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The Credit Crunch: A Monetarist's Perspective

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I. Introduction

Credit problems have figured prominently in both public and political discussions of our economic problems in the past several years. Few borrowers are said to be satisfied with their access to credit and, similarly, few lenders are thought to be satisfied with their ability to find an adequate volume of quality loans. The debate about these problems has generated much heat and frustration, but relatively few worthwhile solutions.

Before deciding whether the label "credit crunch" fits the developments in the early 1990s, however, the term needs to be defined. Traditionally, the term "credit crunch" denoted non-price rationing of credit during periods of disintermediation in the banking system. An alternative definition of a credit crunch, termed the "credit view," is one that begins with disturbances to total bank assets (bank loans and investments) and to the composition of those assets.

By either definition, the available evidence does not support the existence of a general, nationwide credit crunch, although regionally concentrated banking problems continue, and a sharp reduction in commercial real estate lending has occurred. In my view, we should regard the credit problems that concern us today as short-term market

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adjustments to the economic and political problems of the 1970s and 1980s. The inflation of the 1970s both decimated the balance sheets of short-funded institutions (most notably thrifts) and resulted in a shift by banks away from cash-flow-based lending toward asset-based lending. The trend was reinforced by the superior performance of asset-based loans, vis-a-vis cash-flow-based loans, during the 1982 recession. The stage was set for a boom and bust in the commercial real estate market, and the health of financial institutions that had overexposed themselves to this sector in some regions of the national economy was in jeopardy.

I do not mean to suggest that the financial market adjustments we are now working through are unimportant or painless. We are experiencing wrenching adjustments in several regions and industries. But these adjustments must be made and, indeed, they are being made perhaps more rapidly than some appreciate. Accordingly, we need to be wary of quick-fix solutions to deep-seated problems.

In response to selective credit availability situations, some analysts have suggested that the Federal Reserve should aggressively pursue more rapid expansion in the money supply, which affects the liability side of the banking systems balance sheet. After all, such a policy would indeed require banks to expand their assets -- loans and investments -- to match their now-greater liabilities. Others have suggested that regulatory policies be altered to alleviate credit market problems. They contend that regulators have overreacted to current events in selected markets and forced all banks to comply with excessive regulations. This knee-jerk reaction could be offset, they say, by convincing regulators to change capital requirements, accounting rules,

and risk-assessment policies.

While there may have been some overreaction by regulators, that should be corrected, there is not much to be gained by regulatory forbearance and, as I will argue later, there is much to be lost by going down that road. At the same time, expanding the money supply to counter a perceived lack of credit available in some markets would also be a mistake because this policy would risk re-igniting inflation down the road. As the steepness in the yield curve reminds us today, concern with future inflation is already built into capital market expectations, and in a very prominent way. What monetary policy can do in response to current credit market problems is to provide the stable monetary environment necessary for investment and economic growth.

II. What Does the "Quantity Theory of Money" Say about the Credit Crunch?

The pragmatist's view of a credit crunch is straightforward, probably meaning no more than an abrupt reduction in the flow of credit, either in absolute terms, or perhaps even relative to the demand for credit. Stated in this manner, a disruption in credit conditions could clearly be national in scope, affecting most borrowers and lenders. The disruption could also be regional in nature, or the result of real factors affecting the flow of credit to particular industries or from particular lenders. This may seem obvious, but the implications of these various situations are vastly different.

One reason why there are several proposed solutions for the credit crunch "problem" is that there are several definitions floating around,

and the precise meaning one should attach to the term credit crunch is not always clear. There are some theoretical distinctions that are important to economists. Monetarists, or quantity theorists, focus primarily on the liability side of the banking system's consolidated balance sheet, which is also a part of the asset side of household and business balance sheets. The quantity theory pays attention to depository liabilities because of the close connection between money and inflation. Other economists put forth the credit view of the financial transmission mechanism, which is primarily interested in the asset side of the depository sector's balance sheet--both the growth of total assets and their composition (see Bernanke, 1988). This is not to say that monetarists do not understand the importance of credit in the economic process: they certainly do, but the quantity theory treats credit supply like an allocative process, determined by market forces such as risk and return, and institutional arrangements. Monetarists understand that problems in credit markets may arise either by monetary-policy-induced disturbances to the liability side of the balance sheet, especially in concert with regulated interest-rate ceilings and credit controls, or by real factors that have altered the risk-return trade-off in particular sectors of the economy.

Traditional Credit Crunch

The term credit crunch was used to describe some particular episodes of disintermediation in the 1960s. In the 1966 and 1969 episodes, and to a lesser extent in 1959, prohibition of interest payments on some bank liabilities -- or rigid interest-rate ceilings on others -- caused households and business to channel deposit flows away

from bank deposits and certificates of deposit (CDs) toward higher-yielding U.S. Treasury bills and commercial paper. The result was a marked slowing (or outright decline) of the outstanding bank liabilities subject to such interest controls.

By 1969, large banks could replace some interest-rate-controlled sources of funds with commercial paper, Eurodollar borrowings, and other instruments not subject to ceilings. However, smaller banks and thrifts were not able to manage their liabilities with the same degree of flexibility. Consequently, the 1969 disintermediation process involved a substantial contraction in the consolidated balance sheets of those depository institutions. As was the case in the earlier episodes, the money supply contracted and earning assets had to be divested.

Monetarists pay close attention to the money supply, and during these past episodes they were careful to gauge how much of the money stock's contraction was coming from a change in the money supply process and how much was due to a change in money demand. The distinction is quite important. To the extent that the nonbank public's demand for deposits subject to such rate ceilings falls because of higher rates paid on alternative assets, money demand falls. So, if the disintermediation process induces the public to economize on its holding of transactions balances, we can infer that the resulting monetary contraction is not evidence of monetary policy restraint. The public's savings would be held by other financial institutions, and credit would be extended to borrowers in the form of those lenders' liabilities. Still, if credit were forced to flow through channels less efficient than depository institutions, this would have an adverse and distorting effect on economic activity. Certain sectors and regions would bear the

impact more than others.

As the inflationary pressures subside and market interest rates subsequently fall, the reverse holds. The opportunity cost of holding financial assets as bank liabilities declines. Households and businesses then add to their holdings of such balances. This process of re-intermediation accompanies an acceleration in the growth rates of the monetary aggregates. However, since in this case the demand for money balances increases without any underlying change in total spending, accelerated money growth does not indicate stimulative policy actions.

Current Situation

It would not be correct to regard the credit market problems of the past couple of years as being monetary in nature. First, the growth of monetary liabilities in the banking system, though perhaps slightly slower than some would have preferred, has been maintained. The broad measure of money, M2, rose about 3 percent in 1991, 4 percent in 1990, and 4.8 percent in 1989, and M2 velocity has remained steady. The pattern of M2 growth in 1991 was less than ideal, with 4.4 percent growth in the first half of the year followed by a 1.8 percent growth rate in the second half. Although the unevenness of M2 growth during 1991 could be considered to be a problem, our best estimate of the M2 spending linkages do not suggest much of an impact from short-term gyrations in M2 growth of this magnitude.

Second, the price of credit -- the interest rate -- has declined sharply over this period. At the short end of the maturity spectrum, interest rates are down by about 4 percentage points. This development, though not totally conclusive, strongly suggests that some, and perhaps much, of the decline in credit has been due to reductions in the demand

for credit. The surge in bond and equity issues suggests a decline primarily in the demand for particular kinds of credit that banks extend. Consequently, I am not inclined to regard the credit market problems of the early 1990s as having origins in monetary policy, and it seems to me that monetary policy has few answers for those problems.

Although I do not think that monetary policy contributed to the current credit market environment, I think there is merit in analyzing how the situation emerged. Let's begin with a few facts about the size and distribution of the credit flows themselves. In the past four years, the total flow of credit to the non-financial sector has decreased from 20 percent to 12 percent of gross domestic product (GDP). This is a sharp contraction, but it is a decline from the abnormally high debt binge levels of the late 1980s. The flow of credit relative to GDP is still at, or slightly above, the levels registered in the 1970s and the first half of the 1980s. So, the flow of credit has not dried up. Although it has declined, it is perhaps closer to normal today than during the debt binge of the 1980s.

Regional disparities in the performance of both the real economy and the financial services industry lead some observers to be concerned not about the nationally available flow of total credit, but about the distribution of that credit. Using a credit-view perspective, these observers suggest that depository institution asset-quality problems might be responsible for a nationwide credit shortfall, with the implication that credit would not be allocated to its most productive uses. While the national economy grew steadily from 1982 through the end of the decade, regional economic performance was mixed. Regions heavily dependent on energy and agriculture experienced economic

difficulties during the mid-1980s, while those dependent on the defense industry began to realize problems later in the decade. Poor performance in the real economy translated into bank asset-quality problems, a sharp increase in the number of bank failures, and a reduction in credit availability in depressed regions and for depressed industries. Not only is this situation substantially different from a national credit crunch, it is not indicative of a credit misallocation.

If neither the monetarist nor the credit view approach is consistent with recent developments, then what is the problem? First, we have experienced a massive redirection of credit, away from real estate development and commercial construction toward the federal government. Second, we are seeing a massive swing on the lending side of the markets. Depository institutions, banks and thrifts combined, are not playing their customary role in the financial intermediation process. Credit flows from banks and thrifts to the nonfinancial sector have declined far below the levels customary throughout the 1970s and up to 1988 -- from 6 to 8 percent of GDP to close to zero last year. Although the market share of commercial banks has been gradually eroding for some time, it is the disappearance of the thrift industry that is most remarkable. What forces have produced these sharp swings in the origin and directions of credit flows?

III. The Origins of Current Financial Sector Problems

The credit and financial problems of the early 1990s have several origins. For both borrowers and lenders, the problems are concentrated in the real estate sector. As inflation pressures increased in the

1970s, nominal interest rates rose to levels unprecedented in the United States. By mid-1979, policymakers developed the political resolve to fight inflation, and the Federal Reserve moved decisively to disinflate the economy. The roots of the damage, however, had already been planted. Deeply embedded inflation psychology encouraged bank lending policies to shift from a cash-flow, loan-servicing basis to an asset-appreciation (collateral-value) basis. Moreover, inflation contributed importantly to the thrift industry's decapitalization. Former Federal Home Loan Bank Board Chairman Richard Pratt estimated that by 1982, the FSLIC insurance reserve was a negative \$100 billion (see Pratt 1990).

A speculative real estate bubble was to occur. Commercial real estate construction grew explosively during the 1980s. In all, \$470 billion was invested in commercial real estate during the 1980s, a 57 percent increase (in real terms) over the previous decade. Unfortunately, this construction boom was not met by an increase in demand, as average office vacancy rates in metropolitan areas rose to 20 percent, more than double their normal rates.¹ The problem was even worse in the Southwest, New England, and some West Coast metropolitan areas, where vacancy rates soared to over 30 percent.

Several factors contributed to the run-up in commercial real estate and the subsequent collapse of the market. First, the reaction of legislators and thrift regulators to the interest-rate-induced insolvency of the FSLIC was capital forbearance. Risk of failure was transferred from the private to the public sector through the deposit insurance system. Starting in 1980, capital standards for thrifts effectively were reduced to zero, and the deposit insurance ceiling was increased from \$40,000 to \$100,000 by the Depository Institutions

Deregulation and Monetary Control Act (DIDMCA) of 1980. In addition, both the DIDMCA and the Garn-St Germain Act of 1982 gave thrifts new asset powers, including the ability to invest directly in real estate. Between 1982 and 1985, with encouragement from regulators, this undercapitalized sector of the financial services industry grew at a rate of 16 percent per year, more than twice the rate of nominal gross national product (GNP).

With little or no capital, and thus very little to lose, thrifts became aggressive players in the real estate market by offering favorable financing terms on real estate development (land) loans and by taking equity stakes in a growing number of projects.² From 1982 to 1985, savings and loans collectively increased their land loans by \$24.1 billion and increased their direct equity investments in real estate by \$18.6 billion (see White 1991, tables 6-3 and 6-4). By early 1985, regulators became concerned about the deteriorating asset quality in thrift portfolios and began to take steps to curb both the overall growth of the thrift industry and real estate investments on thrift balance sheets. Thrifts grew more slowly over the second half of the decade, with asset growth averaging 3.6 percent per year.

A second factor that contributed to the commercial real estate bubble was the 1981 tax bill, which provided tax incentives for investing in real estate. The most important provisions were the passive tax-loss rules and the accelerated depreciation schedules that made certain types of real estate projects profitable for investors, even though the projects were not economically viable. These tax incentives added to incentives derived from inflation expectations and, combined with the eagerness of financial institutions to book real

estate loans, were an important cause of the overbuilding. The removal of many of these tax incentives in 1986 contributed to the bursting of the bubble.

The problem was not restricted to the thrift industry. Banks, insurance companies, pension funds, and foreign investors (especially the Japanese) joined the real estate feeding frenzy. Commercial real estate assets on the books of banks increased from about 34 percent of the loan portfolio in 1981 to over 44 percent of total loans in 1989. Much of this buildup occurred after the 1985 peak in real estate market prices and the 1986 tax reform legislation, despite high vacancy rates throughout the country. As a result, bank balance sheets were decimated by the falling real estate market, especially in New England, California, and the Southwest.

By the end of the 1980s, the political fallout from the thrift debacle and direct appropriation of \$50 billion for resolving savings and loan insolvencies had spilled over into the regulatory environment.³ Federal bank regulators came under fire from Congress for the collapse of the banking system in the Southwest. Recognizing that high levels of exposure to commercial real estate were a major cause of losses to the FDIC in the Southwest bank failures, and that similar levels of real estate exposure existed in other regions of the country, bank regulators began targeted examinations of bank real estate portfolios. Regulators went one step further and began to require banks to reserve against asset-backed loans that were current, but whose collateral value had fallen below the outstanding principal.

The net result of the real estate boom and bust of the 1980s was a weakening of some financial institutions, especially banks and savings

institutions on the Atlantic and Pacific coasts and in the Southwest. New regulatory treatment of real estate loans, asset quality problems, and the phasing in of international risk-based capital standards resulted in a reduction of credit available for new commercial real estate projects. On the other hand, the excess office and industrial space, which by most estimates will take many years to absorb, has certainly reduced the demand for commercial real estate loans--at least the number of economically viable projects. The effects of the real estate glut on the risks associated with, and demand for, new loans are magnified by the uncertainty introduced into the market by the warehousing of real estate-related assets by the Resolution Trust Corporation.⁴

IV. Conclusion and Policy Recommendations

Despite the wrenching adjustments under way in several regions and industries, there is little evidence supporting the claim that we have experienced a national credit crunch during the past two years. The data support neither the traditional quantity-theory-based definition, nor the complementary credit-view definition of a credit crunch. Rather, the 1990-1991 episode is more characteristic of a market correction that naturally follows the bursting of a speculative bubble--in this case, a commercial real estate bubble.

There is more to be gained from resisting quick fixes than by taking them. We should not seek to replace the thrift industry with another class of special lenders. Financial markets are highly competitive and innovative. Healthy banks and thrifts are expanding and

exerting great efforts to improve efficiency and customer service. Furthermore, we should not provide either special regional credit facilities or government credit programs for distressed regions. We have a well-developed national--indeed international--capital market that allocates capital to the most productive areas and uses. We do not need special facilities to promote real estate development.

The unprecedented costs of the thrift debacle indicate just how much there is to be lost by going down that road. The profit and loss incentive is a powerful force, and it can channel vast amounts of labor, capital, and materials into virtually any activity in relatively short order. Unfortunately, in responding to the market forces that were operating on financial institutions during the past decade, the government directed the powerful force of the pursuit of profit toward socially unproductive ends. Legislation would help, but not the kind we are likely to get this year. What is needed is legislation both to reduce and rationalize the federal safety net and to expand bank powers.

There is little that monetary policy makers can do, let alone should do, in an attempt to minimize the short-run disruptions caused by the collapse of the real estate market. For one thing, inappropriate monetary policy in the 1970s was a major cause of today's problems. The inflation during the 1970s sowed the seeds of the current problems by decapitalizing the thrift industry, by providing banks with strong incentives to overemphasize asset-based lending policies, and by creating price expectations in real estate that added to its supply. Second, the current credit problems are concentrated in one or two sectors of the national economy and in a few regions, and monetary policy cannot be targeted to regions or sectors of the economy.

It is not helpful to urge that the Federal Reserve aggressively pursue a more rapid expansion of the money supply -- essentially the liability side of the banking industry's consolidated balance sheet -- in an attempt to increase the total amount of bank assets. Such a policy cannot affect the regional or sectoral allocation of credit. It is unlikely to bring much relief to those regions and sectors experiencing credit problems. More important, however, the Federal Reserve should not pursue this course because expanding the money supply for this purpose risks all of the progress that has been made to achieve the kind of sustainable growth that will come from stable prices. The origins of the speculative bubble should be a clear enough warning to those who think that inflation is costless to society.

Footnotes

1. Downtown office vacancy rates reached 16 percent in 1985 and remained above that level for the remainder of the decade. Suburban office vacancy rates exceeded 20 percent over the second half of the 1980s. Other commercial real estate was overbuilt, causing industrial vacancy rates to nearly double and multifamily vacancy rates to increase by 50 percent over the decade (Hendershott and Kane [1991]).

2. Hendershott and Kane (1991) argue that "The favorable terms included requiring very little equity investment by developers without charging a premium for compensation. In addition, developers were no longer required to secure 'take-out' permanent financing as a prerequisite to obtaining a construction loan."

3. In August 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), which provided \$50 billion to begin the cleanup of the thrift industry and prohibited direct investments in real estate by thrifts.

4. On December 31, 1991, the RTC held \$31.3 billion of commercial real estate loans and \$10.7 billion of real estate owned in its portfolio. In addition, the 91 institutions under RTC conservatorship held another \$12.5 billion of commercial-real-estate loans and an additional \$5.1 billion in real estate owned. In other words, 46 percent of the \$129.1 billion in assets under RTC control on December 31, 1991 were commercial real estate related. For an analysis of RTC asset disposition policies, see Kane (1990).

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