

## HAS THE FED IGNORED THE CREDIT CRUNCH?

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Although "the credit crunch" has dominated most discussions of the recent recession and the appropriate response of monetary policy to it, attempts to define it, describe it or measure it have had all the hallmarks of a snipe hunt. There has been much thrashing about in the bushes but, when all was said and done, we were left only with the same assertions: a credit crunch is preventing an economic recovery and aggressive actions by the Fed are needed to deal with it.

These calls for Fed actions or criticisms of the Fed for doing too little illustrate several phenomena that are worthy of discussion. The first, and to me, more disturbing issue is the ease with which a vaguely-defined and poorly-documented concept can become widely-accepted as a serious problem to be addressed. The second, and the primary focus of my talk, is the fundamental difference between two views of how the Fed affects economic activity. I will argue in this vein that, even if there were widespread evidence of a reduction in the supply of bank lending, only one of these views will suggest a monetary policy response that will affect economic activity in the

desired manner. Unfortunately, as I will also point out, it is the other point of view which receives the lion's share of attention in the popular press--and is behind most of my "fan" mail as well.

#### IS THERE A CREDIT CRUNCH?

If by a "credit crunch" observers mean a general unwillingness of banks to extend credit--whether because of worries about adequate capital or greater regulatory scrutiny--the textbook effect is a reduction in the supply of credit. Other things the same--such as a fixed demand for credit--this reduction in the supply of bank credit implies an increase in interest rates charged by banks. And, at the margin, higher bank rates will induce some businesses to turn to the commercial paper market, which should push up the rate on commercial paper as well.

One way to investigate the existence of a credit crunch, therefore, is to look at how various interest rates have moved recently. This is a particularly telling way to examine the problem because, as critics of the credit crunch story have argued, the U.S. economy has been in a recession since July of last year. In recessions, the demand for credit typically falls and, other things the same, should lead to a decline in interest rates. Thus, with two different stories having two completely different predictions

about the direction of interest rate changes, it seems sensible to look at the behavior of various interest rates.

Since last October, when people first started to talk seriously of a recession, the interest rate on 30-day commercial paper has fallen by nearly 250 basis points and the rate on 3-month Treasury bills has fallen about 125 basis points. If one views the prime rate as being representative of bank rates generally, it, too, has fallen 150 basis points this year. At best, one could argue that there is a credit crunch because bank rates have not fallen as much as the commercial paper rate. As a group, however, these interest rate movements are suggestive of an extremely mild credit crunch, if there is any at all.

#### WHAT WOULD BE THE APPROPRIATE MONETARY POLICY RESPONSE TO A CREDIT CRUNCH?

I know that homebuilders and some small businesses will not be persuaded that we are not in the midst of a credit crunch. Giving them the benefit of the doubt, what should the Fed do in such a circumstance? To get at this question, we first need to discuss two views about how Fed actions might affect the economy.

For convenience, we can label these two views as the "credit" view and the "money" view. The credit view is the more popular one, at least in terms of its

broad acceptance. According to this view, the Fed influences the economy by controlling interest rates directly and completely. Thus, when it wants tighter economic conditions, perhaps to choke off inflationary pressures, the Fed simply drives up interest rates. The higher interest rates reduce demand for housing, autos and other things, thereby slowing the economy down. Alternatively, when it wants easier economic conditions, perhaps to head off the threat of recession, the Fed simply drives interest rates down. I am certain that you are familiar with this particular view of how the Fed influences the economy. It is proclaimed daily in the financial press and, as a result, many people believe it to be correct.

To believers of the credit crunch story, however, the Fed has been impotent in its efforts to start an economic recovery, despite its aggressive lowering of interest rates. Instead, the Fed's efforts, it has been argued, have been stymied by the unwillingness of banks to lend. Following this story to its end, you come to one of two conclusions. The first is that the Fed needs to push rates still lower so that banks finally will loosen their purse strings. The other is that, being unable to "push on a string,"--that is, being unable to force banks to lend--the Fed really has no ability in the current environment to stimulate bank lending or a recovery. Whichever conclusion you

choose, in this story it is the role of banks in the allocation of credit that is crucial to the Fed's ability to affect the economy.

An alternative view of the Fed's influence, the money view, attributes the basic thrust of the Federal Reserve's influence to its effect on the nation's money supply. When monetary growth accelerates, total spending accelerates along with it. The immediate effect of this greater spending is to encourage increased output and employment growth. Unfortunately, the long-run effect is reflected solely in higher inflation. The exact opposite pattern occurs when monetary growth slows down. Thus, in the money view, changes in the Federal Reserve's monetary policy stance have two separate effects on the economy. The initial effect is the Fed's ephemeral influence on the real side of the economy; the subsequent, but longer-lasting, impact is on the rate of inflation alone.

In this view, banks play an important role only because they produce the bulk of the nation's money supply. Changes in the Fed's open market operations immediately change the growth of bank reserves. Banks, in turn, respond with commensurate changes in the growth in their loans. Through a multiple-expansion process, explanations of which make money and banking textbooks so interesting to read, the new reserves are

transformed into changes in the nation's money supply. In this money view, these changes in the nation's money supply are the source of the Fed's influence on the economy.

Obviously, the "credit" and "money" views yield very different conclusions about the Fed's continuing influence on the economy. Just as obviously, both views cannot be correct. However, what is not necessarily obvious is which view is correct and precisely why. Part of the problem is that we often confuse the concepts of money and credit; the other part of the problem is that we frequently fail to recognize the crucial difference between nominal and real interest rates.

To be honest, it is easy to be confused about the difference between money and credit. After all, when we borrow, we borrow money; and, when we lend, we lend money. There is, however, a crucial difference that we must recognize if we want to determine how the Fed actually influences the economy.

The nation's money stock is represented by--in fact, is defined as--the sum of currency and checkable deposits available to be spent by you, me and others. In contrast, credit markets are simply arrangements set up to determine who gets to spend the existing money supply. Consider, for example, what happens when you write a \$1000 check to your mutual fund. The banking

system recycles the money from you to the mutual fund. The mutual fund might then purchase a \$1000 certificate of deposit from a bank which, in turn, might lend the \$1000 to a finance company. The banking system has now recycled the money from the mutual fund to the finance company. The finance company, in turn, may lend the \$1000 to someone who buys lottery tickets with the money. The number of financial intermediaries involved and the cascading amount of credit generated by them is certainly impressive. The "bottom line," however, is that the \$1000 simply changed hands from you to the guy who sold the lottery tickets; or, in other words, after all the financial smoke clears, you loaned someone \$1000 to buy lottery tickets.

While this process of financial intermediation makes our credit markets considerably more efficient, it shouldn't blind us to the underlying realities involved. In general, neither these credit arrangements nor the number of intermediaries in the credit chain have any effect on the size of the money supply or the total level of spending. Instead, they simply represent more convenient ways to recycle existing money and, thereby, rechannel spending from some individuals to others. However, an increase in the money stock, whether generated through the usual banking channels or, for that matter, dropped from airplanes, will affect both the total level of spending

and the amount of credit extended. New money, as opposed to recycled money, always produces new spending and new lending.

But what about interest rates? Is their level not important in determining economic activity? And should not the Fed, as the credit view holds, be able to influence economic activity by influencing interest rates? The answer to these questions is an unambiguous "yes and no." The interest rates we observe in financial markets are nominal interest rates. They are made up of two chief components: the expected inflation rate and the expected real (or inflation-adjusted) interest rate. Expected inflation enters the nominal interest rate because it represents the expected decline in the value of the dollars over the life of the loan. The expected real interest rate is the return we expect to pay or receive from the credit transaction after inflation is accounted for.

Real rates of interest, not nominal rates, are what influence real economic activity. They reflect the real forces that underlie supply and demand conditions in credit markets. These conditions include things like the public's willingness to save, investment opportunities for domestic and foreign firms, changes in tax legislation, and changes in trade or capital restrictions across countries. Clearly, despite what people might like to believe, the Federal



Reserve has never had any significant short-run or long-run influence on real interest rates. Yet, this is precisely what adherents of the credit view implicitly hold when they argue that interest rates are the primary channel of the Fed's influence.

On the other hand, monetary policy--or, more precisely, monetary growth--is the prime determinant of the inflation rate. Consequently, the Federal Reserve plays a key role in influencing both U.S. inflation expectations and the actual course of inflation. Through its influence on inflation expectations, the Fed directly influences U.S. nominal interest rates.

This influence is not unique to the United States. Each central bank has the same impact on its own country's nominal interest rates. Countries with higher nominal interest rates, like Brazil, are those whose central banks have followed drastically looser monetary policies. In contrast, countries with lower nominal interest rates, like West Germany, typically have central banks that have pursued tighter monetary policies. Finally, there are those countries, like the United States and the United Kingdom, whose central banks have wavered back and forth between tighter and looser monetary policies; they have generally found that changes in inflation and nominal interest rates have wavered right along as well.

Indeed, once we examine both the domestic and the foreign evidence concerning the impact of monetary policy on the economy, two things become rather obvious. First, the money view, not the credit view, seems to be a better explanation of how any central bank, including the Federal Reserve, can influence its domestic interest rates and its economy. The causal link runs primarily from money growth to spending growth and credit growth, not from credit growth to money growth or spending growth.

Second, despite a myriad of financial innovations and the increasing globalization of financial markets, neither the Federal Reserve nor other central banks have lost their influence on the economy, on financial markets, on inflation or on interest rates. Those who believe otherwise have typically overestimated the Federal Reserve's influence in the past. Now, they are making the opposite error: they are giving the Federal Reserve far too little credit for its influence on the economy.

#### THE RISKS TO MONETARY POLICY

With all 250 million U.S. monetary policy experts now calling on the Fed to take aggressive actions on the credit crunch, I am increasingly worried about the possibility of a policy mistake. In many ways, agencies are like human beings--they make poor choices

when they are under excessive pressure to act. And the Fed may face a special risk because the effects of changes in its policy stance--changes in the rate of money growth--take time to work. So, even if we know from experience that being patient and not over-reacting is the best strategy, the drumbeat for more action may prove too tempting.

But, more precisely, why am I worried? At the moment, most observers look at either the federal funds rate or M2 to gauge the stance of monetary policy. The fed funds rate has fallen sharply, as I mentioned earlier, but many want further declines until a recovery is clearly in progress. Others see slow growth in M2 as further evidence the Fed needs to do more. But, again, to assess these particular indicators and their usefulness, we have to go back to the differences between the credit view and money view. The federal funds rate has declined because the Fed has eased considerably by supplying reserves to the banking system at a sharply increased rate. For example, during the second half of 1990, adjusted reserves grew at a 1.9 percent rate; during the first half of 1991, that rate rose to 8.7 percent. With a dramatic increase in the quantity of reserves in the banking system, the fed funds rate should be expected to fall.

M2 growth, in contrast, has slowed because of portfolio shifts--credit re-allocations if you will--by

the public. Primarily by getting out of large denomination bank deposits and into T-bills, the public has shifted its asset holdings but done nothing to affect the quantity of money readily available for spending. In fact, the rapid growth of reserves has produced an M1 growth rate for the first half of 1991 equal to 6.8 percent, compared to its trend growth rate of 3.6 percent.

Based on past experience, this sort of sharp increase in M1 growth has preceded an economic recovery. It also has signaled--if left unchecked--an acceleration in the inflation rate. Which leads to my concerns for a policy mistake. I've told you that I believe there is little, if any, evidence to support a credit crunch story. The data also tell me that monetary policy already has eased substantially this year. But, despite this easing, the Fed is being asked to ease some more to combat a phantom problem. Responding to these pressures, I feel, is a sure way to lose ground in our fight for price stability.

Thank you.