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# FRBSF WEEKLY LETTER

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## The Credit Crunch and The Real Bills Doctrine

Is the U.S. currently suffering from a credit crunch? If it is, what should the Federal Reserve do about it? These questions have loomed large in recent discussions of the current recession. The credit crunch has been cited as both a cause of the recession and as a barrier to recovery. Some market analysts have attributed a credit crunch to overzealous bank regulators or to contractionary Federal Reserve policy. Others deny that a credit crunch even exists.

Some commentators who believe a credit crunch is seriously hampering the economy's chances of recovery also argue that the Fed's traditional arsenal of monetary policy tools is not enough. Some have called on the Fed to buy commercial loans from the banking sector. If the Fed were to purchase existing loans from banks, the banks could then use the proceeds to make new loans.

This idea appears related to the "real bills" doctrine, which dates back at least to the writings of John Law who proposed a version of the doctrine in 1705. Despite its long history, the real bills doctrine has generally been identified with unsound monetary policy. Mark Blaug (1985, p. 54), a well-known historian of economic thought, places the real bills doctrine "high on the list of longest-lived economic fallacies of all time."

After reviewing the arguments for proposals to have the Fed purchase commercial loans, this *Letter* discusses the arguments against the real bills doctrine to see what light they might shed on recent proposals. In addition, some evidence is presented to suggest that the credit crunch may not be the dominant factor behind the recent contraction in bank lending and economic activity.

### Discounting commercial paper

In principle, a bank that wanted to expand its commercial lending could borrow reserves from

the Fed's discount window; in practice, discount window borrowing is available only for easing very short-term reserve shortages. When the Fed wants to expand bank lending, it purchases government securities held by the banking sector. The resulting rise in bank reserves can be used by banks to expand commercial lending. It has been argued, however, that recent regulations linking bank capital requirements to risk have limited the effectiveness of the Fed's open market security purchases as a stimulus to bank lending.

Under the new bank capital requirements, which were established to help relieve taxpayers of the burden associated with potential claims on the deposit insurance fund, a bank with a large fraction of its assets in the form of commercial loans must have more capital than a bank of similar size that holds more of its assets in the form of lower risk loans or government securities. If a bank sells a government security to the Fed in order to make a commercial loan, its capital requirement will rise. If the bank previously had just the minimum required amount of capital, it would be unable to expand its commercial lending. This would also be true if the bank discounted government securities with the Federal Reserve.

In addition, the differential capital requirement can be viewed as a tax on commercial lending that will induce banks to reallocate their asset portfolios away from commercial loans. As a result, it will raise loan rates relative to interest rates on assets like government securities, a process that will continue until the return on commercial loans is sufficient to compensate for the higher capital tax.

A capital-constrained bank would be able to expand its commercial lending, however, if it could sell some of its existing loans to the Federal Reserve. This is the basis for proposals, such as one by Harvard Professor Martin Feldstein,

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that the Fed purchase high-quality commercial loans from banks. A bank faced with an increased demand for loans could sell some of its existing portfolio of loans to the Federal Reserve and use the proceeds to make new loans. Such a transaction would result in an expansion of the level of bank reserves and the money supply in the face of an increase in loan demand, which potentially could ease a credit crunch in the banking industry.

## **The real bills doctrine**

Such a policy could have undesired effects on the economy as a whole. If implemented without being systematically offset by contractionary monetary actions by the Fed, bank loan discounting amounts to a revival of what monetary economists call the real bills doctrine. The basic argument of this doctrine is that the expansion of money will not be inflationary if banks restrict their lending to commercial paper issued to finance real business activity. The real bills doctrine argues that the central bank should allow the money supply to expand automatically, thereby providing the means of payment to finance the increase in real economic activity.

Under such a policy, a credit crunch could never arise. As the credit needs of the business sector rose, banks would be allowed to expand their lending. The real bills doctrine would argue against any actions by the monetary authority to limit bank lending to finance real activity.

Mainstream economists have rejected the real bills doctrine, arguing that it can lead to runaway inflation. In 1802, for example, Henry Thornton pointed out that inflation would, under a real bills policy, cause an automatic increase in the money supply that would simply fuel further inflation. He argued that an initial rise in prices would increase the demand for bank credit to finance commercial activity. If prices rise 5 percent, a company that formerly needed to issue \$1 million in commercial paper now needs to borrow \$1.05 million, and if the real bills doctrine were followed, the money supply would automatically rise by 5 percent. Thus, any inflation is automatically accommodated. Rising prices increase the demand for credit which, in turn, is allowed to cause the money supply to rise, which simply results in further inflation.

The fallacy of the real bills doctrine is that it allows the dollar value of credit demand to deter-

mine the dollar value of the money supply. As a result, money and prices can rise without limit. A rise in the money supply pushes up prices. This raises the dollar value of credit demand, thereby leading to a rise in the money supply and a further rise in prices.

## **Real bills and the Federal Reserve**

Despite its rejection by most economists, the real bills doctrine heavily influenced the 1913 Congressional act that established the Federal Reserve System. The preamble sets out very clearly that one purpose of the Federal Reserve Act was to afford the means of discounting commercial loans. In its report on the proposed bill, the House Banking and Currency Committee viewed a fundamental objective of the bill to be the "creation of a joint mechanism for the extension of credit to banks which possess sound assets and which desire to liquidate them for the purpose of meeting legitimate commercial, agricultural, and industrial demands on the part of their clientele."

The similarity between these objectives and a policy of fixing the market rate of interest was made explicit in the Committee's report which argued for the establishment of a liquid commercial bills market, with the Federal Reserve ensuring "a constant and unailing market for such bills at a steady rate of interest." However, the experience of the 1970s shows how a policy that acts to limit interest rate increases in response to increased nominal demand for credit will result in an accommodative monetary policy that simply fuels inflation.

## **The credit crunch and Fed policy**

The real bills doctrine does not provide a satisfactory framework if low inflation is to be an objective of monetary policy, since it suggests the Fed should always accommodate credit expansion. At times, of course, the Fed will want to stimulate bank lending as part of a short-run policy designed to speed the recovery from recession. In those times, the Fed's traditional tools are adequate to the task. For example, increased Fed open market purchases of government securities will increase reserves and thereby raise the liquidity of the banking sector and alleviate a credit crunch caused by a lack of liquidity. If banks use the additional reserves to buy government securities themselves instead of making loans, the sellers of those securities will need to reinvest the proceeds in such assets as com-

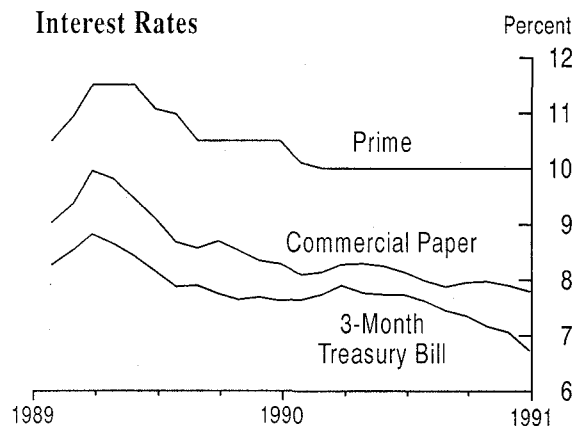
mercial paper, so that the total supply of credit still rises.

In the present circumstances, evaluating the appropriateness of expansionary Fed policy requires a determination of the cause of the recent slowdown in overall lending, in other words, a demonstration that a credit crunch actually exists. While the nature of the information problems between borrowers and lenders is important for understanding the operations of credit markets, a simple supply-demand perspective is useful as a guide to what might be happening in lending markets. The causes usually cited for the credit crunch—banks' unwillingness to lend due to increased capital requirements or "overzealous regulators"—are factors that would lower the supply of bank credit. A reduction in the supply of bank loans will lower the quantity of loans and tend to push up interest rates on bank credit. As bank rates rise, some firms will turn to other sources of credit, such as the commercial paper market. This will push up interest rates on commercial paper if the reduction in bank lending is having a significant effect on the total supply of credit.

In contrast, a fall in bank lending due to a decline in loan demand—perhaps as a result of the current recession—would be accompanied by a decline in lending rates. While other factors influencing interest rates will also be at work, an examination of lending rates may provide some clue as to the source of the decline in bank lending.

The accompanying chart shows monthly data on the prime rate, the 90-day commercial paper rate, and the 3-month Treasury bill rate during 1989 and 1990. Contrary to the situation expected in a credit crunch, commercial paper rates declined steadily during 1990, suggesting an overall fall in the demand for credit. The prime rate, however, has failed to move downward with the Treasury bill rate and the commercial paper rate, suggesting some evidence of greater bank reluctance to lend—a situation undoubtedly compounded by the heightened

uncertainty about the near-term prospects for the economy. And the commercial paper rate since late 1990 has fallen less than the 3-month Treasury bill rate, perhaps also reflecting the impact of a decline in bank lending. The chart seems most consistent with some reduction in the supply of credit from banks, although its impact on the total supply of credit appears to have been smaller than the recession-induced decline in credit demand.



In sum, the Fed's traditional tools—open market operations, the discount window, and reserve requirements—are adequate to alleviate any constraints on total credit that do exist. Open market purchases that increase reserves in the banking sector will expand the total supply of credit in the economy, even if banks do not directly increase their lending.

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