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CONSUMER CREDIT: A ROSE OR A THORN?

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In his essay on Compensation, Emerson observed that "Every sweet hath its sour; every evil its good. . . . For every benefit which you receive, a tax is levied. . . . Every thing has two sides, a good and an evil."

The age-old problem of how to have roses without thorns is well illustrated by consumer credit. Consumer credit may properly be referred to as a rose because of the role that it has played in advancing the scale of living of citizens generally. Doubtless technical advance would have permitted Americans to achieve eventually the wide ownership of homes, autos, bathtubs and television that they have now achieved. But consumer credit enabled them to get these things sooner than otherwise. The saving process is so slow for a young family with children that they prefer to go into debt to own a home of their choice and to equip it rather than to wait indefinitely. Even those who are critical of the gadgets that surround us must admit that an astounding proportion of Americans now have the physical basis for a pleasanter life. And those who were skeptical of the consumers' ability to handle debt must recognize that the record of financial responsibility has been remarkably good.

Like most roses, consumer credit also has its thorns. The recession from which we are emerging, in part a consumer-durable-goods recession, reminds us of the influence of consumer credit in the consumer boom of 1955. In that year the outstanding volume of instalment credit increased \$5-1/2 billion or almost 25 per cent. This increase was accompanied by a significant easing in the terms on which consumer credit was extended, particularly

credit to purchase new automobiles. By mid-1955, 30-month instalment contracts on new automobiles were typical as against 24 months the year before, and contracts with 36-month maturities were becoming common. At that time, the down-payments standard of one-third of the transaction price was still being adhered to, but over-allowances on trade-ins were lowering the effective down payment and the buyer's equity. With this impetus, 7.4 million new cars were sold in the domestic market, an increase of more than one-third over 1954. The same liberalization of terms was evident in the use of credit to expand residential construction at an accelerated rate. You will remember that in 1955 new housing starts reached 1 million 329 thousand.

In the second half of that year the thorns began to appear in the shape of increases in the prices of industrial products amounting to almost 4 per cent. The chain of events that followed has caused many thoughtful persons to question whether the obvious gains from the use of consumer credit are bought at too high a social cost if it accelerates an already booming market for consumer durables. You will recall that the consumer boom of 1955 was followed by an expansion of inventories in every consumer-durables industry during 1956 even though the sale of automobiles declined sharply. This industry, a mighty force in the economy, appeared to have over-extended itself and to have slowed down for a while. Automobile executives and workers must have regretted that the 1955 market was over-sold by at least a million cars.

This consumer boom was no small factor in inducing subsequent management decisions that were not altogether prudent. In 1956 businessmen expanded their outlays for plant and equipment at a rate 22 per cent faster

than in the year before. Thus a plant-expansion boom, triggered in part by the consumer boom of 1955, drove the cost of building materials and labor higher and higher. This upward movement led some manufacturers to believe that if they were going to need expanded capacity, they had better get it promptly before costs rose still higher. As a result, many of them discounted the growth in demand for their product for years ahead. When the awakening came during the last half of 1957, many industries became aware of excess capacity.

Most tragic of all was the unemployment that resulted. Having obtained the consumer durables that they needed most, having automobiles that were still good for thousands of miles, and becoming disenchanted with the increased prices, consumers went on a buyers' holiday. There developed an over-supply of stoves, refrigerators, washing machines, radios and television sets. Production schedules were cut back and men were laid off. The construction boom also languished and here again men were laid off. And so, in 1957 and 1958, society paid in unemployment, lost salaries and lost profits the price of another bust that followed in the wake of a boom which we must, in all honesty, recognize was helped on its way by the excessively rapid growth of consumer credit.

This poses the question as to whether it is socially desirable to have selective control over consumer credit, in addition to general fiscal and monetary control. The decision must represent a value judgment based upon a balancing of gains against disadvantages. To diminish the unstabilizing effects of consumer credit has strong appeal to those who feel that, despite its benefits, excessive fluctuations in its use should be prevented

in order to minimize economic instability. But if selective control is to be employed, the disadvantages of such control need to be faced up to and removed if possible. In the use of margin requirements to prevent excessive flow of credit into the stock market, supervision and enforcement are not too difficult. In three previous efforts to regulate consumer credit, however, the administrative difficulties were so great that the Federal Reserve System, which had the task of enforcement and the 200,000 retailers and financial institutions to whom the regulation applied breathed a sigh of relief when the ordeal was over.

To gain a proper perspective of the role of selective controls, one must compare them with general fiscal and monetary policy. Fiscal policy acts through governmental surpluses or deficits, which reflect both governmental spending and taxing. The direct responsibility rests upon the Congress and the Treasury. General monetary control, entrusted by the Congress to the Federal Reserve System, has the particular role of regulating the reserves available to the commercial banks so that bank credit may contract and expand flexibly in accordance with the fluctuating needs of the economy. The Federal Reserve has the task of controlling the supply of money and credit in total, leaving its allocation to the competitive forces of the free market. Credit is allocated in the marketplace to those credit-worthy borrowers who are willing to pay the going price. The apportionment among individual borrowers is left to competition between private borrowers and private lenders, even though the responsibility for influencing the total supply of credit rests with the central bank.

In contrast to this relatively impersonal allocation of the money supply are so-called selective or direct controls. Broadly speaking, they embrace rationing, and price and wage controls, as well as regulation of specific uses of credit. If any of these is used, government intervenes in the operation of the free market. Of course it also intervenes when it uses subsidies, price supports, and guarantees to shelter particular groups of citizens. It is clear that even if these supplementary controls are helpful in meeting emergencies, they are no substitute for general fiscal and monetary controls. Without the general controls, inflationary pressures will break loose eventually.

Through the use of general credit measures, supplemented by stock-market margin regulations, economic fluctuations have been greatly moderated in the period since 1950, despite a sharp increase in both public and private debt. Since 1950 we have added \$20 billion to consumer instalment credit outstanding, \$90 billion to mortgage debt, and \$85 billion to corporate debt--in considerable part to finance additions to plant and equipment. We have also added to the Federal debt, largely as a result of the need to reorganize and reequip the defense establishment in view of the rapid technical advances which have taken place in a world of continuing international tensions. At the same time State and local governments have borrowed \$30 billion to finance schools and highways and for other purposes.

When one contemplates these magnitudes and the rates of increase they imply, both in credit and in our stock of real wealth--homes, automobiles, factories, and public facilities--it seems almost a miracle that we have been able to accomplish so much growth and still maintain as much stability as we have had in prices and employment. I am convinced that we could not have

done even this well if we had not clung tenaciously to a sound, flexible monetary policy.

Reliance on general credit measures alone, of course, has limitations. Despite the manifest necessity for a sound general credit policy, and despite the manifest advantages of permitting the market to carry out the function of credit allocation, conditions may at times develop in specific areas that to some people would justify selective credit controls. Developments in a particular area may be unsound in themselves; or the area may be absorbing too much of the total credit expansion that is appropriate to the situation. Under such circumstances, public opinion may come to insist upon selective controls to supplement general ones.

The Federal Reserve System made a study of the consumer-credit field almost two years ago and concluded that selective controls of consumer credit were not called for at that time. It is possible, however, that developments in the future might call for a reconsideration of that view. They might create a widespread public demand for consumer-credit controls as an alternative to enhanced cyclical fluctuations or to an increased degree of general credit restraint. Such feeling might be generated, for example, if terms were once more eased radically at a time when credit demand and consumer spending were on the increase. In that case, society might decide that the benefits to be gained by consumer-credit regulation would outweigh the difficulties. If so, we should benefit from the experience during prior periods of regulation so as to minimize administrative difficulties.

And so I return to the question posed at the beginning of my remarks. This question has been put into verse by the economist, Kenneth Boulding:

The Fruits of the Financial System  
Are quite impressive, once you list 'em,  
Although the system has the power  
To turn its fruits extremely sour. 1/

1/ "Principles of Economic Policy" by Kenneth E. Boulding, p. 210.