

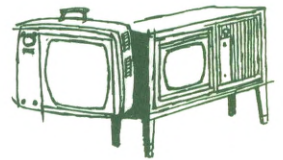


APRIL 1960

# BUSINESS *REVIEW*

**\$52 Billion on the Cuff**

**A Cross of Gold?**



FEDERAL RESERVE BANK OF PHILADELPHIA

# \$52 BILLION ON THE CUFF

## *How Burdensome is Consumer Credit?*

Fifty-two billion dollars is a little less than the amount of consumer credit outstanding, not counting mortgages. It represents a great many unpaid automobiles, television sets, doctor bills, and the like. Fifty-two billion dollars plus is a lot of credit. Some people think it's too much.

Credit dollars have without doubt given consumers what they feel they want—the appliances

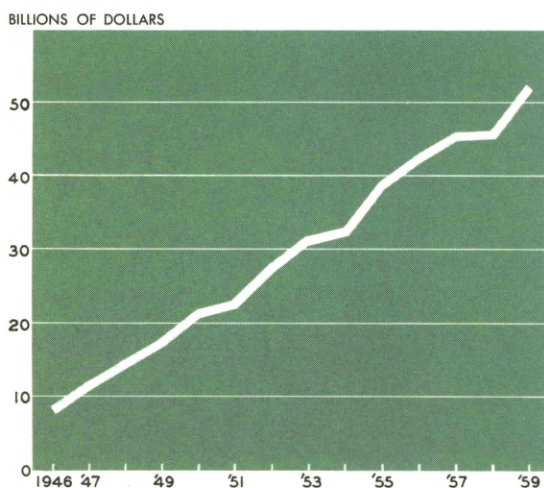
and conveniences that distinguish the American standard of living. They have given many businesses what they feel they want—the ability to penetrate mass markets, to produce for less, sell for less, and make more. They have given many financial institutions a profitable outlet for reserves and savings. Credit has made some people very happy, some people very rich, and some people a little of both. On the whole, it has been beneficial.

But like other revolutionary devices, fire and atomic energy, for example, consumer credit could be dangerous. It can and has made some people unhappy and poor—especially those who have plunged into debt with abandon. If it makes too many people unhappy and poor, the entire economy, even the cautious, will suffer. Widespread defaults, such as were experienced in the mortgage markets in the late 1920's and 1930's, could put tremendous pressure on financial institutions and undermine prosperity.

Some observers are currently concerned about consumers who have used credit in a misguided way, and families that now carry very heavy burdens. But despite the unwise use of credit by some consumers the economy and its financial system are basically sound and not overburdened. The likelihood is that this will continue to be the case in the foreseeable future.

### FIFTY-TWO BILLION DOLLARS—AND STILL CLIMBING

Short- and intermediate-term consumer credit has been rising rapidly since the end of World War II. The debt outstanding increased \$6.5 billion in 1959, and in the first two months of 1960 (on a seasonally adjusted basis) it continued to climb.



## CONSUMERS IN THE AGE OF DEBT

In this Age of Debt large numbers of people are borrowing record amounts of money. For most, going into debt demands a certain way of looking at things; indebtedness is also a technique of economic living.

The total debt of consumers, businesses, and

governments in the United States amounted to more than \$825 billion in 1959—about \$4,600 per person. This was almost twice the amount of the gross national product. Almost 70 per cent of the consumer spending units in the United States had some sort of debt outstanding. Probably even a larger proportion of businesses and governments

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## A CONSUMER CREDIT SAGA

The April sun shone brightly through the windows of the university classroom. The professor peered over his glasses at what seemed to be an attentive group of students in his Personal Finance course.

"We all know or have heard of people," he began, "who have gotten too deep into debt. But how deep is 'too deep?'"

He ignored four students who raised their hands, and continued. "It's really very hard to generalize. This is a question that can be answered only after taking into account the individual's total resources and obligations. Now take the case of James S.—an actual case taken from the files of the local credit bureau. Only the names have been changed to protect the guilty."

The professor paused a moment. There was scattered laughter from the class. He went on.

"James is a truck driver, married, and has five children. He clears about \$470 a month—a relatively good income—but he has no financial savings to speak of.

"He recently purchased a house with the help of a \$7,000 mortgage. He borrowed \$900 to improve his home and \$800 more for furniture. He purchased clothing for his family at several department stores with charge accounts and now owes \$300 there. He has an additional \$300 debt for a freezer and food plan. Including doctor bills and other miscellaneous debts, the total amount he owes comes to well over \$9,500.

"After James S. gets through buying the bare necessities of life each month, he only has about \$150 left. But he has committed himself to monthly payments of \$300. He has clearly over-committed himself. His freezer will probably be

repossessed and his credit standing ruined.

"Now observe that we had to know a good deal about James S. to arrive at this conclusion. If he hadn't such a large mortgage or such a large family, or if he had some savings, the burden of his debt might have been heavy but not overwhelming."

A student majoring in Economics raised his hand and the professor recognized him. "I think," he began, "that James S. must either be a crook or unusually stupid. He knows what he makes each month; he knows what it costs to live. He should never have agreed to pay out more than he could afford."

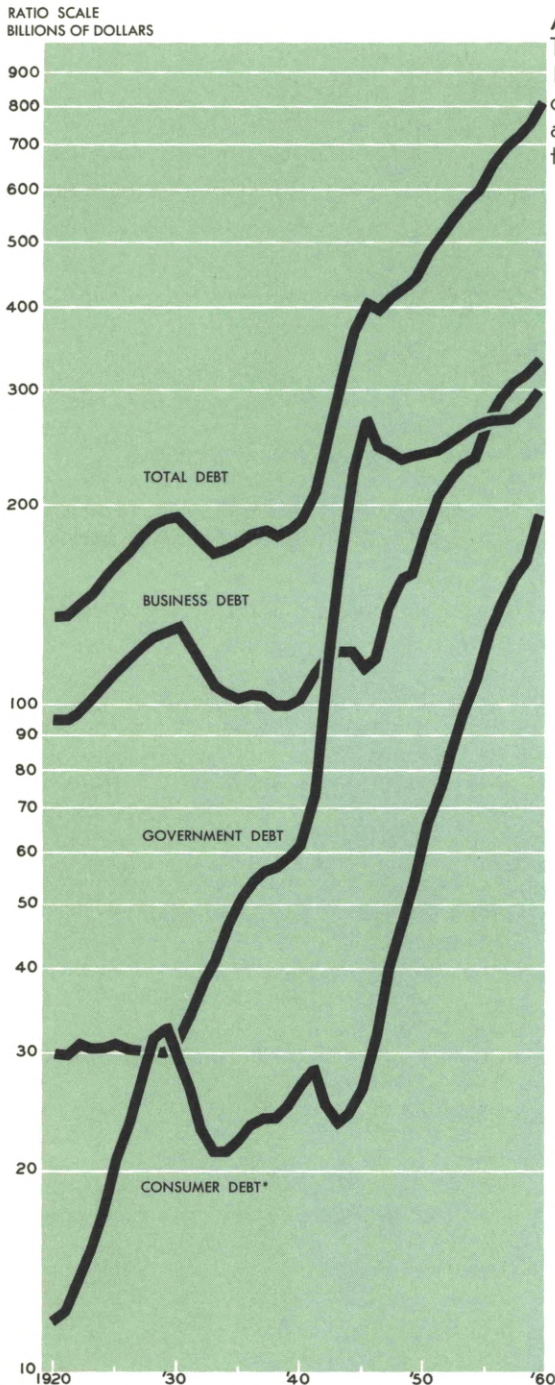
"Oh, I don't know about that," broke in a student majoring in Psychology. "He was probably barraged by salesmen until he couldn't remember how much he owed or how much he made. And, after all, he only wanted the better things in life for his family. Modern advertising has no doubt persuaded him that to be a good provider he has to provide an awful lot."

"Yes," offered a student majoring in Social Work, "and how about his family—a wife and five children. Now they're going to suffer for his good intentions."

"Perhaps so," answered the Economics major, "but an economy can't suffer too many people like James S. How many are there like him in the United States today?" He looked toward the head of the classroom. . . . But no one was there.

. . .

The professor had left while the discussion was going on. The bell had rung and he was on his way to get a loan on a car he was planning to buy.



\* Includes mortgage debt, short- and intermediate-term and other consumer debt.

### A DEBT EXPLOSION

Total debt seems to have exploded upward around 1940. But this reflects varying movements in the components of debt. Total consumer debt took off after the war and has been rising more rapidly than either business or government debt since.

had debt outstanding. The chances are that never before have so many owed so much to one another.

When did the Debt Age begin? It's hard to say. The accompanying chart seems to show that total debt exploded upward about the beginning of World War II. This upsurge, however, reflects varying movements among the component parts of total debt. Consumer debt did not start moving rapidly until the war was about over.

Moreover, our figures only go back to 1920. What looks like a 20-year-old debt explosion may in reality be only the continuation of an interrupted long-term trend. Everything considered, total debt is not too much higher today than it would have been had the average rate of increase during the 1920's simply continued without interruption to the present. It would appear that the Age of Debt has been on its way for some time.

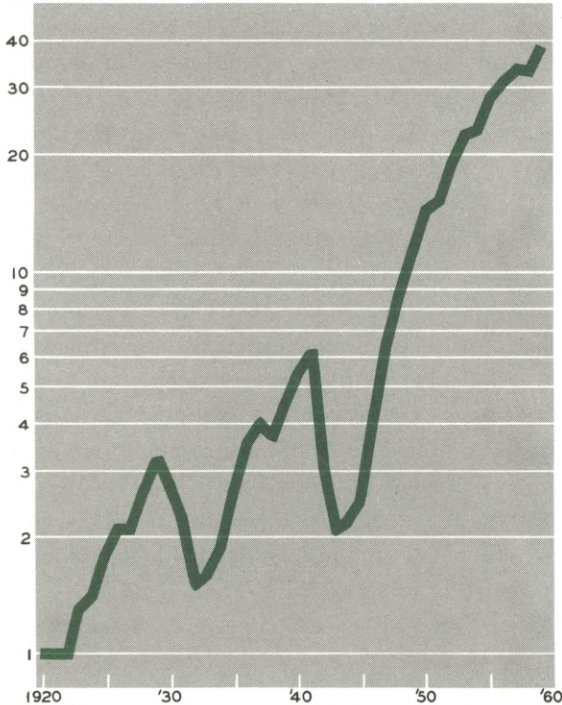
In 1959 total consumer debt, including mortgages, amounted to about \$200 billion. This was considerably smaller than either business or government debt. But, consumer debt has increased considerably faster than either since the end of World War II and much faster than over-all economic activity. During this period the instalment credit part of consumer debt has provided the biggest upward push. Instalment debt has grown in three distinct surges from practically nothing in the early 1920's to its present levels. The postwar surge has been strong and of long duration. It is only recently that the rate of growth has seemed to slow down.

Behind the rapidly rising instalment debt in the postwar period has been a growing demand for a variety of consumer products; most of all a

**INSTALMENT DEBT IN THREE INSTALMENTS**

Instalment debt has grown in three distinct surges from very low levels in the early 1920's to about \$40 billion currently. The postwar surge has continued for some time, but in recent years has seemed to be slowing down.

RATIO SCALE  
BILLIONS OF DOLLARS



growing demand for automobiles. Automobile credit amounts to about 42 per cent of the total instalment debt outstanding. It is likely that at least an additional 15 to 20 per cent of instalment debt outstanding is accounted for by other consumer durables such as washing machines, refrigerators, freezers, and related plug-ins. The era of the automobile, the household appliance, and the Age of Debt have moved along in harness.

A new attitude on the part of consumers has also developed in the last 40 years. Consumers who go into debt voluntarily today—with the exception of a few confirmed deadbeats—are generally optimistic, emancipated, and want some-

thing very badly “right now.”

They are optimistic in the sense that they frequently believe their incomes are going to rise and that the burden of their debts will therefore grow lighter as time goes on. They are emancipated in the sense that they don't believe that being in debt is a blemish on their character. Their desire for “certain things” must be very immediate and strong because they are willing to pay such large amounts in financing charges and therefore give up so many other goods.

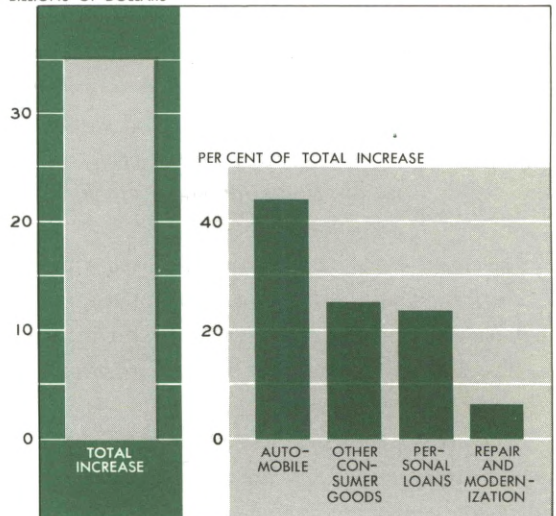
Several generations ago only the public honor of being a gentleman could offset the public disgrace of being in debt. People generally waited for what they wanted, partly because of custom and partly because of harsh law. Until the 1830's, the delinquent borrower went to jail.

Consumer indebtedness today also represents a technique available to every family for organ-

**THE DEMAND BEHIND INSTALMENT DEBT**

Automobile loans have accounted for the largest portion of instalment debt growth since 1946. Other consumer goods such as refrigerators, freezers, and washing machines have also been important.

BILLIONS OF DOLLARS



izing its economic resources. The one quality that houses, television sets, automobiles, and other consumer durables have in common is that none are consumed immediately. All yield service over a period of time. Purchasing a durable good on the instalment plan permits the consumer in a rough way to pay for these services as he consumes them.

Consumer borrowing in recent years, however, has gone far beyond purchasing durables. The consumer today can eat, sleep, and travel on credit. New bank plans permit him to use a line of credit for a variety of purposes. Some consumers now borrow to buy services directly—such as airline tickets—as well as goods that yield services. Others borrow for everyday expenditures as a convenient way of having their creditors keep financial records for them. Some go into debt in order to get out of debt.

In the Age of Debt, indebtedness has become a way of life. This, without doubt, has benefits, but it also has some burdens.

### THE CONSUMER'S BURDEN

*Salesman: If you buy this dishwasher, Madam, you will save the cost of a maid.*

*Housewife: We bought an automobile to save bus fare, a television set to save entertainment expense, and a washer to save laundry bills. I really think we are saving about as much as we can afford.*

The entire world has become enamored with the "American standard of living." It's not surprising that Americans have fallen in love with it themselves—and have sometimes pursued it with more courage than wisdom.

How many people are in debt over their heads today? How many people are so close that a minor financial disturbance caused by illness in the fam-

ily, a strike, or a layoff at work can make things really difficult? The data available are not detailed enough to provide final answers. Yet these questions concern many, and it's important to look at what is available.

The over-all statistics suggest that consumers are not overburdened. The ratio of instalment debt repayments to consumers' disposable income—a figure frequently used to weigh the burden of the debt—rose slowly in 1959 despite a \$5.4 billion increase in instalment credit. At its current 13 per cent level, the ratio is slightly lower than it had been in the latter part of 1957.

Moreover, year in and year out, consumers on the whole tend to save more than they borrow—in technical terms their total acquisition of financial assets exceeds new borrowings. Mainly as a result of this, the net financial equity of consumers (financial assets minus financial liabilities) is almost always increasing. Since the end of World War II, liquid assets held by consumers have grown in a parallel fashion.

These over-all statistics, however, leave much to be desired. It's conceivable that a low ratio of repayments to income simply reflects the very heavy burdens of some and the very low burdens of others. Those with unimportant debts may be doing most of the saving, while those with significant debts are saving little.

There are several facts that suggest that a large number of the most highly burdened debtors are low-income recipients. On average, indebted families in the lowest income groups have the highest ratios of debt repayments to income. In addition, a relatively large majority of these indebted low-income families have unusually high ratios. Finally, the indebted families in the low-income groups probably have only small amounts of liquid savings.

We cannot estimate the number of families with “too much debt.” But it does seem clear that low-income receivers are among the most highly burdened.

It’s significant, however, that there are not too many high-burdened, low-income families; a relatively small proportion of low-income receivers are indebted. Moreover, a relatively large proportion owe only small amounts of money. High burdens among these families really reflect low incomes rather than large amounts of debt.

Middle-income debtors, on the other hand, have moderate ratios of payments to income; but in the middle-income classes, debts are generally large compared to liquid assets. It would seem, therefore, that the burden of existing debt for these families would only become very heavy if their incomes fell sharply.

General statistics on the consumer sector of the economy and breakdowns by income groups both suggest that there are at present relatively few families with excessively high burdens.

### THE ECONOMY’S BURDEN

If consumers could keep their debts and their burdens to themselves, there wouldn’t be much more to say—except perhaps a word of caution delivered with a wagging finger. But of course that’s impossible. Consumers are the bedrock of American prosperity; they spend over \$300 billion a year purchasing about 65 per cent of gross national product; and anything that affects large numbers of them affects the entire nation.

Consumers have wanted credit and they’ve gotten it; and this, in and of itself, must be marked down as beneficial; so, too, must the high level of economic satisfaction that seems to come with the ownership of durables. It’s not too surprising, however, that along with the *public* benefits have come some *public* burdens.

These burdens aren’t simply a matter of heavy debt obligations relative to income. They result from the impact of consumer credit on the intricate economy in which we live.

### Economic ups and downs

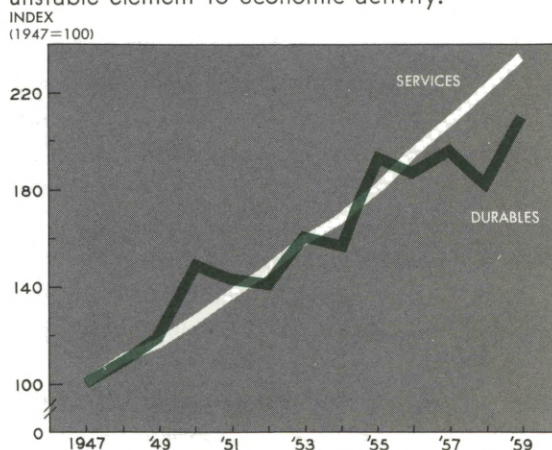
Consumer credit does not cause booms and busts. The business cycle is older than consumer credit and would exist without it. But credit is probably one of the forces now at work that contributes to economic instability.

Because credit gives the average consumer the opportunity to drive an automobile rather than ride a trolley car, it also gives him the opportunity to postpone or accelerate a large portion of his expenditures. He can easily say “It rattles a lot but I think I’ll drive the old wagon a year or so more.” On the other hand, buying an automobile compels him to make an unusually large expenditure when he only wants a little bit more service.

When the economic horizon is sunny and

### STEADY SERVICE, BUT ERRATIC SPENDING

Consumer expenditures for services typically move in a steady fashion. But expenditures for service-yielding durables fluctuate widely. To the extent that credit has permitted consumers to substitute durables for services, it has added an unstable element to economic activity.



bright, consumers tend to be optimistic and they all trade in the old one at about the same time. When clouds appear on the horizon, consumers all tend to be pessimistic and they'll "use it a while longer."

Lenders keep an eye on the horizon as well. When economic conditions look good, they encourage and promote consumer loans. When the gale warnings go up, they usually are reluctant to lend.

The result is that the business of automobile companies fluctuates more widely than the business of trolley car lines—expenditures for all durables tend to fluctuate considerably more than consumer expenditures for services. This has been a problem in the past, particularly during periods of prosperity. Optimistic and aspiring consumers have been able to obtain supplemental purchasing power and have helped to feed the fires of inflation.

One frequently expressed fear, however, has not materialized in the postwar period. A stiff recession, some have said, might easily overwhelm many consumers who are just about making their payments as it is. If large numbers of indebted consumers were to experience a severe loss of income during recession, the repayments they were obliged to make might depress their expenditures for currently produced goods and services. With consumer incomes falling still further, there would be widespread defaults and financial panic as well as economic crisis.

In the postwar years, despite the rapidly growing consumer debt, total consumer expenditures have held up remarkably well during recessions; to a large extent, this has been because incomes have held up. The consumer may be more vulnerable to troubled times today because of his large debt, but so far in the postwar period the nation has been able to prevent serious trouble.

### Financial stability

The supply side of the credit industry has grown in step with the demand. Six individual loan companies today have consumer receivables exceeding \$1 billion each. Commercial banks have moved into the field strongly in the last 20 years and now are the largest single lender. In the past six years, credit unions have almost tripled their holdings of instalment debt and their total holdings, while still small, now exceed \$3 billion. Department stores and other retail outlets have also continued to expand their activities.

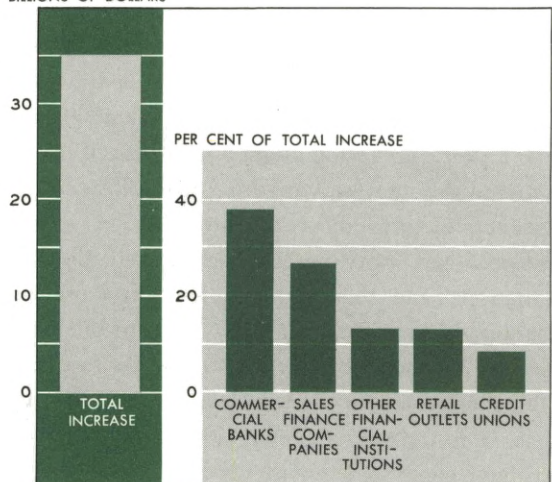
Creditors have advertised, promoted, extended terms and pioneered new schemes. At times the competition has been fierce. Some critics claim that this strenuous rivalry may already have resulted in the extension of unsound credit to many overburdened consumers. They fear that sooner or later the chickens will come home to roost and the whole business will lay an egg.

In most cases, so far, consumer credit has been a profitable business—well worth the pursuit.

### THE SUPPLY BEHIND INSTALMENT DEBT

Commercial banks have accounted for the largest proportion of instalment debt growth since 1946, with sales finance companies not too far behind.

BILLIONS OF DOLLARS





While delinquencies typically rise during recessions, the experience of lenders has never really been bad, and most of the time it's been very good. With incomes increasing, it's very unlikely we would have a sudden wave of defaults.

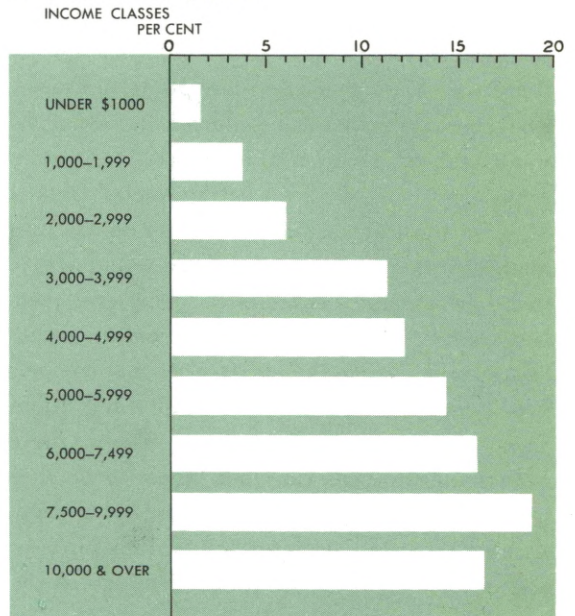
If for any reason we did, however, what the exact impact on the financial system would be is hard to say. It does seem clear that some lenders would suffer more than others. The defaulting borrowers would probably not be evenly distributed among all types of creditors; those, who for one reason or another typically negotiated loans with better risks would be better off. Beyond this, lenders would fare according to their financial strength generally, the proportion of their assets in non-consumer loans and investments, and their ability to get outside help. There would, of course, be significant indirect effects as well. For example, widespread defaults by consumers would inevitably depress retail sales, and this would make it difficult for businesses to meet their own debt obligations. But the probable impact on individual lenders is very difficult to determine.

Nevertheless, there are some general considerations that suggest the financial system is not currently in an overly exposed position. The lenders who do most of the lending are large, reputable, and basically sound businesses. Moreover, in any wave of defaults, it would most likely be the families with the highest ratios of repayments to income who would be unable to pay their debts—as we have already indicated, mostly families in the lower-income groups. These defaults, however, would involve a relatively small proportion of the total debt outstanding—and the assets of creditors. In 1959, more than 75 per cent of all personal debt was owed by consumers with incomes of \$4,000 and above.

It seems, then, that consumer creditors and debtors are basically sound, and that the credit

### WHO OWES THE DEBT?

In 1959, low-income families owed a relatively small proportion of the total personal debt. About 23 per cent was owed by families with yearly incomes under \$4,000.



Source: Survey of Consumer Finances, 1959

extended has not undermined the soundness of the financial system. On the other hand, credit has been an unstabilizing force in the economy; but its serious effects have been minimized by policies designed to promote economic stability.

### The backward art of borrowing money

Economists tell us that when the consumer goes out to buy, he thinks about how much he really wants the different goods and services that are offered and the prices he must pay for them. He spends his money so as to get as much satisfaction as he can.

Of course, his success or failure in consuming doesn't show up on any kind of satisfaction-meter, as the businessman's success or failure in buying shows up in his profit and loss statement. But assuming that the consumer usually knows

what's best for himself, the free enterprise economy is well calculated to make him happy.

Consumers signal their desires by casting dollar votes in the market place. Producers who want to make a profit follow these signals. The greater their efficiency and dispatch in following—or anticipating—the signals, the more profit they make. The consumer, therefore, should get what he wants with efficiency and dispatch.

But does he *really* get what he wants? Only if he gives the right signals. Since it's in his own interest, is there any reason why he wouldn't give the right signals? At times he can't give them because he doesn't know enough about the differences among the goods and services that compete for his dollar—differences in quality and differences in price. A consumer who doesn't have enough information can hurt himself; he may not get the most out of his income. If many consumers lack adequate information, they hurt the entire economy by permitting relatively inefficient firms to stay in business. We may think of the consumer as an economic planner doing the best he can for himself. But the plans he formulates don't always fulfill his personal objectives because he is sometimes either uninformed or misinformed.

When a consumer buys an automobile on time, he usually knows what his monthly payments come to, say \$50, and that he must make payments for a year or two. In one sense, then, he knows the total cost of the product he is buying. What he frequently fails to realize is that he is borrowing money as well as buying a product. In order to properly evaluate the merits of various offers in the market, he really must know the cost of the loan as well as the packaged cost of the loan and product.

If the consumer knows the cost of borrowing he may decide to wait a while before buying, save up

a little more and borrow less. On the other hand, he may borrow the same amount or even more. Regardless of the results, his decision would be on the basis of actual cost and his planning would be more rational, and less subject to bitter afterthoughts.

Even if the same products in the same amounts were sold, there would be benefits for the entire economy. If the consumer knows the alternative costs of borrowed money, he can systematically patronize the most efficient, lowest-cost lenders. Inefficient, high-cost, slick-operating lenders could not persist in siphoning business away from reputable and efficient financial institutions.

Take this case that came to light recently in court. A young housewife had borrowed \$50 from a loan shark on the promise to repay \$6 per week for every \$5 borrowed. She ended up owing him \$4,395. She didn't realize that the true annual interest cost on the \$50 she borrowed was over 1,000 per cent. Loan sharking is, of course, illegal but a good deal of it must persist simply because of consumer ignorance.

In recent testimony before a congressional committee, William McChesney Martin, the Chairman of the Federal Reserve Board, summed it up this way:

"As I remarked at the outset, men of good will wish the consumers not to be deceived by lenders and thus fail to receive the value they thought they had bargained for. *Caveat emptor* can scarcely operate in the absence of knowledge by the potential buyer and debtor as to how much he is really paying."

It has often been asserted that most consumers don't care about the cost of loans—that all they care about is the monthly payment. This may well be true. But it is another thing to argue that this is all they *should* care about. For their

(Continued on Page 14)

## THE COST OF BORROWED MONEY

The cost of a loan is often expressed in terms of an annual interest rate. For example, 6 per cent is the interest rate on a \$100 loan which must be repaid with \$106 at the end of one year's time. Interest is a customary and convenient way to state the cost of money. Six dollars, in this case, is another way of expressing the same cost.

On an instalment purchase it is frequently difficult to translate financial charges in dollars into simple interest rates. Insurance requirements, late-payment penalties, and a variety of other terms can make such a translation a difficult and sometimes impossible project.

Nevertheless, consumers could benefit by making interest rate comparisons where possible. Consumers must frequently decide between borrowing and saving. If the decision is to borrow, they must decide "who from." Returns for saving are often expressed as interest rates and interest rate comparisons show, in a simple fashion, higher and lower costs of borrowing.

There are certain classes of loans made by certain types of lenders for which it is not too difficult to determine annual interest rates. Commercial banks often deduct the cost of a personal loan in advance. The bank may charge a 6 per cent discount rate on a \$100 loan for a year; it will give the borrower \$94 on condition that he pays back \$100 in equal monthly instalments. Since the borrower does not have the use of \$94 for a full year—only in fact for the first month—the true annual interest rate is higher than the bank discount rate. It's about twice as high—12 per cent.

Some financial institutions, like credit unions and consumer finance companies, will charge a given per cent per month on the unpaid balance of a loan. The annual interest rate will usually amount to about 12 times the rate stated. A charge of 1 per cent a

month means a simple rate of 12 per cent a year. A charge of 2 per cent a month means a rate of 24 per cent a year. A 3 per cent per month rate on the unpaid balance of a loan may seem low but it amounts to a simple annual interest rate of 36 per cent a year.

All things being equal, interest will be lower if payments are monthly instead of weekly; the borrower obtains the use of a larger average amount of money on a yearly basis. If after the dollar cost of the loan is fixed the borrower has a year rather than nine months to pay it off, the interest rate will also be lower—basically for the same reason.

The annual interest rate on any loan can be easily approximated by using the following formula:

$$r = \frac{2 \times m \times I}{P(n + 1)}$$

- Where
- $r$  = the annual interest rate.
  - $m$  = the number of payment periods in one year (12 if you repay monthly, 24 if you repay semi-monthly).
  - $I$  = the cost of the loan in dollars (The cost of \$100 loan for which a 6 per cent discount has been charged is \$6.)
  - $P$  = the actual amount of the loan itself, excluding the dollar cost of the loan (\$94 in the above example).
  - $n$  = the number of repayments actually made.

If \$6 were deducted from a \$100 loan to be repaid in 12 equal monthly instalments, the formula would be filled in as follows:

$$r = \frac{2 \times 12 \times \$6}{\$94 \times (12 + 1)} = 11.8\%$$

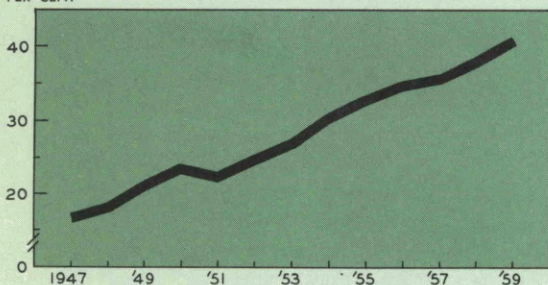
# IS THE CONSUMER OVERBURDENED?

To support a record-breaking buying splurge in 1955, consumers borrowed record-breaking amounts of money. Many observers tightened their lips and wondered. But in 1956 the growth of credit slowed and prosperity continued.

With credit again moving up rapidly in 1959—and with continued growth in prospect for 1960—many are beginning to wonder again.

The questions and the concern really go back further than 1955. Throughout the postwar period, total consumer debt has been growing more rapidly than over-all economic activity. *Consumer debt\* as a per cent of gross national product* has been climbing and in 1959 it reached an all-time peak.

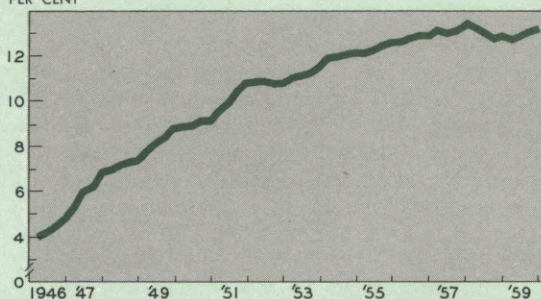
PER CENT



\* Includes mortgage debt, short- and intermediate-term and other consumer debt.

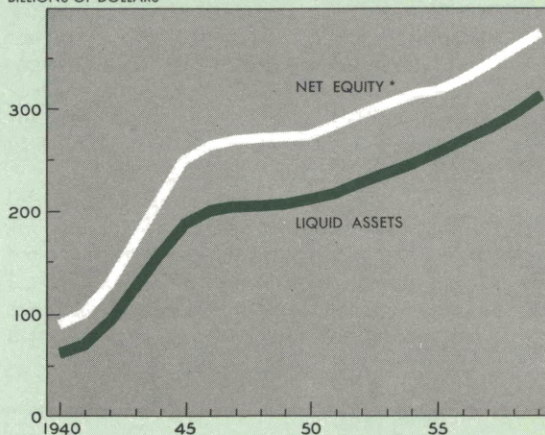
A rule-of-thumb ratio to weigh the burden of consumer debt—*instalment debt repayments as a per cent of disposable income*—has also been climbing through most of the postwar period. But in 1958, a year colored by recession, it fell; and last year, despite a rapid increase in instalment debt, it climbed slowly. At the end of the year it was still below the level reached in the last quarter of 1957.

PER CENT



While consumers have been borrowing heavily since the end of World War II, they have also been saving heavily—in fact, more heavily than they've been borrowing. Even in years when consumer debt has climbed steeply, financial savings of consumers as a whole have exceeded new borrowings. Mainly as a result of this, the *net financial equity of individuals* has been rising consistently. *Liquid assets* have been increasing in a parallel fashion.

BILLIONS OF DOLLARS



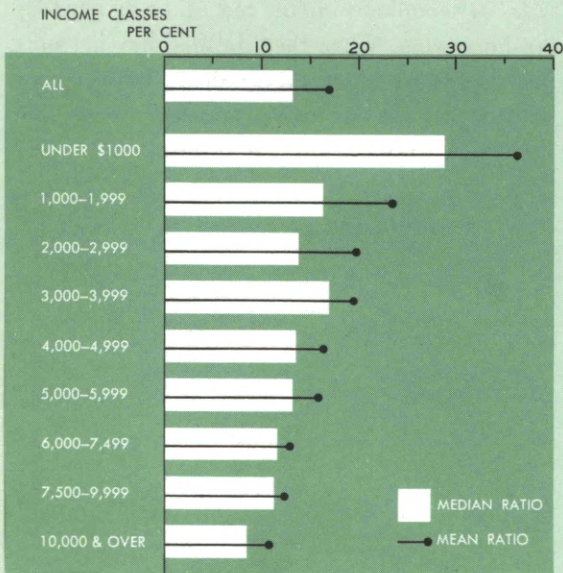
\* Total financial assets (excluding corporate securities) less total liabilities.

Source: Securities and Exchange Commission

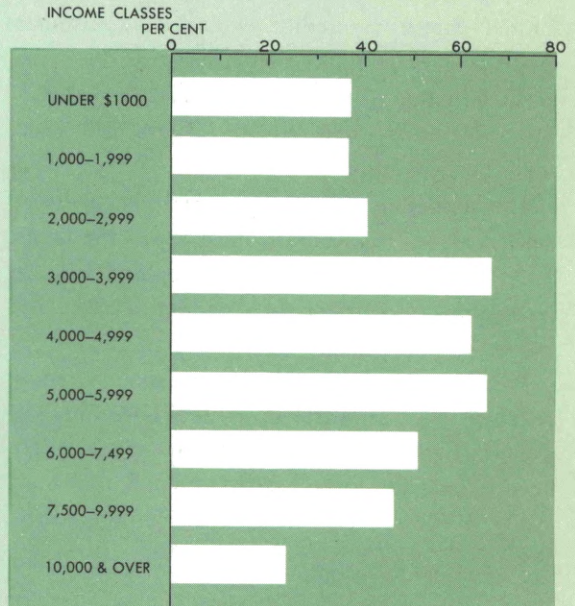
These general statistics on the consumer sector of the economy suggest that the consumer has not mortgaged his soul for an automobile and a freezer; and that he has the wherewithal to handle his debts. But they do not reflect the position of all individuals. When family units are divided into income groups, it becomes apparent that the debt burdens are not evenly distributed throughout the economy.

Families in the lowest-income groups tend to have the highest *average ratios of instalment payments to disposable income*; average ratios generally fall as incomes rise. In addition, there is a relatively large majority of indebted low-income families with unusually high ratios.\* But, it must be added, relatively few low-income families are indebted, and most of these owe only small amounts.

Middle-income debtors, on the other hand, have moderate ratios of payments to income. But middle-income families as a whole have high *ratios of personal debt\* to liquid assets*. If incomes fell sharply, these families might find it difficult to handle their existing debts easily.



\* In technical language, the mean ratios are greater than the median ratios in each income class. The differences between the mean and median ratios generally fall as income increases.  
 Source: Survey of Consumer Finances, 1959



\* Includes all short- and intermediate-term consumer debt other than charge accounts; excludes mortgage and business debt.

Source: Survey of Consumer Finances, 1959

In answer to our beginning question: Is the consumer overburdened? It depends on whether you are talking about a sector of the economy or human beings. The consumer sector does not appear to be "over its head" in debt; on the other hand some families in the low-income brackets are currently carrying very heavy loads.

*(Continued from Page 10)*

own well-being, as well as the well-being of the entire economy, consumers are well-advised to know and understand the prices they pay, including the price of money.

### **CONCLUSIONS**

During the past 40 years we have had in the United States a credit revolution. Consumer credit is so large today that it has really become a way of living. It has brought unquestioned benefits to consumers and industry. There have been some burdens also.

The individual consumer carries the heaviest burden alone. He, himself, must repay the debts he incurs. If he does not, his collateral will be repossessed and his credit standing severely injured.

The most heavily burdened consumers today seem to be concentrated in the lower-income groups. But the number with excessively high burdens appears to be relatively small.

The burden of consumer credit for the entire

economy does not at the moment seem alarmingly heavy. It is true that consumer credit has probably made the economy a little less stable than it otherwise would be; but the excessive difficulty large debts create when incomes fall has so far been minimized in the postwar period by over-all economic expansion, relatively mild recessions, and policies designed to keep incomes from falling during recessions.

The financial system today does not seem overly burdened by the rapid expansion of consumer credit. Lenders would probably run into serious trouble only in the event of a depression—and then, consumer debt wouldn't necessarily be the greatest difficulty.

A less measurable economic burden for the economy—but one just as real—occurs because consumers often buy on time in an uninformed way—without knowing the cost of the money they are borrowing. When they do this they not only hurt themselves, but they reduce the efficiency with which the economy provides goods and services in accordance with consumer tastes.

*“We will answer their demand for a gold standard by saying to them: You shall not press down upon the brow of labor this crown of thorns, you shall not crucify mankind upon a cross of gold.”*



## A CROSS OF GOLD?

The speaker was William Jennings Bryan. His audience: the 1896 nominating convention of the Democratic Party. His issue: the gold standard.

In recent months an important aspect of the gold standard has once more become the subject of lively controversy. That aspect: can the Federal Reserve System continue to ease money and credit during business recessions without massive outflows of gold; or will it be forced to keep money tight and interest rates high in order to protect our gold stock? In this article we shall

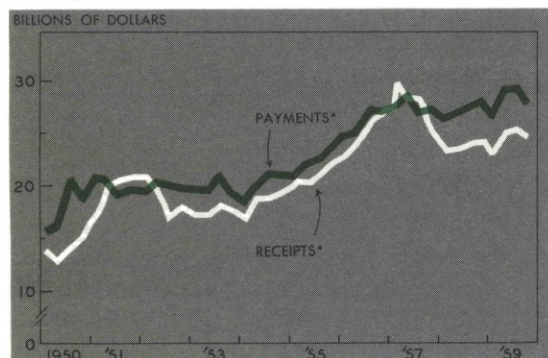
examine the issues and reasoning behind the current controversy.

### THE PROBLEM

In recent years the United States has run a fairly sizable deficit in its international balance of payments; that is, we have paid more to foreigners for imports, investments, economic and military aid than we have received from them for our exports and services. To settle the difference, we have transferred gold and dollars to foreigners.

The build-up in foreign-owned dollars has been especially significant. As the chart shows, foreign

**IN RECENT YEARS WE HAVE PAID MORE TO FOREIGNERS FOR IMPORTS, INVESTMENTS, AND ECONOMIC AID THAN WE HAVE RECEIVED FROM THEM FOR OUR EXPORTS AND SERVICES. . . .**

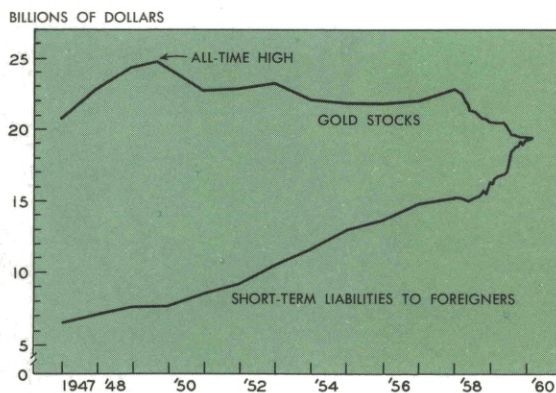


\* U.S. balance of payments, less short-term gold and dollar movements. Excludes military grants. Seasonally adjusted quarterly totals at annual rates.  
Source: U.S. Department of Commerce.

short-term dollar claims climbed from around \$8 billion in 1949 to over \$19 billion at the present time.

Now if this were the whole story, if foreigners simply owned more dollars, the present controversy might never have arisen. But since the

**. . . TO SETTLE THE DIFFERENCE, WE HAVE TRANSFERRED GOLD AND DOLLARS TO FOREIGNERS**



Figures plotted at year-end, except all-time high in 1949, and 1958-1959.

Treasury stands ready to sell gold to friendly foreign governments and official institutions for legitimate monetary purposes, these short-term

## WHY SHOULD A NATION BE CONCERNED ABOUT GOLD?

The nations of the world keep a watchful eye on gold because it affects their economic welfare.

Essentially, gold performs two important tasks. First, it serves in some countries as a “domestic cover.” That is, the volume of gold a nation owns sets some legal limit on the amount of money which may circulate. In the United States, for example, the Federal Reserve must hold a 25 per cent gold certificate reserve against its notes and deposits.

Second, gold serves as an “international money.” It is accepted by all nations for current purchases or in payment of debts. Since gold has this quality of an international money, many nations of the world feel that they should keep a reserve of gold around just in case they should ever want to make more purchases than they can pay for with receipts from current exports. For example, a predominantly agricultural country might hold a gold reserve so that it could maintain its purchases of farm equipment even if a severe drought should ruin its crops.

In the United States gold serves both these functions. It is a domestic cover and it is held as an international reserve.



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## WHY DOES THE U.S. ALLOW FOREIGN NATIONS TO BUY ITS GOLD?

The United States acts as a sort of “international gold banker.” The Treasury stands ready to buy all gold offered to it by friendly foreign governments, central banks, and international financial institutions at a rate of \$35 per ounce. Conversely, it will sell gold for dollars at the same price. But why is the United States willing to take on the responsibility of an international gold banker, thereby adding to the claims on its gold stock?

By standing ready to convert dollars into gold, dollars become “as good as gold.” Nations are therefore willing to hold dollars along with gold in their international reserves. Thus in effect, the world’s gold stock is stretched. This has important implications for the volume of world trade.

A nation is somewhat like a big family. When the family has “a little bit tucked away” to take care of emergencies, chances are father will permit the family to spend a little more out of current income. Similarly, a nation which has “a little bit tucked away” will probably be more disposed to let its citizens freely import goods without a maze of tariffs and controls. Thus by increasing the amount which may be tucked away—by adding to the world’s international reserves—the United States helps increase the volume of world trade and improve the world’s living standards.

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liabilities represent a potential claim on our gold stock—a claim which conceivably could result in a substantial gold outflow.

Is such an outflow likely? What could happen to set off such a drain?

Concern expressed recently runs something like the following.

During a cyclical downturn in business activity, the Federal Reserve System traditionally takes steps to make money and credit more easily available. As a result, the supply of lendable funds tends to rise relative to demand, and interest rates fall.

With falling interest rates, it is said, many foreigners will be tempted to shift their funds to other countries where interest rates are higher. As a result, foreign central banks (which must ultimately buy the expatriated dollars if no businessman or other individual is willing to do so) will own an increasingly larger volume of dollars. If these central banks should decide to convert dol-

lars into gold, the United States could sustain a sizable gold loss.

This puts the Federal Reserve in an awkward position, the reasoning continues. Instead of encouraging credit expansion during recession—thereby stimulating investment and employment—the Fed may be forced to tighten money and let interest rates rise to stem the gold loss. Thus, the argument concludes, recession-oriented easy money policy is a thing of the past. The Fed’s hands are tied.

To what extent may this reasoning be accepted at face value? To answer this question we must (a) examine the nature of our short-term foreign liabilities as compared to the United States gold stock, and (b) take a look at 20th century institutional structure and national objectives in comparison with their 19th century counterparts.

### **GOLD VS. SHORT-TERM LIABILITIES**

United States gold reserves amount to almost \$19.4 billion. After deducting required reserves

against Federal Reserve notes and deposit liabilities, the Treasury has \$7.6 billion in gold that could flow out before the Fed would legally be forced to cease expanding credit. How likely are we to lose \$7 billion in response to international interest-rate differentials?

As mentioned, our short-term liabilities to foreigners total a little over \$19 billion, almost as much as our gold reserves and a great deal more than our free gold. But not all of this amount is sensitive to fluctuations in interest rates. Let's take a look at the structure of our short-term dollar liabilities.

About \$3 billion belongs to international institutions, such as the International Monetary Fund, and does not move in response to international interest-rate differentials. Another \$9 billion belongs to foreign governments and official institutions. These funds may move from one type of dollar asset to another—as from time deposits to Treasury bills—but they are not likely to move in any large amount as a result of international interest rate differentials. Finally, about \$6 billion of the remaining \$7 billion are in large part working balances of private businesses and financial institutions. These working balances are needed in handling a large volume of international trade and financial transactions. They are not sensitive to rate differentials.

Thus the great majority of foreign funds is held in this country, not because interest rates are higher than those abroad but because of our role in foreign trade financing and because the dollar is an international reserve currency readily convertible into gold or into any other foreign currency. There is no evidence that more than a small fraction of these short-term dollar liabilities would be transferred abroad as a result of falling interest rates in the United States. A gold loss of this amount could easily be sustained

without adverse impact on the Fed's ability to expand our money and credit base during downturns in the business cycle.<sup>1</sup>

But there is a second important factor to consider in an analysis of the current gold controversy, a factor involving fundamental social and economic changes which have occurred since the 19th century.

## **A STUDY IN CONTRAST**

### **The role of gold in the 19th century<sup>2</sup>**

Under the classical gold standard of the 19th century, gold movements played a crucial role in the economic affairs of a nation. Gold flows served as a signal to the central bank that the domestic economy was out of step with the world, that either prices or interest rates deviated from the international norm.

It was reasoned that gold was shipped to foreigners only because (a) domestic merchants bought more than they sold abroad, or (b) capitalists lent more than they borrowed abroad, settling the balance in gold. Merchants and capitalists behaved in this manner because foreign prices were lower or interest rates higher than those currently prevailing at home. For a country on the gold standard, however, gold movements, working in conjunction with central bank policy, would soon correct the domestic imbalance. How?

An important part of the gold standard was the so-called "rules of the game." Strict adherence to the "rules" required central banks to permit an outflow of gold to have a deflationary

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<sup>1</sup> Even if some of these privately held balances were transferred abroad a gold loss need not result. Withdrawals of foreign private funds usually have been effected through a sale of dollars to a foreign central bank. To the extent that the foreign central bank follows a policy of holding its international reserves in dollar assets (rather than gold) the net effect of the transaction is merely the substitution of one dollar holder for another.

<sup>2</sup> The term "19th century" is used here to include both the 19th century proper and the first part of the 20th century up to the beginning of World War I.

effect on the domestic economy.<sup>3</sup> In a nation losing gold, private bankers (who expanded and contracted credit according to the amount of gold in their vaults) were forced to contract loans. The central bank, in turn, raised its discount rate, further discouraging the expansion of credit. With less money pursuing domestic goods, prices tended to fall to levels prevailing in foreign lands. With less credit available, interest rates rose.

Thus, argued advocates, the gold standard provided a great advantage to participating nations. First, it kept domestic prices internationally competitive. Second, it kept interest rates in line with those prevailing in other nations. Third, it contributed toward stable exchange rates.

But the gold standard also had its disadvantages. Suppose, for example, that lower foreign prices resulted not from greater efficiency but from severe depression in foreign lands. Obedience to the rules of the game in such a situation would mean imposing on the domestic economy the same depression suffered abroad.

Thus the gold standard was not without its costs; and heavy those costs were. Two words summed them up: internal instability. Whenever gold flowed out in quantity, the 19th century rules of the game called for a central bank policy which often led to falling prices, production, and employment.

But why does the 20th century refuse to accept the dictates of the gold standard rules? The answer: a wide chasm separates the two centuries, a chasm encompassing far-reaching social and economic change.

### The 19th century id

The gold standard rules evolved over time. Some

committee just didn't sit down and legislate them. Yet social and economic conditions had to be such that society would *accept* the rules. What were the conditions of the 19th century which led to this acceptance?

First of all, the 19th century desperately needed the stable exchange rates and competitive price structure the gold standard promised—more so than any period history had yet seen. The reason why is implicit in the explosion of economic activity associated with the Industrial Revolution.

Through invention and innovation, the Industrial Revolution substituted steam for muscle, machinery for manpower. As a result, the productive capacity of Western Europe and the United States expanded enormously. We could make more barrels and bottles, textiles and train tracks.

But this great expansion in productive capacity was no wholly unmixed blessing. If all capacity were to be utilized, if profits were to be maximized, businessmen had to sell abroad as well as at home. Indeed, in the latter part of the 19th century Britain exported over 30 per cent of the output of farms, mines, and factories. To sell in foreign markets, competitive prices were a necessity, stable exchange rates an extremely desirable corollary. These the gold standard promised.

Yet the need to export was only one of the prerequisites necessary for acceptance of the gold standard. Alone it probably would have been insufficient. A second ingredient was also necessary. That ingredient was a peculiar public resignation to domestic recession.

For the 19th century, recession simply did not hold the “chamber of horrors” it does for the 20th century. There were several reasons for this. First of all, recessions—though numerous and often sharp—never compared in length, depth, or breadth with the Great Depression of the 1930's.

<sup>3</sup> Though sometimes central bank action was not so automatic as our elementary textbooks describe. See Arthur I. Bloomfield, *Monetary Policy Under the International Gold Standard, 1880-1914* (New York: Federal Reserve Bank of New York, October 1959).

As a result, public pressure for remedial action was never as strong.

A second reason for Victorian insensitivity to recession lay in the prevailing habits and mores of the times. In the Victorian ethic, recession was the inexorable price of profligacy—a sort of economic purgatory where society paid for its fiscal sins. The rising middle class thought of the trade cycle (if they thought of it all) as a necessary purge of the inefficiency built up during booms. Since legislative action reflected middle-class sentiment, no stringent anti-recession measures were passed.

Along with the necessity to export and resignation to recession, a third factor was characteristic of the 19th century: a preoccupation with economic laws, with the doctrines of the classical economists—Adam Smith, David Ricardo, and Thomas Malthus, to name but a few. Just as the physicists expounded the laws of Nature, economists sought to posit the laws of economics. They enunciated the law of supply and demand, and countless other doctrines. From these laws to the “rules” of the international gold standard was but a short leap for minds already conditioned to the acceptance of sacred economic dicta; a short leap indeed for an age fascinated by the scientific method; an era eager to embrace a logically defensible package which explained in simple terms how a complex international economy could function successfully.

And so it came about. The growing necessity to export, resignation to recession, a predisposition to accept economic laws—this was the stuff of which the classical gold standard was made. In an age of political nationalism, the Victorians virtually surrendered their economic sovereignty to the forces of international gold movements.

Yet, with its emphasis upon domestic stability, the 20th century could hardly be more different.

What forces have contributed to this fundamental about-face?

### **The 20th century**

Today we still want internationally competitive prices and stable exchange rates, but we are unwilling to surrender domestic economic stability to get them.

Our reluctance stems from basic economic and social changes which have occurred in the 20th century. Today one of the vital ingredients of the gold standard is missing. We are no longer resigned to recession. We have experienced the Great Depression of the 1930's.

During the Great Depression the average man saw one out of every four of his fellow employees out of work for months, even years. He saw machines capable of satisfying human wants go unintended because of some mysterious defect in our economy. He saw his own family deprived of the goods these machines might produce. He saw bread lines, poverty, shanty towns growing up overnight.

And these scenes left telling scars on the American conscience, scars that were soon translated into government action. For times had changed since the 19th century. Whereas the middle class was once the nucleus of political power, the average man was now the common denominator of political success.

Reflecting both this shift in political power and the widespread discontent of the jobless, talk of recession as “a necessary purge” came to have a decidedly hollow ring in the ears of our legislators. Government realized that something had to be done to relieve the mounting pressures of unemployment. Disenchanted with Victorian ethic and the logic of *laissez faire*, a new concept was born. If private business could not provide employment opportunities for all those willing and

able to work, the reasoning went, public authority must come to their aid.

And what of a money standard that called for internal deflation in response to outflows of gold? By executive proclamation on March 4, 1933, the United States officially left the international gold standard.

But what of today? Once again we are experiencing gold drains. Is there a chance that we might deflate to stem the tide?

Society's answer to this question is best expressed in the Employment Act of 1946 which calls on all agencies of the Federal Government to "use all practical means . . . to promote maximum employment, production, and purchasing power."

Since 1946 we have had further pertinent comments from Congress. One need only leaf through the pages of such studies as "Employment, Growth, and Price Levels" by the Congressional Joint Economic Committee to find ample evidence of our growing intolerance of unemployment and domestic recession.

Yet it goes without saying that the United States is suffering serious balance-of-payments difficulties, difficulties which will be hard to reverse. To correct them we must keep our economic house in order. We must keep costs down and prices stable if we are to sell abroad.

Thus, even if society will not permit gold movements to dictate domestic economic policy, we still are not relieved of fiscal and monetary

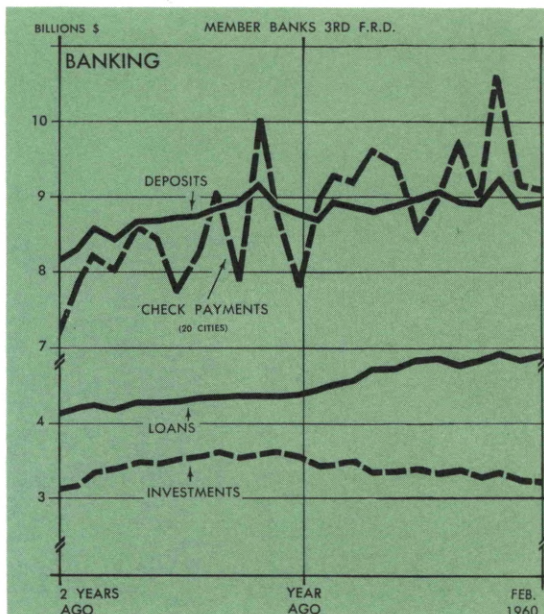
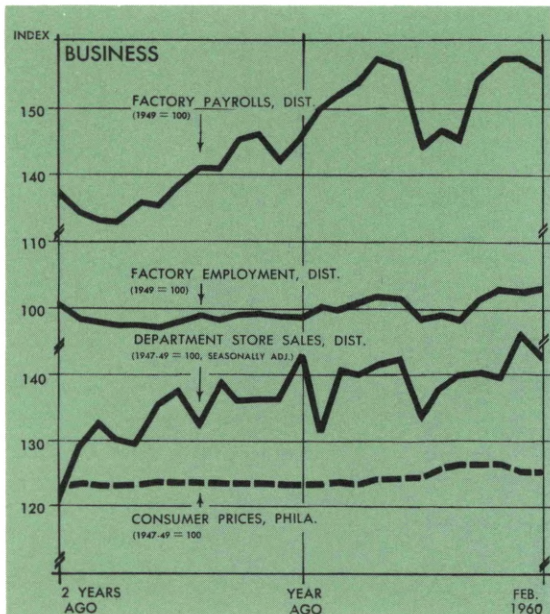
*responsibility.* Society has simply evolved *new approaches* to that responsibility, approaches which combine the best qualities of the old gold standard with our new emphasis on domestic stability. Today we obtain stable exchange rates and more liberal international trade through our participation in institutions such as the International Monetary Fund. Yet by this participation we are not bound to a policy of deflating with every decrease in our gold stock. In determining the amount of money and credit which will circulate, we call on the judgment of trained central bankers rather than automatic reflex action based on gold flows. Central bankers examine a host of criteria in determining monetary policy—employment, capacity, prices, production, as well as gold movements. They weigh these criteria in formulating that policy best calculated both to meet our international economic commitments and to maintain maximum domestic employment, stable prices, and conditions favorable to a sustainable rate of economic growth.

What would William Jennings Bryan say if he could see the economic institutions we have evolved today—if he could see how we have combined the best qualities of the old gold standard with our new emphasis on domestic stability? Though it is difficult to know precisely what Bryan would say, we can be pretty sure of one thing. He could *not* say that mankind today is being crucified upon a cross of gold.

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*Additional copies of this issue are available  
upon request to the Bank and Public Relations Department,  
Federal Reserve Bank of Philadelphia,  
Philadelphia 1, Pa.*

# FOR THE RECORD...



SUMMARY	Third Federal Reserve District			United States		
	Per cent change			Per cent change		
	Feb. 1960 from		2 mos. 1960 from year ago	Feb. 1960 from		2 mos. 1960 from year ago
	mo. ago	year ago	year ago	mo. ago	year ago	year ago
<b>OUTPUT</b>						
Manufacturing production...	-1	+2	+3	+2	+10	+10
Construction contracts ...	+22	-3	-15	+2	-3	-4
Coal mining .....	-8	-7	-5	-4	-4	-2
<b>EMPLOYMENT AND INCOME</b>						
Factory employment (Total) .....	+1	+4	+4	0	+5	+5
Factory wage income.....	-1	+7	+8	0	0	0
<b>TRADE*</b>						
Department store sales ...	-2	0	+4	-3	-1	+2
Department store stocks ...	-1	+5	0	-2	+5	0
<b>BANKING</b> (All member banks)						
Deposits .....	0	+2	+1	-1	0	0
Loans .....	+1	+12	+12	+1	+13	+13
Investments .....	-1	-10	-10	-3	-14	-14
U.S. Govt. securities.....	-2	-12	-13	-4	-18	-17
Other .....	0	-1	-2	-1	-2	-2
Check payments .....	-1†	+15†	+9†	-4	+13	+8
<b>PRICES</b>						
Wholesale .....	0†	0	0	0	0	0
Consumer .....	0†	+2†	+2†	0	+2	+1

LOCAL CHANGES	Factory*				Department Store†				Check Payments	
	Employment		Payrolls		Sales		Stocks		Check Payments	
	Per cent change Feb. 1960 from		Per cent change Feb. 1960 from		Per cent change Feb. 1960 from		Per cent change Feb. 1960 from		Per cent change Feb. 1960 from	
	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago
Allentown ...	+3	+6	+3	+14	0	0	0	0	-7	+13
Harrisburg ...	0	+10	-3	+16	0	0	0	0	-2	+12
Lancaster ...	0	+3	+1	+6	-12	-4	-9	+9	+6	+26
Philadelphia ...	0	+3	-2	+7	-4	0	-2	+5	0	+14
Reading ...	+1	+6	+2	+10	-4	-1	-8	+4	-5	+16
Scranton ...	+1	-1	-1	+1	+1	0	-1	+3	+1	+2
Trenton ...	0	+5	-4	+10	+8	+10	+6	+13	-12	+5
Wilkes-Barre ...	+3	+3	+5	+6	-7	-2	-3	+11	-4	+7
Wilmington ...	+1	+8	+2	+13	-1	+2	-6	+4	0	+33
York ...	+1	+4	+1	+5	+5	-2	+5	+8	0	+32

\*Not restricted to corporate limits of cities but covers areas of one or more counties.  
†Adjusted for seasonal variation.