Center for Real Estate and Urban Economics, Pebble Beach
For delivery October 11, 1991

THE LIQUIDITY CRISIS: A MONETARY POLICYMAKER'S VIEW

I. It's a pleasure to be part of this panel on the liquidity crisis in real estate.

A. To help "walk you through" my views on the situation, I've brought along a few charts.

B. I'll start with a brief look at the breadth of the weakness in credit markets.

C. Then I'll consider some of the factors contributing to the weakness.

1. Here I'll be looking at the evidence from a broad perspective, which is appropriate for monetary policy.

D. I'll conclude by describing how weak credit conditions fit into policy deliberations.

II. Let me start with some evidence of weak credit in the real estate sector that you're probably all too familiar with.

A. Chart 1 shows net credit flows to mortgages relative to GNP. In this chart and those that follow, scaling by GNP is used to account for the general rise in the nominal value of economic activity.[1]

1. As you can see, flows to single-family mortgages are higher than in prior recessions,

2. but flows to the commercial and multifamily real estate sector are weaker than they've ever been in the postwar era.

III. Now let me turn to the broader picture.

A. Chart 2 shows the net flow of debt and equity relative to GNP for households and businesses.

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[1]**BOB:** These are the 4-quarter moving averages of the ratios of net flows to GNP by quarter. Data are through 1991:II.

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1. This chart, too, indicates unusual weakness compared to previous recessions.

B. Where does the unusual weakness come from?

1. Given home mortgage data, which account for most household debt, you wouldn't expect it to be from households. In fact, it's not.

IV. Instead, the unusual weakness is in the business sector.

A. Chart 3 shows three measures of business reliance on external financing.

B. The solid line plots net debt issuance.

1. The heavy issuance of debt in the middle of the 1980s is clearly evident in this measure.

C. But the focus ought to be on the combination of debt and equity issuance, since a good portion of debt through most of the 1980s was used to retire equity.

1. This measure is shown by the thick dashed line,

a. which indicates that net external financing _is_ unusually weak.

2. It's also interesting to note that the decline began in the mid-1980s--well before the economy began to turn down.

a. This raises suspicions that today's weakness may be rooted at least partly in developments that were taking hold before the recent concerns over credit market conditions.

D. The dotted line on the chart shows business debt and equity excluding commercial real estate loans.

1. And it drives home the point that the decline in mortage financing by no means accounts for all the weakness in credit.

a. Instead it accounts for roughly one-half the drop in the thick dashed line since the mid-1980s.

V. Popular explanations for the unusual weakness in lending are the recent shocks to the thrift and banking industries that have put unusual constraints on the supply of credit.

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A. A look at Chart 4 can help us explore this issue. It shows the sources of funds for private sector external financing.

B. The most obvious shock from the chart is the massive contraction in the thrift industry.

   1. We might have expected to see the effects of this contraction most strikingly in home mortgage lending.

   2. But, as we saw before, the cyclical pattern of home mortgage lending actually has held up relatively well.

      a. This is in part because the market had the necessary institutions and instruments to make a quick shift in the financing channels.

   3. But the market was less well-prepared with new channels of funding for development loans.

      a. So this area was more vulnerable to the decline in the thrift industry.

C. Now let's look at commercial banks, the solid line on Chart 4.

   1. While the decline here isn't nearly so dramatic as it is for thrifts,

      a. bank lending is thought to be unusually constrained by a combination of banks' weak condition and stiffer regulatory pressure.

   2. Research at our Bank does show that bank lending has become more sensitive to weakness in capital positions and loan portfolio quality.[2]

   3. Balancing these results, however, is other evidence that suggests that current weak bank lending is a normal response to economic conditions.

      a. For example, Fed survey results on bank lending practices show that to a large extent banks have tightened credit conditions because of the weak economy and problems in

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[2]**BOB:** This research is based on regression analysis using micro bank data.

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industries where banks normally lend.

(1) As you know, one of these industries is commercial and multifamily real estate, which boomed in the 1980s and ended up with excess capacity in the 1990s.

(2) Therefore, the record lows in credit flows we see now are in part an adjustment to that period of overexpansion.

D. Now let's look at lending outside the banking and thrift industries.

1. The third line on Chart 4, labeled "Other," shows that other funding sources were helping to fill the financing gap until the onset of the recession.

2. At that point they also reduced their lending-- more likely in response to the economic climate than to any regulatory constraints.

E. In sum,

1. shocks to banks and thrifts have constrained their ability to lend.

2. But regulatory constraints don't explain it all. Part of what we are seeing reflects a normal response to economic realities.

VI. As I said in the beginning, the Fed is concerned about the unusually weak credit market flows. The problem is, how to account for them in making monetary policy.

A. First, credit market developments are affecting policy variables like M2.

1. This makes it harder than usual to interpret movements in money.

B. Second, we learned from the 1980s that the level of debt isn't a good guide to future economic activity.

C. But this time around, there <u>is</u> a question of how to account for the shocks to banks and thrifts.

1. These shocks amount to an increase in the cost of intermediation.

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2. To some extent, the effects of these costs on the economy will be temporary, diminishing as the market shifts the channels of financing.

3. Monetary policy <u>can</u> have some stabilizing effect on the economy during this transition.

   a. Indeed, Alan Greenspan indicated as early as July of last year that credit market conditions were part of the reason for easing policy.

D. But it's also important to remember:

   1. monetary policy actions can't be expected to neutralize all the costs of the shifts that are occurring across banking and other sectors,

   2. nor can it solve individual sectoral problems.

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