FRBSF WEEKLY LETTER

Number 92-01, January 3, 1992

The Problem of Weak Credit Markets: A Monetary Policymaker's View

The following is adapted from a speech given by Robert T. Parry, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, on October 11, 1991, before the University of California Center for Real Estate and Urban Economics.

Weak credit markets have been headline news for some time. Indeed, weak credit markets are seen as one of the substantial downside risks in the economy's recovery from the recession.

In theory, though, there is not a tight link between credit developments and the economic outlook. In fact, our experience in the early 1980s bears this out, as credit surged far more than economic growth did. Therefore, we have to approach the question of today's weakness in credit markets and its relation to the weakness in the economy very carefully.

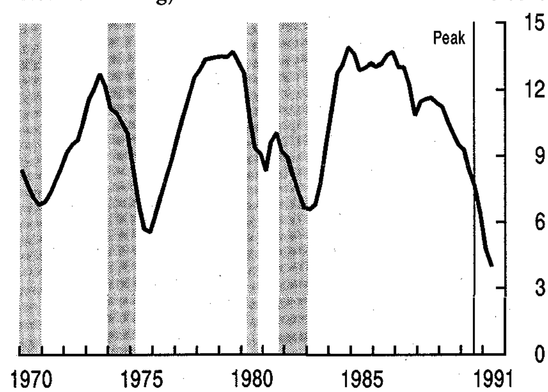
Still, the *unusual* weakness in credit markets does warrant our attention. One reason is that some special factors appear to be playing a contributing role, and they may have implications for the economy. Where is the unusual weakness concentrated? And which lenders are affected? Exploring these questions can help make sense of the underlying developments that are now affecting credit and the economy and what they might imply for monetary policy.

Where's the weakness?

The basic symptom that has raised concern is *unusually* weak credit flows. Chart 1 shows the net flow of debt relative to GDP for the private nonfinancial sector (households and businesses). The flows are scaled by GDP to account for the general increase in nominal values. We do see evidence of greater weakness compared to previous recessions.

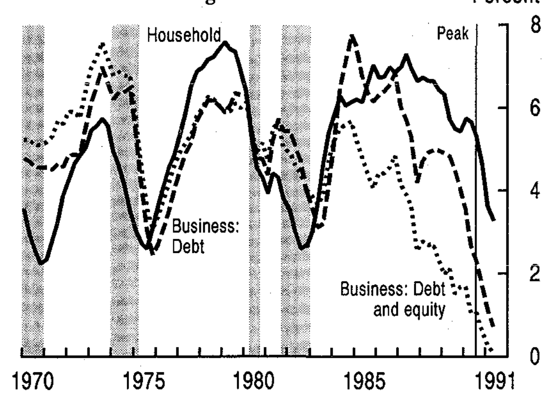
To give an idea of where the weakness has been concentrated, Chart 2 plots net household borrowing and two measures of net business external financing. Looking at the data on households,

Chart 1
Net Borrowing, Private Nonfinancial Sector



Note: 4-quarter moving average measured relative to GDP. Last observation 1991 Q2.

Chart 2
Net Household Borrowing and Net Business External Financing



See note to Chart 1.

it is clear that borrowing has been weak, but not unusually so. Instead, the unusual weakness appears to be in the business sector, whether flows are measured by total business debt—the dashed line—or by debt plus equity—the dotted line. I think it is appropriate to focus on the latter measure, since a good portion of debt was used to retire equity through most of the 1980s.

FRBSF

In addition to indicating where the weakness is concentrated, the chart also indicates when the weakness began. It is worth emphasizing that external financing flows were on the decline well before the weakening of the economy in 1989 and the downturn in 1990. Thus, some of today's weakness may be rooted in developments that were taking hold long before the recent concerns over credit market conditions.

In any case, the main lesson from the 1980s is that debt does not have a close relationship with economic activity. This point is sometimes forgotten when people talk about a "credit crunch": It is simply hard to say in general *what* weak credit flows might mean for the economy.

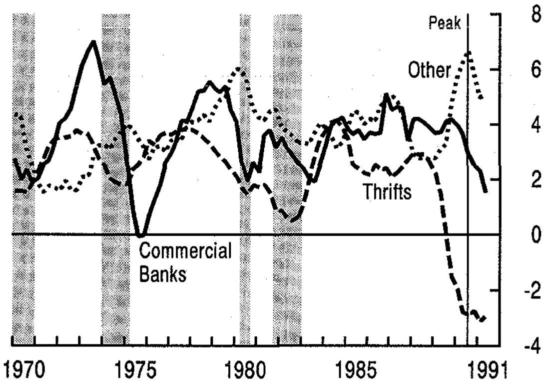
One case where weak credit flows *do* have an effect on the economy, though, is when the supply of funds has been artificially restricted. A classic example from the old days is when interest rates rose above Regulation Q ceilings. Today, the focus is again on depository intermediaries as the channels for the "credit crunch." The commonly proposed shocks are the turmoil in the bank and thrift industries and a generally stiffer regulatory environment.

A look at lenders
To see where lending patterns have changed, Chart 3 plots the sources of funds for private sector financing. The most obvious development in the chart is the massive contraction in the thrift industry, as failed institutions were closed and the survivors grew more cautious in their lending. We would expect to see the effects of the thrift contraction most strikingly in home mortgage lending, the "bread and butter" of the thrift industry.

But as we saw from Chart 2, net household borrowing, most of which is home mortgages, has not been unusually weak. This is in part because the mortgage market had the necessary institutions and instruments to make a quick shift in financing channels. Commercial real estate lending, of course, is another story altogether. But the weakness here has more to do with high vacancy rates than with thrift failures. Overall, I think the thrift crisis has not created a major disruption in credit flows.

What about commercial banks—the solid line on Chart 3? The decline does not look unusual

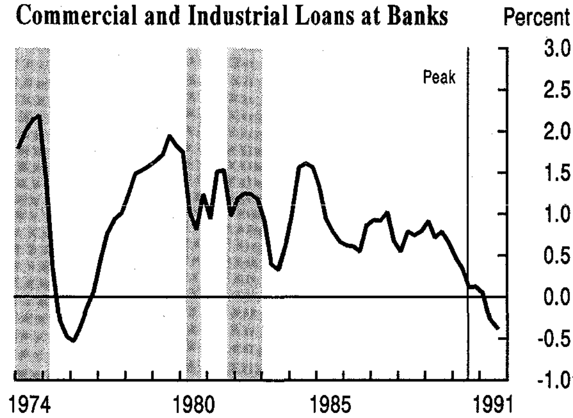
Chart 3
Source of Funds: Net Household Borrowing and Net Business External Financing *



* Debt and equity.
See note to Chart 1.

compared with past cycles. But we have to remember that some effects are masked by the inclusion of direct and indirect shifts of assets—largely mortgages—from thrifts. One area where banks are not picking up activity from thrifts is commercial and industrial (C&I) loans, which are plotted in Chart 4. This chart shows that the net flows of bank loans to business have been weak relative to GDP.

Chart 4
Commercial and Industrial Loans at Banks



See note to Chart 1. Last observation 1991 Q3.

The weakness in bank lending has been attributed to a number of factors—some related to the credit crunch, some to the business cycle, and some to unusual sectoral problems in the economy. For example, nationwide, the ratio of nonperforming loans to total loans has risen above the level we observed coming out of the last recession. This could be one factor affecting the credit crunch. And stiffer regulation has played some role. Research at this Bank shows that bank lending has become somewhat more sensitive to weakness in capital positions and loan portfolio quality on an individual bank basis. At the same time, Fed surveys on bank lending practices show that to a large extent banks have tightened credit conditions because of the weak economy and problems in particular industries where banks normally lend.

Looking at lending outside the banking and thrift industries also suggests more general influences have led to weak financing flows. The dotted line on Chart 3 shows that other funding sources were helping to fill the financing gap until the onset of the recession. At that point they also reduced their lending—more likely in response to the economic climate than to any regulatory constraints.

To sum up, regulatory shocks and weakened financial condition may have constrained banks' ability to lend. But regulatory constraints do not explain it all. Part of the shrinking volume of financial activity is simply a predictable response when the economy is weak and perceived risk is high.

What role for monetary policy?

How do these restraints relate to policy? The shocks to banks essentially represent increases in the cost of intermediation, which in part must be passed through to borrowers as a rise in the cost of capital. I think that many of the effects of these costs on the economy will be temporary, diminishing as the market shifts the channels of financing. To the extent that banks are special, however, we can expect some long-lasting reduction in intermediation. A good deal of this is probably appropriate in view of the need to restrain excessive risk-taking by intermediaries. Indeed this is an important element of bank and deposit insurance reform.

Monetary policy has tried to have a stabilizing effect on the economy during the transition. Alan Greenspan has indicated on more than one occasion that credit market conditions were part of the reason for easing policy over the past year or so. At the same time, I do not think that consideration of credit market conditions has radically altered policy.

This is appropriate because monetary policy actions cannot be expected to neutralize the real costs of the shifts that are occurring across the banking and thrift industries, nor can they solve the problems of individual borrowing sectors where lenders consider relative risks to have risen significantly. Given the uncertainty over the relative importance of factors affecting credit markets, it is important not to overreact and thereby destabilize inflation expectations.

Robert T. Parry
President and Chief Executive Officer

Research Department
Federal Reserve
Bank of
San Francisco
P.O. Box 7702
San Francisco, CA 94120

Index to Recent Issues of *FRBSF Weekly Letter*

DATE	NUMBER	TITLE	AUTHOR
6/7	(91-23)	Using Consumption to Forecast Income	Trehan
6/14	91-24	Free Trade with Mexico?	Moreno
7/5	91-25	Is the Prime Rate Too High?	Furlong
7/19	91-26	Consumer Confidence and the Outlook for Consumer Spending	Throop
7/26	91-27	Real Estate Loan Problems in the West	Zimmerman
8/16	91-28	Aerospace Downturn	Sherwood-Call
8/30	91-29	Public Preferences and Inflation	Walsh
9/6	91-30	Bank Branching and Portfolio Diversification	Laderman/Schmidt/ Zimmerman
9/13	91-31	The Gulf War and the U.S. Economy	Throop
9/20	91-32	The Negative Effects of Lender Liability	Hermalin
9/27	91-33	M2 and the Business Cycle	Furlong/Judd
10/4	91-34	International Output Comparisons	Glick
10/11	91-35	Is Banking Really Prone to Panics?	Pozdena
10/18	91-36	Deposit Insurance: Recapitalize or Reform?	Levonian
10/25	91-37	Earnings Plummet at Western Banks	Zimmerman
11/1	91-38	Bank Stock Risk and Return	Neuberger
11/8	91-39	The False Hope of the Narrow Bank	Pozdena
11/15	91-40	The Regional Concentration of Recessions	Cromwell
11/22	91-41	Real Wages in the 1980s	Trehan
11/29	91-42	Solving the Mystery of High Credit Card Rates	Pozdena
12/13	91-43	The Independence of Central Banks	Kim
12/20	91-44	Taxpayer Risk in Mortgage Policy	Martin/Pozdena

The *FRBSF Weekly Letter* appears on an abbreviated schedule in June, July, August, and December.