demands on the market should remain quite strong, as consumer income expands further and becomes spread more evenly among the purchasing public—as well as more concentrated in the hands of the heavy-spending, credit-conscious younger age-groups.

William Burke