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Where Are Consumers Getting Their Money?

Remarks by

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<u>Where Are Consumers Getting Their Money?</u>

Thank you. It is my pleasure to be here today to discuss some financial developments in the household sector. I'm particularly grateful that the audience is one of economists. This talk is going to be that of a real two handed economist. Some of what I want to report can be viewed as a very positive social development. But some of the same information can also be pointing to trouble ahead.

One thing I don't want to do is sound yet another alarm that Americans aren't saving enough. Now it's true I don't think they are, you probably don't think they are, and probably every economist in the country doesn't think they are. Indeed, it's probably also true that most Americans think that other Americans don't save enough. It's possible that we have a case of the old saying "Everyone in the world is crazy except thee and me and sometimes I suspect thee." I think it much more likely that we Americans are responding to the incentives that are before us in a quite rational way. Our focus should be on those incentives.

Let me begin by just observing some facts. As measured in the National Income and Product Accounts, the personal savings rate has been running at its lowest rate in more than 40 years. It has fallen from roughly 7 3/4 percent in the first half of the 1980s, to roughly 4 percent today. Unfortunately, I think that level of saving probably exaggerates the actual saving position of most American households who, in fact, have less discretion over and less access to their accumulated wealth than those figures would imply.

Of course, there probably is no perfect definition of saving. But a good step forward was made in 1978 when Phillip Howrey and Saul Hymans developed a concept in the Brookings Papers which they termed "Loanable Funds Saving". Their concept defined saving as the increase in resources available for capital formation. Conceptually, I prefer to think of their concept as being personal cash saving -- the difference between total cash receipts and total cash expenditures made directly by households on anything except purchasing a financial asset. Note that the internal buildup in pension funds or life insurance plans is not part of personal cash saving.

To redefine the national accounts to get at this new measure of saving, we should first divide personal saving into net investment in owner occupied housing and net financial investment. Of $192.5 billion of NIPA personal saving in 1993, $123.2 billion was taken up by net housing investment, leaving just $69.4 billion for net financial investment including saving by the pension and life insurance sectors.

It is difficult to measure the saving of the pension sector. One possible measure comes from the Federal Reserve's Flow of Funds Accounts. The problem with this measure is that although it is based on the same underlying source data as the NIPA measures, it does not provide a truly independent estimate of pension saving. So, I would consider the figures and analysis below illustrative rather than definitive.

The Flow of Funds estimates that the buildup in the reserves of private pension and insurance plans is $230.1 billion. That implies that personal cash saving actually fell by $160.7 billion in 1993. Measured this way, the cash saving rate was actually a negative 3.4 percent of disposable personal income. How can this be?

To help understand, let me bring this analysis down to a family level -- my own. The amount of money the Lindseys have in our checking and money market account is essentially the same today as it was a year ago. Thus, our cash saving rate was essentially zero. But, the value of my pension fund rights, and 401(k) increased by about 14 percent of my income last year. This 14 percent would be part of the NIPA based personal saving rate.

Essentially, the Lindseys are spending everything they take home, though 14 percent of spending is going into building pension related wealth that can't easily be touched. Using the same analysis, the American household sector in the aggregate is spending <u>more</u> than it takes home -- $1.034 for every dollar it earns, and spends about 7.5 cents of this $1.034 on building non-liquid wealth. From a Howrey-Hymans standpoint, their saving is falling as they divert their saving, and even borrow, to build non-loanable funds types of wealth.

A time series of this definition of saving suggests a secular change has occurred which may have begun in the late

1970s but was clearly in force in the mid-1980s. Prior to then, periods of net positive cash saving, in and around recessions, offset periods of modest cash dissaving at other times. This should not surprise us. Cash saving acted as a liquidity constraint and liquidity constraints have always played an important part of the consumption function literature. Since 1985 however, cash saving has been unremittingly negative. While the precise amount of dissaving may be subject to some technical measurement issues, the trend is not encouraging.

What seems to be happening is that Americans are choosing to hold their wealth in less liquid forms. The reasons for this are not hard to discern. The tax advantages of building wealth in some sort of pension arrangement instead of in a taxable discretionary account are quite large. Similarly, investments in owner-occupied housing produce an untaxed stream of benefits. The price that is paid is less easy access to savings. Pension money may be accessed usually only with a substantial tax penalty. Further, selling ones house is a very painful way of generating liquidity.

Financial Innovation and Household Liquidity

But two key financial innovations have eased the liquidity constraints that households face. These innovations have probably facilitated the move into housing and pension saving. The first is the increased ease with which housing may be turned into collateral for a mortgage. The second is the incredible increase in the use of credit card and other installment debt.

Let me begin by looking at housing. Recall that if the funds from mortgage financing are invested either in a home or consumed, then household cash saving goes down. In 1984, mortgage debt outstanding against homes was $1220 billion out of a total value of $4349 billion, or 28 percent. By 1992 mortgage debt had grown to $2788 billion out of a total value of $6709 billion or 41 percent. The data are more surprising when looked at as a change. Two thirds of the $2.36 billion increase in home values over that eight year period was consumed by increased debt on those homes.

The 1993 data show just how great reliance on home mortgage debt can be. Gross investment in owner occupied housing was $230.3 billion. Increased mortgage debt represented $178.2 billion or 77.4 percent of this. However, mortgages are taken out by existing homeowners as well as new homebuyers. This requires us to evaluate the borrowing of the whole household sector by netting out depreciation on existing homes of $107.1 billion. So, while consumers added, on net, $178 billion to their mortgage debt, they collectively made a net investment in their homes of only $123 billion. The $55 billion difference was used elsewhere.

The other great source of increased liquidity in recent years was the development of the credit card. It is easy to forget how recent the development of revolving credit really is. It was not until 1968 that the Fed actually started collecting data on outstanding consumer revolving credit. That year ended with consumers owing $2 billion on revolving credit which is primarily credit card debt. Even in 1976 credit card debt was only $16.6 billion, or about 1.5 percent of consumer spending. By 1979, that had exploded to $53 billion, causing President Carter to urge us to tear up our credit cards.

We didn't listen. Credit card debt outstanding doubled by 1984 and doubled again by 1989. These average annual growth rates of about 14 percent slowed to a mere 8.9 percent during the so-called consumer retrenchment of the early 1990s. But growth rose again to an 11.8 percent annual rate during 1993 and a seasonally adjusted annual rate of 16.8 percent during the first 10 months of this year. Yesterday the Fed released the November consumer installment credit report showing credit card debt that month had increased at an annual rate of 24.6 percent.

Some have argued that any concerns we might have about these numbers are mitigated because some of this explosive growth actually represents the increase in the convenience use of credit cards. Many individuals use credit cards more frequently today because it is easier than using cash or checks, or because of incentives such as cash-back rebates or frequent flier miles. Even if the customer ultimately pays the credit card bill in full at the end of the month, at any point during that month some purchases are outstanding. On average, half a month's purchases are being carried on credit at any point in the month.

While I think the convenience-use argument is true, I do not believe that it offsets much of what is a truly explosive increase in consumer debt. A simple numerical experiment indicates the limits of the convenience use argument. Let's imagine that the relevant market is all consumer goods purchases except automobiles. (A well developed auto-financing mechanism already exists.) That leaves a potential market of about $1.8 trillion in purchases. Assume furthermore that market penetration for the convenience use of credit cards is going to go from zero to 100 percent over 20 years -- a gain in market share of five percentage points per year. That will mean that $90 billion more will be charged by convenience users every year. But, since these users only carry an average 15 days of purchases on their revolving balances at any one time, less than $4 billion of the $47 billion increase in consumer installment debt last year can be attributable to increased convenience use each year under these assumptions.

A more startling story about growth in consumer credit is seen by making a somewhat different comparison. Between the third quarter of 1993 and the third quarter of 1994, personal consumption expenditures rose $256 billion. On an October over October basis, credit card debt rose $47 billion, outstanding auto loans rose $40 billion and other types of installment credit rose $25 billion. That means that $112 billion of the increased spending of $256 billion -- or 44 percent -- was paid for by increased installment debt.

That 44 percent figure is the highest figure I could find historically, but it is not completely unprecedented. During what was then considered a time of wild expansion of consumer credit during 1984, installment debt amounted to 41 percent of increased personal consumption expenditures. However, that earlier credit expansion was much more concentrated in automobiles and less in credit cards than is the current expansion. Thus, unsecured consumer credit growth seems to be entering an unprecedented period.

Macroeconomic Implications

I do think that it is safe to conclude that such a level of personal installment credit expansion is unsustainable. If for example, the ratio of installment debt to disposable personal income is to be held constant at some point, installment debt growth must be cut by $60 billion at an annual rate. To do that would require an increase in the official personal saving rate of about 1.2 percentage points. It seems difficult to see how this could be accomplished without a sharp slowdown in consumption and overall economic activity. Yet, with installment credit now at 17.5 percent of disposable personal income, it seems hard to imagine that such a slowdown will not happen at some point in the not too distant future. Failure to trim the rate of growth of installment debt will mean that the installment credit to income ratio would increase by 1 percentage point per year. How the economy will perform in the next few years depends very much on when and how consumers will respond to this increased debt to income ratio.

The Democratization of Credit

While all of this information may sound bleak, there is an important bright spot in the trends described here. One of the key points that has been overlooked by many commentators is the increased democratization of credit in America. One of the positive side effects of the advent of the credit card has been to remove liquidity constraints from millions of American families. While economists may bemoan the resulting decrease in the national saving rate, the net effect on these families is a substantially greater capacity to meet emergencies and an improved financial quality of life.

In the Survey of Consumer Finances, conducted by the Federal Reserve, the proportion of families earning under $10,000 reporting having credit card debt outstanding rose from 11.1 percent in 1983 to 13.4 percent in 1989 and 23.7 percent in 1992. The same proportions for families earning between $10,000 and $25,000 rose from 26.8 percent in 1983 to 29.1 percent in 1992 and 43.2 percent in 1993. The same numbers for families earning between $25,000 and $50,000 were 50.1 percent in 1983, 53.1 percent in 1989 and 54.8 percent in 1992. By contrast, the share of upper income families using credit card debt declined over the period.

The same trend held true using a racial or ethnic comparison. The proportion of white families holding outstanding credit card debt was 42.5 in 1989 and 43.8 percent in 1992. The growth in credit card use for credit among non-whites was much greater: from 34.1 percent in 1989 to 41.9 percent in 1992. Again, I believe that we should view increased access to credit as a socially desirable development.

Recent developments in housing finance also show a very large expansion of credit opportunities and therefore homeownership opportunities for traditionally underserved groups. For example, the most recent information from the Home Mortgage Disclosure reports, called HMDA reports, shows that home loans granted to lower income groups rose 38 percent, compared to 8 percent for high income groups. Among racial and ethnic groups a similar pattern of growth existed, with mortgages granted to blacks rising 36 percent, compared with a 25 percent increase for Hispanics and an 18 percent increase for whites. Between 1990 and 1993 the number of Hispanic homeowners has risen 8.6 percent, the number of black homeowners by 6.3 percent and the number of white homeowners by 3.4 percent.

Thus, a portion of the increased levels of both installment and housing debt is attributable to what I would consider a very positive social development. American financial institutions are extending credit to both income and racial/ethnic groups that traditionally have been underserved. I believe an important area for further research is to disaggregate this sociological development from the broader economic development. The extent to which the increased democratization of credit has caused the overall increase in consumer debt levels should mitigate our macroeconomic concerns.

Credit Market Concerns

I do not believe it is possible, however, to attribute anything approaching a majority of the current very expansive use of consumer credit to positive sociological factors. Whenever a financial development is approaching what seems to be unsustainable levels it is important to consider why market forces are permitting what appears to be an excess to exist. Specifically, why are banks and other financial institutions expanding consumer credit so aggressively?

First, the evidence on delinquency rates of credit card, auto loan, and other consumer debt is currently very positive. The rate of delinquency on credit cards fell to a cyclical low of 2.49 percent in the third quarter of 1994. The same was true for commercial bank auto loans and for home mortgages at all lenders. These low rates of delinquency apply to both the number and dollar amount of loans.

But, part of the improvement in delinquency rates this year has reflected rapid growth in the number and amount of debt outstanding. These are, in effect, the denominators in the delinquency rate ratios that are being provided. Insofar as loans typically do not go delinquent in their first few months, rapid debt growth generally contributes to declines in the ratios of delinquency. In addition, cyclical factors are currently very favorable with rapidly rising employment levels.

While it is clear that market pressures will cause rapid expansion of credit under these circumstances, current average delinquency rates should certainly not be considered appropriate for assessing newly offered credit extensions. The new extensions of credit are riskier than the existing stock of credit in two ways. First, expansion of credit lines to existing customers raises their borrowing potential, thus increasing both the likelihood the customers will get in over their heads and the losses the lenders will ultimately face. Second, a generalized easing of credit standards to get new customers is necessarily risky. Indeed, the anecdotal reports are that what banks classify as C and D class credits are now being granted. As a former teacher, I know that what a grader calls a C or a D does vary, but I do know that it isn't a very good grade.

It is certainly a part of any natural market cycle that lenders push the envelope both on new customers and increased lending to existing customers. Losses are part of any market cycle, as well. What I find particularly concerning this time is that a new response is given whenever I probe banks and credit agencies about their motives. This time is different, I am told, because this time we have very sophisticated credit tracking models. So, whenever credit conditions get out of hand, we will simply cut back on our credit lines.

With all respect to the individuals involved, we may have been there before. Haven't we learned enough from the financial revolution of the last 20 years? Remember the phrase "portfolio insurance", for example? Sophisticated credit tracking models clearly have their advantages. But, they will not repeal the credit cycle. And, if they are used as an excuse to believe that the credit cycle has been repealed, they will inevitably worsen the problem when the cyclical downturn actually begins.

I am also a bit concerned about what is meant by cutting back on credit. Does it mean that the company that has been raising my credit limit each year with a glowing letter about how great a customer I am now proposes to lower my limit when I approach it? Or how about the new sophisticated models that pool information about your overall credit use? Will the long term customer with 6 cards and an aggregate credit limit of $50,000 or more now find those cards cancelled when he starts to use his credit to start a new business or cover a period of unemployment, causing the computer to say that trouble is brewing?

I find it interesting that management would consider cutting the credit limit of someone who has been a long term customer and is at least making the minimum payment on the card, whether currently employed or not. Even if such a practice is considered acceptable from a business point of view, I can assure the industry that it will encounter political problems if it attempts such a practice in any widescale way during the next cyclical downturn.

Forgive the showmanship, but here's the colloquy between the Congressman and the witness. Prior to cutting your credit line, did the credit card company ever correspond with you? Yes, I have eight letters here from each of the last eight years telling me of my exemplary credit record, each time raising my credit limit. Have you ever missed a payment? No. Why was your line cancelled? Well, I was temporarily laid off because of an illness and put my medicine on my credit card. The company said that there had been a "material change" in my circumstances and pointed to some clause in the fine print. So the company cut the credit limit so you couldn't buy your medicine on a card with a credit line that you had been paying money for just when you needed to use that credit line the most? Yes, Congressman.

Would any of you like to be the credit card executive who is the next witness? We should bear in mind that there is a social cost to inappropriate credit extension as well as the economic cost. While the democratization of credit is on balance a good thing, lenders do have a responsibility to honestly assess the capacity of the borrower to repay the loan, and to take prudent risks.

Furthermore, the evidence on consumer behavior I described above suggests that grantors of consumer credit may now have collectively taken on a macroeconomic responsibility they did not seek. The evidence indicates that the old liquidity constraint which used to discipline household consumption behavior has been replaced by a new constraint -- the credit card limit. To the extent that is the case, the willingness of the industry to extend credit in ever greater quantities will determine in a major way the duration of the current consumer spending binge, the ultimate extent to which consumers become over extended, and therefore the depth of the next macroeconomic downturn.

In that context, the term "prudent risks" takes on a new meaning. The prudent man never assumes that this time will be radically different, or that mathematical tools and closer monitoring will repeal the business cycle. That rule must apply to both macroeconomic policy makers and their judgments about the business cycle and to individual grantors of credit and their microeconomic decision making.