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Testimony by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing & Urban Affairs

United States Senate

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Mr Chairman and members of the Banking Committee, I welcome this opportunity to discuss the issue of credit availability--whether it has changed and, if so, why--and its effects on the health of the economy. We at the Federal Reserve have for some time been monitoring various indicators of credit supply, and have been assessing implications for the economic expansion. To date, we have found that lenders have tightened their standards in certain sectors and locales, but that there has not, so far at least, been a broad-based squeeze on credit, and lenders are generally not retreating from lending opportunities. Nonetheless, significant problems cannot be ruled out in the period ahead, and we will continue to devote close attention to credit conditions.

The topic of credit availability is intertwined with the issue of the asset quality of depository institutions. Let me preface my remarks today by emphasizing the necessity of a stable, efficient financial system, including sound depository institutions, for satisfactory economic performance. Healthy commercial banks and thrift institutions promote growth by providing a ready source of loans, especially to households and smaller businesses that lack direct access to credit markets. By exercising sound credit judgments, deposit intermediaries direct funds to productive uses and by offering secure, liquid deposits to the public, they encourage thrift.

Doubts about the soundness of depositories can disturb this process. When depositors and investors become reluctant to entrust

their funds to these institutions, access to depository credit can be curtailed or become more expensive. Vigilant, consistent supervision, strong capital positions, as well as actions by lenders to avoid excessive exposure when new risks appear, are all essential to retaining public trust in our depository system

The efforts of our examiners reflect this dictum. When examiners visit a bank, they determine whether it has adequate systems in place to measure and control its risk exposure. In addition, they ascertain whether borrowers have sufficient collateral and cash flow, given local market conditions, to service their loans. Our standards in these areas have not been tightened, though they may, because of deteriorating conditions in certain markets, be catching more doubtful loans than before. This process may cause difficult, short-run adjustments in those markets, but these must be viewed as reactions to changing circumstances and a correction of earlier overenthusiasm on the part of lenders. Ultimately this should prove to be a positive force for the economy by preserving the health of our commercial banking system

Of course, anecdotal reports suggest that some bankers and their regulators have become overly cautious, and have thereby exacerbated the very problems they have been trying to avoid. It is difficult to get hard evidence to assess the extent of this problem, but I suspect that, since many loan extensions of recent years are now nonperforming, it is inconceivable that bankers and their regulators would not currently have turned cautious, either consciously or subconsciously. To believe otherwise presumes a change in human nature

Although some increased caution unquestionably is prudent in current circumstances, the issue is whether, owing to an overreaction on the part of some lenders or regulators, creditworthy borrowers are being denied funds. Potentially, such unwarranted caution can put downward pressures on asset values, stunt investment or spending more generally, and curtail employment.

To date, however, whatever overreaction that may have occurred does not appear to have been widespread, and access to credit has not been reduced to an extent that has had a significant damping influence on the American economy overall. On balance, the economy appears to be growing at a subdued pace so far this year, in line with the recent slower growth of our labor force, thus keeping the unemployment rate around 5-1/4 percent. In several sectors conditions have been difficult to read owing to distortions such as last winter's unusual weather. But, available indicators suggest that overall activity remains on a slow uptrend.

Indeed, moderate growth is inevitable at this stage of the expansion given that we no longer have considerable slack in resources to be taken up. Late last year, indications that a slowdown was in train led to concerns that the weakness would cumulate to a recession. Now those concerns seem to have less basis. One reason is that producers and distributors apparently trimmed their inventories rather promptly this winter, most notably in the auto industry but elsewhere as well. With this period of adjustment complete, factory output in recent months has picked up a bit, and at this stage, inventories appear to present no impediment to further growth in production.

Some sectors of the economy, however, are stronger than others, and pertinent to the topic of these hearings, particular weakness is apparent in some real estate markets. In the residential market, unusually favorable weather early this year temporarily boosted housing starts, but more recent monthly numbers appear to reveal some underlying softness in this market. The most substantial adjustments have been underway for some time in the commercial real estate and construction industry. Construction of office buildings and other commercial structures is down from last year's pace. There are, of course, regional differences to the real estate slowdown. Nonetheless, in the aggregate, the statistics clearly indicate considerable softness. And forward-looking measures, such as contract awards and building permits, suggest this weakness is likely to continue a while.

The cause of this weakness almost surely rests in the excesses of earlier years. Developers and their equity partners built housing and commercial structures at a more rapid pace than could be supported by economic fundamentals. The overbuilding was supported in part by the ready availability of credit from thrifts and banks that, in hindsight, partly reflected lax lending standards and, unfortunately, insufficient attention by supervisors. Speculation, fed by visions of ever-rising prices, also led to new construction that simply outpaced demand in many markets. When properties were completed, there were not enough buyers willing to pay prices that covered construction costs or tenants willing to pay enough rent to cover mortgage payments and operating costs. The most obvious signs of this overshoot are the high vacancy rates for office buildings, rental apartments and condominiums. For example, the

average office vacancy rate for downtown areas increased from near 5 percent at the start of the 1980s to over 16 percent by the end of the decade, and has reached 25 to 30 percent in some parts of New England and the Southwest. Residential markets also have been affected, though less severely, with prices levelling off and even falling in some markets, and sales of new homes at their lowest rate since 1982.

Paralleling the softness in activity, lending by depository institutions for real estate purposes has slowed this year. In large measure, this reflects the absolute contraction of the assets of thrift institutions which, historically, specialized in this market. And, while banks' real estate lending has slowed only slightly, they have been unwilling to fill all of the void left by thrifts. Both banks and thrifts appear to be reacting to the worsened prospects for real estate projects and, particularly for thrifts, a more stringent regulatory environment.

In the case of S&Ls, provisions of the FIRREA legislation limited the amount a thrift institution could lend to one borrower. This reportedly had a marked effect on construction financing in many markets, and some developers have been forced to find new sources of credit. Commercial banks also have pulled back from commercial real estate lending. Data for all commercial banks show a small contraction in credit for construction and land development in the first quarter of 1990, and a reduced rate of expansion in mortgages on existing commercial properties. In the several surveys of senior bank lending officers we have conducted this year, a large majority consistently have indicated that they were very reluctant to extend credit in these areas.

A falloff in credit demand and deteriorating conditions in the real estate sector appear to lie behind much of banks' reduced lending. In one survey taken last January, almost all banks that had pulled back from construction lending did so because of a less-favorable economic outlook. In addition, half of them cited problems with such credits in their own portfolios as a factor. These concerns are substantiated in an increased delinquency rate for real estate loans which, in the first quarter, reached its highest level since 1984. Only a minority of bankers have reported to us that increased regulatory pressure or tighter capital requirements caused them to curb their supply of credit.

In contrast to the situation with commercial real estate, credit market conditions appear more resilient in the market for residential property. This was the main market of the savings and loan industry, and residential mortgage credit has accounted for the bulk of their asset reductions. Nevertheless, there are no indications that permanent financing for purchase of an existing home has become more difficult to obtain. Interest rates charged on home loans have not risen on balance relative to other long-term rates, and lenders generally have not tightened downpayment requirements. A recent trade association survey of mortgage bankers concluded that ample funds were available for home buying, and, indeed, the volume of existing home sales, which is sensitive to credit availability, so far this year has held close to the pace of last year.

The continued flow of credit in residential mortgage markets probably owes to the many alternatives to depository credit. The

securitization of home mortgages has become a routine financial transaction, with about \$1 trillion in mortgage debt held in that form. Buyers of these securities, such as pension funds, insurance companies, and mutual funds, have stepped up to acquire assets shed by thrifts and to fund new lending. Commercial banks have been avid purchasers as well, even while they have slowed the pace of their direct residential mortgage lending.

Outside of the real estate sector, one area where banks unquestionably have made credit less available is the financing of corporate mergers and restructuring. Banking regulators have specifically instructed banks to review their procedures in this area, and a majority of bank lending officers surveyed in January reported that they had tightened their standards for loans to highly leveraged borrowers. This is one sector where the decisions of banks can be corroborated by financial markets more generally. As you well know, the market for junk bonds slumped badly earlier this year, and new issuance has slowed to a trickle.

A pullback from lending to highly leveraged borrowers has contributed to recent sluggish growth in commercial lending, though it is not the only factor. In last month's survey, senior lending officers reported weakness in commercial lending to all sizes of borrowers. In the case of larger borrowers, reduced demands for credit were cited by survey respondents as the primary reasons for the slower pace of lending, while more stringent credit standards and tighter loan terms were quoted more frequently than reduced demand for smaller borrowers. Recent surveys of small businesses do reveal some near-term reduction in

credit availability. However, small businesses consistently report difficulties in obtaining loans, and credit conditions have not become appreciably tighter relative to a year ago.

Greater caution with regard to commercial lending probably is warranted in the current economic environment. The decade of the 1980s was a period of rapid leveraging of many corporations, and the resulting debt burdens probably made some deterioration of credit quality all but inevitable. Indeed, banks are reporting increased delinquency rates on commercial lending.

Nonetheless, with the exception, perhaps, of the troublesome situation in the New England region, credit availability more broadly appears not to be significantly impaired. Banks reportedly remain ready to make loans to larger and more creditworthy commercial borrowers, and they consistently have reported increases in their willingness to extend credit to consumers. Moreover, it is worth noting that while banks are principal suppliers of credit to certain classes of borrowers, they supply less than a quarter of total net borrowing in the broader economy. Other credit conduits generally show little or no stress. For example, the volume of issuance in most securities markets, smoothing through the volatility, generally has been well maintained. In addition, spreads of interest rates on private over government issues in these markets have remained quite narrow. If reluctance by banks and thrifts to make loans were inhibiting the overall flow of credit in the economy, it should be visible in conditions in credit markets, including higher yield spreads.

The pace of aggregate credit flows upholds this impression. Credit growth has eased, but debt still appears to be growing about as fast as GNP, a relationship typical of the three decades before the 1980s. In part, at least, the economy may be seeing the cessation of the unusually heavy borrowing pace of the 1980s, certainly a salutary development to the extent it promises lower leverage and healthier balance sheets.

Of course, the link between current debt growth and economic activity is a loose one. Indeed, it is plausible to expect that impaired credit availability would have lagged effects on debt and spending, as first commitments are cut back, then actual lending, and finally consumption and investment. Naturally we are alert to this possibility and are complementing our attention to debt and credit flows with close scrutiny of a full panoply of related indicators.

The monetary aggregates are among such indicators, containing as they often do portents of future spending trends. Both M2 and M3 have slowed to relatively low growth rates this year, more so than we had anticipated last February. The massive redirection of credit flows that has accompanied the government's program to close insolvent savings and loan institutions appears to have depressed growth of M2 as well as M3, somewhat degrading the value of both aggregates as indicators. On net, commercial banks are taking up relatively little of the lending foregone by the shrinking thrift industry; the resultant cutback in total lending by depository institutions has slashed their needs for funds, showing through directly to M3. Even at the M2 level, the reduced need for funds by both commercial banks and thrifts appears

great enough to have reduced the aggressiveness with which these institutions have pursued deposits. Terms offered on deposits have become less generous, and depositors have been turning to alternative financial assets. At least some of the recent weakness of M2 has come from this channel. However, there is still some unexplained weakness in M2 and M3 which will require continuing scrutiny

Summary

All things considered, continued modest economic growth remains the most likely outcome, and looking at the economy as a whole, enough credit appears to be available to fuel this growth. Certain sectors or individual borrowers appear to be having trouble obtaining credit, but these specific difficulties are largely consistent with lenders' and regulators' reactions to shifting risks. We are attentive to the possibility that this more cautious stance in the granting of credit could cumulate to threaten the economic expansion and are closely monitoring the evolving complex interrelationships between credit availability and economic expansion.