

**CREDIT CRUNCH: FACT OR FICTION**  
**Remarks by Robert P. Forrestal**  
**President and Chief Executive Officer**  
**Federal Reserve Bank of Atlanta**  
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I am honored to be here at the University of Tennessee to discuss an extremely important issue for our economy. The topic I have been asked to address is whether the credit crunch is fact or fiction. From a practical point of view, I believe the credit crunch is very much a fact and that it has been with us for at least two years. With the credit crunch having existed for this long, it has become one of the factors fueling widespread disappointment regarding the economy. As you know, over the past year a low level of consumer confidence seems to have dampened the momentum of recovery and contributed to a lengthening of the recession.

However, I am very sensitive to the point of view that sees the credit crunch as fiction, a concept with reality only in the minds of those unable to obtain credit for new projects. Part of the problem in coming to grips with the reality of the credit crunch is that the term itself is used in varying ways. Policy makers have not been immune from this debate over definitions. For monetary policymakers in particular, the credit restraint situation we have faced has been extremely difficult to deal with because of its vagueness and complexity. Let me begin today by summarizing the main points of view regarding the definition of a credit crunch. Then I will discuss what led to this particular credit crunch, what the Fed has done about it, and, finally, what we can expect in the future in regard to this matter.

## Defining the Issue

In the most basic sense, a credit crunch exists when the demand for credit outstrips the willingness of the financial system to supply it, perhaps due to externally imposed controls like interest-rate ceilings. Although such ceilings were phased out by the mid-1980s, many people, including a number of bankers, believe that bank regulators created this credit crunch by tightening examination standards. I would view the situation essentially in these terms, although, as I will discuss shortly, I think the roots of the problem go far deeper than examination practices.

In applying this definition, economists often focus on aggregate statistics and the economy as a whole. Viewing a credit crunch from such a macroeconomic perspective, many argue that no credit crunch exists as long as credit can be obtained somewhere in financial markets. The supply exists, they maintain; it is simply not being supplied through the banking industry right now.

In sharp contrast to economists, business people tend to take more of a microeconomic viewpoint, being most knowledgeable about and concerned with their own company or industry. Consequently, they often believe a credit crunch exists any time they cannot obtain credit. In recent times, this attitude may be a reaction to the fact that many businesses enjoyed relatively ready--some would say too easy--access to funds during the 1980s. On the other hand, I often hear complaints from businesses that banks are turning away good credit risks along with the bad. Thus, while both bankers and business people believe we have been in a credit crunch,

bankers put the blame on regulators while business people tend to point the finger at bankers.

For their part, bankers have changed their thinking over the last year or so, according to conversations I have had. While some still complain about tightened regulatory standards, many bankers do not believe the current problem is on the supply side. Rather, they see the matter in terms of weak demand, at least demand from creditworthy applicants.

Closely related to the issue of defining the problem is that of interpreting specific data and other information to gauge whether a credit crunch exists. I must say 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, the Fed has statistics on bank loans made, but a fall in these numbers or a deceleration in their growth 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 follow the guidance of economists and look at credit markets as a whole. We are all aware that U.S. banks have been losing market share, thanks to such trends as securitization. So, softness in bank lending need not be a problem so long as we see credit growing elsewhere, for example, in the commercial paper market, where many large corporations have increasingly been meeting their borrowing needs. On the other hand, we know that these other suppliers are not a perfect substitute for smaller and many medium-sized businesses. We also know that such firms contribute importantly 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, policymakers must probe beneath the aggregate statistics on lending.

At the Fed we solicit information from banks through a formal survey of senior loan officers. In this survey we periodically ask banks 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.

We also solicit anecdotal information from business contacts, and these informal polls can provide valuable insights. Unfortunately, it is very hard to know how much weight to assign them at any given time because, by their nature, they are narrow in scope and speak more to private rather than public policy concerns. I believe, however, that in the case of the current credit crunch, the anecdotal evidence led the statistical evidence in accurately reporting the problem.

Given these diverse definitions and often confusing signals, it is clear that reasonable people could well question whether the current credit crunch is fact or fiction. Even if all the evidence seems to be pointing toward a tightening of credit, policymakers must assess the underlying causes before we act. Thus, the central bank must proceed cautiously as it tries to deal with this issue. It is not our job to interfere with markets that are allocating credit efficiently or wisely, given the stage of the business cycle the economy is in. No central banker should tell a bank to make a loan that its lending officers believe is bad. Of course, the monetary authorities in any nation have a certain mandate to help the economy through the difficulties of a transition period. Yet this must be done in such a way that does not weaken the beneficial discipline that market forces may be bringing.

### **Sources of This Credit Crunch and Fed Responses**

Let me turn now to present circumstances and review what led to this period of credit restraint and what measures were taken in response. The proximate cause is, as I mentioned, the excessive real estate construction that took place during the last decade. At a more

fundamental level, however, the problems of the last two years can be traced to the fiscal and monetary policy mix that prevailed during much of the 1980s.

In the United States, as in many other industrialized nations, the central bank in the latter part of that decade began to pursue a more restrictive approach toward monetary and credit growth. The purpose of the strategy was to move domestic economies 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 some significant adjustments in tax laws affecting real estate investment. These laws had been altered in the early 1980s in a way that encouraged too much building. They were reversed with the 1986 Tax Reform Act, which sharply lowered rates of return to construction. Subsequently, bank regulators began to look at the loan portfolios of banks with these changes in mind. In my view, if these actions by both lawmakers and regulators had not been taken when they were, the inevitable market correction to the imbalances that were building would have been far more abrupt and painful. It was time to change course.

When early signs of credit tightness began to emerge, the Fed 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. In retrospect, however, it seems that banks, facing a situation in which changes in tax laws regarding real estate weakened their balance sheets at the same time regulators were seeking more strength, responded by cutting



back generally on lending. Thus the impact was not limited to real estate borrowers but extended to others, including many small businesses. However, it took awhile for this picture to emerge convincingly. We had to begin to sort through the conflicting evidence I described earlier. Ultimately, though, we recognized that we needed to step in to ease the transition taking place.

Over the past two years or so we have taken a variety of significant actions. These included several monetary policy moves, ranging from accommodative open market operations and a number of cuts in the discount rate to reductions in reserve requirements. One of the biggest moves came just before Christmas, you will recall, when the discount rate was reduced by a full percentage point. About a year ago the Board eliminated reserve requirements on non transaction accounts, and just last week, the Board of Governors announced a lowering of reserve requirements on transaction accounts from 12 percent to 10 percent. This recent change, which will begin in April, should reduce funding costs for depositories and strengthen their balance sheets. In turn, this reduction will put banks in a better position to extend credit.

As a result of these monetary policy measures there has been a substantial cumulative reduction in interest rates. The federal funds rate has declined nearly 6 percentage points from its cyclical peak, and the discount rate is down 3 1/2 percentage points. In turn, other interest rates have fallen. While the decline is most noticeable in the short end of the maturity spectrum, rates on bonds and mortgages are about 1 1/4 percentage points below their cyclical highs. The effects of this decline in interest rates have spilled over into equity markets, giving stocks a significant boost.

In addition to these monetary policy moves, the Fed, along with other supervisory agencies, 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. These steps also sought to establish clearer communications between bankers and their examiners. This change is significant because such communications have not always been optimal. One of the most recent steps was taken this month when the Board of Governors, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation announced that government regulators will discontinue using the supervisory definition of highly leveraged transactions after June of this year. Also, staff at the twelve Federal Reserve Banks not long ago apprised chief executive officers of state member banks about our standing policy on the procedures for appealing an examination.

At the Atlanta Reserve Bank, members of our staff have also been meeting with senior bank officials to discuss credit availability issues, particularly in regard to real estate lending, and to solicit their opinions on the conditions their banks are facing. Finally, representatives of the examination staff of the Atlanta Fed have also participated in the four town meetings that have been held in the Southeast by members of Congress. These town meetings have allowed bankers and real estate developers, among others, to air their complaints and suggestions.

### **Where Do We Go From Here?**

All of these actions should help to ease tightness in credit markets and improve communications between regulators and banks on credit standards. Moreover, as the economy



improves, the excess real estate inventory will eventually be drawn down. Already, the loan portfolios of banks are beginning to show some improvement. In turn, the balance sheets of banks are strengthening, and as a result the stock market is showing renewed interest in bank stocks. All of these developments mean that it should become easier for banks to offer credit. At the same time, it is clear to me that the industry will not be going back to the easy standards of the 1980s, nor should they.

It is also clear to me that we have not seen the end of credit crunches during this decade. Some people like noted economist Henry Kaufman believe that credit crunches have become a feature of a deregulated financial system and thus are likely to be more common as time goes. According to this viewpoint, deregulation allows and even encourages institutions to take on excessive risks, prompting periodic but unpredictable credit crunches. I am not this pessimistic, and I believe that deregulation has been beneficial. If anything, we have not gone far enough in some areas like interstate banking and branching.

Nonetheless, I believe that a worldwide tightness in credit could surface during the 1990s. As we all know, the integration of financial markets on a global scale is proceeding much faster than formal 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, adjusted for inflation, could turn out well above those in the industrialized countries, where many markets are saturated. In other words, there will be more international competition

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.

Of course, this situation is different from the most basic definition of a credit crunch in which non-market forces limit the supply of credit. In other words, the imbalance between supply and demand could be resolved through higher lending rates. However, I am somewhat concerned that in such a scenario, we would indeed see efforts being made to impose artificial barriers to the flow of savings to their most productive investment opportunities. These might come in the form of subsidies or restrictions on capital outflows. Unfortunately, the protectionist sentiments that periodically surface in the area of trade make me concerned that such proposals would be advanced if foreign investment in the United States were to diminish dramatically.

What is the best way to prepare for such developments? I think the main course of action must be in the realm of fiscal policy. In particular, we must refocus tax and spending policies to increase U.S. productivity. Only faster productivity growth can enhance our competitive position in the long run. There are many steps that need to be taken to attain this goal--better

education, rebuilt infrastructure, and, of course, appropriate spending on one of the most basic forms of human capital investment--health care. However, the most basic step in this direction is reducing the large federal budget deficit. Doing so will free more of our savings for all kinds of productivity-enhancing investment.

## **Conclusion**

In conclusion, the past two years have been difficult for banks, their customers, and policymakers. For the latter, the difficulty has revolved very much around the question of whether the credit crunch is fact or fiction, and, if it is fact, how best to address it without subverting the necessary adjustments, especially in real estate, and without sacrificing the gains made against inflation. I am optimistic that the regulatory measures which have been undertaken are dovetailing with the monetary policy moves by the Fed, positioning the economy to move beyond the credit crunch and the recession. As we look ahead, the challenge for policymakers and voters alike is to draw the proper lessons from this painful episode. In my view, the foremost lesson is that we must not adopt measures that promote rapid growth for a short while, as happened with the tax-induced real estate boom of the 1980s, but rather seek measures that foster truly sustainable expansion of the U.S. economy so that we are better able to compete in what has become a global marketplace.