Developments in consumer credit: a central banker's perspective

*The **Governor** reviews[1] financial and economic developments in 1984 and discusses current trends and future prospects in the market for consumer credit. Two major challenges face the industry in the years ahead—the likelihood of more restrained growth in consumer lending after the rapid increases since the abolition of hire purchase controls in 1982, and the prospect of increased competition, notably from the building societies. The **Governor** notes that the Bank welcomes any extensions of competition provided that such competition is on broadly equal terms and does not lead to imprudent lending and provided also that its results do not pose undue problems for monetary control.*

The last year has been difficult but not wholly unsatisfactory. In particular, despite a recent upturn in the rate of growth of retail prices (largely because of one-off factors) inflationary pressures remained under control. Indeed, as measured by the RPI, inflation ended 1984 at the rate—around 4% year-on-year—that had been forecast by the Treasury the previous spring—a forecast widely dismissed at the time as optimistic. Encouragement can also be taken from the fact that economic growth ran at about 2% in real terms in 1984, rather better, if anything, than Treasury forecasts of a year ago, given that it was depressed by the effects of the miners' strike. This was sufficient to allow some growth in employment even if, with a rapid increase in the size of the potential working population, it was not enough to prevent a further rise in unemployment.

Closer to home, so far as the Bank is concerned, the growth of the monetary aggregates over the last year has been reasonably satisfactory. One of the two targets set by the Chancellor last spring looks like being met with ease, as M0 rose by 5% in the year to mid-February against a target range of 4%–8%; while the other, £M3, came out just below the top of its 6%–10% range over the same period.

This outturn was not achieved without difficulty. Abroad, the US dollar strengthened for longer than almost anyone thought possible, despite a marked and welcome decline in interest rates there towards the end of 1984. The oil market, too, has been highly volatile. At home, we have had monetary numbers which have given a more volatile and at times a much more disturbing picture than the underlying conditions probably warranted.

But while underlying monetary conditions generally have been sound in my view, there have been two points of concern. The first is that public spending has risen faster than intended. I welcome the Chancellor's reassertion last week of the need to maintain the tightest rein on public expenditure. The second is that the demand for bank credit by the private sector—which was already high—began to accelerate as the year progressed, reaching an annual rate of around 20%. Almost needless to say, such a rate is far higher than is consistent with the comfortable attainment of the present target for broad money; and it complicates—but does not undermine—our firm intention to provide financial conditions appropriate to non-inflationary, sustainable, growth.

Such conditions are vital but they are not, of themselves, enough unless and until the private sector's response is sufficiently positive. In particular, one of the more disturbing domestic features of the last year has been a sharp upturn in the rate of growth of unit wage costs in manufacturing. During 1983 these rose by a mere 1%. During 1984, however, although average earnings may have risen rather less rapidly, productivity gains were much reduced so that unit wage costs may have risen by over 5%. Continued wage discipline, and the payment of higher earnings only where justified by higher productivity, is a continuing precondition for stable prices, in the long term.

No-one could ever sensibly argue that it is easy to achieve the conditions for non-inflationary sustainable growth, particularly in the sort of conditions we have seen in international financial markets in recent months. But I do not subscribe to the views put into Henry IV's mouth by Shakespeare when he said that if one could read one's future, then:

> The happiest youth, viewing his progress through,
> What perils past, what crosses to ensue,
> Would shut the book, and sit him down and die.

Our book may be hard reading at times, particularly in respect of unemployment, but it is up to us how the book ends.

This is not to say that I am unconcerned about the ups and downs along the way. I know that those involved in consumer credit suffer particularly when interest rates rise sharply, because so much of this lending is on a fixed-rate basis. But I should now like to look more

(1) In a speech to the annual dinner of the Finance Houses Association on 26 March.

broadly at trends in this market and their likely future course. In doing so, I shall return to the main theme of my predecessor—Lord Richardson—when he addressed you three years ago. For these years have demonstrated very well his proposition that the financial markets in this country are undergoing change at a great rate, as the result of government policies, competitive pressures and technological change.

At the moment, it may be that the members of The Stock Exchange feel that they are at the sharpest end of the pressures for change. But those of you involved in equipment leasing will also not feel left out. I note that the initial effects of the 1984 Budget—together with an encouraging rise in the level of investment—led to a major jump in the volume of leasing last year; but this business was done on much finer margins than previously. Looking forward, there must be the prospect, as noted recently by the Chairman of the Equipment Leasing Association, that the volume of leasing business will settle down at a somewhat lower level than prior to the 1984 Budget, once the transitional effects of the new tax system have finally worked through the economy.

Compared with these examples, the challenges which you face in respect of consumer credit may not appear to be dramatic but they are there nevertheless.

The first challenge is that, as in leasing, there is likely to be a considerably slower rate of growth in your consumer credit business over the next few years than in the last three, when progress has been astonishing. Indeed, the outstanding stock of FHA members' consumer lending has almost doubled since Lord Richardson addressed you. And this, I should add, postdates the Prime Minister's Churchillian quip in 1980 that "Never in the history of human credit has so much been owed".

Part of the explanation of this growth, of course, lies in the largely once and for all effects of the abolition of hire purchase controls in mid-1982. No similar boost is likely in the future.

Also, it is clear that the rise in recent years in both mortgage and non-mortgage lending to persons has led to a sharp rise in the ratio of their indebtedness relative to their income. Thus, the household sector's debt is now well over half its annual disposable income; and the percentage of its income devoted to paying the net of tax interest on this debt has doubled in the last six years. It must be a major question—to which I can offer no definitive answer—as to how much further consumers will be prepared to go in raising their commitments.

The second challenge for you is that, despite its ups and downs, consumer credit still looks an attractive market to enter. There have always been new entrants to the industry, as an analysis of the FHA's own membership shows. But, in addition to the usual rivalries, you also have to take into account the future development of the building societies.

It can be argued that further competition from the building societies will only be an extension of the existing reality; for building societies' net lending already far exceeds the amount necessary to finance net additions to the housing stock. Indeed, estimates prepared in the Bank suggest that this excess for the housing market as a whole—generally known as 'equity withdrawal' or 'cash extraction'—was about £7 billion in 1984, over 40% of the total of net new lending for house purchase last year. This excess will have been put to a number of uses; but some will have gone to boost consumption.

If new legislation for building societies goes along the lines set out in the 1984 Green Paper, competition from this source will become more immediate and direct. For the Green Paper envisaged the large societies being allowed to put up to 5% of their commercial assets into a range of non-mortgage assets, including the provision of unsecured consumer credit. If all the eligible societies were to put only half that percentage into consumer credit, this would lead to their extending £2 billion at present prices, and give them a market share approaching 10%.

Now the Bank welcomes any extension of competition provided that it meets three criteria. The first is that competition should be on broadly equal terms, and the Green Paper recognised this principle.

The second requirement is that the new business should be conducted prudently; and again the Green Paper recognised that societies have to allow fully for the managerial and capital resources which would be necessary to underwrite any venture into consumer credit.

The third thing for which we look is that the results of extra competition should not pose undue problems for monetary control. And here, to return to an earlier theme, I must confess that I see no easy or simple answer. Over recent years, the private sector has borrowed heavily from banks and from building societies. This has put considerable upward pressure upon the broad monetary aggregates and, no doubt, has caused short-term interest rates at times to be higher than they would otherwise have been. I have set out several reasons why consumers may increase their borrowing less rapidly in the future than in the recent past. But if their borrowing does continue to rise sharply, the resultant monetary pressure would be of major concern to the authorities.

The Bank will also be looking to ensure that any further competitive pressures in the consumer credit market do not lead to imprudent lending by those for whom the Bank has a supervisory responsibility. In this context, I am pleased to note that there has been a measured response to the abolition of controls. Such restraint needs to be maintained, particularly if I am right in arguing that, in both your consumer credit and leasing business, you need to plan on the basis of more restrained growth rates in the coming years.

In this way you will avoid the fate of two of Beatrix Potter's less well known characters, a dog named Ginger and a cat named Pickles, who set up a village grocery store in rivalry to the only other one in the village run by Tabitha Twitchet. The new arrivals gave unlimited credit. As a result "the customers come again and again and buy quantities. But there is no money in what is called the 'till'. Sales are enormous; ten times as large as Tabitha Twitchet's". However, when the rates demand arrives there is no money to pay it and the store has to close. So the villagers again have no choice as to where they shop and Beatrix Potter concludes: "The closing of the shop caused great inconvenience. Tabitha Twitchet immediately raised the price of everything a half-penny; and she continued to refuse to give credit".

Although the effects of inadequate competition remain the same, consumer credit has come a long way since those words were written in 1911. It has a lot further to go yet, one suspects. I have no doubt that members of the FHA will be at the forefront of further innovation. May all your credit scores be positive—and accurate.