CRUNCH IN '73?

by

David P. Eastburn, President

Federal Reserve Bank of Philadelphia

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Picture the following set of conditions:

- A Federal funds rate of, say, 9 percent.
- Corporate borrowers reluctant to issue long term securities at 8½ percent and other unfavorable terms.
- Municipalities finding it impossible to float bonds under existing interest rate ceilings.
- Homebuyers scouring the market to find mortgages, even at six to eight points.
- Savers investing in bonds and other market issues rather than putting their funds into savings and time accounts.
- Large banks, unable to issue enough CD's, pulling large amounts of funds from the Euro dollar market and inventing new techniques of liability management.
- Country banks selling large amounts of Federal funds to city banks at profitable rates.
- All banks facing strong demands for credit but worrying about declining liquidity and a rising volume of classified loans.
- Increasing bankruptcies.

This is not a prediction. It is a description of what could happen if we were to have a credit crunch this year. The question I should like to explore is what is the likelihood of seeing conditions like these in 1973.

Causes of Crunches

Having gone through two crunches in the latter '60's we now know something about what causes them and therefore what to do to avoid them.

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Three elements are basic: strong demands for credit under inflationary conditions, sharp restraint on the supply of money and credit, and interferences with the flow of credit.

In both the '66 and '69 crunches, demands for credit were extremely heavy in all sectors of the economy. The upsurge in borrowing reflected the rapid pace of economic activity and inflation. As borrowers expected further increases in prices, they increased their demands for credit in anticipation of repaying their debts with cheaper dollars. This, of course, put further upward pressure on interest rates. Thus, the increase in inflationary expectations made financial markets riper for a credit squeeze.

In response to inflationary pressures, the Federal Reserve brought about a very sharp drop in growth of the money stock.* In 1966, the money stock, after growing at a rate of over 6 percent for about twelve months, actually declined in the last nine months of the year. In 1969, following an increase of over 7.5 percent in 1967-68, money grew at a 3 percent annual rate with almost no growth in the second half of the year. Thus, financial markets were caught between one blade of the scissors--heavy credit demands--and the other--a sharp slowdown in the supply of funds.

Add to this mix of ingredients a complex scheme of interest rate ceilings on deposits, mortgages, and municipals, and you have the recipe for a credit crunch. Deposit ceilings brought on disintermediation by preventing thrift institutions from keeping pace with rising interest rates. Unlike large banks, savings intermediaries were unable to substitute costly non-deposit sources for deposits, and so their loans to particular borrowers,

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* Currency plus demand deposits.

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such as homebuyers, dried up. States and municipalities also suffered as rates on municipals rose above legal maximums. Housing activity and state and municipal expenditures were particularly hard hit as a result.

Will History Repeat?

The question for the future is whether these three conditions for a crunch are likely to recur in 1973. I think not.

Credit Demand. Some aspects of the economy look much the same as in '66 and'69. Certainly, inflationary pressures are intense. Prices have been rising faster than at any time in two decades. Surveys indicate that consumers are becoming increasingly concerned about inflation, so the expectational element is strong--and with good reason. As the economy continues to move forward this year, upward pressures on prices will almost certainly intensify as more and more industries approach capacity. Added to demand-pull pressures will be cost-push pressures. So far, wage costs have been contained remarkably well and everyone is hoping that this record can be extended. But as prices rise and productivity gains slow down, there will be upward pressures on wage costs and these, in turn, will lead to still more pressure on prices.

Yet there are good reasons why credit demands are not likely to be as strong, relatively, as they were in '66 and '69.

For one thing, I'm looking for a slowing in the rate of economic expansion as the year unfolds; not a recession, but a more moderate growth rate. As a consequence, overall credit demands are not likely to be so strong as to bring on a credit crunch. A rundown of various factors likely to be at work supports this conclusion:

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- The recent upsurge in business loans has been stimulated in part by the fact that the prime rate has been so attractive compared with rates on commercial paper and other instruments. As a dual prime rate becomes operative, this kind of artificial stimulant should disappear. Business loans will tend to rise as the economy expands, but the pace should be slower.

- Demands for longer-term funds should be held down by the fact that corporations are still generating large amounts of internal funds.

- Credit demands on the part of states and municipalities should be restrained as these governmental units enjoy large surpluses and increased revenue sharing.

- Demands for mortgages should tend to slacken as the expected modest decline in housing materializes.

- Hopefully, the Treasury's needs for the remainder of the year will be tempered by governmental efforts to hold the line on spending and by larger-than-anticipated tax receipts.

In short, except for the fact that inflationary expectations will be inducing some to borrow, forces should be at work moderating the pace of credit demands and avoiding a buildup of crunch dimensions.

Monetary Policy. What about the supply of credit? I can't predict that the Fed will not make any mistakes, but I think that any mistakes will not be so great as to bring on a credit crunch. We have learned at least two important lessons from the past.

Lesson #1 is that serious consequences can ensue from permitting sharp changes in the money supply. The Fed does not concentrate single-mindedly on the money supply, but we have given increasing emphasis to it in recent years. We still, of course, pay much attention to what happens

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to other variables, such as interest rates, but in doing so we are, I believe, more aware of the trade-offs involved than we once were. Certainly, the crunches of '66 and '69 suggest what can happen when the Fed pulls very sharply on the money reins.

Lesson #2 is that monetary policy cannot do everything. An important part of the financial history of the past three decades relates to what monetary policy can accomplish and what it cannot accomplish. In the late 1940's the Fed learned that it could not effectively control inflation and still support prices of government securities. The Accord of 1951 ushered in a period which raised hopes that monetary policy could do a great deal in minimizing extreme fluctuations from boom to bust to boom. Then in the '60's we learned that monetary policy cannot contain inflation if fiscal policy is strongly expansionary in an overheated economy and upward cost pressures go unchecked. Or, more precisely, we learned that monetary policy cannot quickly curb inflation under these conditions without running the serious risk of a crunch and recession.

As I look ahead, I see evidence that both of these lessons will stand us in good stead. The Fed already has begun to slow down growth in money and, hopefully, will be able to exert a consistent moderating influence without cutting back sharply. And this time monetary policy has help both from fiscal policy and direct controls on prices and wages. The reliability of this help is not completely assured and the Fed may find itself again fighting a lonely battle. If so, it will be important for policymakers in and out of the Fed to bear in mind the risks of allowing the whole job of fighting inflation to fall on monetary policy.

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Interferences in the flow of credit. A third symptom of a crunch has been especially tight conditions in particular kinds of sources and uses of funds. What is the possibility that these spot stringencies can be avoided in '73? This will depend partly on how much can be done to permit funds to flow freely from one market to another. It seems to me that some progress has been made in this respect since the late '60's, but much remains to be done.

As a result of experiences in the crunches of the 60's, some constraints have been eased. Interest ceilings in some cases have been raised or removed. This should help to relieve some of the pressures in municipal and housing financing. In housing, the Federal credit agencies, such as F.H.L.B. and F.N.M.A., demonstrated in 1969 their ability to reduce the impact of tight credit on mortgages. I suspect that these agencies will continue to serve as a buffer between the deposit flows of financial institutions and their mortgage lending.

What is done with Regulation Q could be perhaps the single most important factor in the flow of funds. There is now no ceiling on CD's with maturities under 90 days. As a result, banks have been able to keep on issuing these obligations despite sharp increases in money market rates. If market rates move substantially further, however, a piling up of large amounts of very short-term CD's would build strong pressures on banks to find other sources of funds, as they did in '69, and on the Fed to raise the ceilings.

The biggest problem with Regulation Q, however, is a longer-run problem. Many agree that Regulation Q is undesirable and, in the end, ineffective. The difficulty is in moving away from it. There never seems

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to be a good time. As thrift institutions restructure their balance sheets they should become less dependent on protection from rate competition, but this will not happen overnight. I would hope that in the meantime greater flexibility with Regulation Q ceilings, particularly on large marketable CD's, might indicate the direction of the future.

Conclusions

The odds are against a credit crunch in 1973 because:

- demands for credit should not be all that overwhelming
- the Fed probably can benefit from past experience and avoid a sudden and sharp contraction in money and credit
- some modest progress has been made toward alleviating causes of especially tight conditions in particular markets.

This conclusion can be interpreted as an optimistic one. But bear in mind that it rests on several assumptions, one of the most important being that the Fed will get help from fiscal policy and wage-price controls. If that help is not forthcoming, the Fed faces the unhappy choice of making up for deficiencies elsewhere and thus risking a credit crunch, or doing what it can and thus tolerating more inflation for longer than it would like. I hope that choice will not be necessary.

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