Business insights

Instalment credit—benefits and burdens

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Consumption spending, led by autos and other durables, rose 11 percent in 1977. As in 1976, spending rose somewhat faster than disposable (after tax) personal income. As a result, the rate of savings—disposable income not spent on consumption—declined to 5.1 percent, the lowest ratio in 14 years. Many households would have been unable to manage purchases of cars, expensive vacations, medical bills, and college fees had it not been for the availability of instalment loans.

The rapid rise in consumption spending during the past two years has been accompanied by a much faster rise in consumer instalment debt. A question is posed as to the ability and willingness of consumers to continue to incur instalment indebtedness at the recent pace. Failure to do so could endanger the general expansion, now three years old, already a fairly respectable age for an uptrend.

This article examines the record of relationships between instalment credit extensions, liquidations, and outstandings with disposable personal income (DPI). Adjusted for changes in the way in which instalment credit is extended and liquidated, these ratios appear to have reached levels that signaled slower rates of advance in the past. The meaning of debt to income ratios, however, is not clear cut. The credit picture has become more complicated in recent years. Bank credit cards have emerged as a major factor in personal finance. Auto loan maturities have lengthened, with four-year loans now common. Mortgage credit is being used increasingly as a substitute for instalment credit, or supplement to it. The variety of goods and services financed by instalment credit has broadened markedly. Other developments defy statistical analysis, for example, the drive for "equal credit opportunity," new life styles and attitudes, and, perhaps most important, spiraling inflation.

Extensions and outstandings

Instalment credit extensions, including precomputed finance charges, totaled $226 billion in 1977, up 17 percent from 1976, and twice the extensions in 1970. At year-end, outstandings were $217 billion, also up 17 percent from the beginning of the year and twice the amount at the end of 1970. Instalment credit outstanding is about a third as large as outstanding one-to-four family mortgages, a relationship that has been fairly stable for years.

In the fourth quarter of 1977, extensions of consumer credit amounted to 17.4 percent of DPI. In only two earlier periods has this ratio been higher—in the first half of 1969 and the first half of 1973. Significantly, both these earlier periods were followed by a slowing in consumer purchases and, eventually, a business recession.

Instalment credit outstanding in the fourth quarter was 15.8 percent of DPI. That was equal to the all-time high reached in the fourth quarter of 1973, a period that marked the high point of the last expansion as measured by real GNP. The ratio of outstandings to DPI has been rising irregularly since World War II. It was 4 percent in 1947, 11 percent in 1957, and 15 percent in 1967. Since 1967, however, this secular uptrend appears to have been slowing.

Liquidations appear to lag

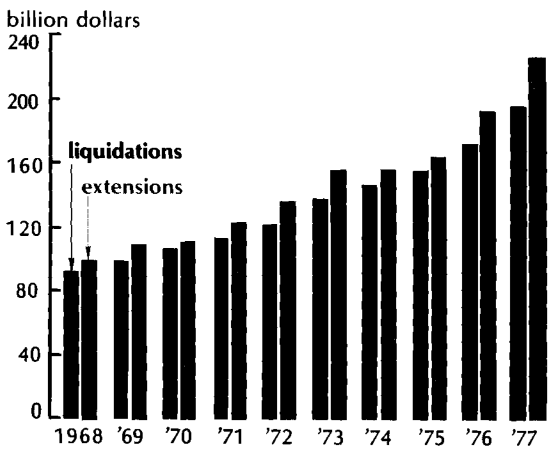
The burden of instalment credit payments on consumer budgets is often measured by the ratio of liquidations to DPI, rather than by extensions or outstandings. Of course, averages of this sort need not apply to any particular household. At any time some households are deeply mired in instalment debt, while a much larger number are completely free of such debt. The "burden" of instalment credit usually shows up in substantially increased delinquencies only when a general recession brings layoffs and reduced compensation for affected households.

Instalment credit liquidations include regular payments of interest and principal, prepayments (often from the proceeds of new loans), and chargeoffs. Prepayments involve not only advance payments of principal but also lender "rebates" of precomputed finance charges.

Liquidations in 1977 totaled $195 billion, up 13 percent from the year before and 60 percent in five years. Liquidations usually lag extensions by about a year. In 12 of the last 15 years, liquidations have been within 2 percent of extensions in the *preceding* year. In the other three years the relationship broke down when new extensions changed rapidly.

In 1968 and again in 1976, a surge in new instalment sales led to an increase in prepayments, and liquidations rose 5 percent above extensions in the preceding year. With the slowdown in instalment sales in 1974, particularly auto sales, lower prepayments held

Instalment credit extensions outpace liquidations



liquidations 6 percent below 1973 extensions.

The liquidations ratio rose almost every year from the end of World War II through the 1960s, reaching a record 15.9 percent in 1969. Beginning with the 1970 recession, the ratio declined, but in 1973 it rose to 15.4 percent. It then declined again, reaching a low of 14.1 percent in the second quarter of 1975, which was near the low point of the last recession.

Despite rapidly rising extensions for the past two years, the liquidations ratio increased to only 15.1 percent in the fourth quarter of 1977. The sluggishness in liquidations relative to extensions is magnified in *net* extensions. In 1977 net extensions totaled $31 billion, half again more than the previous high in 1976. Relative to DPI, net extensions in 1977 were 2.3 percent, the highest for any year on record.

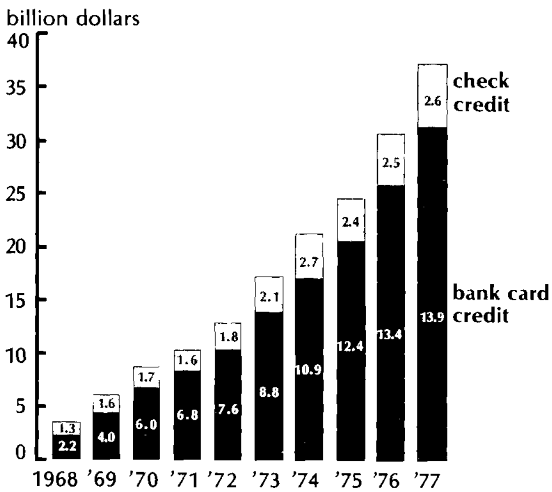
Three principal factors have limited the rise in liquidations of instalment credit in recent years: (1) increased use of revolving credit, (2) longer maturities on auto loans, and (3) use of mortgage credit to finance consumer outlays.

Revolving credit increases

Instalment credit often takes the form of "revolving credit," a specified line that may be used repeatedly with periodic partial or total repayments, including interest charges. Some retail stores have offered revolving credits for years. In the 1970s the fastest growing types of consumer revolving credit have been loans from commercial banks.

Banks offer revolving credit to individuals through bank credit cards and check credit plans, the latter often in the form of overdraft privileges on regular checking accounts. These credits are used for a variety of purposes, including cash advances. In 1977 credit extensions on bank cards (virtually all by VISA and Master Charge) were $31 billion, 21 percent more than in 1976 and three times as much as in 1972. Bank card extensions approached 14 percent of total instalment credit extensions, compared with 9 percent in 1973 and 4 percent in 1969. Check credit exten-

Bank revolving credit extensions have grown rapidly



NOTE: Figures in bars refer to percent of total instalment credit extensions.

sions reached $6 billion in 1977, compared with less than $2 billion in 1969.

Beyond a regular minimum (usually monthly), the amount of revolving credit repayments is largely determined by the borrower. Therefore, in contrast to conventional instalment loans, revolving credit extensions include no precomputed finance charges, and liquidations include no prepayments or rebates of unearned interest. To the extent that revolving credit replaces conventional instalment loans, extensions and liquidations are understated in comparison with earlier periods.

Simple interest loans now offered by some banks, finance companies, and credit unions also involve no precomputed finance charges. Such loans, made practical by computers, allow borrowers to prepay part of the outstanding principal without interest penalties. The simple interest format is offered for personal loans and loans to finance autos and home improvements.

Auto loan maturities lengthen

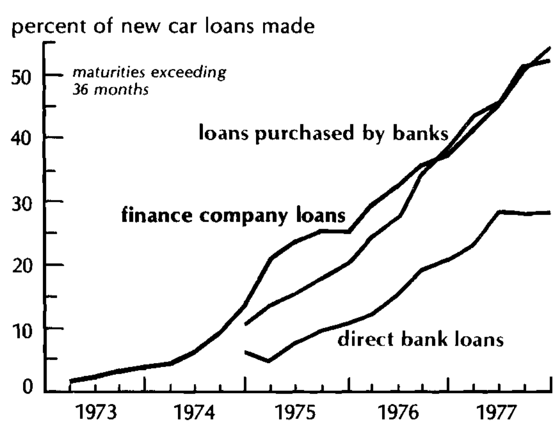
Until 1955, few loans on new autos were written with maturities longer than 24 months. Then, the maximum was extended to 36 months, a limit that generally prevailed until the early 1970s. As recently as 1972, less than 1 percent of the new car loans at finance companies had maturities of more than 36 months.

In the fall of 1973, a decline in auto sales was associated with a new stretchout in loan maturities. In the fourth quarter of that year, 4 percent of the finance company loans (primarily from the Big Three "captives") were written with longer maturities, usually 42 or 48 months. The proportion has since increased to 14 percent in 1974, 25 percent in 1975, and 52 percent in the fourth quarter of 1977.

Other lenders also increased maturities. By late 1977, 54 percent of the new auto loans purchased by commercial banks carried maturities exceeding 36 months. Three years earlier only 11 percent had been for more than 36 months. For loans originated by banks, the proportion increased from 6 percent in 1974 to 28 percent in late 1977.

Longer maturities make auto sales easier by reducing monthly payments. In the case of a $5,000 loan, which is about average, the monthly payment at 11 percent interest and 36 instalments is $164. Increasing the maturity to 48 months, even with an interest rate of 13 percent, reduces monthly payments to $134. Although the credit extension rises from $5904 to $6432, reflecting both the higher in-

Share of new car loans over 36 months increases



terest rate and the additional interest to be paid for another year of the contract, monthly payments are reduced 18 percent.

In the aggregate, auto credit liquidations are lagging extensions much more than usual after three years of recovery. Extensions in 1977 were $72 billion, up 15 percent from a year earlier and 59 percent since 1974. Liquidations, on the other hand, were $59 billion, up 12 percent from a year earlier and 31 percent from 1974.

Mortgages and instalment debt

The median price of existing homes sold in December 1977 was $44,200, an increase of 13 percent over a year earlier and 63 percent in five years. These figures, reported by the National Association of Realtors, show inflation in home prices has given most homeowners substantial appreciation in their equities—appreciation that can be used as collateral for new borrowings.

Many homeowners have chosen to cash in these capital gains by (1) refinancing their homes with larger mortgages, (2) taking out second mortgages, and (3) trading up, using the increased equity as downpayments on more expensive properties. Funds raised out of capital gains are sometimes used to pay off consumer debts. Even when added mortgage debt does not substitute directly for instalment credit, it may do so indirectly by providing funds for outlays that might otherwise have been financed with instalment credit.

Because national income accounting procedures do not recognize capital gains (realized or unrealized), as income, homeowners that cash in capital gains add to spending power without adding to disposable income. That at least part of this spending power was used to buy consumer goods is consistent with the reduced rate of personal savings in the past two years. As mortgage credit is used more to finance consumption spending, instalment credit outstanding rises less rapidly than would otherwise be the case.

Combining instalment credit and home mortgage credit provides a more comprehensive measure of household debt than a look at instalment credit alone. These types of household debt totaled $870 million at year-end 1977, 17 percent above a year earlier and up 74 percent in five years. This total rose from 21 percent of DPI in 1947 to 46 percent in 1957 and 60 percent in 1967. In 1977 this total surpassed 66 percent of DPI, well above the previous record of 62.6 percent in 1973 and 1976.

A slower rise ahead?

In the first quarter of 1978, consumer spending was dampened by severe weather, and the impact, actual and potential, of the prolonged coal strike. Most observers believe that spending will rebound with the coming of spring. Nevertheless, it is probable that consumption spending will rise less this year than last, particularly for passenger cars. This suggests significantly slower growth in instalment credit. Housing starts are expected to decline, mainly because higher interest rates have been diverting funds from the thrift institutions.

Instalment and mortgage debt have reached relatively high levels, compared to disposable personal income. But income continues to rise at a rapid pace. Moderation in the growth of consumption spending will provide individual households, which may have become overextended, with an opportunity to adjust their financial positions. If a general business recession can be avoided in 1978, and few forecasters predict such a development, no serious retrenchment in the household sector is anticipated.