Research Department
Federal Reserve
Bank of
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Never Never

The dollar figures can be almost terrifying. American families increased their liabilities by roughly $150 billion in both 1977 and 1978 — in other words, they went into debt twice as fast as they did in any period prior to the present cyclical expansion. Many families also stretched out the maturity of their debt, making that descriptive British term for consumer credit — the "never never" — even more apropos.

This situation has created much alarm, not only among those concerned with the nation's moral fiber but also among hard-eyed credit managers concerned with people's ability to pay their debts. They note that total household liabilities roughly doubled between 1972 and 1978 to about $1.2 trillion — whereas total household financial assets rose only about one-third over that period to about $3.3 trillion, reflecting such factors as an actual decline in the value of corporate equities. (Incidentally, personal trusts and nonprofit organizations account for a minor share of the "household" statistics in the Federal Reserve's flow-of-funds data.)

Build-up and stretch-out

No one denies that consumers have been taking on debt at a feverish pace, and that that credit upsurge has accounted for most of the strength in the four-year-old business expansion. (Consumer spending has accounted for more than 60 percent of total GNP growth since the early-1975 upturn, compared with roughly a 50-percent average share in earlier postwar cycles.) With this upsurge, some traditional measures of debt burden have obviously worsened. For example, outstanding consumer instalment debt approached 15 percent of personal income in recent months, after holding in the 12-13 percent range throughout most of the past decade. But traditional measures may give a misleading impression because they ignore some key developments of this inflationary decade, especially the ability of consumers to expand purchases by utilizing inflation-based gains in home-equity values.

The net increase in household liabilities reached a record 10.9 percent of disposable (after-tax) personal income in 1977, and apparently remained near that level in 1978 as well. That ratio, like credit use generally, tends to rise in each business expansion, but the 1977-78 statistics were far above the previous peak figure of 8.6 percent reached in 1972. But an increase in liquidity went along with this relatively greater dependence in debt financing. Household acquisitions of financial assets amounted to 16.1 percent of disposable income in 1977 — somewhat higher than the earlier (1973) peak of 15.5 percent — and this ratio remained quite high in 1978. Much of the increase centered in highly liquid assets, with households adding roughly $100 billion to their time and savings accounts in each of the past three years.

Moreover, many debtors recently reduced their current repayment burden by stretching out their debt maturities, most obviously in the auto-financing field. Until 1974, practically all new-car loans had maturities of three years or less. Today, four years is the norm, and many banks — indeed, most California banks — are even offering five-year maturities. The financial attractions

(continued on page 2)

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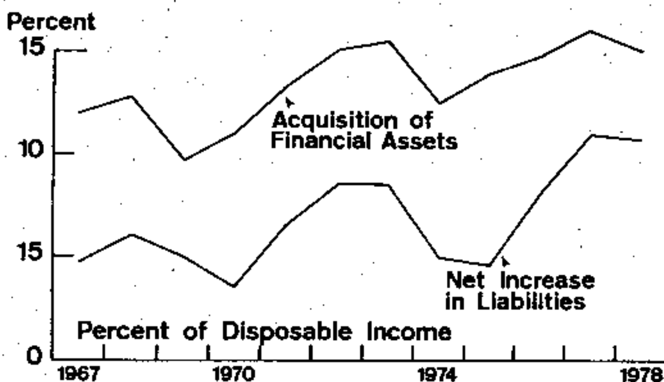
are obvious; with $8,000 owed on a new auto, for example, the borrower pays about $275 monthly for a three-year loan, $220 monthly for a four-year loan, but only $187 monthly for a five-year loan. But of course the total interest payments are much greater for the longer loan, not to mention the likelihood of continued payments when the car is almost ready for the scrap heap.

Key role of inflation
In making their borrowing and spending decisions, households have come to be strongly influenced by the build-up in their home equities — perhaps $1 trillion is now available to serve as potential collateral for additional borrowing. Residential property represents by far the major tangible asset of the household sector, and the rapid inflation in prices of existing homes — spurred partly by expectations of future price appreciation — has sharply boosted the value of the nation's housing stock. In the decade to date, the median price of homes has jumped from $22,600 to $57,300.

With that heaven-sent boost in borrowing power, the household sector has raised unprecedented amounts of mortgage funds against its inflated equity, and used those funds for a number of purposes other than home building. Borrowing against equity in existing homes accounted for about one-quarter of total home-mortgage debt formation in the first half of the decade, and that proportion jumped to nearly one-half in the 1976-77 period. These funds have been raised primarily in connection with sales of existing homes, and only secondarily through the refinancing of outstanding first mortgages or the financing of second mortgages. (Still, California banks alone have been making roughly $1 billion a year in "home equity" second mortgages.) Households have used the funds raised against their home-equity values to bolster consumption spending — new cars, college educations and European vacations — but also to replace other forms of debt or to build up their financial assets.

Inflation has also stimulated the debt upsurge by persuading consumers to adopt a "buy in advance" strategy as a hedge against future increases in prices. Households have gone heavily into debt to purchase such tangibles as houses, land and durable goods, especially in view of inflation-caused declines in the values of financial assets such as stocks and bonds. Increasingly sophisticated about inflation, many households have leveraged themselves to the limit, since they know that they can pay off their debts in cheaper dollars — and that they meanwhile can deduct their interest payments from their tax returns.

Life cycle and business cycle
Demographic factors have also stimulated demand during this decade, according to the "life cycle" thesis — which states that most borrowing is done by young households who need credit to build up their basic stock of cars, furniture and appliances. For the 1970's as a whole, the number of persons in the 25-34 age bracket has been



increasing by 11½ million — a 46-percent increase, as against the 10-percent increase of the preceding decade.

This new generation is building on the experience of the first post-World War II generation. Credit usage mushroomed in the first decade following the war, partly because of the pent-up needs left unsatisfied during the depression and war periods, and partly because of the growing social acceptability of paying on time. And for several decades, widening credit usage has stimulated a process of *embourgeoisement*, which permits blue-collar workers to adopt living standards previously available only to more affluent white-collar workers. If anything, the process has speeded up in recent years because of fair-credit legislation, which prohibits creditors from discriminating in various ways when considering credit eligibility.

Credit usage has also risen during this cyclical expansion because of the easy availability of mortgage and consumer-credit funds from highly liquid financial institutions. During each of the past two years, the banking system recorded gains of almost 20 percent for both mortgage and consumer loans. Moreover, all types of financial institutions worked to find new ways of making credit available to consumers. As already noted, banks advertised "home equity" second mortgages as a means of unleashing household spending power locked up in inflation-bloated equity values. Many brokerage firms encouraged their customers to look upon them almost as banks — specifically, to use their margin debt to purchase consumer goods and services as well as securities. (According to one survey, "non-stock" borrowing might represent about one-sixth of total margin loans.) And institutions everywhere provided instant credit availability through the 600 million credit cards now located in the nation's wallets.

Continued upsurge?

Will the upsurge in credit usage continue in 1979 and 1980? Probably not at the recent pace, at least partly because of recent policy measures designed to reduce the easy availability of credit in a highly inflationary atmosphere. Moreover, many households now appear to be borrowed to the hilt, even if some traditional debt-burden ratios overstate the danger. According to a recent Harris Poll, 77 percent of the nation's households now report themselves in debt — up substantially from the 54-percent ratio of 1971 — and a large majority of those owing money express serious worries about their debts.

At the same time, demographic data suggest a continuation of heavy demand for at least the next several years, as young families (especially two-income families) continue to accumulate all the durable goods they consider their birthright. And as long as inflation remains unchecked, the flight into goods — and into debt — seems likely to continue. Even if not true before, "never never" now seems to be imbedded in the American Way of Life.

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