

**POLICY IMPLICATIONS OF A CREDIT CRUNCH**  
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Good afternoon! I am pleased and honored to be here in Wellington and to have the opportunity to speak to you about the policy implications of a credit crunch. Obviously, the policy options central bankers apply to a particular situation will depend on our reading of the extent and seriousness of the problem and, from a policy perspective, whether there really is a problem. Thus my remarks today will begin with an overview of the indicators of a credit crunch. This is no easy task, as evidenced by the fact that it is difficult to agree on the definition of a credit crunch. Perhaps that job would be easier if the term itself didn't carry such negative connotations. If the choice of wording had been left to economists, it might have been called a "market rationalization," and perhaps nobody would have reacted. In fact, we might not be meeting at this conference, lovely as it has been.

My point here is simply that it is not easy to diagnose a credit crunch, and this uncertainty makes the application of appropriate policy options a profound challenge. This challenge is further complicated by the intrinsic dilemma we monetary policy makers face: that of helping the economy through the difficulties of a transition period, but in such a way that our actions do not weaken the beneficial discipline that the markets bring.

Today, I would like to discuss the policy implications of a credit crunch from this somewhat philosophical perspective. I will not neglect the practical realm, however: My

comments will cover measures that have been used in the current situation and some additional measures I would like to see enacted legislatively. I believe this discussion is all the more important as we face the possibility of a worldwide credit crunch in years to come. I plan to say more about this later by way of concluding my remarks.

### **Leading Indicators of a Credit Crunch**

Let me turn first to the topic of indicators. My remarks in this regard--and with respect to policy options--will focus on the Federal Reserve System and largely on monetary, rather than on regulatory, policy. Nonetheless, I will touch briefly on some measures other major industrialized countries have used. As I mentioned, many of the speakers before me, like the U.S. business leaders, bankers and academics with whom I have discussed this issue over the last year or so, find it difficult to agree on the definition of a credit crunch. Interpreting the specific indicators of an imbalance between credit supply and demand is equally difficult.

I must say, to our credit, that many of us in the Federal Reserve System recognized several years ago that potential problems were brewing as a result of the excesses in commercial construction in the United States. Unfortunately, we were like the cardiologist who reminds patients to cut down on the fat in their diets: no one seems to listen until after the heart attack. Similarly, many of us at the Fed had warned about the fatness and overbuilding in the real estate industry. But, sadly, all too few developers and their creditors listened to us. This, of course, is the basis of the credit crunch we have been facing in the United States.

As the crunch itself began to develop, we were less prescient. That was because the information we had available on which to base our diagnoses was, and continues to be, less conclusive than we might like. In regard to credit markets, for example, we have statistics on bank loans made, but a fall in--or deceleration in the growth of--these numbers *per se* cannot tell us whether the supply of credit is being constrained or demand has slackened. In addition, we know that we cannot look only at bank loans as a source of information about credit. We must look at the credit markets as a whole. We all know that U.S. banks have been losing market share, thanks to such trends as securitization and bigger corporations' increased issuance of commercial paper. So, softness in bank lending need not be a problem, so long as we see credit growing elsewhere. On the other hand, these other suppliers are not a perfect substitute for smaller and medium-sized businesses, which do, in fact, contribute mightily to the strength of the U.S. economy. Firms in this "middle market," as bankers term it, have always had a close relationship with their banks, because they have had to share so much proprietary information in order to obtain a loan. Such companies do not have access to the commercial paper market. Thus, to ascertain whether a credit crunch is taking place, we have to delve beneath the aggregate statistics on lending.

To get past these problems of interpretation, we solicit anecdotes from many business contacts, for example. These informal polls can provide insights. Unfortunately, it is very hard to know how much weight to give them because, by their nature, they are narrow in scope and speak more to private rather than public policy concerns. We also have a more formal vehicle, namely, the Fed's survey of senior loan officers, in which we often ask large banks essentially

whether they are tightening credit, loosening it, or holding steady. These surveys can be a good indicator of how the credit situation is changing from one period to the next on a relative basis. However, it seems that some healthy skepticism is useful when judging these surveys on an absolute basis. Responses to surveys often have some bias, and, in the case of these respondents, their bias is apparently against admitting to their regulatory agency that they have loosened credit. In other words, they are prone to tell us what they think we want to hear.

Even if all the evidence seems to be pointing toward a tightening of credit, policymakers must assess the underlying causes before we act. In the midst of reading our indicators and gathering our intelligence, the Fed must ask whether the information reflects a credit crunch or a phase of the normal business cycle. This question is easier to answer *ex-post* rather than *ex-ante*, particularly because the symptoms are similar. It could be that markets are somehow not allocating credit efficiently. On the other hand, a weakness in credit growth could well reflect bankers' appropriate assessment of risk, given the stage of the business cycle we are in. No central banker should tell a bank to make a loan that the bank believes is bad.

Another even more basic cause of the current tightness involves the fiscal and monetary policy mix. In the United States, as in many other industrialized nations, the central bank during the late 1980s had begun to pursue a more restrictive approach toward monetary and credit growth. The purpose of this strategy, of course, was to move the economy toward a more sustainable pace of expansion and to achieve a lasting reduction in inflation. On the fiscal policy side, however, this move was contemporaneous with the adjustments in tax law changes affecting

real estate investment. These laws had been altered in the early 1980s in a way that encouraged excess building and were reversed with the 1986 Tax Reform Act, which sharply lowered rates of return to construction. Thus, in gauging the early signs of credit tightness, we could not avoid viewing the complaints we heard as part of the adjustment process that takes place in an environment that was both disinflationary and reflective of a shift in fiscal policy.

### **Policy Options**

As you can see, the indicators of a credit crunch pose serious interpretation problems that are inextricably linked to policy options. But this sort of problem is common to policy makers. We do not have the advantage of working out our solutions in a sterile laboratory setting where we can conduct controlled experiments. And we do have a fundamental social mandate toward action rather than analysis. Borrowing again from my earlier medical analogy of diagnosis and treatment, we cannot afford to remember only part of the Hippocratic oath -- that of doing no harm to the patient. At some point, we must take action--whether to correct imbalances when they seem to have become self-perpetuating or to ease the period of transition.

In the United States, as you heard yesterday, the Fed has taken several actions over the past 12 months that were intended to soften the impact of our credit crunch. To refresh your memory, these included several monetary policy moves--open market operations, a change in the discount rate, and a reduction in reserve requirements. In addition, we took several important steps on the regulatory side. These were designed to clarify supervisory policies, particularly in regard to problem loans and concentrations of real estate loans.

Other nations have taken different tacks with their tight credit situations. In Japan, the banking system is closely tied to the stock exchange, because equities make up a large portion of bank assets. Thus, the recent move by the central bank with the discount rate seemed to be consistent with the idea that further declines in the Nikkei could adversely affect the credit markets. The Bank of Japan has also sent a clear signal to bankers that they should not increase the number of outstanding loans for property, given the concerns about bloated land values. It has also been reported that some central banks have relied on a certain amount of moral suasion or "jawboning," encouraging bankers to provide liquidity to borrowing firms that have been reliable but were encountering liquidity problems.

In certain other countries--such as New Zealand, Australia, and Canada--credit is tight largely due to a sustained tightening in monetary policy, which was designed to address domestic inflation and other imbalances. The tightening in credit markets was thus part of the process of disinflationary adjustment, as in the United States. Unlike the United States, though, these countries did not face the complication of tax law changes and attendant dislocations in real estate markets. Given this nexus between monetary policy and the perceived credit crunch, their options have been more limited. As long as they remain committed to the longer run goal of lowering inflation, the most they can do is to take a slower path toward lowering inflation.

How effective have these policy measures been? With regard to the Fed, it is really too soon to pass judgment. On one hand, the regulatory clarifications were helpful, I believe, in several ways. Clearly, their most immediate impact is at the microeconomic level, that is, on

the balance sheets of individual banking institutions and those of their customers. There is no way to measure how much these helped, but we can take some satisfaction in knowing that we did what we could to prevent disruptions in the important relationship between banks and small to medium-sized business. Given what we know about the limited credit options of small firms, insofar as our actions helped preserve these relationships, they may have helped prevent a significant loss to the economy. These measures also probably had a beneficial macroeconomic effect, that of reducing uncertainty in credit markets.

These supervisory measures seem to have dovetailed with our monetary policy moves, helping to lead us out of the recession into recovery. Certainly, some critics would say we should have done more, sooner, but one can counter that we might never have entered a recession were it not for Saddam Hussein. In addition, there are fundamental reasons why our actions were incremental and marked by considerable restraint. That restraint is grounded in the basic perspective of central banks and their policy tools, which are more macroeconomic and long term in nature than those of other economic policy makers. As the central bank, we must focus on the nation's economic health, not one sector's health, in spite of political pressure to do so. It is not appropriate for us to try to ameliorate the plight of the banking industry--or small business or agriculture--if this plight reflects the adjustment to a more sustainable pace of growth and a reduction in inflationary expectations. Neither are we credit allocators. We cannot urge bankers to help out one industry at the expense of another. Because we serve a public purpose, we must refrain from interfering with private sector decisions.

In addition to keeping our focus on the economy as a whole, we must also try to keep a longer-term perspective in mind. Indeed, in creating the U.S. central bank with a decentralized structure and removing it from the political arena, Congress intended to keep the Fed from being caught up in short-term political considerations. Taking the long-term view may sound like a passive activity, but those who are known for their vision are far from passive. Instead, visionaries take actions now to arrange for better results later and then have the patience to await the outcome.

In the United States, we are at a watershed point in preparing for a better future, because the legislature is engaged in debating a number of measures to reform the banking industry. I would hope that this new regulatory framework will also make credit crunches less likely in the future, although I have my reservations about some aspects of these proposals. Many good ideas and some bad ones will wend their way from committee meetings to the full Congress to the President's Oval Office. There are three ideas I would like to see incorporated into new banking legislation or regulation that will help to prevent a credit crunch in the future.

First, we must continue pushing banks to build up their capital, so as to create a bigger cushion when accidents happen. I acknowledge that, in the short term, banks will have a tough time accomplishing this, given our still soft economy and banks' low average profits. Because banks are finding it expensive to sell stock in the equity markets, some are likely to constrain their lending to achieve the new balance in the risk-based capital/assets ratios. I know small business owners won't like the loan tightness that will ensue and probably last for a while. Our



job as central bankers, however, is to support measures that work to make a stronger and safer financial system and help the overall economy.

A second imperative, as I see it, is to encourage consolidation in the overpopulated banking system. Our deposit insurance system acts in perverse ways, albeit unintentionally. For problem banks, as we have seen with savings and loans, the asymmetry of rewards and penalties encourages management to engage in very risky activities in the hopes of saving a sinking ship. If the tactic fails, insurance picks up the bill. More generally, though, deposit insurance has served as a subsidy, attracting too many entrants into the field. The resulting competition has driven spreads down on average -- not just in troubled banks -- to levels that are not profitable and that cannot be sustained in the long run.

A third reform we need is to enable regulators to obtain prompt resolution of troubled banks. This will reduce risky behavior by banks, because they will fear being closed down. Ultimately, it will also reduce the costs involved in taking over ailing banks.

If the United States banking system is reformed in these ways, I believe credit crunches will be less likely in the future. But change, adjustment, and dislocation are an intrinsic part of market economies. We cannot assume that we will have eliminated this problem completely. And as we face new situations, the Fed will have to continue our complex balancing act of progressing toward longer term goals while we also respond to shorter term adjustment problems.

### **Looking Ahead to a Possible Global Credit Crunch**

Let me turn then from today's policy problems to those of tomorrow. My remarks so far have been based on the present context we face in the United States, that of a credit squeeze resulting largely from a swing in the pendulum on standards for real estate loans. The credit crunches of the future could crop up in forms that have nothing to do with real estate, so we must not fall into the habits of old generals who are always fighting the last war.

Another kind of credit squeeze that would be even more difficult to identify could well arise globally. A shortfall in credit worldwide could surface for a variety of reasons. As we all know, the integration of the financial markets on a global scale is proceeding much faster than political efforts like GATT to facilitate trade flows. Over the next decade, the changes that have taken place in Eastern Europe and Latin America could bring these developing nations into the mainstream of the world economy. Consequently, potential rates of return to investment -- on an inflation-adjusted basis -- could turn out well above those in the industrialized countries, where many markets are saturated. In other words, there will be more competition worldwide for credit. The United States has the additional problem of a relatively low savings rate. This long-term phenomenon, which makes it difficult for us to finance our investment and credit needs, was muted during the 1980s, because of the large amount of foreign investment in our country. In the decade ahead, however, we may not have the luxury of the same amounts of foreign investment to make up for our own shortfall of savings.

All of this points to a potential imbalance in the supply and demand of credit globally,

perhaps not in the next few years, given the extent of changes to be made in these developing economies, but possibly toward the end of this decade. From a general point of view, I would hope that we in the industrialized nations would respond by taking the mature attitude that the richer countries in the world should be happy to see other countries doing better in the global economy. We should also be preparing ourselves now to coordinate our responses to such a global credit crunch, which would be more interconnected than the current essentially coincidental credit crunches in a number of domestic markets.

Because each country has a different mix of fiscal and monetary policy, each would, of course, have its own responses to this global credit crunch, and coordinating our responses would not mean homogenizing our fiscal and monetary policies--no more than it did when the G-7 countries addressed their currency alignment problems in the mid-1980s.

In the United States, I believe the main policy response should be in the realm of fiscal policy. I am certainly not talking about subsidies or restrictions on capital outflows, which, unfortunately, could be proposed if foreign investment were to diminish drastically in the United States. If such proposals were put forth, I am sure we at the Fed would try to use moral suasion to prevent their use. Instead of such a protectionist response, U.S. legislators should use tax and spending policies to increase the productivity of the country's resources and, thus, the domestic rates of return. More might need to be done on behalf of investment in infrastructure and education, for example. In addition, fiscal policymakers would, I hope, maintain the resolve to lower the federal budget deficit.

But our central bank role should not be limited to a solely educational one. We must bear in mind how difficult it is to reverse some legislative measures compared with how relatively easy it is to reverse monetary policy -- should a move turn out to be inappropriate. As I mentioned in the context of the current credit crunch, the Fed and other regulators took steps to facilitate the workout of problem loans to ease the credit tightness in an incremental way. In contrast, during the early 1980s, thrift institutions were given an artificial subsidy by legislative decree in the form of net-worth certificates, which boosted their "regulatory capital." We could see that this got us past the problem in the short run, but it is one of the factors that has left us with a huge bill for the savings and loan bailouts. That is a long-term effect of legislation that all Americans would rather be without. For this reason, I believe that bringing monetary tools into play might be preferable to seeing legislative bodies enact measures that are difficult and expensive to deal with and that are hard to repeal once they become law. Such actions would not be caving in to political pressure, as I see it, but a move that serves the overall economy better in the long run.

### **Conclusion**

This overview of policy options -- specific measures and broader principles -- highlights the complexities of addressing problems like a credit crunch, bringing me to the philosophical dilemma of monetary authorities I mentioned at the outset. Central banks must balance long-term, macroeconomic objectives with the need for easing a present economic problem. On the one hand, if we hold too purely to the long view, our policy will tend to exacerbate the adjustment problems not only for the banking industry but also for many businesses. On the

other hand, to ease their plight might also induce unnecessary inflation and prevent a necessary market correction. What's more, we must make this tough decision in a context of uncertainty-- that is, on the basis of elusive economic indicators. And our decisions are not completely immune from political pressure.

It would be easier for us to hide behind our macroeconomic views and insist that there is no credit crunch unless the situation fits our narrow definition. That would mean we would not take any action and could rationalize our inaction with economic theory. But, in my view, in the present circumstance, that would be wrong. As policy-making bodies, central banks bridge the ideal world of economists, who theorize using stylized models, and the real world of business people, who deal in the practical realm. Economists are good at explaining how things work and the dynamics involved, but they cannot take into account political considerations -- not only of issues themselves but also of time schedules for reform.

Central bankers are the ones who make the hard choices in policy that may not be a perfect -- or swift -- solution, but will at least keep us moving in the right direction. We know what our goals are, but we are not starting from zero or even the best place, as theoreticians do. Thus, we must from time to time make decisions that seem suboptimal or second-best -- as when credit crunches occur or when we have to accept slower progress on inflation than we might like, because society and its political leaders find more rapid adjustment too painful to bear. But in exercising this flexibility, we also demonstrate that we are a product of society and, therefore, ultimately accountable to it.