Are households financially overextended?

American households have played a key role in the course of the current economic expansion. Their expenditures on consumption and residential construction have contributed more to the growth of demand than at similar stages in most earlier postwar upturns. However, the strong gains in household spending have been accompanied by sizable increases in household indebtedness. Consumer instalment debt grew particularly rapidly in the first half of this year. Households have also taken on a considerable amount of mortgage debt. Their purchases of new homes have jumped sharply at a time when home prices and the average value per mortgage have continued to rise markedly While this willingness to undertake debt is a sign of consumer confidence, it has also raised concern that households might become financially overextended If they did, that would act to slow the growth of consumption in the near term as well as raise delinquency rates on outstanding consumer debts

It is difficult, though, to identify excessive debt levels with any precision. A household's ability to service debt depends on a number of factors such as family size and stability of income. The trend to smaller families, the greater number of women and teenagers at work in recent years, and relatively more household heads in the ages during which income gains have traditionally been the greatest may have increased the amount of debt which households in the aggregate can service. Yet, with sharply rising housing prices and interest rates still high by historical standards, households that purchase their first homes are initially committing a somewhat larger proportion of income to service their mortgages than families in earlier postwar years did. As to consumer instalment debt, relative to income it is not out of line with experience in the past decade Moreover, delinquency and bankruptcy data, while somewhat difficult to interpret over time, do not currently indicate excessive debt burdens. However, maturities on auto loans have increased markedly, and this development could be troublesome since auto repayments will be a charge on household budgets for a longer time than before.

Recent changes in consumer debt

As the recovery got under way, consumer instalment credit appeared to be expanding somewhat more slowly than in most previous postwar upturns. Beginning in late 1976, however, it speeded up markedly and posted a record gain in March 1977. Since that time, the increases have remained sizable, although below the March rate. All major categories of instalment credit with the exception of credit to finance mobile homes have expanded notably· automobile, home improvement, bank credit card, and bank check credit loans, personal loans at commercial banks and finance companies as well as loans in the "all other" category.[1] And, according to annual data, substantial gains have occurred in noninstalment credit (single-payment loans, charge accounts, and service credit). The total in recent years has been about one-fifth as large as instalment credit and has exhibited fairly similar movements

There has not been any recent major change in the market shares of the main sources of credit. banks, finance companies, credit unions, and retail stores. However, over the last ten years the market shares of banks, credit unions, and the "other" group have risen at the expense of finance companies and retailers (see table).

The burden of debt

One common way to gauge the burden of consumer debt is to divide various measures of debt by disposable income. Two such ratios—the instalment credit-to-

[1] The "all other" category consists chiefly of retail store credit, personal loans at credit unions, and loans for other consumer goods

income ratio and the instalment credit repayment-to-income ratio—appear in Chart 1.

The repayment-income ratio may be a better measure of the current financial vulnerability of consumers than the debt-income ratio because the former measures ability to pay. But the debt-income ratio is a better measure with which to judge whether the debt burden may impair a household's future ability to buy The reason is that increases in the maturity of debt (longer terms) are more directly reflected in outstanding debt than in repayments.

At present, both measures are somewhat below their respective peaks in the previous business expansion even though they have been rising in the current recovery largely as a result of increasing expenditures on durable goods This, however, is typical behavior during an economic upturn Compared with the past, the debt-income ratio is above the cyclical peaks it reached prior to the 1970's, while the repayment-income ratio remains below the peaks prevailing in the latter half of the 1960's

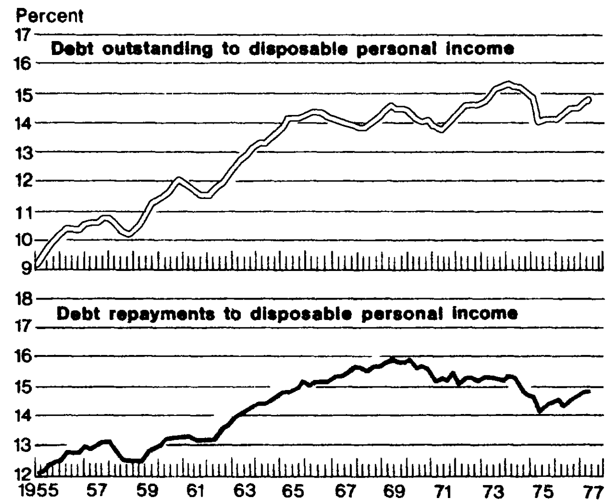
One reason why it is hard to determine whether debt burdens are nearing a level that might trigger delinquencies or cause consumption to weaken is that, when more closely inspected, the two ratios seem to be giving off somewhat different signals. For example, relative to the experience of the past ten years, the debt-income ratio looks somewhat higher than the repayment-income ratio. In part, this reflects the impact of inflation. Given the dependence of repayments on past extensions, the percentage rise in repayments will be less than the percentage rise in disposable income when accelerating inflation causes current disposable income to grow faster than extensions granted in a previous period. This process helped depress the repayment-income ratio in the early 1970's, a period when the debt-income ratio was rising. Instalment debt has also grown somewhat faster than repayments, partly because the average maturity of total outstandings has risen owing to the longer maturity of auto loans granted in recent years.

There is some concern that debt relative to income is getting too high because the ratio is nearing its previous peak However, the particular level that might signal a slowdown in consumption is difficult to determine since in postwar business cycles the debt-income ratio has peaked at successively higher levels.

Another problem in interpreting the two instalment debt ratios is a lack of information about how debt is distributed among households. For example, it is uncertain whether an increase in outstandings reflects more consumers taking on higher but still prudent amounts of debt or whether some borrowers are getting overextended We know that through the mid-1960's the ratios registered strong secular increases, reflecting the wider acceptance and availability of consumer credit, and at that time neither

Chart 1

Key Instalment Credit Ratios



Sources Board of Governors of the Federal Reserve System and Department of Commerce

Consumer Instalment Credit Outstanding

In percentage of total

Category	Year-end 1965	Year-end 1970	Year-end 1975	Year-end 1976	End-June 1977
By holder					
Commercial banks	40.9	44.5	47.7	48.3	48.6
Finance companies	33.6	27.0	21.8	20.8	20.8
Credit unions	10.3	12.7	15.6	16.5	17.2
Retailers	13.4	13.4	10.9	10.3	9.2
Others	1.8	2.3	4.0	4.2	4.3
By type					
Automobile	40.1	34.5	33.9	35.6	36.9
Personal*	†	21.6	19.3	18.5	18.4
Mobile home	†	2.4‡	8.7	7.9	7.4
Home improvement	5.3	4.9	5.7	5.9	6.0
Bank credit card	†	3.7	5.8	6.1	5.8
Bank check credit	†	1.3	1.7	1.6	1.6
All other	54.6	31.6	24.9	24.4	23.8

* At commercial banks and finance companies

† Not available

‡ At finance companies

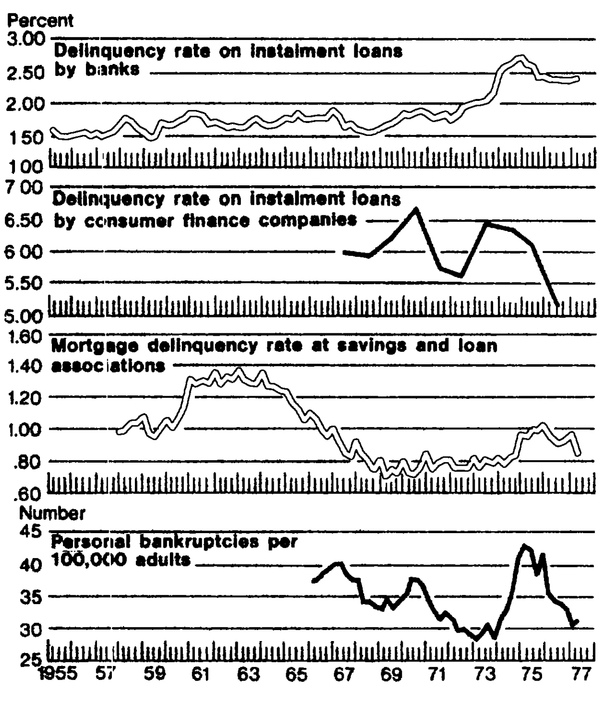
Source. Board of Governors of the Federal Reserve System delinquencies nor general economic instability was increasing. The difficulty of identifying a dangerous level of debt is intensified by lack of information about the effects on consumer vulnerability resulting from changes in family size, the number of workers per household, and earnings prospects. Moreover, it is hard to tell whether consumer debt as a whole is burdensome without also examining mortgage debt liabilities and here, as will be discussed below, the difficulties multiply.

Delinquency and bankruptcy

There are other gauges of the consumer debt burden in addition to the measures that relate aspects of debt to income. Among them are the ratios of the number of delinquencies to total consumer instalment loans at banks and to loans at finance companies, as well as the number of personal bankruptcies per capita (Chart 2). All three measures are below their recession highs, and in 1976 delinquency rates at finance companies were at their lowest level in the ten-year history of the series

Chart 2

The Credit and Bankruptcy Records of Consumers



Sources. American Bankers Association, National Consumer Finance Association, United States League of Savings Associations, Administrative Office of the United States Courts, Board of Governors of the Federal Reserve System, and Department of Commerce

Comparisons of delinquency rates with earlier periods reflect changes in various institutional practices as well as in debt burdens. For example, while the delinquency rate on bank instalment loans is below its previous recession high, some analysts emphasize that it is still above the levels reached in the 1971-73 recovery and in the 1950's and 1960's However, the higher rates of 1972-77 relative to earlier postwar years follow a period when commercial banks successfully gained market share, mostly at the expense of consumer finance companies; the customers of finance companies traditionally experience higher delinquency rates than the customers of commercial banks Consequently, during the past five years the bank delinquency rate has risen relative to the finance company rate. Even so, the bank loan delinquency rate is now only about one half of the rate at finance companies.

Bankruptcy data are also shown in Chart 2. The recent level of bankruptcies appears to be on the low side. However, it is difficult to draw very firm conclusions from this, particularly because state laws and judicial practices vary over time.

The longer maturities on auto loans

Even though debt-income and delinquency ratios do not now depict an overextended consumer, the recent trend toward longer maturities and lower monthly payments on automobile loans raises some potentially troublesome questions. In May 1977, 38 9 percent of new auto loans at commercial banks were for more than thirty-six months, compared with 22 4 percent in May 1976 and 12.9 percent two years earlier. At finance companies, this percentage amounted to 44.9 percent in May, 32.0 percent a year earlier, and 22.8 percent two years earlier. This trend has made auto loans affordable to more families and thus contributed to the strong auto sales in the current recovery

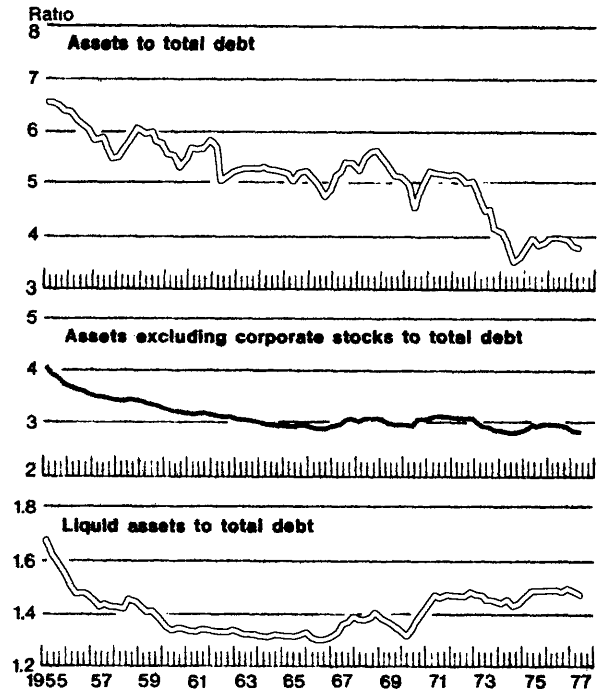
If consumers continue to spend the same proportion of their income, then the lower monthly repayments on auto loans will leave more room for other expenditures However, the repayments will remain in household budgets for a longer period than before, and whether this will cause households to keep their cars longer before replacing them depends on a number of considerations Should the repayment period for some households become longer than the desired period of owning a car, some of the proceeds from the car sale may be used to repay the existing car note. In that case, households would have less money to make a downpayment on another car. If securing enough downpayment became a problem, households might have to hold on to their old cars until the existing note was paid out on the original terms. The result would be a temporary drag on the total demand for autos. While this example illustrates only one of many possible sets of assumption about such factors as holding periods, repayment practices, and savings rates, it does demonstrate some of the concerns about the effects of longer maturities.

Mortgage debt
The burden of consumer instalment debt cannot be judged without also considering the claims mortgage debt service makes on household budgets. However, the burden of mortgage service payments is particularly difficult to evaluate because of the variety of possible financial positions homeowners may be in after the rapid rise in home prices and the relatively high mortgage interest rates in recent years. A family that purchased an average price new home with a conventional mortgage in July 1965 paid $24,700 and took out an average $18,525 mortgage of 25.0 years bearing an interest rate of around 5.75 percent. It then faced monthly amortization payments (principal and interest) of $117. A family that purchased an average price new home with a conventional mortgage in July 1977 paid $53,700 and took out an average $40,000 mortgage of 27.9 years bearing an interest rate of around 9.00 percent. It then faced total monthly payments of $327. While the average monthly payment almost tripled over the period, the size of median family income only about doubled. The average conventional mortgage payments on purchases of existing homes have also about tripled over the same period. Thus, compared with homeowners who purchased their properties in the 1960's and earlier, recent home buyers who had no equity in older homes to use for large downpayments have taken on a higher repayment-income ratio.

Families buying their first home in the 1970's are still a reasonably small minority of all homeowners, however. And the above comparisons somewhat exaggerate the burden even on such families. With higher interest rates, tax deductible interest payments are now a larger portion of debt service payments in the early years of a mortgage than they were previously. For example, on average price homes purchased with average conventional mortgage terms, interest payments as a percentage of total monthly debt service in the first year of the mortgage were about 75 percent in 1965 but rose to 90 percent in 1977. Moreover, if inflation continues, a family's mortgage debt repayments as a percentage of nominal income will diminish substantially over time. Should inflation slow considerably, long-term yields would undoubtedly fall and homeowners may then be able to refinance mortgages at lower rates.

Chart 3

Financial Asset Ratios of Households



Source. Board of Governors of the Federal Reserve System.

In addition, newly assumed mortgage burdens will seem less onerous the more homes are viewed as a relatively attractive investment. Prices of single-family homes have, of course, risen strongly in recent years and, if the associated increases in homeowners' equity are realized, the gains are not taxable when reinvested in another home; if another home is not purchased, the increases receive the favorable tax treatment given to capital gains with additional tax advantages for individuals sixty-five years of age and older. Another tax advantage is that part of the return on housing is a rent saving which, unlike most other investment income, is not taxable. Homeowners can also use the rising equity on their homes as a source of funds by refinancing or by taking out second mortgages. For many reasons, therefore, home buying, almost irrespective of the size of mortgage outlays, is looked upon as a good investment as well as a purchase of housing services.

While recent home buyers have been initially committing a somewhat larger fraction of their incomes to mortgage repayments, mortgage loan delinquency data do not indicate that the resulting debt burden has become excessive. The percentage of loans that are delinquent at savings and loan associations has recently fallen back to near the pre-recession level (see Chart 2). To be sure, the mortgage loan delinquency ratio was much higher in the past recession than in the far milder 1969-70 downturn, but even so it never went much above 1 percent. (Savings and loan associations hold roughly 50 percent of total home mortgages, which makes them by far the largest mortgage lending institutions.)

Debt and financial assets

Debt should also be compared with household financial assets in addition to income. An increase in debt is naturally less burdensome if there is an accompanying increase in financial assets that can provide a cushion of liquidity in times of financial distress. Selected ratios of household assets to instalment plus mortgage debt are depicted in Chart 3. In these comparisons, total financial assets (deposits at banks and other financial institutions, short- and long-term securities, equities, and contractual retirement and savings plans) cover a far smaller fraction of indebtedness now than they did in the 1950's and 1960's.

The picture improves somewhat if corporate stocks are deducted from total financial assets, since equity values have dropped quite precipitously in the 1970's. Stocks probably do not constitute an important source of wealth for lower and middle-income families. Therefore, their financial asset position relative to debt has probably not deteriorated much since the mid-1960's. This conclusion is reinforced by a look at household deposits at commercial banks and thrift institutions. These would seem to be a very important source of liquidity for lower and middle-income families, and at present they are not unusually low relative to debt. Also, the debt-financial asset ratios understate the wealth of a substantial number of households whose homes are mounting in value.

Household debt can undoubtedly become too large, thereby curbing consumption and raising delinquency rates. However, analysis of various measures of consumer debt burdens—notwithstanding their imperfections—indicates that they are generally not out of line. Nevertheless, the whole consumer debt situation warrants continued close attention.

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