For release on delivery
9:30 A.M. E.S.T.
Thursday, March 17, 1983

Statement by

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before the

Subcommittee on Consumer Affairs
Committee on Banking, Housing and Urban Affairs

United States Senate

March 17, 1983

Madam Chairman, I appreciate the opportunity to appear before this Subcommittee on behalf of the Federal Reserve to discuss consumer interest rates. I feel that the Subcommittee has adopted a very appropriate focus on consumer finance at this early stage in what is expected to be a "consumer-led" recovery. Increased purchases by households of homes, autos, durables, and other goods and services, if sustained, will tend to induce merchants and manufacturers to restock inventories, increase production, and eventually hire and rehire those who are suffering unemployment and underemployment.

Interest rates are important to the consumer. Various public opinion polls have indicated that shoppers consider interest rates to be quite high and that postponement of purchases often is attributed to rates which exceed what the consumer thinks is acceptable. Recent surveys of consumer attitudes indicate that many shoppers for credit are willing to pay around 11 percent to finance purchases. At the same time, as you are well aware, the merchant or lender generally requires rates of 14 percent or more.

Of course, interest rates are not the only constraint on increased spending by households. Unemployment is very high and the pronounced slowing of inflation has removed much of the motivation for "hedge buying." House prices in some areas have declined and mortgage refinancing may be costly. Saving looks more attractive via the higher returns offered through new money market deposit accounts and the tax advantage offered by more liberal IRA and Keogh account provisions.

Given the present environment of a modest and uncertain recovery, consumer interest rates could play a major role in ensuring that the recovery will be a sustainable one. Interest rates on most forms of credit used by consumers have been coming down recently, and further declines apparently are in train for some types of loans. The dimensions of the declines we can look forward to differ for various types of loans--partly because of the characteristics of particular markets, differences in administrative costs, and the extent to which the earlier upward rate movements had been constrained by usury ceilings. Because of the nature of the markets involved, consumer loan rates have typically fluctuated less widely than other rates in response to changes in cyclical movements of the economy, and I believe there is nothing particularly unusual in the recent patterns of interest rate movements. Some say that the pricing of consumer and other loans by some institutions may reflect some caution by institutions with respect to potential loan losses in foreign, agricultural and energy related credit. However, it has been our experience that present-day credit markets generally are too competitive and too fluid for lending institutions to extract excessive profits in any given market over any significant period of time.

Nevertheless, it is true that rates have come down on some kinds of consumer credit less than business loan rates or the rates on Treasuries. Short-term market rates generally are 9 to 10 percentage points below their earlier peaks; long term market rates are lower by 4 to 5 percentage points. Mortgage rates are the exception among consumer finance rates; the Federal Home Loan Mortgage Corporation quotation of 12.79 percent on conventional home loans last week was nearly six percentage points below the peak in 1981.

Mortgage rates, of course, are a good deal more closely tied to market rates than is true for other types of consumer credit, thanks to the increasing use of mortgage-backed securities and the secondary mortgage market. Those who originate mortgages more and more are a different group from those who invest in them. Installment loans, revolving credit and other consumer credit forms generally have no true secondary market, and thus rates tend to be "sticky" relative to open-market and mortgage rates. Some loan originators sell the consumer "paper" they originate, but these tend to be bulk sales to a commercial bank or some other buyer, not to capital market investors. Thus the majority of installment and revolving loans are held in the portfolios of the originators. The very marketability of the mortgage loan may result in a lower rate compared to a largely nonmarketable consumer credit contract.

An additional factor is that mortgage loans are much larger, on average, than other types of consumer credit. The Federal Home Loan Bank Board's February data indicated conventional 75 percent-of-value loans ranging from about $42,000 in Pittsburgh to around $108,000 in the San Francisco area. Other than mobile home chattel mortgages, most consumer loans are for amounts ranging from a few hundred dollars to something like $10,000. Thus the mortgage lender can spread his costs of loan origination, servicing, and collection over a larger base. Faced with somewhat similar administrative costs and higher collection or servicing outlays, the supplier of consumer credit tends to need a higher percentage rate of interest.

Recent Behavior of Consumer Interest Rates

What factors explain the relative insensitivity of consumer rates to the dramatic decline in other rates in recent months? Households borrow funds primarily in three forms that are, to some extent, substitutes for each other. These forms are consumer installment loans, open-end or "revolving" credit-card plans, and mortgage loans collateralized by homes. Movements in interest rates on these types of borrowing have differed considerably in recent periods. Changes among the various rates paid by households, and movements in consumer rates relative to other rates have largely reflected two factors: the degree of credit market segmentation, and the impact of artificial constraints on rate movements in the consumer-oriented market sectors.

As mentioned, home mortgage rates have come down about in line with other long-term market yields. Federal Reserve data on consumer finance rates, however, show a mixed pattern. In early February, average consumer finance rates (APR) at reporting banks were down from peak levels, as follows: new auto loans, down 2.55 percentage points;[1] mobile home loans, down 1.70;[2] other consumer goods and personal expenditures, down 1.62 points.[3] Average rates on bank credit card plans rose in February 1983 to a level of 0.75 percentage points above February 1982. Table 1 contains the relevant data.

Consumer installment loans. The reductions in rates on consumer installment loans, to be sure, have been modest when compared with other types of interest rates. Spreads between installment loan rates and the bank prime lending rate have risen since the middle of last year, and much the same pattern is evident when comparisons are made with CD rates at banks or with yields on Treasury securities having maturities comparable to those for consumer loans. However, these various yield spreads--while relatively large--are not out of line from spreads that emerged during the 1970s.

It should be stressed that the recent increases in spreads between installment loan rates and other yields followed substantial reductions in

1. 36 months maturity.
2. 84 months maturity.
3. 24 months maturity.

spreads that occurred as market interest rates climbed during the 1977-81 period. This pattern, also evident during earlier interest rate cycles, suggests that recent movements have mainly reflected fundamental market mechanisms.

There are several reasons why rates on consumer installment loans tend to lag movements in open-market rates of comparable term, and to move over a narrower range during the cycle. As interest rates peak, state usury ceilings may limit upward movements in consumer loan rates, encouraging lenders to tighten nonrate loan terms and lending standards. Subsequently, when market yields decline, lending terms and standards tend to ease first, followed by downward adjustments in consumer loan rates. It is clear that interest rate ceilings in various states constrained upward movements in installment loan rates to some extent in 1981-82, even though many states adjusted their statutes and federal law enacted early in 1980 provided a limited preemption of state limits for all federally insured depository institutions.

In addition, the sluggish movement of consumer loan rates also is attributable to the imperfections in the linkages between consumer credit markets and other components of our credit system--as I noted earlier. Imperfect linkages to the general capital markets, of course, do not imply that individual lenders can maintain consumer loan rates far out of line from those prevailing at other institutions in their local markets. Although households may not shop as intensively for rates on short-term consumer loans as they do for rates on large and long-term home mortgage loans, competition in the primary markets for consumer loans is increasing.

In support of that thesis, there is evidence that savings and loan associations, a relatively new entrant in many of these functions, are currently expanding their nonmortgage portfolios to put the MMDA and Super-NOW dollars to work. They are fast becoming a factor in the growth of consumer installment credit. In January of this year, savings and loans increased their participation in the consumer installment credit market at nearly a $5 billion annual rate, and they increased their credit outstanding by 22 percent over the 12 months ending in January.

Bank credit cards. Although rates on closed-end consumer installment loans have been declining, albeit sluggishly, average interest rates on bank credit-card plans actually have continued to rise. The behavior of average rates on credit card plans has been strongly influenced by state ceilings on the rates that banks may charge cardholders on outstanding balances.

While rates on closed-end installment credit at banks climbed by about 6 percentage points during the 1978-81 period, and those on open-market investments rose still more, average rates charged consumers on bank credit-card plans rose only about one percentage point as most states maintained interest rate ceilings of 18 percent or less. Under these conditions, of course, banks resorted to other ways of passing on the rising cost of their card plans as the profitability of this function plummeted. Many institutions imposed annual fees on their credit cards and also raised their merchant discounts--i.e., the percentage deducted by the bank from the face amount of receivables purchased from retailers.

Increases in average bank credit-card rates during the past year reflect upward adjustments to rate ceilings by some states, and shifts of credit card operations by some banks to states with higher ceilings or with no ceilings at all. States like South Dakota and Delaware became the haven for the credit card operations of a number of large banks located in states with more restrictive interest rate limitations.

Outlook for Consumer Loan Rates

Further movements in interest rates on home mortgages will depend primarily upon developments in the markets for longer-term debt instruments generally. Average rates on credit-card accounts may continue to be influenced, at least in the short run, by changes in usury statutes and by interstate shifts of credit-card operations by banks seeking to bolster the profitability of their plans; increases in rates associated with these factors, of course, may be accompanied by downward adjustments in annual card fees and merchant discounts. With respect to closed-end consumer installment loans, average interest rates could fall somewhat further in the near future. If so, this would reflect the usual lagged adjustment of these loan rates behind movements in yields on market instruments. In this regard, it is noteworthy that nearly half of the banks routinely surveyed by the Federal Reserve last month indicated greater willingness to make consumer installment loans than three months earlier.

Further reductions in the entire structure of interest rates in the economy will depend critically upon progress against inflation and positive developments on budget deficits. Remarkable progress against inflation has been made during the past year, and favorable conditions in markets for oil and basic food commodities bode well for the near future. As inflation has come down, so have market interest rates. However, interest rates across all markets remain high relative to the current rate of price inflation particularly on longer-term instruments. This suggests that expected rates of future price inflation, which profoundly effect nominal interest rates, remain well above current actual inflation rates.

Such skepticism is understandable. A year or two of progress, following more than a decade of rapid inflation, is not enough to quell fears that prices will accelerate again as the economic recovery proceeds. And it is widely anticipated that we will see a return to aggressive wage bargaining and price setting if it appears that inflation is being permitted to accelerate once again. The current situation is fragile, and it is clear that the major test of the sustainability of our anti-inflation effort lies ahead.

The Federal Reserve remains committed to policies that will permit the economy to expand without regenerating inflationary pressures, and adherence to this course should lead to lower interest rates over time. There are, however, some obstacles along this path. In particular, the prospect of huge Federal deficits looms ahead even as the economy expands; that is, the "structural" deficit promises to remain very large even as the "cyclical" deficit declines. That expectation is widely held in the financial markets and by the public at large, and the prospect of intensified public sector "crowding out" of private demands for the available supply of credit appears at least partly responsible for the maintenance of high "real" interest rates on longer-term instruments. Fears abound that the large deficits will not only place heavy demands on the credit markets but that they will thereby create pressures for excessive monetary expansion, causing the battle against inflation to become considerably more difficult.

Clearly, the fundamental outlook for interest rates does not lie, primarily, in the hands of the Federal Reserve alone. Market confidence in the success of monetary policy must be supported by the continued commitments and decisions in both the Congress and the Administration to reduce the large structural federal deficits that threaten to place heavy pressure on our financial resources as the economy picks up speed. Complementary monetary and fiscal policies will foster the easing of inflationary expectations essential to sustained reductions in rates on consumer loans and other types of credit. Then the recovery can be sustained on a basis of the growth of household purchasing power in real terms, in concert with increasing strength in other sectors.

TABLE 1

MOST COMMON FINANCE RATES (APR) ON DIRECT CONSUMER INSTALLMENT LOANS
AVERAGES AT REPORTING COMMERCIAL BANKS

Date	New auto (36 month)		Mobile home (84 month)		Other consumer goods and personal expenditures (24 month)		Credit card plans	
	Finance rate (percent)	Change (basis points)	Finance rate (percent)	Change (basis points)	Finance rate (percent)	Change (basis points)	Finance rate (percent)	Change (basis points)
1972 - Feb.	10.20		10.88		12.50		17.13	
May	9.96	-24	10.73	-15	12.44	-6	17.24	11
Aug.	10.02	6	10.71	-2	12.47	3	17.25	1
Nov.	10.02	0	10.85	14	12.44	-3	17.23	-2
1973 - Feb.	10.05	3	10.76	-9	12.51	7	17.16	-7
May	10.05	0	10.84	8	12.48	-3	17.22	6
Aug.	10.25	20	10.95	11	12.66	18	17.22	0
Nov.	10.49	24	11.19	24	12.75	9	17.23	1
1974 - Feb.	10.53	4	11.25	6	12.82	7	17.24	1
May	10.63	10	10.96	-29	12.88	6	17.25	1
Aug.	11.15	52	11.71	75	13.11	23	17.17	-8
Nov.	11.57	42	11.87	16	13.16	5	17.16	-1
1975 - Feb.	11.51	-06	12.14	27	13.20	4	17.24	8
May	11.39	-12	11.57	-57	13.11	-9	17.21	-3
Aug.	11.31	-8	11.80	23	13.05	-6	17.14	-7
Nov.	11.24	-7	11.76	-4	12.96	-9	17.06	-8
1976 - Feb.	11.18	-6	11.77	1	13.02	6	17.14	8
May	11.01	-17	11.61	-16	12.96	-6	17.02	-12
Aug.	11.07	6	11.84	23	13.02	6	17.01	-1
Nov.	11.02	-5	11.77	-7	13.06	4	17.04	3
1977 - Feb.	11.14	12	11.83	6	12.95	-11	16.89	-15
May	10.81	-33	11.73	-10	13.00	5	16.87	-2
Aug.	10.86	-5	11.89	16	12.87	-13	16.86	-1
Nov.	10.86	0	11.91	2	13.06	19	16.92	6

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	Finance rate (percent)	Change (basis points)	Finance rate (percent)	Change (basis points)	Finance rate (percent)	Change (basis points)	Finance rate (percent)	Change (basis points)
1978-Feb.	10.86	0	11.92	1	12.94	-12	16.90	-2
May	10.84	-2	12.01	9	13.11	17	16.97	7
Aug.	11.09	25	12.16	15	13.30	19	17.10	13
Nov.	11.29	20	12.18	2	13.42	12	17.16	6
1979-Feb.	11.60	31	12.37	19	13.59	17	17.05	-11
May	11.73	13	12.54	17	13.65	6	17.06	1
Aug.	11.88	15	12.65	11	13.76	11	17.09	3
Nov.	12.85	97	13.51	86	14.39	63	16.93	-16
1980-Feb.	13.28	43	13.57	6	14.69	30	17.13	20
May	15.72	244	15.96	239	16.31	162	17.31	18
Aug.	13.91	-181	14.95	-101	15.33	-98	17.39	8
Nov.	14.29	38	15.49	54	15.54	21	17.41	2
1981-Feb.	15.84	155	16.58	109	17.14	160	17.58	17
May	16.04	20	17.02	44	17.48	34	17.71	13
Aug.	16.92	88	17.89	87	18.52	104	17.78	7
Nov.	17.36	44	18.29	40	19.21	69	18.04	26
1982-Feb.	17.05	-31	17.98	-31	18.76	-45	18.14	10
May	17.20	15	18.23	25	18.90	14	18.41	27
Aug.	17.08	-12	18.43	20	18.93	3	18.73	32
Nov.	15.97	-111	17.55	-88	17.99	-94	18.75	2
1983-Feb.	14.81[1]	-116	16.73[2]	-82	17.59	-40	18.89	14

Note: Finance rates are annual percentage rates as specified by Regulation Z (Truth-in-Lending). They apply to the "most common" rate charged on the largest dollar volume of loans in the particular credit category during the first full calendar week of the month.

1. 48 month maturity beginning in 1983.
2. 120 month maturity beginning in 1983.

Source: Federal Reserve