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Minnesota AGRICULTURE ECONOMIST



Consumer Credit

Mary E. Ryan

The volume of consumer credit outstanding has increased markedly in the past two decades. Today, a larger share of the population uses more credit for a greater variety of purposes than ever before. But, in spite of its widespread use, many lenders, borrowers, and educators do not clearly understand the function of credit in financing consumer investments and expenditures. And they have difficulty evaluating the ability of debtors to carry a debt burden without trouble. This article describes the function, types, and quality of consumer credit and reports the findings of a study of consumer installment credit users.

FUNCTION OF CONSUMER CREDIT

Financing consumer expenditures for an individual or family is much like financing a business. In each case, certain goals require the expenditure of financial resources. Consumers have needs and goals, such as housing, food, transportation, education, and retirement, and they have resources, including credit, income, and assets. The function of credit is to make future income available for present expenditures.

Current use of future income is desirable for (1) balancing asymmetric flows of income and expenditures throughout a lifetime, (2) making investments that are expected to return greater money income or satisfaction than the cost of credit, and (3) paying for emergency needs that cannot be met with current income or savings.

For most consumers, income peaks later than expenditure pressures. Heads of households who are 45-54 years old have had the largest median income in recent years. But needs for housing, household durables, and nondurables, such as food and clothing, are greatest for young families. Since most families don't have sufficient assets to supplement their incomes during the early years, they can either reduce their level of living to equal current income or borrow against future income. Those who choose the second alternative assume that their present satisfaction will outweigh the cost of credit.

Credit also can be used to make investments that would not be possible with current income. Borrowing to finance education is an example: The increase in lifetime income is expected to be greater than the cost of education and credit. Purchasing durables on credit is another example. Some families buy appliances on credit rather than using commercial services while saving to buy with cash, arguing that total outlay is less.

Many credit purchases combine income-expenditure balancing and investment; e.g., mortgage financing of houses. Larger or higher quality housing is obtained than would be likely with cash purchase, while equity acquired in the property provides an investment.

Borrowing to meet emergencies represents unplanned use of future income. In practice, emergency borrowing most frequently is for paying medical expenses, consolidating bills, or supplementing income during unemployment.

TYPES AND USES OF CONSUMER CREDIT

Long term mortgage debt accounts for the largest share of consumer debt outstanding (figure 1). Since after World War II, approximately \$7 of every \$10 of consumer debt has been incurred as mortgages on one to four family nonfarm houses. The amount of mortgage debt outstanding grew from \$17.7 billion in 1945 to \$233.7 billion in 1966. This growth reflects (1) a 55 percent increase in the number of households, (2) a shift from rental to owner status (according to 1940, 1950, and 1960 censuses, 44, 55, and 62 percent of housing units, respectively, were occupied by owners), (3) an increase in the percentage of nonfarm owner-occupied homes with mortgages (from 44 in 1950 to 57 in 1960), and (4) an increase in prices paid for homes, due both to inflation and to upgrading of quality.

The amount of noninstallment debt also has increased, but its share of the total has declined from 10 percent or more before 1950 to 6 percent in 1966. Approximately two-thirds of noninstallment debt is for 30 day charge accounts

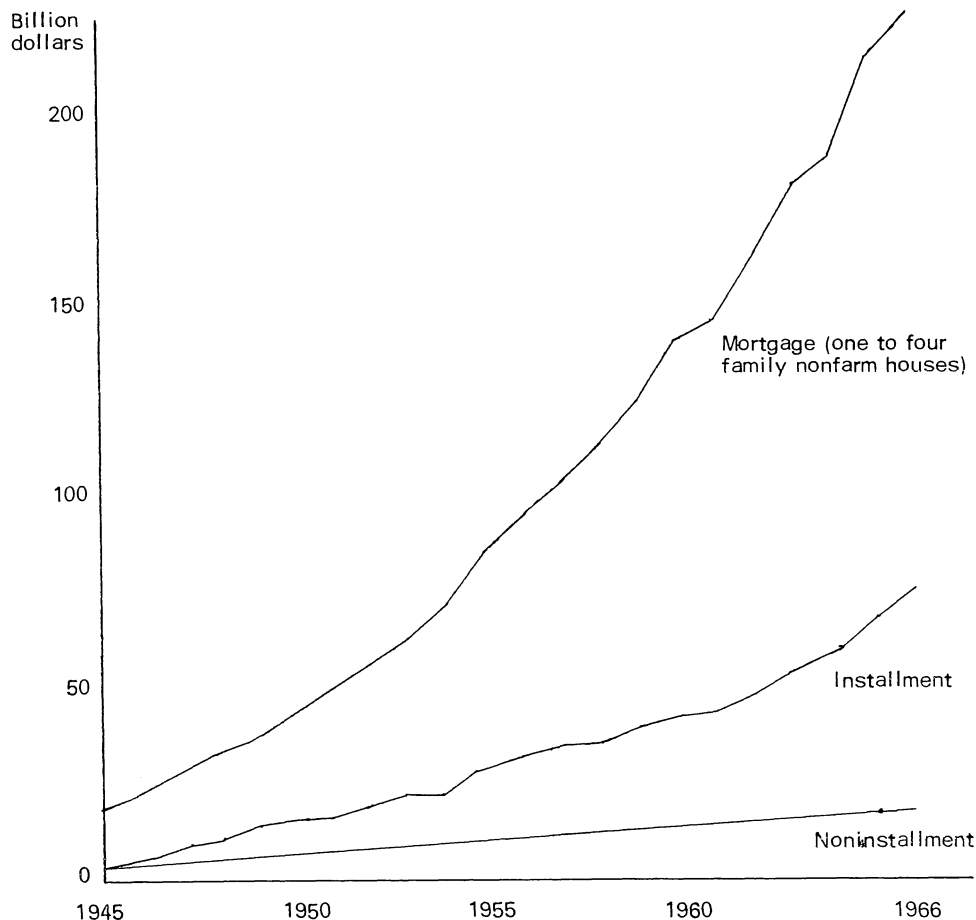


Figure 1. Amount of consumer debt outstanding, by type, 1945-66

and service credit used for medical and household utility bills. These uses are more for convenience than they are means of using future income for present expenditures. The remaining third is for single payment loans that most often are available only to high quality credit risks.

Installment debt has grown most. Currently, it represents one-fourth of all consumer debt, an increase from less than one-fifth before 1950. Installment credit is used primarily to purchase durables — automobiles, household furnishings, and appliances. In each year since 1950, automobile debt has accounted for about two-fifths of total outstanding consumer installment debt. The portion incurred for purchase of nonautomotive durables has been approximately one-fourth since 1955, down from one-third during the previous 10 years. Personal loans, which include loans for bill consolidation, medical expenses, travel, and tax payments, have taken an increasing share, rising from about one-fifth in 1950 to slightly over one-fourth during the mid-sixties. Home improvement loans account for the remaining 5-8 percent of outstanding installment debt.

QUALITY OF CONSUMER CREDIT

The growth of consumer debt has raised questions about its quality: **Can debts be repaid at all? Will payments be made on time? Are debt burdens creating stresses within families?** Politicians, consumer educators, and members of the financial industry are concerned about the possible harmful effects of poor quality credit on the consumer and business sectors of the economy. Efforts to examine credit quality are discussed below.

Debt burden, an indicator of quality, can be measured by comparing outstanding debt with assets, inasmuch as debt can be liquidated with assets, and by examining the share of income committed to debt repayment, since debt payments usually are made from current income.

Figure 2 presents a comparison of consumers' financial assets, liabilities, and after tax income. As shown in the figure, the consumer sector has increased assets more than debt, improving its solvency position during the 16 year period. If nonfinancial assets, such as equity in homes and household goods, were included the improvement in aggregate consumer net worth would be even greater. But this bright picture provides only a partial answer to credit quality questions. Knowing the **distribution** of assets and liabilities among consumer units is necessary before we can conclude that the financial position of all or most consumers has improved.

The share of income committed to debt repayment also measures debt burden. In general, the ability to carry debt rises faster than income because more of high than low income is left after paying for necessities.

During 1950-66, the share of consumer disposable income committed to installment debt payments increased from 7 to 14 percent. To determine if this increasing share reflected a deterioration in credit quality, some estimates of the debt burden of debtor families were made. The conclusion was that the debt/income ratio for the average debtor has remained fairly constant from the early fifties to the mid-sixties.

Further examination revealed that the increase in the aggregate debt to income ratio for the whole economy resulted from an increase in the proportion of installment debtor families in the population (38 percent in 1952 and about 50 percent since 1963). This increasing proportion of debtor families is attributable to increasing ownership of cars and other consumer durables and to increasing acceptance of installment debt as a means of financing such purchases, especially by families with high incomes. The percentage of families with installment debt who had incomes of \$10,000 or more (in constant dollars) increased from 35 percent in 1956 to 46 percent in 1962.

It is obvious from these data that debtor ability to carry and repay debt has not deteriorated.

Data on bankruptcies and delinquent loans also are relevant. U.S. district courts report that the number of personal (nonbusiness) bankruptcy filings increased six times from 1950 to 1966. Some of the increase no doubt is attributable to a greater awareness of bankruptcy as a solution to excessive debt. But the fact that there were approximately three bankruptcies for every 1,000 U.S. households in 1966 means that excessive debt

is a serious problem for some families.

The American Bankers Association computes a series on delinquent consumer loans held by commercial banks. The annual average number of loans delinquent from 30 to 89 days fluctuated between 1.3 and 1.8 percent of all consumer loans from 1950 to 1960. During 1965 and 1966 the percentage remained in the same range. Measured by this criterion, commercial banks have not experienced any deterioration of consumer credit quality.

RESEARCH RESULTS¹

A study of debtors was undertaken to explore credit quality further. The purpose was to differentiate the overburdened debtor from the successful user of consumer installment credit.

In the study year (1960), 48 percent of U.S. households had installment debt. Debtors were classified as overburdened or not on the basis of their income and liquid asset and debt positions. The ratio of debt payments to income was used to measure debt burden: the larger the ratio, the heavier was the burden. But it was assumed that high incomes could support a larger ratio without being overburdened than low incomes and that debtors who had more liquid assets than debt were not overburdened regardless of their debt/income ratio, since they could liquidate their debt if desired (29

¹ The study concerned U.S. nonfarm households in 1960. More recent data on installment debt and debtors indicate that the relationships reported here remain appropriate. The research was supported by the Federal Reserve Bank of Minneapolis. Study details can be obtained from the author.

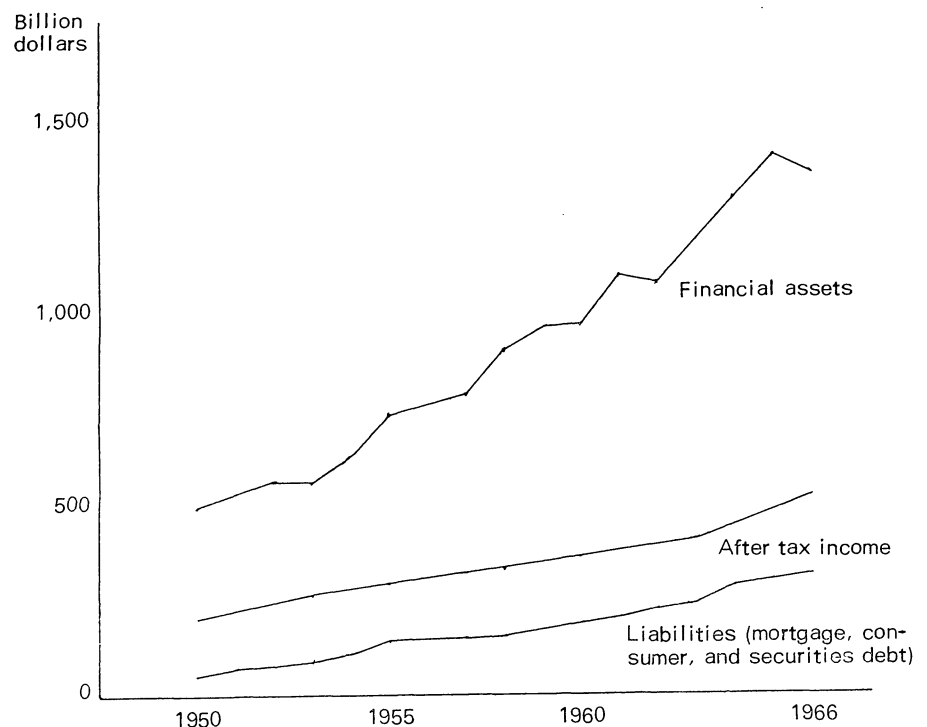


Figure 2. Consumer assets, liabilities, and income

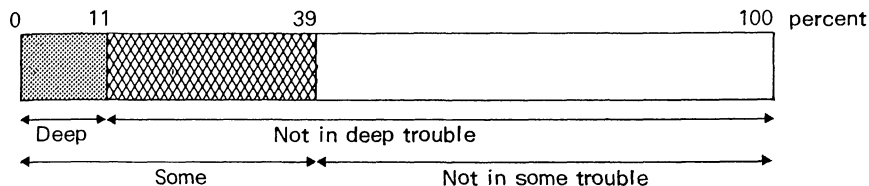


Figure 3. Percentages of debtors in trouble

percent had liquid assets that exceeded their debt by at least \$200).

Two groups of overburdened debtors were formed: those in deep trouble (DT) and those in some trouble (ST) with respect to installment debt (DT was a subgroup of ST). DT debtors were those with debt/income ratios of .40 or more and those with .20 to .39 ratios whose 1959 incomes were less than \$4,000. The ST group included debtors with debt/income ratios of .20 or more and those with .10 to .19 ratios whose 1959 incomes were less than \$6,000. Remaining debtors were considered not in trouble.

Figure 3 shows the proportion of debtors in each group. DT and ST debtors and those not in trouble were analyzed to determine who fell into each group and what spending behavior was associated with debt trouble.

Characteristics of DT and ST Debtors^a

The debtor in trouble was different from the typical user of installment credit. Married, middle income consumers between 25 and 44 years old are the most frequent users of installment credit. But the greatest proportions of debtors in trouble were among the unmarried (especially the widowed, divorced, and separated), the poor, and those under 25 or 65 and older.

About 40 percent of single person households and Negro households were DT debtors. Households headed by a woman were more apt than others to have debt trouble. If the head of the household had 12 or more years of education, the likelihood of debt trouble was below average, in contrast to above average incidence for those with less than 12 years.

Economic factors such as the amount of liquid assets, size of debt, level and change in income, and occupation also were examined. As might be expected, debt trouble increased as the amount of liquid assets decreased and the size of debt increased up to \$1,000. For debts of \$1,000 or more, repayment periods usually are longer than for smaller debts, so current debt burden (size of payments) does not increase proportionately with loan size.

Proportions of DT and ST households decreased as income levels increased up to \$10,000 (1959 income). No households with \$6,000 or more disposable income were in DT. The proportion of households with ST increased from 9 percent

for those with incomes between \$6,000 and \$9,999 to 13 percent for the \$10,000 and over group.

Change in income from the previous year was a relevant factor. Less than average likelihood of debt trouble was experienced by debtors who had annual income increases of 5-24 percent. Average or above average proportions with trouble were found among those with smaller increases or those whose incomes had declined. The greater the decrease, the higher was the proportion with trouble. At the other extreme, households with income increases of 25 percent or more had average incidences of DT and above average proportions of ST (47 percent compared with the average of 39 percent).

The latter finding, along with the increase in proportions in trouble for those with incomes of \$10,000 or higher, suggests that some consumers increase their levels of debt-financed expenditures on the basis of expected increases in income. If incomes do increase, the financial squeeze may be alleviated and financial trouble averted. But such consumers are in vulnerable positions if unemployment or unexpected expense occurs.

Except for unskilled laborers and service workers, all employed occupational groups had below average proportions of debt trouble. But the unemployed had 21 and 52 percent in DT and ST, respectively. This finding supports earlier ones, since persons not working or persons with few skills also are more apt to have relatively low incomes and experience income declines. And these groups include those with relatively low educational levels, the young and old, Negroes, and the poor.

Many of these characteristics are interrelated. For example, low incomes are associated with unskilled occupations, retirement, and income declines as well as with less than high school education, households headed by women, Negroes, and the young and old. This analysis did not permit determination of which attributes are basic. It only pointed out the likelihood of financial trouble for debtors with such characteristics.

The characteristics of debtors who were classified in trouble in this study parallel those of more limited studies. Several financial institutions have examined good and bad risks. Although their research involved a variety of lenders and creditors in different parts of the country, common characteristics of poor risks were found. Delinquencies were

highest among the young, unskilled or semi-skilled workers, those with short term employment, and those with low incomes. Some studies of bankrupts reveal the same characteristics.

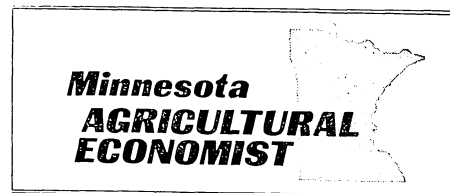
The similar findings about debtors in trouble, bad risks, and bankrupts support the classification scheme used in this study. It further means that debtors in trouble can be identified before they become delinquent or reach a bankruptcy court. So consumer educators and debt counselors can focus their efforts on consumers most in need of help.

Spending Behavior Associated with Debt Trouble

Spending for housing, automobiles, and nonautomotive durables by all debtors was examined. It was expected that debtors who overspent for these items would be more apt to be in debt trouble than underspenders in the same income class. This expectation was considered plausible because most installment debt is incurred for automobiles, other durables, and home improvements.

As expected, overspending in each category was associated with DT and ST. But large underspenders also were in debt trouble. Since comparisons for each spending category were made individually, it was thought that underspenders of one category might compensate for overspending in another. For example, an overspender for housing might underspend for automobiles. To test if such balancing accounted for the debt trouble of underspenders, spending for the three categories was summed and related to debt trouble. But DT and ST remained high for extreme underspenders.

Since the underspender's debt trouble was not due to overspending for housing, automobiles, or other durables, it must result from other situations. Perhaps he has incurred installment debt to meet an emergency situation or finance current living expenses. Or he might be an incompetent financial manager. Further analysis was not possible in this study. But further research is desirable, since debtors who spend less than others with like incomes and still encounter trouble are those who most need financial management assistance. ■



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Views expressed herein are those of the authors but not necessarily those of the sponsoring institutions.

^aIn general, characteristics of DT and ST debtors were the same. Exceptions are noted.

IN PERSPECTIVE



Inflation

Arley D. Waldo

Consumers, businessmen, and U.S. government policymakers are deeply disturbed by inflation and the corresponding decline in the purchasing power of our currency. Retail prices in 1968 averaged 20.5 percent higher than 10 years earlier, and the rate of price rises has been accelerating since 1965.

Inflation, an increase in general price levels, is caused by two distinct but inter-related economic forces: increases in demand that outrun the output of goods and services and increases in wages and other production costs that exceed advances in productivity. Since increases in living costs foster higher wage demands by workers and since some contracts call for automatic wage increases as prices climb, danger of a wage-price spiral arises. The government's unsuccessful attempt to limit wage increases according to advances in labor productivity was an early victim of current inflationary pressures that have been building up for several years.

Economic policy in the late fifties and early sixties was aimed chiefly at stepping up economic growth and reducing unemployment. These actions were successful. Between 1960-65, real output grew by an average annual rate of 4.7 percent, compared with 3.1 percent for 1950-61. And unemployment dropped to a yearly average of 4.5 percent in 1965, the lowest rate since 1957.

The federal government can influence business activity and prices through two channels. One is monetary policy—actions that affect the money supply and, therefore, the availability of credit and the level of interest rates. The other is fiscal policy—

decisions concerning taxation, spending, and debt management. To avoid economic distortions and inflation or recession, the timing, magnitude, and coordination of monetary and fiscal policy are extremely important.

The U.S. unemployment rate fell to 3.8 percent in 1966, and the pace of price rises quickened. The Federal Reserve Board restricted the money supply in order to slow price advances. Interest rates moved sharply upward, credit tightened, and stock market prices plunged. Meanwhile, federal spending grew faster than receipts, adding to aggregate demand.

In his economic report to Congress in January 1967, President Johnson said that "restoring price stability is one of our major tasks." Between January 1966 and January 1967, consumer prices rose by 3.3 percent, the first significant increase since 1957-58.

As the cost of the Vietnam War escalated, the federal budget deficit reached nearly \$8.8 billion in the year ending June 30, 1967, an increase of \$5 billion from the previous year, and soared to over \$25 billion in fiscal 1968. The nation's output increased, but excess purchasing power drove prices higher. By January 1968 the Consumer Price Index, a measure of retail price changes, had reached 118.6 percent of the 1957-59 average, up 3.4 percent from 12 months earlier. Prices rose even faster in 1968, climbing by 4.6 percent between January 1968 and January 1969.

Shortly before leaving office, President Johnson said that "the immediate task in 1969 is to make a decisive step toward price stability." And he warned that "We must adopt a carefully balanced program that curbs inflation and preserves prosperity."

Slowing economic expansion while avoiding recession and sharp increases in unemployment is likely to be difficult, both economically and politically. By April the

Consumer Price Index already had risen 1.9 percent above the January level. A continued rise at this rate would mean a price increase of 7.4 percent for the year, the sharpest rise in retail prices since the Korean War.

Both monetary and fiscal policy tools are being used to slow economic expansion and shrink price increases. The Federal Reserve discount rate on loans to member banks has been raised, as have bank reserve requirements. These actions, coupled with a strong demand for loans, have led to sharply higher interest rates.

Monetary authorities hope that tightening credit will slow borrowing by business firms. In an attempt to ration available funds, commercial banks recently raised the prime rate, the interest rate charged their best business customers, from 7.5 to 8.5 percent. It is too soon to know if this action will appreciably reduce loan requests, but many bankers fear that a further increase in interest rates may be needed to curb borrowing.

The major fiscal policy actions taken to combat inflation were last year's federal income tax surcharge and cutbacks in federal spending. President Nixon has asked for a 12-month extension of the surcharge at a rate of 10 percent from July 1 to the end of the year and 5 percent from January 1 to June 30, 1970. Although the surcharge extension is virtually assured of passage, Congress had not yet acted on the measure by mid-June. Another proposal by the President to repeal the 7 percent investment tax credit also awaits Congressional action.

There is some hint that inflationary pressures may be easing. But even with an extension of the income tax surcharge and continuation of monetary restraints, we can expect substantial price increases in the last half of 1969 and on into 1970. With the 1970 elections now less than 18 months off, politicians face a dilemma. Too much economic restraint could lead to recession and, especially among certain segments of the labor force, sharply higher unemployment. Such an outcome hardly would provide an attractive campaign platform. At the same time, voters are not likely to support candidates who have done little to slow inflation or bolster the dwindling value of the dollar. ■

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