2. Because the data in the charts aggregate all consumers, individual consumer balance sheets may differ from the average.

3. The collapse in values of tangible assets and credit market instruments is understated in chart 3; tangible assets also resulted from a change in relative prices. These prices are inversely related to interest rates. When interest rates rise, outstanding bond prices fall. This is not a problem if consumers plan to hold the bonds to maturity; the original equity they had accumulated; the original owners then may find themselves with a home they did not expect to have, putting pressure on their spending plans as well.

Because the current weakness in the housing market may be an important constraint for homeowners to turn to financial assets to meet their saving goals. Consumers plan to hold the bonds to maturity; some of the improvement on the liabilities side of consumer balance sheets affects the degree of success in meeting desired consumption plans. Not only the amount of debt relative to assets, but also the types of assets owned by consumers influence their spending plans.

Debt. The amount of debt held by consumers is a very important constraint on subsequent spending and saving decisions. Debt represents an obligation to repay in the future. The timing of the repayment of noninstallment loans is mostly at the discretion of the debtor, although the whole amount eventually must be repaid. Hence, current debt will not leave income available for other spending, saving, or servicing additional debt. This is not to say that debt necessarily constrains all spending plans. The convenience of debt undoubtedly shifts the time pattern of spending from the future to the present and may promote more spending over time than would be true in a world without available debt.

The real burden of debt repayments experienced by consumers depends on the interest rate. If the inflation rate is greater 3.

The Strength of Consumer Balance Sheets

by K.J. Kowalewski

Since the end of 1979, U.S. consumers have strengthened their balance sheets considerably. The growth of outstanding household liabilities fell from 14.3 percent in 1979 to an annual rate of 7.7 percent over the period 1979:IVQ to 1981:IVQ. Consequently, debt repayments relative to disposable income has fallen. Conversely, debt repayment relative to assets has fallen substantially from their high 1979 values. In several respects the improvement in consumer balance sheets has been more dramatic since 1979 than improvements in past recessionary periods. Indeed, this improvement is a key factor underlying recent discussion of a consumer-led economic recovery later this year. However, there have been some marked changes in the composition of consumer assets in recent years and in the values of these assets in the past year. These changes could affect consumer behavior over the next several quarters in ways that may moderate the recovery in consumer outlays. This Economic Commentary discusses the significance of the recent changes in the composition of consumer balance sheets and speculates on the possible impact of these changes on consumer spending in the next several quarters.

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Asset Characteristics

The value of an asset at some point in time is the maximum amount of cash that would be realized by selling or otherwise liquidating the asset at that time under the most favorable conditions and with all useful prior preparation for its disposal. The value of an asset can vary considerably with its age or across the business cycle. For example, equity prices fall during recessions, and depreciation continuously lowers the value of tangible assets. In addition, the real values of tangible assets tend to remain unchanged with inflation, while those of financial assets tend to fall.

The liquidity of an asset is the ease and speed with which its value can be realized and depends on the market in which the asset is traded. Currency is the most liquid asset, since it is a medium of exchange. Consumer durables and pension funds are illiquid assets; resale markets for durables are imperfect, and it is difficult, if not impossible, to borrow against pension funds or liquidate them before retirement.

The predictability of the value of an asset refers to the certainty with which its value in the future can be forecast. Predictability is highly divisible, since any denomination of a Federal Reserve note can be expressed in an equivalent number of pennies. An automobile is indivisible: a whole car must be owned to obtain its transportation services. Equities and bonds must be purchased in integer multiples of their unit prices, unless they are held in mutual funds.

The yield of an asset over an interval of time is the amount of all receipts and costs earned by ownership over the interval. The yield of a money market mutual fund (MMDA) during a given time period equals the interest received minus the fund's management fees and other transactions costs and any taxes on the fund's income received.

The yield of a refrigeration service over some time period equals the value of its services (the refrigeration of food) minus the electricity and repair costs that it requires.

Finally, the return of an asset over some time interval equals the increment in value of the asset plus the yield of the value. The return on an equity over a certain interval, for example, equals the after-tax capital gain or loss on the price of the equity plus its yield. The variance of the return is one measure of an asset's riskiness.

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The liquidity of an asset is the ease and speed with which its value can be realized and depends on the market in which the asset is traded. Currency is the most liquid asset, since it is a medium of exchange. Consumer durables and pension funds are illiquid assets; resale markets for durables, houses, and land, tend to be concentrated in tangible or risky financial assets, he/she may have considerable trouble weathering income declines. Instead of drawing down assets or acquiring additional debt, the consumer may have to reduce his/her current spending. If assets are drawn down, any capital losses from their sale act to reduce future spending further.

The predictability of the value of an asset refers to the certainty with which its value in the various futures dates can be anticipated by informed investors. Apart from numismatic considerations, currency has a perfectly predictable nominal value, since the value of one dollar is always one dollar. While insured deposits also have perfectly predictable nominal values, consumer durables, houses, and land, tend to be less liquid, less reversible, and less valuable because they depend on future inflation rates.

The reversibility of an asset refers to the discrepancy between the value an owner can realize and the contemporaneous cost of obtaining the asset. Perfect reversibility is impossible, as every asset exchange involves transactions costs. These costs include, for example, the time and trouble required for a trip to the bank, brokerage fees, or advertising in the classified ads. Some assets, such as nonmarketable U.S. government savings bonds, lose most of their value in the event of the owner's death, while others, such as currency, are indivisible: a whole car must be owned to obtain its transportation services. Equities and bonds must be purchased in integer multiples of their unit prices, unless they are held in mutual funds.

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The predictability of the value of an asset refers to the certainty with which its value in the near future can be determined by informed investors. Apart from numismatic considerations, currency has a perfectly predictable nominal value, since any denomination of a Federal Reserve note can be expressed in an equivalent number of pennies. An automobile is indivisible: a whole car must be owned to obtain its transportation services. Equities and bonds must be purchased in integral multiples of their unit prices, unless they are held in mutual funds.

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Because the data in the charts aggregate all consumer assets relative to those of most financial institutions, this deterioration has offset some of the improvement on the liabilities side. Although the current strength on the liabilities side suggests recovery in consumer spending later this year, the weakness on the asset side suggests that spending will remain weaker than it was in the 1970s. The current weakness in the housing market may be an important constraint for many consumers. Unit sales of new and existing single-family homes are very weak; such sales in June 1982 were just over one-half of their 1979 rate. This weak demand has lowered selling prices and, consequently, housing values. For example, after increasing at an annual rate of 11.9 percent from 1979 to 1981, the median price of existing single-family homes fell from 108 by the end of July 1982, from a high of 136 in November 1980. Lower prices, as with lower housing prices, may force some consumers to curtail their spending. Finally, the high interest rates of the past two years have depressed the values of many consumer bond portfolios. Bond prices are inversely related to interest rates. When interest rates rise, outstanding bond prices fall. This is not a problem if consumers plan to hold the bonds to maturity; the negative effect on interest rates is lessened. The interest rate risk associated with certain bonds means that many consumer bond portfolios may indicate a less vigorous recovery than anticipated this year.

Recent Changes in Consumer Balance Sheets

In the past two years, slow real personal income growth and high real interest rates have reduced consumer spending and the associated demand for consumer credit. As shown in charts 1 and 2, the consumer debt/assets ratio has remained at 0.19 for the past two years, and debt/asset ratio has remained at 0.19 for the past two years, and debt/assets have fallen to about 20 percent of disposable personal income. At the same time, there has been a marked deterioration in markets for housing, equities, and previously purchased bonds; coupled with the significant reduction in consumer real purchasing power, these trends have affected consumer spending.

The composition of consumer balance sheets has a strong influence on consumer spending and saving decisions. There is a direct influence simply because the spending depends on what is actually owned. For example, the number of refrigerators that a consumer purchases depends on how many refrigerators the consumer currently owns. A corollary is that the size of a consumer's net worth influences his spending and saving decisions. There is another influence, arising from the fact that the composition of consumer balance sheets affects the degree of success in meeting desired consumption plans. Not only the amount of debts relative to assets but also the types of assets owned by consumers influence their spending plans.

Debts. The amount of debt held by consumers is a very important determinant of subsequent spending and saving decisions. Debts represent an obligation to repay in the future. Installment and mortgage loans require periodic payments of fixed amounts for long periods of time into the future. The timing of the repayment of noninstallment loans is mostly at the discretion of the debtor, although the whole amount eventually must be repaid. Hence, current debt obligations do not leave income available for other spending, saving, or servicing additional debt. This is not to say that debt necessarily constrains all spending plans. The convenience of debt undoubtably shifts the time pattern of spending from the future to the present and may promote more spending over time than would be true in a world without available debt.

The real burden of debt repayments experienced by consumers depends on the inflation rate. If the inflation rate is greater than the interest rate, the real burden of debt repayments is greater. The real burden of debt repayments is greater if the inflation rate is greater than the interest rate.
2. Because the data in the charts aggregate all consumers, individual consumer balance sheets may differ from the average.

Recent Changes in Consumer Balance Sheets

In the past two years, slow real personal income growth and high interest rates have reduced consumer spending and the associated demand for consumer credit. As shown in charts 1 and 2, the consumer debt/asset ratio has remained at 0.19 for the past two years, and debt growth in the housing market remains very weak. Average consumer balances are not likely to increase by more than 3 percent in the years ahead.

The convenience of debt undoubtedly shifts consumer purchases depends on how many months of 1982, after growing at an annual rate of 11.7 percent from 1979 to 1981, to $69,100. These changes could affect consumer behavior over the next several quarters in a way that may moderate the recovery in consumer outlays. This Economic Commentary discusses the significance of the recent changes in the composition of consumer balance sheets and speculates on the possible impact of these changes on consumer spending in the next several quarters.

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