Controlling the Terms on Consumer Credit

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The reexamination of an old economic problem is like a trip to a childhood hometown. Nothing is quite like you remembered it. Time has changed our perceptions of the problems of controlling the terms on consumer credit. Part of the change can be traced to research that was stimulated by the last attempts to use these controls. Part can be traced to advances in theory that have placed some of the old problems in a new perspective.

Nearly all of the research on consumer credit controls dates back to the 1950s and, in reviewing that literature, it is surprising to realize how much our views and insights have changed. Many of the old debates now seem to be resolved and many of the old problems have been clarified. An encouraging amount of progress has been made but some of the most important issues are still unresolved.

The remaining problems center around the effectiveness of selective controls as a substitute for general monetary controls in controlling the economic aggregates. There seems to be little doubt that selective controls have selective effects. The difficult question is whether the selective effects merely change the shape and composition of the aggregates or whether they work directly to alter the totals. Unfortunately this question is seldom explicitly discussed. The implicit answer is usually buried in the assumptions.

Characterizations of the extreme positions on this question will be familiar to those who have followed the discussions of selective controls. At one extreme, we find the "someone else will use the money" school that focuses on the supply side of the problem and assumes that, if we keep someone from borrowing, the funds will be used by someone else. This school uses the analogy that you do not change the size of a balloon by pushing it into a different shape. At the other extreme, we have the "additive" school which accepts as obvious the fact that all of the parts add to the total and that, if we change any part, we change the total. They focus on the expenditure

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side of the problem and assume that, if we reduce expenditures on automobiles, we will automatically reduce the aggregate level of expenditures. Clearly the holders of these positions will not agree about the effectiveness of selective controls as an alternative to general monetary controls.

Areas of Agreement

It may be helpful to identify some of the old problems that seem to have been resolved as background for the discussion of the unresplved issues. Since this subject has received very little academic attention in recent years, some of what appears to be agreement may be in part the silence of indifference. But it will be asserted that the following propositions are accepted by most students of the problem of controlling the terms on consumer credit.

1. Terms on instalment contracts are an important determinant of the demand for expensive durable goods and the associated credit.

This proposition has long been accepted by practical marketing experts. It is now firmly established both by empirical evidence and theoretical arguments as part of the theory of consumer behavior as it applies to the use of consumer credit. Empirical evidence on this point has come from a variety of sources. Supporting evidence has been obtained from studies of the demand for consumer credit (14), from studies of the demand for durable goods (2, 24) and from earlier experience with the regulation of credit terms (18, 4).

Modern utility theory and its application to investment decisions have paved the way for the application of utility theory to the purchase of consumer durable goods on instalment credit. Recognition of the similarity between the stream of services from consumer durables and the earnings stream from capital goods has made it possible to demonstrate that consumer purchases of durables on credit, even at extremely high rates, can be perfectly rational behavior. It can be shown that the utility of the discounted present value of the stream of services from consumer durables can be larger than the disutility of the discounted value of a stream of repayments that includes substantial amounts of interest charges. It can also be shown that the sum of the disutility that arises from a stream of payments is reduced by spreading the payments over a longer period of time. The reduction in disutility that accompanies the reductions in monthly payments will more than cover the added interest costs, so that the spread between the discounted present value of the stream of services and that of the repayment stream is widened, making the purchase more attractive.

Experience, statistical evidence and the theory of consumer behavior all support the claim that changes in the terms on consumer instalment contracts have an important impact on the demand for credit and the demand for goods purchased on amortized repayment contracts including many types of business expenditures. The effects are most important on the demand for houses, automobiles, and other expensive items where the service and repayment streams extend over a long period of time.

Controls on credit terms are in many ways an attractive approach to the problem of controlling spending. They go directly to the sources of the problem – the demand for goods and services. They do not really deny the consumer the right to make the purchase. They just make it unattractive. They work like price changes. The relaxation of credit terms can be used to stimulate the demand and the tightening of terms can be used to contract it.

2. *The consumer sector is potentially an important source of instability*

The consumer sector is no longer viewed as a slow-moving aggregate that responds only to the changes in income that are generated by business or governmental decisions. It is recognized as a potential source of exogenous change. George Katona has been one of the most articulate spokesmen for this position (13) but the view has developed in so many ways that it hardly needs elaboration.

Consumer credit plays a role in the new independence of the consumer by giving him greater flexibility in the timing of his purchases and by extending the range of financial decisions available to the average consumer. The growth of liquid assets, the increase in discretionary income, the growing importance of durable goods and the increased sophistication of consumers are other factors cited as contributing to the new role of the consumer.

The new status of the consumer sector in economics has mixed implications for the control of consumer credit terms. First, it emphasizes the potential need for controls over this sector. Second, it destroys the oversimplified distinction between "nonproductive" consumer expenditures and "productive" business expenditures that has often been used as an argument for the selective control of consumer credit. It can no longer be considered obvious that controls that restrain the consumer sector and encourage business outlays are automatically desirable.

3. *The impact of changes in credit on aggregate income should be measured by the differential effects of changes in the volume of new credit and changes in the level of credit repayments (or the rate of change in outstanding credit)*

This seemingly minor technical point is crucial for the interpretation of historical events and for any decisions about the timing and usefulness of controls on consumer credit. This measure gives a very different picture of the timing of the impact of consumer credit than the older measure which involved the use of the change in outstanding credit (4, 11, 15, 20, 27). The older version portrays consumer credit as an expansionary force that continues at least up to the turning point and perhaps beyond. The newer measure indicates that consumer credit may often be exerting a depressing effect for some time before the peaks are reached. A similar but inverted difference in impact can be observed on the downside.

4. *The volume of consumer credit is affected by money market conditions in much the same way as other types of credit*

A number of studies, that were either done by the Federal Reserve System or stimulated by the use of selective controls in the 1950s, make a convincing case for the responsiveness of consumer credit to money market conditions and hence to general monetary controls (3, 4, 26). These results refute the arguments that selective controls are necessary because consumer credit does not respond to general monetary controls. The older arguments depend upon the assumptions that the demand for consumer credit is inelastic to changes in interest rates and therefore has first claim on scarce funds when general monetary controls are used. The new evidence suggests that consumer credit is subject to a variety of forms of credit rationing that are effective in curtailing the supply of funds to this sector despite the presumed inelasticity of demand.

Unresolved Economic Issues

If the state of the arts has in fact resolved the problems covered by the preceding propositions, we can turn to the unresolved questions with less interference from side issues. We start with the knowledge that consumer credit terms can be used effectively to influence the demand for automobiles and other expensive consumer durables. The impact of these controls on retail sales of these items and upon the manufacturer and the productive and distributive chains in these industries can be taken for granted. We also know that these particular sectors of the economy are not uniquely the villains of our aggregate economic problems nor are they in some favored position that makes them insensitive to more general fiscal and monetary policies that would affect other sectors as well. The basic economic question then becomes whether or not we can achieve the aggregate results we seek by using controls that we know will affect one particular segment of the market. If selective controls cannot be depended upon to produce the desired effects on economic aggregates, the debate is over. If they can produce the desired effects, the debate must continue but it shifts to the broader social questions of the choice among control techniques.

The following statement by Paul McCracken and his co-authors is one of the few explicit statements on the aggregate impact of selective controls that we could find in a search of the literature. They take the position that in periods of high levels of economic activity ". . . the effect of an increase in consumer credit outstanding is largely a diversion of credit from other uses, with little effect on total demand" (18, p. 27). If this is the case, the imposition of controls on consumer credit terms will have little effect on total demand and there will be little economic justification for the use of these controls.

However, their position requires some rather special assumptions about the nature of market adjustments which they unfortunately do not specify or attempt to defend. Their position implies that the market is not in equilibrium and that there is an overhanging excess demand for funds that is excluded from the market by some unspecified force – presumably credit rationing. If this is the case, the imposition of controls that reduce the demand for consumer credit would merely open the door for the unsatisfied credit demand.

An attempt to trace the effects of the imposition of selective controls on consumer credit within the context of an aggregate theoretical model illustrates the demanding assumptions that the McCracken position requires. Any shift in the demand for funds, such as the one we know we can induce by the use of selective controls, should result in a shift in the aggregate demand function with traceable results on the aggregate level of spending and the interest rate that depend upon the relative elasticities of the functions. There will be an interest-rate effect but no spending effect only if the supply function is absolutely inelastic. Spending and interest-rate effects of some type should occur unless it is assumed that the shift in demand is offset by an equal and opposite shift in other forms of demand. The normal certeris paribus assumptions do not provide for this possibility. The mechanism might be provided by the "credit availability doctrine". But it requires a great deal of faith in the effectiveness and timing of the availability adjustments to assume that an induced reduction in the demand in one sector will be offset completely by an increase in the availability in other sectors.

My own reading of the theoretical and empirical evidence leads me to the view that credit availability adjustments are an important part of credit market behavior during periods of tight money and that the supply function may be highly inelastic. Yet I find it hard to believe that the reduction of the demand in any major sector would have no effect on the toal amount of credit extended. I would expect the imposition of consumer credit control to produce some easing in the credit markets.

Despite the possibility that consumer credit controls may have a significant impact on aggregate spending, it is possible to oppose their use on the broader grounds that they are inferior to general monetary controls for achieving the same objectives or that they have undesirable social side effects.

Broader Social Issues

The case against the use of selective credit controls has to be based not on the fact that they are discriminatory but on the fact that the method of discrimination is inappropriate. Since all types of controls have an unfavorable impact on someone, the technique used to select the victim becomes important. A number of studies have found evidence that general monetary controls have a discriminatory impact (22, p. 474). The selective impact of general monetary policies reflects differences in wealth, economic position and perhaps social position. But it results from the give and take between thousands of banks and their customers. The credit decisions reflect factors that have some bearing on the credit process. It is unlikely that anyone who reviewed all of these cases would find them to be equally fair and equitable. But if they were making the loans themselves, the results would probably be much the same.

The discrimination that results from selective controls does not represent the impersonal operation of the demand for and the availability of funds. It represents the decisions of administrative officials about the appropriateness of a particular class of expenditures. Selective controls place a great deal of power and authority in the hands of administrative officials to affect the spending decisions of a great many people and prosperity of many businesses. The centralization of this type of power should be avoided.

Automobiles, and particularly those that have to be purchased on credit, have never been very high on anyone's list of social priorities. Their contributions to our energy and pollution problems have not increased their popularity. Some reductions in expenditures for automobiles would seem to be a small price to pay for a reduction in inflationary pressures and some easing in credit market conditions. A popular case can be made for the imposition of consumer credit controls at the present time. But our monetary system should not be based on such tenuous and largely irrelevant considerations.

The recent revival of interest in selective controls reflects disappointment and disillusionment with the performance of general monetary policies. But good arguments can be made that these problems can be traced to the inadequacy in the present conceptions and structure of control systems rather than to the basic inadequacy of the general monetary approach. The first step would seem to improve the techniques of general monetary controls rather than to turn to less desirable alternatives. When a car gets a flat tire, the usual approach is to fix the tire. You do not start adding new wheels to the car.

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Discussion

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My overall reaction to the paper is that I wish I were as certain as Paul about the issues surrounding selective credit controls in general and consumer credit controls in particular. As I see the thrust of the paper, there are three important conclusions, about which we are told there is or ought to be little doubt.

1. The empirical evidence is clear, consumer credit controls of the sort we had in the 1940s and 1950s can have substantial predictable impacts on the demand for consumer goods relative to other demands.
2. While there might be some logical possibility that the effect of consumer credit controls on real consumer demand will be offset elsewhere in the real economy, this seems implausible. Thus, consumer credit controls can be used to affect total real demand and hence, be used as a countercyclical tool.
3. But they should not be so used because the market is preferable to governmental authorities as resource allocators.

In many ways, my "gut" feelings are not very different from Paul's conclusions, but I continue to have substantial doubts and find it difficult to close the books on any of these three issues. Let me look at each of the three points in turn.

Can Consumer Credit Controls Be Used to Affect the Demand for Consumer Durables?

My guess is that in the short run, but perhaps not in the long run, restrictive consumer credit controls will restrict the demand for consumer durables. However, I see little systematic evidence to support this view.

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The evidence offered in the paper is in part indirect and in part direct. The indirect evidence is the observed relation between the demand for consumer durables and credit terms. Such a relation, however, is merely necessary but hardly sufficient to demonstrate that consumer credit controls would or did affect real demands. The studies that show a link between real demands and credit terms look at absolute credit terms rather than the more relevant (in the present context) relative terms among liability classes. Selective credit controls are supposed to affect real demand *selectively*. In the context of selective controls, it is not enough to show that demand for consumer durables is inversely related to the interest rate. It is necessary also to determine whether by administratively raising the rate on consumer credit relative to *other* rates we can selectively cut down the demand for consumer durables.

Whether the answer is yes or no, of course, depends on the ease with which consumers can switch sources of finance, the substitutability between consumer durables and other commodities, and so on. I find these questions to be the crux of the matter. And the answers depend on how much time you give consumers and lenders to learn how to beat the system. Once you allow time for this kind of learning process, it becomes much less certain that the controls would selectively allocate resources.

The direct evidence cited on the allocational efficacy of consumer credit controls relates to tests of the U.S. experience with these controls a few decades back. The evidence indicates that by regulating allowable credit terms, the demand for consumer durables was in fact altered. Since, however, the period of investigation includes many war years when there were "shortages" of consumer durables as well as other special situations, I find it difficult to interpret the evidence. Moreover, because the laws were in effect for relatively short periods it is difficult to analyze the impacts of learning and longer-term adjustments of the sort I talked about a minute ago.

Finally, it is not clear how relevant the earlier experience is to the current situation. It is hard to see how consumer credit controls based on minimum down payment and maximum maturity would have a very big impact in a world with rapid growth in unsecured, revolving type consumer credit. My guess is that reimposition of consumer credit controls based on down payment and maturity would simply accelerate the expansion of this kind of debt as borrowers and lenders seek to avoid the regulation.

Can Selective Credit Controls Be Used as a Countercyclical Tool?

A second issue of selective credit control efficacy that Paul touches on is countercyclical efficacy. He sees this as being the significant outstanding economic issue surrounding consumer credit controls. He divides the economics profession between (a) those who see that consumer credit controls will have little impact on aggregate demand because restriction of consumer demand will set in motion forces to encourage demand elsewhere that will completely offset the decline in consumer demand and (b) those who see less than a complete offset in demand elsewhere. Economists who believe that consumer credit controls have no impact on real variables whatever would, of course, represent a third category.

For Paul, the relevance of selective controls to countercyclical policy hinges on whether view "a" or "b" is adopted: "If selective controls cannot be counted on to produce the desired effects on economic aggregates the debate is over". Moreover, he comes down firmly on the "b" side – that is, that selective credit controls can have aggregative effects. I'm not so sure either that the debate ends if choice "a" is selected or that "b" is the appropriate selection. Even if consumer credit controls have no net aggregative impact, it would still be possible to use them in conjunction with more general controls. That is, if the authorities decided that the "burden" of a restrictive policy ought to be borne more heavily by the consumer sector than would be the case if the market were left alone, they could impose a generally restrictive policy and a restrictive consumer credit policy simultaneously.

With regard to the view that selective credit controls can have aggregative effects, Paul argues that the alternative view hinges on a credit availability doctrine which he believes (correctly, I think) cannot be counted on except under certain overly-restrictive assumptions. It seems to me, however, that he has not looked at the whole story and the case for view "a" might be made on other grounds.

In the Smith paper, we read that "Any shift in the demand for funds, such as the one we know can be induced by the use of selective controls, should result in a shift in the aggregate demand function with traceable results on the aggregate level of spending and the interest rate. . ." The point of view expressed by this sentence, I think, is that aggregate commodity demand is a function of the demand for funds. A more symmetric view, however, would be that the demand for goods and the demand for funds are jointly determined and that neither is ultimately a function of the other.

Under this more symmetric view the aggregate demand for goods and the demand for credit might be thought to depend on interest rates and regulated selected credit control terms.

In such a world, when credit controls are tightened credit markets will respond by equilibrating at lower interest rates. The aggregate demand for goods and services may go up or down. On the one hand, commodity demand will be depressed because of the restrictive credit control; on the other, it will be encouraged by the decline in interest rates. What in fact will happen to the demand will depend on the amount by which interest rates change in response to the imposition of the credit control and the relative elasticities of aggregate demand to interest rate changes and the credit control. Without specific information regarding the relative magnitudes of these effects, I know of no way of anticipating the impact of a particular selective control on aggregate demand.

The Broad Social Issues

Let me now finish up with the last of the three points I raised at the outset: if we assume that selective credit controls can affect aggregate demand, should they be used for that purpose? The answer we get in the paper is no. I believe the reasoning behind the answer roughly parallels what might be called the traditional conclusions of the old welfare economics: it is preferable to allocate resources through the market as compared with government administrators. As a general rule, I would concur with this proposition but I think in the current context a case can be made in favor of market interference.

In part because of the legislated restrictions on mortgage and deposit rates, restrictive monetary policy has sharp differential impacts against the housing industry. These differential impacts probably are economically inefficient, although in a world of "second best" there is no way of knowing. Perhaps more importantly, however, anticipations of these impacts by monetary policymakers can move them in the direction of monetary ease more often than appropriate on other grounds. Selective controls – if they have aggregate impacts – could be one way out of the dilemma. That is, policymakers might elect to restrict consumer demands so as to ease the pressure on the housing sector and so obtain more flexibility in aggregative policy making. I know that the response to this suggestion is frequently that we should get rid of interest rate regulation, and I would agree. But I don't know how quickly interest rates are likely to be deregulated. Whether or not one agrees with this justification for consumer credit controls, I think the argument has some merit and requires some response.