

The U.S. Credit Markets: Is the Trauma Over?

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For the economist interested in financial markets, the period since August of last year has been one of the most interesting over the last 50 years or more. The Russian default in mid-August set off a series of market adjustments that I find puzzling—indeed, amazing. That there were impacts on emerging markets was not so surprising, but the greatly enlarged spread between U.S. Treasury bonds and Aaa bonds issued by U. S. corporations was truly a surprise to me, and I believe to almost all economists. Market participants were also taken aback by these events.

Consider some of the other manifestations of this disturbance to the financial markets:

- The U.S. equity market declined substantially from mid-August to mid-October.
- The volume of new issues in the bond and equity markets plummeted.
- Spreads, measured relative to short-term U.S. Treasuries, widened substantially in both the CD and commercial paper markets.
- Spreads between on-the-run and off-the-run issues in the Treasury market rose significantly.

In short, the disturbance was large, widespread across markets, and persistent for a significant period of time. My purpose today is to review what has happened and to speculate on how we can understand these unusual events. I spoke on the same topic last October, and so my remarks today are to a degree an update on the picture I saw back then. I will discuss the trauma of the early weeks after August of last year, and the healing process in the markets starting, perhaps,

in mid-October. I then want to reflect on the types of events that surprise the markets and create the problems we observed. Finally, I will discuss the critical role of a strong banking system in helping the economy deal with the market upset.

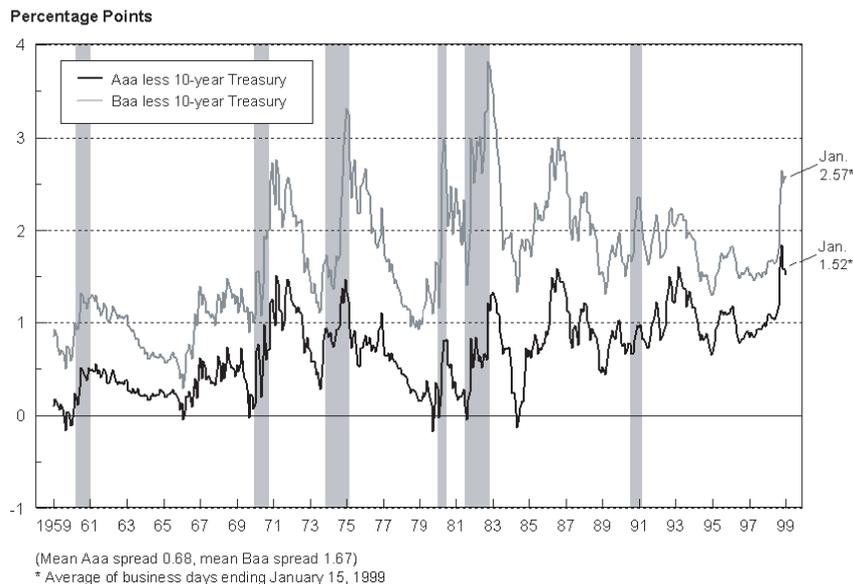
Before I get further along, let me emphasize that the views I express here are my own. Trying to understand the markets is a difficult process, and not everyone may share my interpretation. Thus, my remarks do not necessarily reflect official views of the Federal Reserve System.

THE TRAUMA

Let's begin by reviewing what happened after the middle of last August. When Russia announced it was rescheduling its debts, the U.S. markets reacted quickly. Yields on Treasury bonds of all maturities declined. Yields on corporate bonds in the United States rose relative to Treasuries; the increase in yield spreads was greater the lower the quality of the bonds. Spreads for high-yield bonds—often called “junk bonds”—rose the most. Aaa bond spreads rose the least, but nevertheless significantly.

Figure 1 tells the story for Aaa bonds. By showing the period since 1959, with the shaded areas representing recessions, we can obtain an appropriate perspective on what happened. The spread of the Aaa yield over the 10-year Treasury yield rose to the highest level shown over this entire period. Note that the spread typically rises during periods of recession; that outcome makes perfect sense as corporate earnings decline in recession, reducing the earnings coverage of interest payments and increasing the riskiness of the

Figure 1
Quality Spreads in the U.S. Bond Market
(monthly, January 1959–January 1999)



Aaa bonds relative to Treasuries. But last fall there was no recession in the United States. Although a few forecasters expected a recession in 1999, the prevailing view was that the economy would continue to grow, albeit at a slower rate than in 1998. I regard the greatly increased spread for the highest-rated U.S. corporate bonds as a truly remarkable effect flowing from the Russian default. Although the Baa spread did not reach unprecedented levels, the increase in that spread was nevertheless substantial and the size of the spread remains high even today.

Figure 2 shows that the Aaa spread rose primarily as a consequence of the decline in the Treasury yield rather than from an increase in the Aaa yield itself. In the markets for lower-rated bonds, the spread rose both because Treasury yields fell and because corporate bond yields rose. This fact is readily apparent from Figure 2. Although the uptick in the Baa yield was minor, the yield increases were more substantial for junk bonds.

Figure 3 shows what happened to the issuance of new bonds. By October of last year, the flow of financing in the bond market was less than half the average monthly volume earlier in the year. Many firms that had planned to come to market postponed or cancelled their bond issues. They judged that the cost was too high, certainly relative to their expectation that the markets would settle down in due time. As these charts show, this expectation has yet to be fully justified. Spreads have indeed narrowed somewhat since October, and the volume of new issues did rise in November before settling back again in December.

Everyone is familiar with the significant decline in the stock market from its July peak to its double bottom in early September and early October. That decline amounted to approximately 20 percent according to broad stock price indexes, and considerably more for indexes covering smaller firms. The stock market, you will recall, was unusually volatile during the several months after August. Public offerings in the equity market

Figure 2

**U.S. Long-Term Interest Rates
(monthly, January 1959–January 1999)**

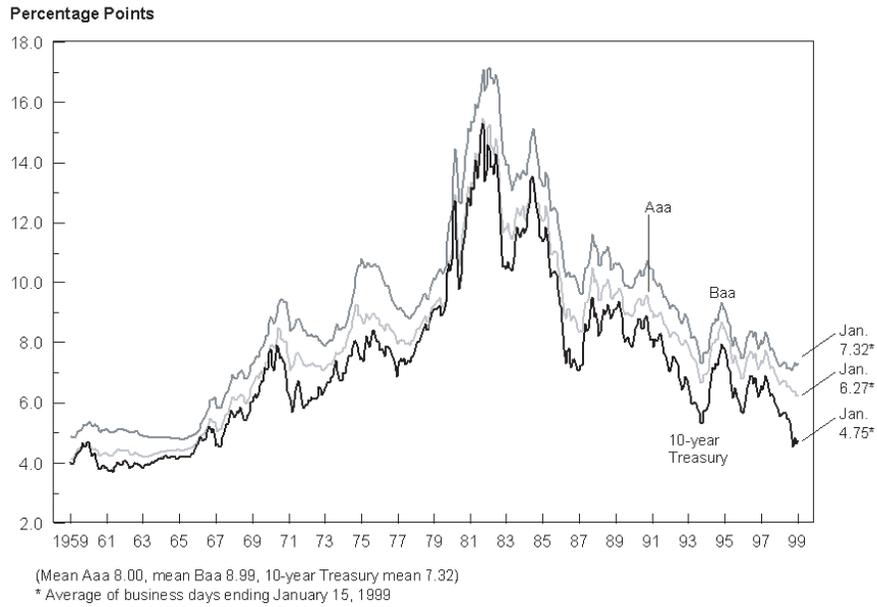


Figure 3

**Volume of New Corporate Bond Issues
(public offerings, monthly, January 1995–December 1998)**

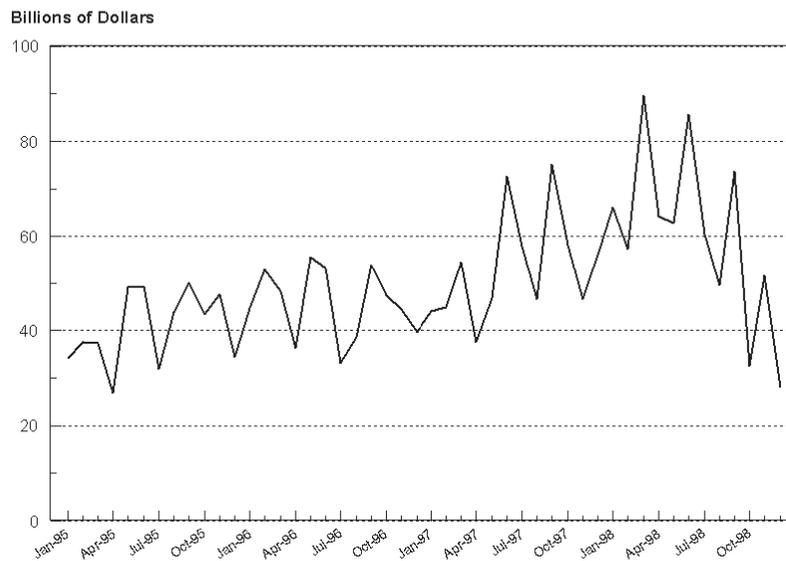


Figure 4
Certificate of Deposit Spread
(3-month CD less 3-month Treasury bill, monthly)

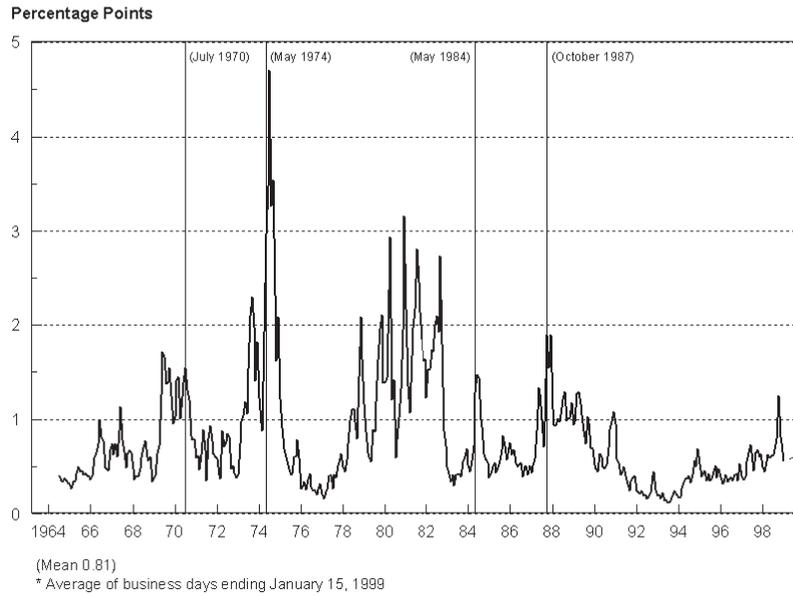
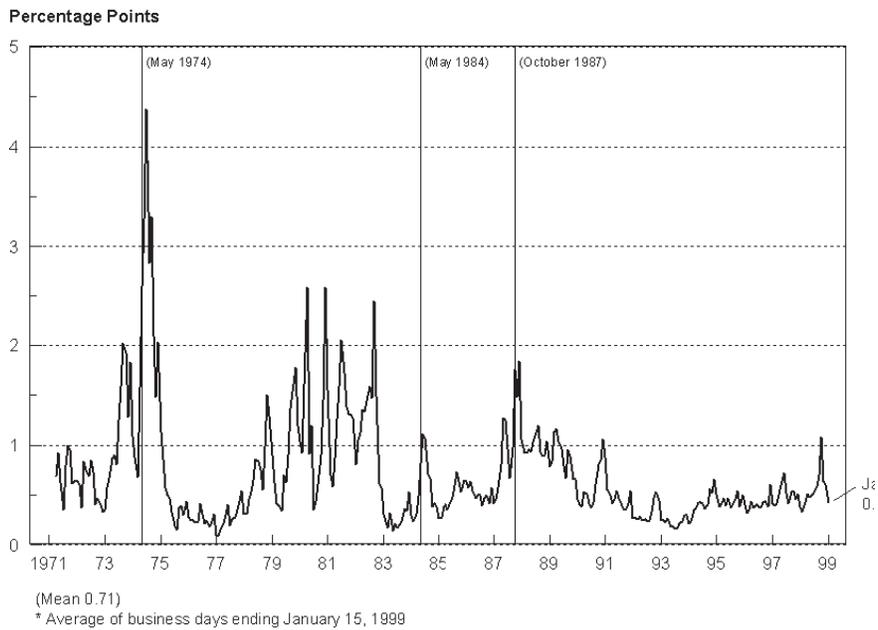


Figure 5
Commercial Paper Spread
(3-month nonfinancial CP less 3-month Treasury bill, monthly)



declined significantly, more or less tracking experience for new issues in the bond market. Merger and acquisition activity all but ceased.

At the short end of the fixed-income market, spreads also rose significantly. Figures 4 and 5 show spreads in the CD and commercial paper markets over a period of years. Today, these spreads are back to the levels prevailing in the months before August of last year.

Finally, *within* the Treasury market, yields for off-the-run issues rose relative to those for on-the-run issues. Trading is concentrated at the 5-, 10-, and 30-year maturities—these are the so-called “on-the-run” issues. At one point last October, the 30-year Treasury bond was trading 35 basis points less than the 29-year Treasury bond. Before August, this spread was more commonly 5 to 7 basis points. Apparently, traders’ hunger for liquidity was so great that they were willing to hold the 30-year bond even though its yield was far below the 29-year bond. Quite frankly, I do not understand why liquidity in the 30-year bond would be so important to anyone, because it makes no sense to me that traders should park funds temporarily in such a long maturity.

In sum, the generality of the disturbance in the credit markets was remarkable. I don’t think it is an exaggeration to refer to these events in the credit markets last fall as “traumatic.” The effects were large, widespread across markets and sustained for a period of quite some weeks. In fact, the episode is not yet completely over.

THE HEALING PROCESS

The charts show that the healing process began in October. Spreads narrowed across all of these markets and the volume of new issues rose. The CD and commercial paper spreads were back to normal by mid November. By late November, the stock market was back to its July peak. Spreads have remained on the high side in the corporate bond market, but the volume of new issues has picked up.

What happened, I believe, is pretty straightforward. The healing process is a normal market

phenomenon. Investors began to look at the high spreads and concluded that the risks were lower than the compensation offered in the marketplace. Corporate bonds began to look like bargains relative to Treasuries. The improved receptivity of the market place led corporate treasurers to bring new issues to the market. The Russian default did not spread to other emerging markets, increasing investor confidence that the situation would not unravel in a serious way. And, of course, the Federal Reserve reduced the intended federal funds rate on three occasions, providing further reassurance to the market that the Fed would provide any necessary liquidity support to ensure that the overall economy remained healthy.

This view of the healing process is certainly supported by the way markets have responded recently to the Brazilian problems that led to the depreciation of the real (the Brazilian currency unit) against the dollar. Investors have taken the Brazil situation in stride. The puzzle to me is not the market reaction to Brazil this month but the reaction to Russia last August. How can we understand which events surprise the markets and which do not?

WHAT SURPRISES THE MARKETS?

The Russian default in mid-August clearly did surprise most market participants. We know that to be the case because Russian bonds would have been trading at much lower prices prior to the default if the market had widely expected the default.

Why should the Russian default have been such a shock to the market? My impression long before the default was that the press was full of reports disclosing the fundamental weakness of the Russian position. President Boris Yeltsin and the Russian parliament were at loggerheads, Yeltsin’s health was unsteady and there was no visible sign of progress on government finances. Reports about the continuing large budget deficit in Russia included stories about large numbers of unpaid bills, including salaries for military

officers. With Russian reform stalled, it seemed obvious to me that a fiscal crisis was brewing.

When I have raised these observations with market participants in private conversations, the answer I get is that the market developed a sense of euphoria about Russian prospects. Those who invested in Russian stocks and bonds pointed to continuing privatization of the Russian economy and the great opportunities in the transition from a centralized to a market economy. The International Monetary Fund was heavily involved in lending to the Russian government and in assisting with the transition. It seems that confidence in Russia was so great that most market participants simply brushed off reports of the lack of progress by the Russian government. The magnitude of the market upset provides the most convincing evidence for just how unprepared market participants were for an event such as the Russian default.

Looking back, as painful as market reactions to the default have been, a constructive feature of this situation is that market participants began to take a hard look at a wide range of investments around the world, including in the United States. It is not surprising that emerging market investments were given special scrutiny. But the changed outlook extended deep into U.S. markets as well. The reassessment included, as I have emphasized, even the Aaa bond market. In this period of great uncertainty and reexamination, a tremendous hunger for liquidity led to the dramatically wider spread between on-the-run and off-the-run Treasuries.

The Russian default and its aftermath make clear the dangers of complacency. Market participants and policymakers should be constantly asking themselves “what if” questions about all sorts of things. Having a plan of attack for every contingency we can think of prepares us for dealing with the contingencies we do not think of, which often are the ones that actually arise.

In economic terms, the Brazilian situation is potentially much more serious for the United States than the Russian situation, but the market has responded in a measured way to Brazil. I

suspect that the differing responses reflect widespread contingency thinking after Russia. Competitive markets ought always to respond in the well-informed way they have responded to Brazil. The fact that they do not always respond this way is a matter of concern to me as a policymaker and a matter of mystery to me as a social scientist.

What are policymakers supposed to do when they become convinced that certain markets are displaying too little awareness of the risks inherent in the situation? My observation is that jawboning by policymakers is likely to be ignored, or produce unpredictable results, or may be simply a wrongheaded view of any particular situation. Not a promising set of possibilities, that’s for sure! I think that my most constructive contribution as a policymaker is to concentrate on getting the fundamentals of Fed policy right, as best I can, trusting that the markets will eventually take care of themselves just fine.

THE CRITICAL ROLE OF A STRONG BANKING SYSTEM

One of the Fed’s responsibilities is to supervise and examine banks. A sound banking system contributes greatly to a strong economy. An important fact about last fall—a fact too little appreciated—is that the banking system did indeed play a major role in defusing the credit-market trauma. Banks were not themselves seriously affected by the trauma. Some, to be sure, lost money on the Russian default and from the problems facing Long Term Capital Management Corporation. Long Term Capital, you may recall, found itself in trouble because the generalized nature of the credit-market problems made lots of its bets go sour at the same time. But bank solvency was not threatened. Think about the nature of the crisis we would have had if a number of money-center banks had been in trouble at the same time.

Clearly, strong bank capital going into the Russian default was an element of great strength for the economy. Banks themselves deserve much of the credit for their strong capital positions, but

we big bad policymakers certainly had something to do with it.

Not only did banks not aggravate the credit trauma, they also have had a lot to do with easing the economy out of the problem. Some of the firms that could not borrow as they had planned in the securities markets turned to banks. Many observers have pointed to this phenomenon to explain recent rapid growth in bank credit. Banks had the inherent capacity to fill the gap; accommodative Federal Reserve policy permitted and encouraged banks to do so.

ENDPIECE

I'll finish by recapping my argument. First, the trauma in the credit markets touched off by the Russian default was significant. When we examine charts of historical data we realize just how large the disturbance was. What we saw was not a mere ripple, not business as usual.

Second, standard market processes are well along in taking care of the problem. The healing process is not yet complete, but I think there is good reason to believe that the whole episode will be history in a matter of weeks.

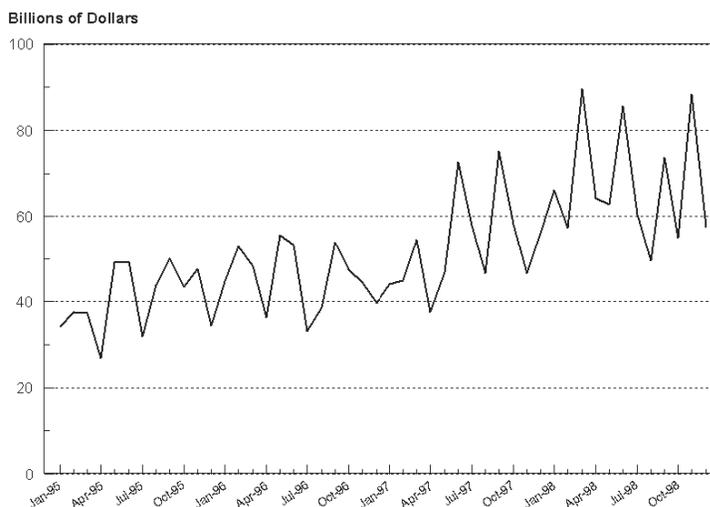
Third, a sound banking system played an important role. Avoiding a banking problem isolated the trauma to the securities markets, and the banks offset a significant part of the effects of the trauma on many individual firms.

The economy is coming through this very unusual period that began last August in pretty good shape. There are downward pressures in certain sectors—especially agriculture, some parts of manufacturing, oil production—that are independent of the credit-market trauma I've been discussing. Fortunately, these sectors are a relatively small part of the total economy. Full revival in these sectors may have to await a stronger international economy.

The self-healing process within the securities markets, the strength of the banking system and the Fed's timely response have prevented the credit trauma from having serious negative effects on the real economy. The episode is not totally closed as yet, but I think it fair to say from everything we know that the Russian default and its fallout are rapidly passing from an active policy concern into the realm of historical interest only.

Revised Figure 3

**Volume of New Corporate Bond Issues
(public offerings, monthly, January 1995–December 1998)**



POSTSCRIPT: FEBRUARY 25, 1999

The data for Figure 3 were revised in mid-February 1999. What we thought had happened in late 1998—the sharp decline in new bond issuance—did not in fact happen. The table below reports the data used in the original version of Figure 3 and the revised data. Data used in Figure 3:

	Original	Revised
October 1998	\$32.569 billion	\$55.092 billion
November 1998	51.655	88.310
December 1998	28.170	57.540

This illustrates why policymakers need to collate information from a wide variety of sources in assessing the economic situation. Policymakers

often must act on the basis of incomplete information, knowing the data are subject to revision. In this case the revision was upward but, of course, it might have gone the other way. I took up the issue of data reliability, along with other issues, in my speech entitled, “A Policymaker Confronts Uncertainty” (presented to the St. Louis Gateway Chapter, National Association for Business Economics, St. Louis, Missouri—September 16, 1998). This speech is available on the St. Louis Federal Reserve web site.