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## Ways in Which Instalment Credit May Influence Economic Stability

THE present chapter is devoted to a preliminary discussion of the various ways in which consumer instalment credit may affect economic stability. It will formulate the problems that are to be subjected to further factual and theoretical analysis in subsequent chapters.

### CHANGES IN AGGREGATE EXPENDITURE

Fluctuations in the flow of money in exchange for goods and services—producer as well as consumer—that is, fluctuations in aggregate effective demand, are one of the most striking and important manifestations of business cycles. The upswing of the cycle is accompanied by a rise, and the downswing by a fall, in aggregate demand. Therefore the question arises at once whether consumer instalment credit exerts an influence on aggregate spending.

In static theory the influence of credit on fluctuations in expenditure has been largely ignored. An expansion of consumer credit is regarded as likely to entail an increased outlay on consumer goods, but it is assumed that this increase is offset by a decrease elsewhere; and conversely for a contraction of credit. Consumer credit, as well as credit in general, is thought merely to bring about a shift within the aggregate total of expenditure, presumably from producer to consumer goods. When a new credit is granted the result envisaged is merely that the borrower rather than the lender spends the sum in question; when a credit is repaid the result envisaged is merely that expenditure is increased by the

lender and contracted by the borrower. In either case aggregate expenditure remains the same. Simon Kuznets<sup>1</sup> and Fritz Machlup<sup>2</sup> have aptly designated this kind of credit as "transfer credit."

In dynamic theory, however, especially in the modern theory of money, banking and business cycles, credit expansion is regarded as implying, or as leading to, an expansion of aggregate monetary demand and expenditure on goods, and credit contraction is said to lead to a contraction of aggregate expenditure. Some writers speak of inflationary, or deflationary, effects in this connection, in order to distinguish such credit from pure transfer credit.<sup>3</sup> In the present study these influences will, as a rule, be referred to as "stimulating" and "depressing" rather than as "inflationary" and "deflationary."

Obviously it makes a great difference whether credit is of the transfer or of the stimulating-depressing type. If it is of the transfer type demand rises in some places and falls in others, and the most that may be said without more detailed information is that some industries are stimulated and others depressed. It is impossible to tell in general which of these two contradictory influences will outweigh the other—although a minute consideration of all the circumstances attending secondary and tertiary effects, if it were possible, might lead to a conclusion as to which will prevail.

But if credit fluctuations entail fluctuations in aggregate demand, a credit expansion may be assumed to stimulate and a contraction to depress economic activities. The next question is then what shape the stimulating or depressing influ-

<sup>1</sup> In an unpublished memorandum on consumer credit.

<sup>2</sup> In *The Stock Market, Credit and Capital Formation* (London 1940) p. 224.

<sup>3</sup> This usage does not imply that an inflationary, or deflationary, effect must show itself in rising, or falling, prices. If there is much unemployment and unutilized productive capacity an increase in demand may lead to a rise in production rather than in prices. Therefore some writers object to this terminology because they prefer to reserve the term "inflation" for instances of strong rises in the general price level. It has become common usage, however, to speak of "deflation" when demand contracts, irrespective of whether prices are flexible and fall or are rigid and do not fall.

ence will take. Will a stimulating influence, for example, be accompanied by a rise in output or a rise in prices, and if by both, in what proportion? The answer depends upon the existence of excess plant capacity and unused productive resources (unemployment) and their distribution over various industries, and on the flexibility of prices and costs, especially labor cost. These factors, in turn, differ according to the phase of the cycle in which the economy finds itself when the credit expansion occurs. In the neighborhood of the trough of depressions, unemployment and excess capacity are greatest, and an expansion of credit and effective demand will ordinarily raise output rather than prices.<sup>4</sup> Near the top of the boom employment is high and excess capacity small, and a credit expansion will manifest itself more in a rise of prices than in increased output. But booms rarely reach a position of literally full employment; there may still be a considerable amount of "slack" in the economy, making possible an increase in output.

It is not safe, however, to assume without careful examination that credit of any sort is of the stimulating-depressing type, although this attitude is now frequently adopted. There is no certainty that an expansion of credit will in all circumstances lead to an expansion of aggregate expenditure, or that a credit contraction will always lead to a contraction of such expenditure. Whether a change in credit results in a change in aggregate expenditure depends on the economic position of the debtor and the creditor, both at the time the credit is extended and at the time or times it is paid off. As for the creditor-lender, it depends on whether he is forced to cut his expenditure or to reduce the supply of funds for other types of lending when instalment credits are extended, and on whether he is induced to expand expenditure or other loans when instalment credits are repaid. And as for the debtor-borrower, it depends on how he uses the credit—

<sup>4</sup> It is quite possible, however, that large price rises occur long before full employment has been reached. This will happen, for example, if aggressive labor unions succeed in raising wages sharply when employment rises.

whether he spends it on goods or uses it in other ways than for the purchase of commodities, for example for repaying a bank loan; on how he would have met these needs if no credit had been available—whether he would have ignored them or financed them in some other way; and on how he makes his payments on principal and charges—whether he cuts down consumption expenditure or depletes cash resources at his disposal or raises the money by further borrowing. In the following pages these questions will be examined in the light of the available evidence.

### *The Supply Situation*

The situation regarding the supply of funds, that is, the repercussions on the lenders' side, is easier to analyze than the situation regarding the debtors, and may be taken up first. For such an analysis we may proceed on the basis of well-known principles of the theory of money and banking.

The money flowing into consumer instalment credit may come from reserves or be withdrawn from other uses. In the former case there are no unfavorable repercussions on other uses of funds. If commercial banks, for example, expand instalment credit under extraordinarily liquid conditions, such as have now existed for a long time in the United States, it is reasonable to conclude that their willingness and ability to lend and invest in other directions are not thereby impaired; and if instalment credit is contracted under similar conditions, no offsetting stimulating repercussions on other types of loans and investments can be expected. But if the banks' reserve ratio has fallen to the minimum level set by law, custom or the policy of individual banks in given circumstances, an expansion of instalment credit can occur only at the expense of other kinds of loans; and in this case a contraction may lead to an expansion of other loans. A situation in which credit has been extended to the maximum limit, and different types of borrowers are therefore close competitors, is the classical instance of transfer credit.

The analysis is not materially changed by the fact that in-

instalment credit is extended mainly by institutions other than commercial banks—institutions that do not “create” credit because they do not receive checking deposits. These institutions borrow freely from the commercial banks and have easy access to the money market. If instalment credit was at one time supplied by lenders who had no direct access to the usual sources of funds, this is no longer so; paper originating from instalment credit is considered a good credit risk and has even a preferred position in the money market.<sup>5</sup> Therefore it is justifiable to say that the supply of funds for the purpose of financing the consumer is now very elastic: funds flowing to the consumer through any of the various instalment credit channels come from the general pool of the money market, and funds flowing back by repayment go into the general pool.

The principal sources of loanable funds for instalment credit agencies other than commercial banks are shown in Table 1.<sup>6</sup> It is clear that these agencies obtain funds on both long-term and short-term conditions, and that they assemble an important part of their working funds through the sale of equity securities. Credit unions, however, are predominantly dependent on the sale of shares to members.

Sales finance companies depend on short-term funds more than any other agency, with personal finance companies next in order of dependence on this source. Short-term funds are acquired both through the sale of paper in the open market and through direct loans from commercial banks. Sales finance companies arrange credit lines with commercial banks in advance, and these usually exceed actual borrowing by a wide margin. Industrial banking companies and credit

<sup>5</sup> It is now permissible to use instalment paper as collateral for advances by Federal Reserve banks to member banks; see Board of Governors of the Federal Reserve System, *Annual Report* (1937) pp. 206-07. See also National Bureau of Economic Research (Financial Research Program), *Commercial Banks and Consumer Instalment Credit*, by John M. Chapman and Associates (1940) Chapter 8.

<sup>6</sup> Detailed information on the sources of funds of the various types of institutions is contained in the respective institutional monographs in the present series.

unions, on the other hand, depend relatively little on short-term borrowing.<sup>7</sup> The fact that the short-term loan market is a sort of buffer source of funds, absorbing cyclical fluctuations, is clearly indicated. When assets fell between 1929 and 1933 short-term borrowings declined in relative importance as a source of funds, increasing again by 1936 when assets had again increased. This was true of all groups of companies except the two largest personal finance chains, whose assets in 1933 were higher than they had been in 1929.

In contrast to other agencies the industrial banking companies obtain about half, sometimes more, of their funds through the acceptance of deposits or the sale of investment certificates, usually redeemable on demand; for these institutions the way in which funds are acquired depends on the legal status of the company, that is, on whether or not it has a deposit-taking privilege. But the fact that these agencies raise an important part of their funds from time deposits does not imply that their credit is not of the stimulating-depressive type, as defined above, in other words, does not convert it into transfer credit. It is true that industrial banking companies offer attractive deposit rates, and if these rates induced people to save money which they would otherwise have spent on consumption, the instalment credit extended by industrial banking companies would have to be regarded as transfer credit. But the view is now rather generally accepted by economists that the amount people save is not much influenced by changes of a few percent in the rate of interest which can be earned on savings. There can be hardly

<sup>7</sup> Industrial banking companies and credit unions have always obtained their funds in the way indicated in the table, but the present position of sales finance and personal finance companies, as regards access to the capital markets, differs somewhat from their earlier status. Although sales finance companies have always depended to a considerable extent on outside funds it was not until 1925 that these companies made any substantial use of long-term borrowing, and then it was mainly the large national companies that used this source. Personal finance companies depended originally on the investments of individual entrepreneurs and on reinvested earnings; in the middle of the 1920's the leading companies began to be generally accepted in the short-term money market, and by the end of that decade they were able to float securities with the aid of established investment banking houses.

TABLE 1  
 PRINCIPAL SOURCES OF FUNDS OF INSTALMENT CREDIT AGENCIES IN VARIOUS YEARS DURING 1929-40, IN PERCENT OF TOTAL ASSETS<sup>a</sup>

| Type of Agency   | Year | Borrowed Funds |               |       | Equity Funds            |                              |       | Deposits | Total Assets<br>(in thousands<br>of dollars) |
|--|------|----------------|---------------|-------|-------------------------|------------------------------|-------|----------|--|
|  |      | Short-<br>Term | Long-<br>Term | Total | Pre-<br>ferred<br>Stock | Common<br>Stock &<br>Surplus | Total |          |  |
| Personal finance companies<br>2 largest chains <sup>b</sup>  | 1929 | 10.3           | 2.5           | 12.8  | 22.6                    | 54.9                         | 77.5  | 0.0      | \$ 77,513                                    |
|  | 1933 | 16.5           | 5.5           | 22.0  | 24.1                    | 48.5                         | 72.6  | 0.0      | 89,079                                       |
|  | 1936 | 37.4           | 0.0           | 37.4  | 17.6                    | 43.6                         | 61.2  | 0.0      | 121,616                                      |
|  | 1937 | 33.8           | 0.0           | 33.8  | 20.0                    | 39.5                         | 59.5  | 0.0      | 143,544                                      |
| 1940   | 25.8 | 17.9           | 43.7          | 17.5  | 38.1                    | 55.6                         | 0.0   | 164,528  |  |
| 153 identical companies <sup>c</sup>                         | 1929 | 25.6           | 2.6           | 28.2  | 16.1                    | 54.3                         | 70.4  | 0.6      | 20,835                                       |
|  | 1933 | 15.2           | 3.5           | 18.7  | 18.1                    | 62.1                         | 80.2  | 0.4      | 20,888                                       |
|  | 1936 | 24.8           | 7.2           | 32.0  | 14.4                    | 52.2                         | 66.6  | 0.3      | 25,758                                       |
| Sales finance companies<br>3 national companies <sup>a</sup> | 1929 | 50.5           | 13.3          | 63.8  | ..                      | ..                           | 25.8  | 0.0      | 859,329                                      |
|  | 1933 | 35.5           | 7.9           | 43.4  | ..                      | ..                           | 41.6  | 0.0      | 400,420                                      |
|  | 1936 | 45.3           | 17.7          | 63.0  | ..                      | ..                           | 20.4  | 0.0      | 1,133,955                                    |
|  | 1940 | 61.4           | 15.6          | 77.0  | ..                      | ..                           | 17.6  | 0.0      | 1,515,226                                    |
| 202 identical companies <sup>c</sup>                         | 1929 | 52.9           | 2.8           | 55.7  | 12.1                    | 26.1                         | 38.2  | 1.0      | 113,645                                      |
|  | 1933 | 39.1           | 2.3           | 41.4  | 16.4                    | 35.9                         | 52.3  | 1.8      | 87,589                                       |
|  | 1936 | 59.0           | 1.6           | 60.6  | 11.0                    | 21.7                         | 32.7  | 1.3      | 188,969                                      |

(continued on next page)

TABLE 1 (concluded)

| Type of Agency  | Year                                     | Borrowed Funds |               |       | Equity Funds            |                              |                   | Total Assets<br>(in thousands<br>of dollars) |
|---|--|----------------|---------------|-------|-------------------------|------------------------------|-------------------|--|
|   |  | Short-<br>Term | Long-<br>Term | Total | Pre-<br>ferred<br>Stock | Common<br>Stock &<br>Surplus | Total             |  |
| Industrial banking companies<br>79 identical non-investment<br>companies <sup>a</sup> | 1929                                     | 31.5           | 6.2           | 37.7  | 19.6                    | 55.6                         | 75.2              | \$10,718                                     |
|   | 1933                                     | 14.3           | 5.1           | 19.4  | 22.4                    | 54.5                         | 76.9              | 9,677  |
|   | 1936                                     | 21.1           | 4.2           | 25.3  | 14.3                    | 40.3                         | 54.0              | 12,656                                       |
| 37 identical insured invest-<br>ment companies <sup>b</sup>                           | 1929                                     | 10.5           | 0.1           | 10.6  | 0.0                     | 19.1                         | 19.1              | 49,160                                       |
|   | 1933                                     | 3.1            | 0.2           | 3.3   | 0.0                     | 29.4                         | 29.4              | 33,822                                       |
|   | 1936                                     | 3.1            | 0.0           | 3.1   | 0.2                     | 19.7                         | 19.9              | 57,929                                       |
| 56 identical non-insured in-<br>vestment companies <sup>c</sup>                       | 1929                                     | 10.4           | 1.4           | 11.8  | 0.8                     | 25.2                         | 26.0              | 39,973                                       |
|   | 1933                                     | 5.4            | 1.4           | 6.8   | 1.0                     | 31.1                         | 32.1              | 32,298                                       |
|   | 1936                                     | 6.6            | 0.8           | 7.4   | 0.5                     | 24.6                         | 25.1              | 42,182                                       |
| Credit unions   | 1,701 federal credit unions <sup>d</sup> | 2.6            | 0.0           | 2.6   | ..                      | ..                           | 95.6 <sup>f</sup> | 9,143  |
|   | 2,103 federal credit unions <sup>e</sup> | 2.3            | 0.0           | 2.3   | ..                      | ..                           | 95.5 <sup>f</sup> | 18,311                                       |
|   | 3,715 federal credit unions <sup>f</sup> | 1.9            | 0.0           | 1.9   | ..                      | ..                           | 95.3 <sup>f</sup> | 72,095                                       |

<sup>a</sup> Data are for end of year. Percentages do not add to 100; the difference represents reserves and other minor items.

<sup>b</sup> Data obtained from the National Credit Office, Inc. These chains not included in the 153 identical companies.

<sup>c</sup> Data obtained from a special tabulation of income tax returns of finance companies made by the United States Treasury Department, WPA Income Tax Unit, Philadelphia.

<sup>d</sup> Data obtained from the National Credit Office, Inc. These companies not included in the 202 identical companies.

<sup>e</sup> Data obtained from periodic reports on operations of federal credit unions, published by Farm Credit Administration, Division of Finance and Accounts.

<sup>f</sup> Includes principally credit union shares, the balance representing undivided profits and profit and loss.

a doubt that the greater part of industrial banking company deposits represents savings diverted from other institutions (rather than savings that would not otherwise be made); as a consequence deposit money, too, comes from the general pool of the capital market, though indirectly. If funds are plentiful in the general money market the diversion of savings does not cause a restriction of credit anywhere. Hence loans so financed add to total expenditure, and do not represent merely a transfer.

It thus seems justifiable to focus attention exclusively on conditions in the general money market when considering the ways in which expansion and contraction of consumer instalment credit may affect the supply of funds for other purposes. The assumption generally made nowadays by economists is that the supply of loanable funds is practically always elastic, in other words, that any increase in demand for funds for a particular purpose, such as for consumer instalment credit, can be met without restricting by an equal amount the supply for other purposes. But it must be borne in mind that this has not always been the case; nor will it necessarily be true in the future.

In the United States the supply of loanable funds has been highly elastic since, say, 1933, but this has not been true of all other countries. Except for the situation in this country in recent years, the elasticity of supply of loanable funds has changed with the cycle. Around the depression troughs of the business waves the supply of funds has usually been greater than around the prosperity peaks. The supply of funds has also been affected by the country's international monetary situation, the policy of its central banking authorities and other such factors. Thus in the United States it is probable that the supply of loanable funds was relatively inelastic in 1929. All this must be taken into account in discussing the cyclical significance of instalment credit when or where the supply of funds is not plentiful. But so long as present conditions obtain—so long, that is to say, as banks and money markets are liquid and there are idle monetary

reserves—an expansion of instalment credit need not restrict by an equal amount the supply of funds for other purposes. Therefore in our discussion we shall, except where another is expressly stated, proceed on the assumption that the supply of funds in general can be regarded as elastic.

### *The Demand Situation*

If it is agreed that in present circumstances consumer instalment credit is not merely “transfer credit,” that is, does not affect producer spending, the question still remains how it influences consumer spending. This question is not so easily answered and requires careful analysis.

The new credit and repayment phases of instalment credit transactions must be considered separately. In the present discussion the two magnitudes will, for convenience, be regarded as equal in each complete credit transaction; in other words, the fact will be disregarded that instalment payments exceed the corresponding new credits by the amount of the finance charge. This procedure is justifiable because a considerable part of the finance charge is absorbed by the operating expenses of the creditor and is therefore disbursed among various income receivers, ultimately finding its way into consumer expenditure. The fraction of the finance charge which is saved by its final recipient cannot be exactly determined, but it can certainly be regarded as negligible for present purposes.<sup>8</sup>

To the question whether consumer instalment credit influences consumer spending it is tempting to deduce an answer merely from the fact that this type of credit is, by definition, credit extended to consumers for use in consumption. There is no justification, however, for assuming without question either that the recipients of commodity credit in-

<sup>8</sup> Strictly speaking, what matters in regard to the finance charge is the difference between the amount saved by the users of credit and the amount saved by those to whom the finance charge accrues. The justification for ignoring the finance charge will become more apparent in the discussion (Chapter 5) of the magnitude of instalment credit in comparison with national income, payrolls, government expenditure and the like.

crease their consumption by the full amount of their credit purchases or that the cash borrowers increase their total expenditure by the full amount of the loans they receive. It would be equally unjustifiable to conclude uncritically that instalment debtors reduce their expenditure by exactly the amount of their payments on principal and charges.

In the first place, although commodity credit is used for the purchase of goods, cash loans are by no means used entirely in this way. The National Bureau studies on consumer instalment financing indicate that a small fraction—perhaps 5 or 6 percent—is used for business purposes, and a larger proportion—probably from 25 to 40 percent—is used for the refinancing of debt and for other financial obligations such as taxes, mortgage principal and interest and insurance premiums.

A second reason why instalment credit may not have the effect of increasing consumer expenditure by the amount of new credits, and reducing it by the amount of repayments, is much more significant. It is possible that if no instalment credit were available consumers would make the same purchases by using cash or salable assets, and would then save the sums that would otherwise be needed to meet instalment payments. And even if consumers would not buy anyway—even if the availability of credit does indeed induce them to buy more than they otherwise would—it is possible that they make their repayments by saving less rather than by reducing their current spending. If this is the case, consumer expenditure is increased by new credits, but is unchanged, rather than reduced, by repayments.<sup>9</sup> Thus consumer ex-

<sup>9</sup> It is probably this behavior which the critics of instalment credit believe to be typical when they contend that the system encourages excessive consumption and undermines thrift. If consumers buy more with credit than they would without it, and meet their debt payments by reducing savings rather than consumption, the instalment system diminishes their savings.

It is the opposite type of behavior which the defenders of instalment credit believe to be typical when they contend that the system encourages thrift. If many consumers would buy as much in the absence of credit as they do when credit is available, and would not replenish the savings used for this purpose, while under the instalment system they are induced to curtail expenditure in order to pay off the debt, there is more saving under the credit system than without it.

penditure is increased by new credits only if instalment credit induces consumers to buy more than they would without credit; and it is reduced by repayments only if the sums needed for this purpose would, in the absence of credit, be used for current spending.<sup>10</sup>

Certainly no universally valid conclusion can be reached as to what consumer behavior would be if no instalment credit were available. And it is equally difficult to generalize about whether consumers meet their instalment payments by saving less or by cutting expenditures. The one thing we do know is that not all consumers would behave in the same way. Even as to what the majority would do, little more than a guess is possible, for only meagre data are available to buttress the conclusions reached on the basis of very general considerations. Facts and inference may be combined, however, to produce a conclusion that is at least plausible.

The first problem is whether debtors regard instalment credit as merely a substitute for the dishoarding of cash or the sale of assets. If they could not obtain credit would they buy anyway, using cash or salable assets to finance the purchase? The answer to this question is the answer to whether consumer expenditure is increased by new credits.

The studies on instalment credit, published by the National Bureau, indicate that the great majority of instalment debtors—probably more than 90 percent—have incomes of less than \$3000 a year, and that well over half of them receive less than \$1500. There can be no doubt, therefore, that a large proportion of debtors would not have the possibility

<sup>10</sup> It might well be, of course, that if instalment credit were not available consumer behavior would not exactly follow any of these lines. For example, rather than refraining altogether from buying what they would otherwise buy on credit, consumers might first save the necessary amount and then buy. In this case the instalment arrangement would bring about a temporal shift, causing buying to precede saving; over the whole period there would be no difference between the cash and the credit systems. Other intermediate possibilities, such as buying a less expensive version of the desired commodity, or saving only part of the money that would otherwise be needed for instalment payments, are equally plausible and would fall between the possibilities outlined in the text and in the preceding footnote. A systematic discussion of the various possibilities will be found in Appendix A.

of buying from accumulated savings if credit were not available.<sup>11</sup>

There is a chance, however, that even if they had no savings they would accumulate funds for the purpose of eventually buying for cash. In this case their behavior would, except for a short transition period, have the same economic effects as it would if they bought from savings already on hand. Consumers are frequently admonished to follow that procedure. It is pointed out<sup>12</sup> that a person who is in the habit of continuously maintaining instalment debt, by contracting a new one whenever an old one is paid off, could buy for the lower cash price all the things he actually buys at the credit price if only he were willing to postpone his first purchase and to set aside for a cash purchase the money he uses for instalment payments on his debts.

Although this may be excellent advice the question remains whether, in the absence of instalment sales credit, people would in fact accumulate cash for the ultimate purchase of the same goods. It is impossible to answer this question with complete confidence but it seems highly plausible that on the whole the answer would be no. Many persons simply lack the will power to renounce a series of daily en-

<sup>11</sup> The same conclusion is reached by Rolf Nugent, *Consumer Credit and Economic Stability* (1939) p. 185. This conclusion cannot, however, be deduced from the finding of the National Resources Committee that "all income classes below \$3000 [a year] made only a negligible net contribution to the aggregate savings of the nation in 1935-36" (National Resources Committee, *Consumer Expenditures in the United States, 1939*, p. 54). For it must not be overlooked that this important report contains information only on *current* saving (changes in net worth) during a single year, 1935-36. It tells us nothing about salable assets at the disposal of instalment buyers. It follows, for example, that "a family might have negative savings and still end the year with large holdings of property" (*ibid.*, p. 22). Moreover, saving is so defined by this report as to count increases in instalment debt as negative, and repayments as positive, saving. Therefore if the income groups below \$3000 had no saving in 1935-36, but increased their instalment debt, they must have performed some positive saving in other forms than instalment debt changes. (On the fact that to a large extent these savings were not a readily available substitute for instalment credit see footnote 14, below.) Furthermore, there seem to be good reasons to believe that the saving estimates for the lower income groups are substantially too low; see R. S. Tucker, "Estimates of Savings of American Families," *Review of Economic Statistics* (February 1942).

<sup>12</sup> See Roger Babson, *The Folly of Instalment Buying* (1938).

joyments in order to pile up a cash balance for the purchase of a high-priced commodity; others cannot resist the temptation to buy an expensive article if it is offered on credit, but would resist if they had to provide the price in advance.<sup>13</sup> Both types of behavior illustrate the famous principle of underestimation of future needs or enjoyments as compared with present ones; in other words, many people are willing, rationally or irrationally, to spend more money for an immediate enjoyment, for which the price must be paid only later and not in a lump sum, than for the same thing if it becomes available only in the future and the price must be accumulated in advance by cutting down expenditure.

There remains to consider the minority of instalment purchasers who do have savings on which they could draw, if need be, in order to finance their purchases. Data from more or less representative samples, presented in the respective studies in the present series, indicate that roughly half of sales finance company customers, a little less than half of the borrowers from personal loan departments of commercial banks, and about one-fourth of industrial banking company customers carry bank accounts, either checking or saving

<sup>13</sup> There may be a real psychological difference between the two types of behavior. The improvident, who in the absence of credit facilities would not have the will power to cut his daily expenditure enough to buy the commodity he wants, may be glad, after he has made his purchase, that by making use of instalment credit he has forced himself to "save" and get the article. But the buyer who could not resist the temptation to buy the high-priced commodity offered to him for credit may afterward regret the deal and find that the commodity is less valuable to him than the current consumption items which he must forego for the service of the debt. On the other hand, the difference may exist only in the attitude and value judgments of the observer. If, in his opinion, the possession of the commodity bought on credit, say an automobile, is more important for the buyer's well-being than the consumption of daily items which must be foregone to repay the debt, he will speak of "the irresistible temptation of daily enjoyments" which instalment credit helps to overcome. If he thinks that the daily consumption items which must be foregone are more important than the possession of an automobile, he will say that the borrower has become a victim of the instalment system. It should be noted too that if the commodity bought on credit, say a sewing or washing machine, relieves the buyer from certain expenses, it may conceivably pay for itself; such purchases were characterized in Chapter I as "productive consumer credit." Few goods are likely to have the effect of reducing expenditure by an amount equal to the required instalment payments, but many may do so to some extent.

or both, at the time they apply for credit; data on the possession of salable assets, such as securities, are so scanty as to be meaningless. These figures cannot be regarded as highly representative but they do suggest that the number of instalment debtors who possess accumulated savings in liquid form is not negligible.<sup>14</sup>

There is a plausible reason for believing, however, that these assets would not be used to any great extent for the purchase of goods otherwise obtainable on credit. Those who incur instalment debt in spite of the fact that they possess liquid assets must have strong reasons for not using these assets for the purchase of goods. Instalment credit is expensive. The annual rate which the consumer has to pay on his average unpaid balance is never much below 12 percent and in most cases is substantially higher. Certainly it is very much higher than the yield of saving deposits, bonds and most other salable assets. Hence it would be very irrational for a man to incur a debt on which he has to pay perhaps 15 percent or even more instead of selling a bond on which he earns perhaps 5 percent or even less, and it would be still more irrational to incur such a debt in order to protect saving deposits or cash reserves on which the yield is next to nothing—unless he is considering other factors than immediate cost.

Such considerations are not difficult to understand. Instalment credit, although expensive, is a short-term obligation, and consumers may not consider it worth while to avoid a short-term indebtedness by liquidating a long-term asset,

<sup>14</sup> Probably a large part of the wealth of the lower income groups is in non-liquid form, such as insurance of various kinds, and is therefore no good substitute for instalment credit as a means of buying durable goods, though it may serve as collateral for instalment loans. The so-called industrial life insurance, the main type held by the lower income groups, carries loan and surrender privileges in only a very few cases. (The question of loans on life insurance policies will be discussed in greater detail in Chapter 4.) Some indirect evidence of the importance of insurance in the capital budget of the lower income groups is contained in U. S. Department of Labor, Bureau of Labor Statistics, Bulletin 642, *Family Income and Expenditure in Chicago, 1935-36* (1939) p. 86, Table 46. This publication, however, like the others in the Study of Consumer Purchases, contains data only on the changes in the various items during 1935-36.

especially if such a transaction would in itself, as in the selling of stocks, entail costs or mean the abandonment of a profit chance; in fact, if a profit can be realized by retaining a salable asset, the financing of a purchase by instalment credit may not be the more expensive method. And even if the liquidation of an asset involves neither cost nor the abandonment of a profit chance—drawing money from a saving deposit, for example—consumers might prefer to retain the asset because it serves as a reserve for unforeseen emergencies, or because they do not trust themselves to replenish their savings after having drawn on them for the purchase of a desired commodity. In the latter case instalment buying is a means of forcing oneself to curtail current consumption sufficiently to buy what one needs or desires without dissipating accumulated savings.

It is not unreasonable to assume that these are the reasons why some consumers incur instalment debt even though they own salable assets or savings accounts, and perhaps even while they increase such assets. Therefore it still seems improbable that many instalment debtors would buy the same amount from savings, if they could not use credit. First, a large proportion of them have no savings. And as for those who do, if they deem it advisable to retain their assets in spite of the high cost of instalment financing, they are also likely to retain them even if instalment credit is not available to them. In times of depression instalment credit is still less likely to be a substitute for dishoarding or the sale of assets, for then a still smaller proportion of debtors have savings available, and those who do are still more reluctant to draw upon them.

If this reasoning can be accepted it follows that the initial use of credit—new credits—causes an increase in instalment debtors' expenditure, though probably not by the full amount.<sup>15</sup> The difference between the volume of new credits

<sup>15</sup> It should be remembered that the comparison is with the situation which would exist in the absence of instalment credit, rather than with any previous period.

and the increase in consumers' expenditure that they produce cannot be determined, but it is probably not great.

The second important problem, the effect of repayments, depends on whether the instalments are met by reducing current spending or by reducing current saving. Here, even more than in considering whether the consumer would buy anyway from cash or salable assets, it is necessary to rely on very general considerations. Again the fact that many instalment debtors have no salable assets, and that those who do have them wish to retain them, suggests the most plausible answer. The more institutionalized saving is, the stronger is the presumption that repayments are made by cutting down current spending: if savings are made mainly through the various types of insurance,<sup>16</sup> saving habits are relatively rigid and are not likely to be influenced by the demands of debt repayments. The situation is probably affected too by the current phase of the business cycle: in depressions, when the rate of saving is low, repayments are more likely to encroach upon consumer expenditure than in periods of prosperity.

Thus an examination of probabilities—which is here the only feasible basis for analysis—seems to corroborate the “commonsense” inference that the use of credit increases consumers' expenditure and repayment diminishes it.

The fundamental question at the basis of this discussion—whether consumer instalment credit exerts an influence on aggregate demand—can now be answered, subject to further elaboration. First, so long as the supply of loanable funds is elastic, instalment credit has little or no direct effect on producer spending.<sup>17</sup> Second, since consumer spending is

<sup>16</sup> On insurance as a channel for the saving of lower income groups see footnote 14, above.

<sup>17</sup> A. G. Hart has suggested (see his review of Rolf Nugent's book in *Journal of Political Economy*, vol. 49, 1941) that instalment credit may indirectly entail a reduction in producer credit and spending by destroying investment opportunities. For example, when consumers are induced by instalment credit to buy automobiles and washing machines their demand for railway, street-car, taxi and laundry services will fall, and this will entail a reduction of investment in those industries. Hart attributes considerable importance to this substitution of consumer for producer credit. We must beware, however, of

probably increased by new credits and decreased by repayments, the effect of instalment credit on aggregate demand is stimulating when new credits outweigh repayments, depressing when repayments outweigh new credits.

Before proceeding to another aspect of instalment credit's influence on economic fluctuations it may be pointed out that the corollary of its direct effect on consumer spending is its direct effect on consumer saving. The saving of an individual during a certain period is here defined as an increment in his net worth, dissaving as a decrement in net worth.<sup>18</sup> Net worth may be defined as assets minus liabilities (debts). By assets we mean earning assets (business capital, real estate and claims such as bonds, shares, loans) and cash. Durable consumer goods such as automobiles, radios, furniture and electric appliances (not used for business purposes), which constitute the bulk of commodities bought on instalment credit, are excluded from the list of assets.<sup>19</sup>

<sup>18</sup> It will be observed that this concept of saving is not the same as that which is understood when we say that somebody draws on his accumulated savings to finance a purchase. In the present sense saving is meant as *current* saving, that is, the change in net worth or in income minus consumption, during a particular period (usually a year). In the former sense saving refers to a *stock* existing at a point of time (the result of the saving activity in the past). In line with current economic usage I shall use the term here in the sense of current saving; when referring to stock I shall use "accumulated saving," "salable assets," "disposable cash" and the like. A similar distinction holds with respect to the word "investment."

<sup>19</sup> If we wanted we could regard durable consumer goods as assets. In this case we would obtain a slightly broader definition of saving, but the difference would amount merely to a difference in dating the act of consumption. Under the narrower definition of assets (and hence of saving) which is adopted in the text, durable consumer goods are, for convenience, regarded as consumed at the moment of purchase. Under the broader definition they must be regarded as consumed gradually. If the analysis is carried through the whole service life of the durable goods it will yield the same result, regardless of which terminology is employed. But the stimulating effect of new credits would, in the broader usage, be ascribed to more investment rather

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double counting. If our assumption is correct that new credits, on the whole, add to consumer demand, they must be assumed to stimulate producer spending in those lines where consumer spending is increased; if repayments subtract from consumer demand, they put a check on producer spending in those lines where consumers cut down their expenditure to meet their instalments. Hence if we take into consideration the indirect effects of instalment credit expansions and contractions (as we shall later, mainly in Chapter 5), we automatically take care of the effect stressed by Hart.

This definition of saving is equivalent to saying that saving is income minus consumption, if by income is understood the sum of values which could be consumed without reducing net worth.<sup>20</sup> It follows that when new credits increase consumer expenditure they cause dissaving (because they increase liabilities and reduce net worth), and when repayments decrease consumer expenditure they cause consumer saving (because they decrease liabilities and increase net worth).

It should be noted that, in commodity credit, if the required down payment is made in cash the dissaving may occur not only because liabilities are increased but also because assets are reduced, and that the subsequent decline in liabilities, as repayments are made, is not sufficient to balance the original decline in net worth. Only in automobile financing, however, is the down payment a highly significant factor: there it has typically ranged from 30 to 45 percent of cash selling price, whereas for other commodities it has averaged about 10 to 15 percent. And the great majority of automobile down payments are made wholly or partly in the form of a trade-in; for other commodities, too, down payments are often made in this way, though not so frequently as in automobile financing. For the entire field of commodity credit it is therefore likely that no more than about 10 percent of the selling price is paid in cash. When the down payment is made by turning in a commodity which is being replaced, the transaction is actually, to the extent of the trade-in's value, one of barter rather than of credit. Therefore it is permissible to disregard the down payment altogether in the present discussion—the trade-in because durable goods have, by definition, been excluded

<sup>20</sup> This definition seems to correspond to the definition underlying accounting practices, provided we exclude from income, and hence from saving, those changes in net worth which are attributable to unexpected capital gains.

than to less saving. In either case the influence of instalment credit on output, employment and prices is the same. Appendix A contains a more elaborate discussion of the concepts and relationships involved. See also R. S. Tucker, *op. cit.*; Tucker adopts, and argues in favor of, the broader definition of saving.

from the category of assets, and the cash down payment because it is a relatively insignificant factor. Thus the value of the commodity purchased is regarded as equal to the amount of credit received.

The conclusion that when instalment credit expands it increases consumption expenditure and causes dissaving, and that when it contracts it diminishes consumption expenditure and causes saving, refers mainly to short-run effects. The question may now be asked what the long-run effects on consumer net worth, and hence on saving, are likely to be.

If we hold rigidly to the assumption that new credits increase and repayments reduce consumer spending, the long-run effect on net worth and saving will be nil. It is possible, however, that even if new credits, on the whole, add to consumption, repayments will encroach to a certain extent upon saving rather than upon consumption, and thus not completely offset the dissaving that was produced by new credits. We cannot be very sure in this matter, but the assumption that the long-run level of consumer saving will be reduced somewhat by consumer instalment credit is fortified by the consideration that the most important commodity sold on instalments—the automobile—is one that tends to encourage further consumption because of the high maintenance and operating expenses involved, and because other consumption expenditures, such as those for excursions and travel, are induced by the possession of an automobile.<sup>21</sup>

It should be kept in mind that only the direct influence of credit on the saving of instalment debtors has been considered. There must also be indirect influences, but these cannot easily be appraised at this stage of our discussion. If, as will be argued, an expansion of credit stimulates economic activity and tends to raise the national income, such an expansion will also lead to an increase in saving, for out of a larger national income a larger amount (some would even say a larger proportion) will be saved.

<sup>21</sup> These considerations do not apply to "productive consumer credit," mentioned in Chapter 1. But this type is certainly in the minority.

### SHIFTS IN RELATIVE DEMAND FOR PARTICULAR COMMODITIES

Apart from the effect of instalment credit on consumer expenditure and consumer saving, we should also consider its influence on particular industries or groups of industries. Is it not likely that this type of credit causes shifts in the long-run pattern of consumer demand, in particular from non-durable to durable goods? If such a shift could be proved to occur on a substantial scale, there would follow important consequences for the pattern of production and for economic stability.<sup>22</sup> Demand for, and hence production of, durable goods is far more sensitive to economic fluctuations than demand for, and production of, perishable goods, and therefore if the production of the former is stimulated at the expense of the latter the economy may be rendered more vulnerable to cyclical fluctuations.<sup>23</sup>

The main uses of consumer commodity credit, as contrasted with cash loans, are fairly well known. Probably at least half of this type of credit is used for automobiles, and nearly one-fifth for furniture; about 15 percent is used for electric refrigerators and over 10 percent for other electric equipment.<sup>24</sup> Thus practically its entire volume is accounted for by durable goods. Not only is the use of commodity credit largely concentrated on a few products, but in some of these industries credit sales amount to a large percentage of total sales. In the decade 1929-38 instalment sales constituted about three-fifths of total sales made by dealers in new and used automobiles, about half of total sales made by house-

<sup>22</sup> It may be observed that these consequences would be largely independent of whether credit was of the transfer type or not.

<sup>23</sup> The importance of this factor can easily be exaggerated, however. What matters for stability is not only the durability of consumer goods, but also the durability of the capital goods required for their production. It is difficult to generalize about how the latter will be affected by a shift in demand from non-durable to durable consumer goods. Demand may shift from theater tickets to automobiles, for example, and while it is true that automobiles are durable, so are the theater buildings.

<sup>24</sup> For further details see National Bureau of Economic Research (Financial Research Program), *The Pattern of Consumer Debt, 1935-36*, by Blanche Bernstein (1940), especially p. 138.

hold appliance stores and about two-fifths of total sales made by furniture stores.<sup>25</sup>

On the use of cash loans information is meagre, but there can be no doubt that a substantial proportion of their proceeds, although a much smaller one than in the case of commodity credit, is expended on durable consumer goods, again primarily furniture, electric appliances and automobiles. In all loan samples showing the intended use of funds a considerable percentage of the loans are classified as used for "miscellaneous" purposes, and it is likely that durable goods account for at least some part of these, and also for some of those classified under other headings, such as "household." According to the scattered evidence available,<sup>26</sup> slightly more than one-tenth of all cash loans are specifically used for the purchase of durable goods, about another tenth for non-durable goods. From this it can be estimated that durable consumer goods—mainly automobiles, furniture and electric equipment—account for 70 to 80 percent of all consumer instalment credit.<sup>27</sup>

Information is practically non-existent on the goods and services whose purchase is curtailed in order to make repayments, but it seems reasonable to assume that these are numerous and diversified—mainly the myriad small items of

<sup>25</sup> For further details see National Bureau of Economic Research (Financial Research Program), *The Volume of Consumer Instalment Credit, 1929-38*, by Duncan McC. Holthausen, in collaboration with Malcolm L. Merriam and Rolf Nugent (1940) p. 47.

<sup>26</sup> The available data are presented in the various institutional monographs of the present series.

<sup>27</sup> According to computations made in the course of the National Bureau studies in instalment financing, loans not specifically classified as intended for the purchase of either durable or non-durable goods amount to 79 percent of the cash loan total. An unknown proportion, but probably not all, of these were used for non-commodity purposes, such as services and incidental expenses. In order to set an upper and a lower limit to the proportion of instalment credit used for durable goods it is assumed first that this 79 percent of cash loans is used entirely for the purchase of durable goods, and second that it is used entirely for other purposes. If the figures for consumer commodity credit and for each type of cash loans are weighted by their relative importance in terms of the volume of credit granted in 1937, these calculations show that the maximum proportion of consumer instalment credit used for durable goods purchases is 82 percent and the minimum proportion is 69 percent.

daily living, such as food, clothing, entertainment, minor luxuries.<sup>28</sup> It is scarcely likely that the particular goods typically bought on instalment terms are wholly paid for by consistently cutting down expenditure on another equally specific group of commodities: the effect of repayments is probably far less concentrated than that of new credits.

Therefore it seems plausible that instalment credit does, in the long run, entail some shift in relative demand in favor of durable goods. It is likely that in the absence of instalment credit the demand for, and production of, automobiles, electric appliances and other durable goods would have increased more slowly. But how much the growth of these industries would have been retarded it is impossible to tell. It has been argued in the preceding section that, in the absence of instalment credit, some of those buyers who could not finance their purchases by drawing on accumulated savings would pile up a balance *ad hoc* and buy a little later for cash. We do not know how many would do this, but the knowledge would be important in answering such questions as whether in the absence of instalment credit the automobile industry would have grown to its present size or would have been considerably retarded. If we could answer this question we might then speculate on the consequences which a strong retardation of such an important industry would have had on the economy as a whole. But without more knowledge than we have this would not be more than speculation. Subsequent analysis will thus concentrate on the effect of instalment credit on total consumer demand, although the short-run impact on particular industries will come up for discussion in several places.

<sup>28</sup> This assumption is confirmed by a study of variations in family expenditures now in progress at the Bureau of Home Economics in the United States Department of Agriculture, on the basis of data taken from the Study of Consumer Purchases. The tabulation is not yet completed, but preliminary results indicate that, among the income groups from which most instalment debtors are drawn, high expenditures on durable goods—automobiles, furnishings and household equipment—are offset by less than normal outlays for non-durable items of consumption. This finding does not refer specifically to credit users, but there is no reason to doubt its applicability to instalment debtors.