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Thomas A. Durkin
National Consumer Finance Association

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There is a widespread view that consumer credit has ballooned in recent years, posing serious questions about the financial health of the important consumer sector of the American economy. Recently both media observers and public policy makers have focused on consumer credit growth as a problem and as cause for alarm. Not long ago President Carter even briefly imposed formal consumer credit controls as part of one of his economic offensives in 1980. Since that time consumer credit growth has been modest at best (and negative in real terms), but it nonetheless remains a convenient target for critics. For example, in March, 1982 witnesses at House Judiciary subcommittee oversight hearings on bankruptcy blamed excessive consumer credit growth for the upsurge in consumer bankruptcies since 1979. At the same time on the other side of the Capitol, a Senate subcommittee held hearings on a bill (S 2214) to control consumers' "credit explosion" which, according to the sponsor, had "pushed interest rates to all time highs." It seems that consumer credit growth has joined Arabs, landlords, oil companies, and the Federal Reserve Board on the list of useful scapegoats for economic ills.

However, like other complex phenomena, consumer credit requires a close look for full understanding. Beyond correct facts, full understanding also requires decent analysis. Careful analysis may show, for example, that market trends which appear disturbing to a casual observer are actually not especially worrisome. Or, that greater attention should be paid to trends which are missed entirely in a quick look. Furthermore, study can suggest the proper perspective for viewing events. Trends that appear highly significant at first glance may appear less (or more) significant when examined in proper context. What is needed is a dispassionate review of consumer credit trends over the past two decades to explore more carefully the question whether credit growth has been excessive. While what is "excessive" or "disturbing" lies to a great extent in the eyes of the beholder, examining the facts and placing them in perspective should help delineate the range of remaining disagreement. But first, a look at possible causes of understanding gaps seems in order.

The Mythology of Consumer Credit

Together with spouses, mothers-in-law, and the Internal Revenue Service, consumer credit is pervasive enough that it has become stock material with stand-up comedians. In such an environment it is not surprising that consumer credit has its own mythology, although the humor wanes somewhat with the realization that consumer credit myths are being advanced as arguments in our nation's legislative halls. Myths in this area abound; three are probably most influential in Washington today.

First is the Tremendous Growth myth. Disciples contend that imprudent consumers and irresponsible creditors have interacted to cause extremely rapid credit growth. Nautical images are common in descriptions - consumer borrowers are alleged to be swimming, sinking, or drowning in "seas of debt" and lenders are reported to be sailing in "uncharted waters." Tremendous Growth is advanced as the cause of all sorts of economic problems ranging from inflation, high interest rates, and other macroeconomic dislocations all the way to personal bankruptcies.

Second is the Uncontrollable Plastic myth. Adherents of this view hold that availability of credit cards is in large part responsible for Tremendous Growth in credit, presumably because consumers armed with credit cards cannot control their own spending. Drug culture images are more common here - the United States is a nation of credit card "junkies" who "pop plastic" for a spending "high." Since Uncontrollable Plastic supposedly leads to Tremendous Growth, all the evils attributed to Tremendous Growth are also attached to Uncontrollable Plastic, although one step removed.

Third is the Better Off Without myth. Believers argue that because consumers cannot practice self denial with respect to unneeded consumption on credit, they would be better off if credit were unavailable. Alternatively, if only consumers would not use so much credit for consumption, they would save more and be better off. Images here tend to be moralistic and even medieval in tone - since living beyond one's means is bad, the engine of doing so (credit) should be forcefully removed by a more knowing hand (presumably, government). Better Off Without is often used as an argument in support of low finance rate ceilings on consumer credit. If creditors cannot make a profit, so the argument goes, they will be driven from the market. However, this would leave the public better off because people would be forced to overcome their baser (spending) motives.

These three myths arise from well meaning people and they gain adherents because, like the sun circling the earth, a quick look can always find some supporting evidence or cases. By some measures consumer credit has grown rapidly, some people cannot control their own spending, and some people probably would be better off if they were forced to do without credit. Nonetheless, these myths are fundamentally fallacious because they make the error of paying insufficient attention to all the available

facts. Of course, hardly anyone intends to neglect important evidence; the logical train leading to these myths is actually more complex than simple bad faith of the myths' apostles. The preachers of consumer credit mythology are actually the victims of a long list of analytical errors.

Fallacious Reasoning

The first fallacy is money illusion, the failure to express economic magnitudes in dollars of constant purchasing power. Expressed in nominal or current (nonconstant) dollars, consumer credit grew relatively rapidly in the past two decades, but in the inflationary environment of this period, so did wages, salaries, incomes, assets, taxes, and virtually everything else. Without a frame of reference, reporting that some economic indicator grew in nominal dollars provides little useful information. This is the reason why even mass market newspapers and news magazines, let alone more technically oriented analysts, routinely provide reports on wages, income, federal deficits, etc. in deflated as well as in current dollars.

Money illusion is responsible for much of the Tremendous Growth myth. Apostles of Tremendous Growth tend to express trends in nominal dollars (or as percentage changes in nominal dollars magnitudes) with no adjustment for inflation. This has the effect of making debt growth appear much larger than it really is in terms of purchasing power.

A second analytical mistake is lack of context. To achieve a clear picture of the potential importance of changes in any economic indicator, it is usually necessary to identify the context for the indicator. Typically, this means comparing it to something else. For example, in examining consumers' use of credit the interesting question is whether debts rise faster than income or assets, thereby adding to "debt burden."

Failure to specify context also contributes importantly to the Tremendous Growth myth. If proponents of Tremendous Growth paid attention to context they would also be reporting Tremendous Growth of income and assets. In this context different conclusions about credit growth would emerge.

Some preachers of Tremendous Growth have shown at least vague awareness of the need for context. Attempting to provide perspective, proponents of Tremendous Growth occasionally compare credit growth to other things but, unfortunately, usually inappropriately. For example, a common approach is to compare growth of some indicator (like consumer credit) that is denominated in current (inflating) dollars to something that does not inflate. For some purposes this may be all right, but other times it produces silly results.

One silly instance occurred at the recent House Judiciary subcommittee bankruptcy hearings. A bankruptcy judge argued that the number of personal bankruptcies should be compared to the amount of consumer credit outstanding. Credit, of course, is

totted up in dollars that inflate while bankruptcies are not expressed in dollars at all. Thus, any comparisons between the two will be impacted by the effects of inflation and will be guilty of money illusion. This did not occur to the judge. He constructed a ratio and found that the number of bankruptcies per million dollars of credit declined over time, and so he concluded that bankruptcy has become less of a problem. He apparently did not realize that his findings merely reflected inflation in the denominator of his ratio. If he had expressed credit in a way unaffected by inflation, such as constant dollars, he would have freed his analysis from money illusion. He also would have come up with a sharply different conclusion - that bankruptcy is increasing rather than declining. This case would probably have been relegated to the dust bin of hot air in Washington had not the subcommittee's staff seized upon the judge's "analysis" as important information to emphasize to the subcommittee members and the press in a staff memorandum. As a result, the judge's erroneous conclusion gained a life of its own in the legislative halls.

A third error is statistical selectivity. This is the tendency of some observers to select only those data that support their preconceived position on some issue and to ignore the rest of the facts. Of all the errors producing myths about consumer credit, this one is most likely to involve bad faith. Subtle examples include such tactics as selecting particular time spans for review because they illustrate preselected points.

Some people have used a particularly sinister form of statistical selectivity - the zero base period fallacy - to support the Tremendous Growth myth. These people have selected (probably misguidedly rather than in bad faith) the World War II period or before as the base period for measuring consumer credit growth. Since there was little consumer credit before the War, and credit was controlled during the War, in the late 1940's, and during the Korean War, these hardly seem like appropriate periods for comparing to the 1970's and 1980's. Even modest increases will show Tremendous Growth when compared to a small or zero base. An example shows the absurdities that can result. Consumer credit growth since 1890 has been virtually infinite since consumer credit in the base year approximated zero. This growth is obviously far, far greater than income growth over the same period since 1890 income was greater than zero. Although the example may be absurd, it is not much different from comparing consumer credit in 1982 with consumer credit in 1950, 1945, or 1939 as was done in Congressional hearings this year. More relevant would be comparison of the 1980's with the 1970's and 1960's, periods with more modern and freer credit markets.

A fourth analytical error contributing to mythology is the apples and oranges fallacy - the old mistake of comparing unlike things. Even if money illusion is absent, context is specified carefully, and fallacious statistical selectivity is not a problem, erroneous conclusions can emerge if analysts compare different things. This mistake can easily occur if there are changes

over time in definitions. For this reason, knowledge of definitional or conceptual changes in the Federal Reserve Board's statistical series on consumer installment credit are especially important in analyzing consumer credit trends. For example, one important change occurred in 1971. At that time consumer credit extended on oil company credit cards was redefined as installment credit rather than noninstallment credit. This purely definitional change raised the ratio of consumer installment credit repayments relative to disposable personal income 1 1/2 to 2 percentage points in the 1970's compared to the 1960's. Thus, without making adjustments or noting the definitional change, comparisons of the 1970's with the 1960's will be guilty of an apples and oranges mistake.

An apples and oranges problem has contributed greatly to the myth of Uncontrollable Plastic. Over time many people have accepted credit cards as transaction devices, equivalent to but more convenient to use than cash or checks. These card users regularly pay their bills in full when they receive them, rarely or never using the cards to generate time payments or credit in the usual sense. Regardless, this kind of card use is included in Federal Reserve estimates of consumer installment credit extended and liquidated, even if conceptually and behaviorally no consumer installment credit is involved. Unfortunately, it is not possible to remove the cash-substitute component from the installment credit numbers consistently, even if its inclusion sharply biases upward the figures for installment credit extended and repaid. Estimates of the cash substitute component range up to one half of all credit card credit extended, or approximately \$72 billion in 1981, every dollar of which contributes to the Uncontrollable Plastic myth.

A fifth analytical error is the macro-micro fallacy. This fallacy refers to the possibility that observance of any particular trend overall - even over a long period - may reveal little or nothing about the micro changes associated with the trend. As a result, aggregate time series trends may not always be helpful in understanding individual-level developments, and conclusions reached about the individual level may be unwarranted. To illustrate, in the consumer credit area an increase in credit or even in the aggregate repayment/income ratio does not necessarily mean that former debt users are using more debt or are now more burdened as observers often allege. It could mean, instead, that some former nonusers of debt may have borrowed a little. In fact, the aggregate repayments/income ratio can rise over time while current debt users actually become less burdened. And, if the shift is toward more borrowing by wealthier members of the public, which appears to be the case in recent years, then overall financial pressure on the consumer sector could actually decrease while aggregate debt increases.

The macro-micro fallacy has contributed to both the Tremendous Growth and Uncontrollable Plastic myths. Preachers of these myths often overlook demographic changes; but, obviously, demographic influences might be important in explaining credit

trends. For example, the rapid increase in the 1970's in the number of family heads in the family-forming and debt-using 25-35 year old age bracket undoubtedly had an impact on aggregate credit use. More people using a little credit raises the amount of credit and the repayment/income ratio, but, by itself, this fact does not imply more people are overburdened.

A sixth analytical error in evaluating consumer credit is consumption myopia. Apostles of the Better Off Without myth allege that if credit were unavailable consumers would be Better Off because they would consume less and save more. But this overlooks the real reason for most consumer borrowing - investment in consumer capital goods, not consumption.

Consumer capital includes investments in homes, durable goods like automobiles and appliances, and durable services like education and medical care. Each of these forms of capital provides a flow of returns over time in the form of valuable consumer services. None of these capital resources are consumed immediately - here today and gone tomorrow. In this sense consumer capital is exactly analogous to corporate capital like factories, machines, and vehicles which provide investment returns over time to business.

By investing in capital goods both consumers and businesses can raise the total returns and the level of real wealth available to them over time. Economic theory, as well as common sense, suggests that as long as the investment return is greater than the rate of interest on borrowing and if cash flow is sufficient to make the payments, then consumers (like businesses) come out ahead by buying capital goods and services on credit. This is what many of them do. Although accurately measuring the rate of return on consumer investments is difficult, available economic studies indicate the rate of return is very high, making consumer borrowing rational. Thus, if a consumer is prevented from borrowing, the opportunity losses from investments foregone may be substantial. From this point of view, the Better Off Without myth falls down of its own weight.

The Consumer Sector's Financial Condition

Cutting through these myths and the analytical errors that produced them, what really is the consumer sector's financial picture? A careful look at the data shows that consumer credit has indeed increased over the past two decades, but so have the means of repayment. As a result, the consumer sector's debt burden has changed relatively little over the past generation despite the increase in consumer credit.

One potential means of repayment is liquid assets including currency, deposits, and money market mutual fund shares. Liquid assets grew at about the same pace as consumer credit in the 1960's and 1970's, although liquid asset growth was somewhat steadier in nominal dollar terms. At year end 1981 consumers' owed \$328 billion in installment credit (including credit with

oil companies) compared to \$1.8 trillion in liquid assets. The ratio between these two magnitudes stood at 17.8 percent at year end 1981 compared to 18.6 percent at year end 1960, the last year of the Eisenhower Administration. During the intervening 2+ decades this ratio fluctuated cyclically but only slightly, ranging up and down only between 17 and 21 percent (Figure 1). Rather than indicating increased illiquidity in the consumer sector lately, this ratio suggest that households have maintained their installment debt level rather consistently at about 20 percent of liquid assets. Stated alternatively, the consumer sector has maintained liquid assets at about five times its installment indebtedness for an entire generation. And, in mid-1982, this ratio stood at its lowest level in more than two decades.

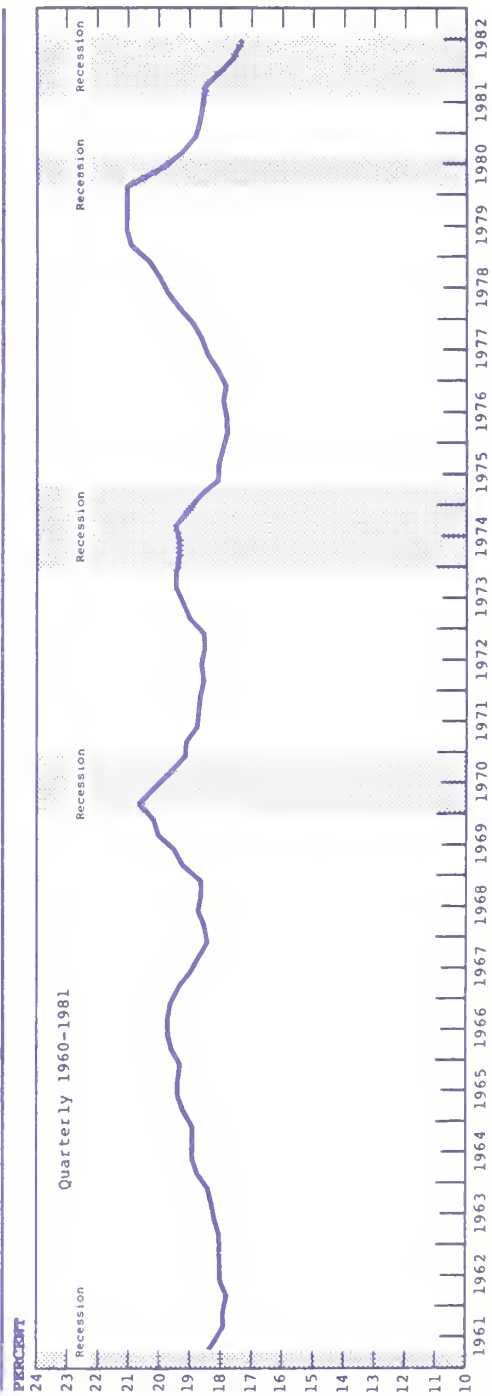
The second way that consumers can liquidate debt is by repaying out of income. Because of the apples and oranges problem two ratios should be calculated after 1970 to highlight the effects of the definitional change to include repayments on oil company credit cards beginning in 1971. In either case the repayments/income ratio shows that installment credit repayments consumed a slightly higher proportion of income in the late 1970's than earlier, but the differences were small (Figure 2). Furthermore, the ratio peaked in mid 1978 and has been declining continuously ever since. Rather than indicating an ever-increasing debt burden, this measure also shows consumers' installment credit debt burden in the early 1980's as about the same as a generation earlier.

A third way to view consumers financial condition is to examine specific measures of financial stress - credit delinquency and bankruptcies. Graphs of the percentage of consumer credit accounts delinquent at banks, finance companies, and credit unions are generally flat and trendless over a long period (Figure 3). They do show some cyclicity, rising during recessions and falling afterward during subsequent recoveries. Before 1979 personal bankruptcies per 1000 households exhibited the same cyclical but trendless pattern until bankruptcies shot up like an arrow beginning late that year (Figure 4). This sharp divergence in pattern arose because of two extraneous developments - the advent of lawyer advertising and changes in the Federal Bankruptcy Code that October that substantially lowered the real cost of declaring personal bankruptcy. The point is that with the special exception of bankruptcies 1979-1981, recent measures of consumers' financial stress are also approximately the same as recorded many years ago.

In sum, consumer credit mythology like the sun circling the earth, is simply not supported by the facts. Nevertheless, mythology lives, and its passionate disciples find easy converts in Washington. Let us hope that like geocentrism, consumer credit myths will disappear without causing too much pain. At the minimum we should expect our nation's leaders to spend their time on problems that really exist.

FIGURE 1

Ratio of Consumer Installment Credit Outstanding to Consumer Sector's Liquid Assets



National Consumer Finance Association Chart. Source: Federal Reserve Board

FIGURE 2

Ratio of Repayments of Consumer Installment Credit
to Disposable Personal Income

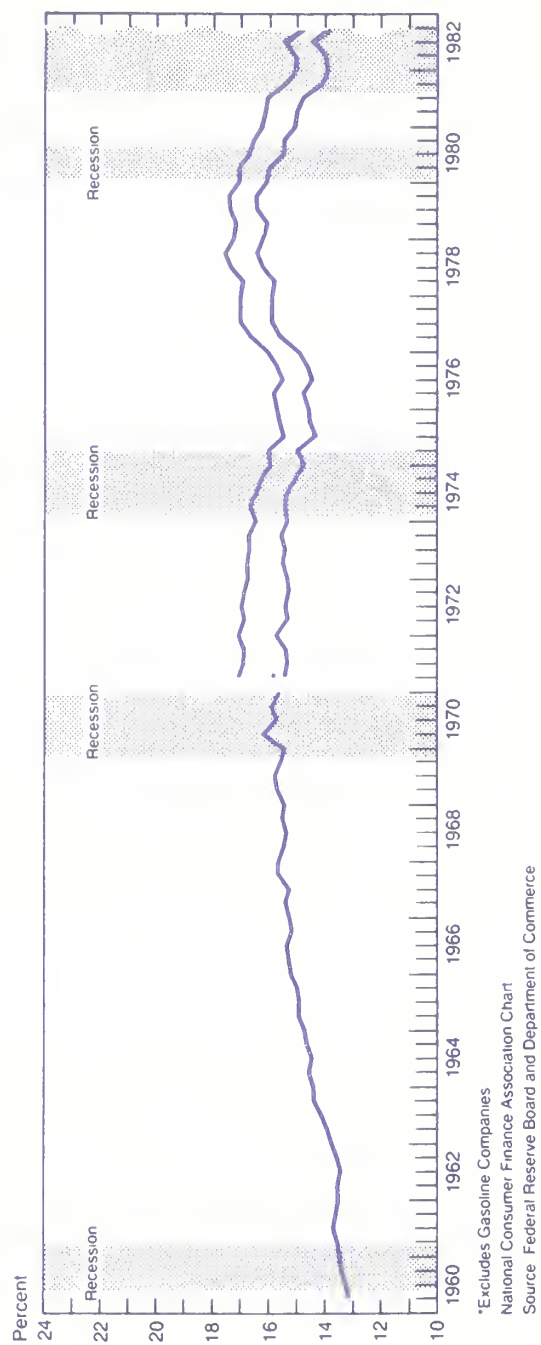


FIGURE 3

Number of Loans Delinquent as a Percent of Total Number of Loans Outstanding, Year-end

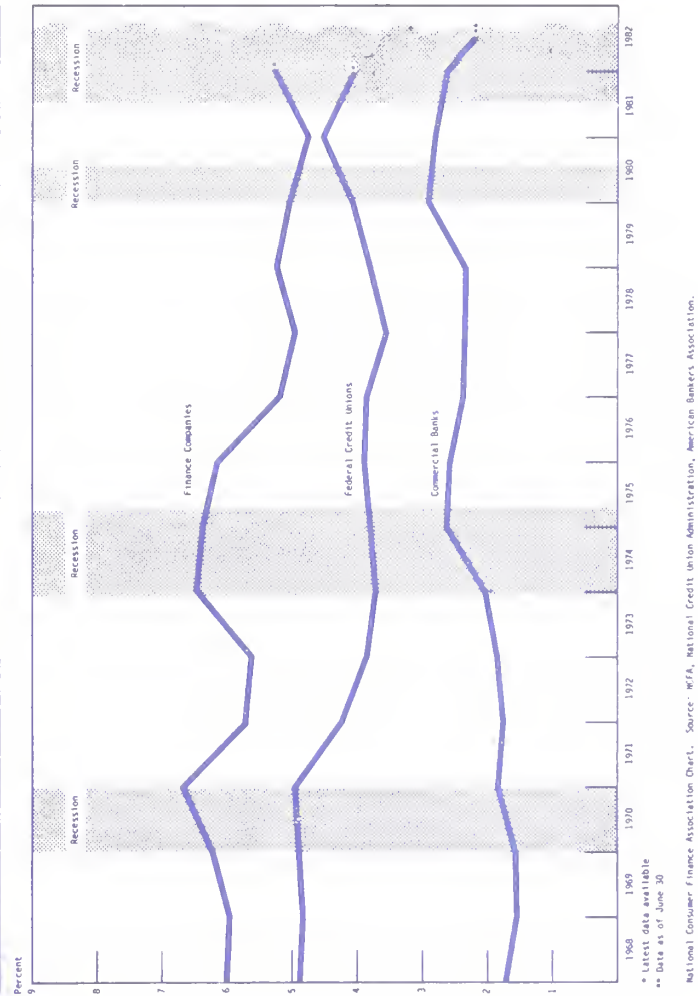


FIGURE 4

Number of Bankruptcy Filings Per One Thousand Households,
Total U.S., 1967-1982

