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Remarks by

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As always, it is a pleasure to have the opportunity to address the Securities Industry Association. From your positions at the center of financial markets, I suspect you are uniquely qualified to observe and assess the unusual forces now at work in the economy.

I am sure we all can agree that these are highly uncertain times. The economic recovery, which seemed to be gathering momentum and spark during the summer, more recently has shown signs of faltering. The normal forces of economic expansion are running up against countervailing forces that I have likened elsewhere to a 50 mile per hour headwind. To a considerable extent, the factors restraining expansion are working through the financial sector. For example, a heavy overhang of debt, an accumulation of bad loans, and doubts about the future have produced an unusual degree of caution among many key lenders, as well as on the part of businesses and consumers.

Boom and Bust in Commercial Real Estate

To better understand these forces and their implications for the current economic situation, it would be helpful to look back some years. A key element in the story is an extended cycle in commercial real estate investment. The cycle started in the early 1980s, when commercial space was in unusually short supply. It received a major impetus from the Economic Recovery Tax Act, which was passed in 1981. In general, that Act represented a significant improvement in our tax structure and its incentives for production, saving, and investment. An important and much-needed component of this improvement was an acceleration of depreciation allowances for capital goods. With regard to commercial structures, however, the Act went too far,

producing far shorter write-off lives for tax purposes than the economic depreciation of the property could justify

This artificial set of incentives helped lead to an extraordinary boom in commercial construction, and the total stock of commercial buildings in the United States doubled during the decade of the 1980s, despite a huge increase in vacancy rates. But the tax change was not the only reason for this development. A similar pattern can be seen in a number of other countries around the world. In many cases, tax credit policies by financial institutions also contributed to the surge in commercial building. These institutions were searching to exploit new powers or to find new, profitable lending outlets as securities markets captured significant portions of their traditional lines of business. Moreover, lenders and developers apparently failed to appreciate that there might be some limit to the shift toward financial services and other office-intensive categories of employment.

The accumulation of vacancies over the first half of the decade, along with provisions of the Tax Reform Act of 1986 that reduced the rate at which property could be depreciated and limited the deductibility of "passive losses" on such property, had a stark impact on this market. Prices of commercial real estate peaked in 1985, the prices of the office building component have fallen by a fourth since then.

The boom and bust cycle in commercial real estate left its imprint on our lending institutions. In the early phases, the surge in the appraised value of collateral was a prime reason for a major increase in commercial mortgage lending by depository institutions and other financial intermediaries, such as life insurance companies. After the market for commercial real estate turned down, many of those

loans became nonperforming or had to be written off, putting significant pressures on lenders' capital positions

Moreover, commercial real estate is not the only area in which asset-quality problems have emerged. You are well acquainted with the difficulties that a large number of businesses have had in meeting their obligations--especially those businesses that substituted debt for equity. Clearly, many businesses as well as households took on considerably more debt in the 1980s than they could comfortably service under less buoyant economic circumstances. Consequently, commercial banks have experienced mounting delinquencies and losses on business and consumer loans, in addition to those on real estate loans, over the past year or two.

That aggressive lending faded rapidly in the circumstances is understandable. While some tightening of credit standards by banks and other lenders was clearly a healthy trend, the contraction continued well beyond that point. Depository institutions endeavored to reduce their commercial real estate exposures. The natural inclinations of lenders were reinforced by the reactions of appraisers and bank examiners as the property boom of the early 1980s reversed. The endeavor to protect capital positions and mounting asset-quality problems led to a general pulling back of normal lending outside of commercial real estate categories as well.

With credit now restricted for a broad range of real estate and non-real estate related firms, we have encountered the development referred to by many as a "credit crunch"--a situation where many creditworthy borrowers face significantly stiffer terms and standards and some find credit simply unavailable, with potentially adverse implications for the economy. The tightening of credit supplies, engendered largely by banks endeavoring to protect their capital

positions, has coincided with a dramatic slowdown in the rate of overall credit growth. The relationship between these two phenomena and their meaning for the economy, however, is not as straightforward as it might first appear. Most of the slowdown in credit growth is related to a slackening of credit demand rather than a constriction of credit supplies. Moreover, some of the fall in demand represents an implication of shifting incentives for carrying debt, rather than a response to a reduction in actual or intended spending.

Balance Sheet Expansion and Contraction

To see this clearly also requires some historical perspective on the current situation. In the 1980s, aggregate non-farm business debt rose substantially faster than gross business product. This occurred as the accelerated pace of deregulation, technological advance, and financial innovation lowered the cost of borrowing for many and probably raised the equilibrium ratio of debt to net worth for a wide range of economic entities. A temporary surge in borrowing was implied in the course of this transition from one equilibrium to another, and a tapering off of that surge would be expected as the new equilibrium was approached. This may be, in part, what we are currently witnessing. If these sorts of structural adjustments are in train, some reduction in rates of credit growth relative to those seen earlier are not necessarily insufficient to support satisfactory economic performance.

A number of considerations suggest that this interpretation of balance sheet adjustments is relevant to an analysis of the current situation. Among the forces that appear to be restraining the demand for credit are those that might be categorized as less "grossing up" of balance sheets and less substitution of debt for equity. During the 1980s, there was a great deal of this "grossing

up" of balance sheets, as credit financed more purchases both of physical assets and of financial assets. As far as physical assets are concerned, the 1980s saw some strong spending on consumer durables and, as I already discussed, nonresidential structures, some of which represented an expression of demands that had been pent up earlier. Spending on longer-lived physical assets, such as these, appears more often to be financed with debt than is spending on most other types of goods and services. A slowing of such spending would be a consequence of having satisfied pent-up demands or, in the case of commercial real estate, of having over-estimated needs. The slowdown in debt acquisition associated with a deceleration of accumulation of these assets would be expected.

In part, higher debt-to-income ratios may actually have been an indirect byproduct of the high interest rates of the late 1970s and early 1980s. Elevated interest rates spurred increased financial innovation and extensive deregulation, helping to bring businesses and consumers increasingly into more complex financial dealings. The state and local sector built up a large stock of financial assets, and the household sector acquired assets from the wider array of instruments available. Moreover, household borrowing behavior was shaped importantly by the rising capital gains available on residential real estate over this period. As house prices escalated, mortgage debt on existing homes increased, both as capital gains were realized in home sales and as unrealized gains were tapped through the use of second mortgages and, more recently, home equity lines. In this process, homeowners were able to redirect a portion of these capital gains toward other assets or current consumption.

Over the decade, the financial services industry grew at an extraordinary rate, in part by creating debt instruments and financial

assets seemingly tailored to every need. While households took advantage of a number of these new instruments, the bulk of them were directed toward business. Mergers and acquisitions took off, financed essentially by debt, resulting in net retirements of equity that averaged nearly \$100 billion annually between 1984 and 1989. As you know, we have seen the converse of this behavior of late. It appears that in 1991 equity issuance by nonfinancial corporations will exceed equity retirements for the first time in eight years.

As I previously indicated, the economy moved toward a higher debt-to-income ratio in the 1980s, and some of the recent slowdown in debt growth likely represents an expected tapering-off as the new equilibrium is approached. But the slower pace of lending and borrowing for commercial and residential real estate, as well as the end of the boom in merger activity, no doubt also reflects a ratcheting downward of expectations about likely rates of asset price inflation. From that perspective, a significant fraction of the credit extended on the basis of projected asset price increases should not have been extended. We need merely look at the recent string of defaults and bankruptcies and the condition of many of our financial intermediaries to confirm this impression.

With the financial system groping toward a new equilibrium, the likelihood of mistakes doubtless was high. Laxity by lenders abetted the spiral of debt, and regulators were too often slow to intervene. Now, financial institutions, regulators, and taxpayers are facing the wrenching unwinding of those lending decisions. A key lesson to be learned is how important it is to avoid these costly adjustments in the future.

Steps already have been taken toward that end. The new banking bill mandates supervisory procedures that will lead to

prompter steps to deal with emerging problems. More fundamentally, regulators and the financial markets are paying increased attention to the capital positions of financial intermediaries. The more prudent approach to capitalization and lending decisions is overwhelmingly a healthy development that ultimately will result in strengthened balance sheets for the nation's financial institutions and more assurance of stability of the financial system.

In the meantime, though, we are faced with the macroeconomic consequences of this balance sheet deflation. For a single bank, responding to loan losses by writing down loans and taking steps to rebuild capital is an appropriate and benign response. But when the entire banking industry attempts to make such balance sheet adjustments, the result can be quite adverse for the economy as a whole.

Monetary Policy in the Current Credit Situation

In these unusual circumstances, economic and financial policy makers must perform a difficult balancing act. We must ensure that our regulatory policies do not unduly constrict loans to creditworthy borrowers. But we also cannot reverse the progress we have made in emphasizing adequate capitalization of depository institutions or undermine the confidence of the public in their soundness. Monetary policy is faced with establishing conditions that, in the face of problems of credit availability, will tend to promote sustainable economic growth without putting at risk the progress that has been made against inflation.

Monetary policy makers face an especially difficult problem at the present time in gauging whether monetary and financial conditions are consistent with this objective. The problem arises because one result of the recent changes in financial structure has

been substantial distortions to traditional relationships between money and other financial measures, on the one hand, and the economy and prices, on the other. The sluggish growth of domestic nonfinancial sector debt is only one example of such distortions.

The monetary aggregates provide further examples. Given the impaired capital positions of many banks and thrifts and their consequent desire to limit asset growth, many such institutions have taken steps to limit increases in their liabilities--first by slowing the growth of managed liabilities, such as large CDs and Eurodollar borrowing, which most directly affect the broadest monetary aggregate, M3. But many banks and thrifts also have taken measures to limit inflows of retail deposits by reducing deposit interest rates, increasing fees, and reducing promotional expenditures, these measures have tended to slow the growth of M2 as well as that of M3.

The consolidation of the banking and thrift industries, including that being conducted through the activities of the Resolution Trust Corporation, appears to be one factor depressing M2. In fact, M2 deposits have declined a bit at institutions involved in mergers or other consolidations, while continuing to expand at other banks and thrifts. Perhaps it is not too surprising that when bank or thrift institutions merge or when one institution's deposits are assumed by another, the resulting entity will have lower asset totals, and therefore will require lower liabilities, than the sum of the two original institutions. Some of the customers of the merging institutions apparently are choosing to shift a portion of their funds out of deposits altogether. This may occur because the acquiring institution reduces rates on assumed deposits, because the acquiring institution's facilities are less convenient for the depositor, or

perhaps simply because the disruption of established relationships leads the depositor to review his investment alternatives

In addition, some of the weakness of M2 appears to reflect changing interest rate relationships within the financial sector, especially as a result of the sharp declines on deposit interest rates. For example, many depositors have responded to the more attractive yields on capital market instruments compared with those on deposits by shifting funds out of M2 instruments and into market-related assets such as mutual funds. Also, many households apparently have used deposit balances to pay down consumer credit. To a considerable extent, these transactions represent portfolio adjustments to shifts in relative interest rates, and therefore such transactions and their associated depressing effects on the aggregates have limited implications for spending and output.

Similar conclusions about the meaning of sluggish growth in the monetary aggregates can be derived, to an extent, from consideration of the credit side of balance sheets. If securities and securitization were able to substitute frictionlessly for credit that banks no longer can provide economically, the slow growth of money and bank credit emerging from the difficulties of depositories would have no necessary implications for aggregate spending and production. For practical purposes, such conditions prevail in the markets for residential mortgages, where securitization transforms pools of mortgages into commodities that can be priced and traded efficiently. This process helps maintain the flow of funds to housing and serves to limit the adverse effects of the impairment of banks and thrifts on the economy.

On the other hand, securitization has not progressed to the point where loans to small and medium-sized businesses can readily be

packaged and sold. The size and idiosyncratic nature of business loans contribute to the difficulties in securitizing them. Given their relatively small size and lack of credit ratings, such firms ordinarily do not have access to the capital markets. Thus, for these firms, especially, the difficulties of the banking industry have had a pronounced effect on credit availability, limiting their ability to invest and carry on normal operations. Moreover, some of these firms, as well as lower-rated firms more generally, in the past have relied on private placements with life insurance companies for longer-term sources of credit. More recently, such firms have found credit from the life insurance industry, which faces many of the difficulties of commercial banks, to be much less available.

On balance, the extraordinarily slow pace of money and debt growth, although partly a product of financial restructuring with only limited implications for the economy, also has indicated that financial conditions have been constraining the economy's ability to expand. To counter these forces, the Federal Reserve has eased monetary policy considerably over the past 18 months or so. As you know, we have taken numerous steps to reduce short-term interest rates, and about a year ago we eliminated reserve requirements on nonpersonal time deposits.

Many of the portfolio adjustments that I discussed earlier have been difficult for the economy, and probably have contributed to its recent disappointing performance. But the process is laying the groundwork for a more efficient, growing economy ahead. Inflation pressures have abated, and the inflation rate is headed down. Banks and other intermediaries are taking steps to strengthen their balance sheets so they will be in a position to meet emerging credit demands. Many households and businesses have improved their financial condition.

and are in better shape to support more normal patterns of borrowing and spending. As a consequence of these developments, I am confident our economy will emerge from its current difficulties in much better health than in many years, and we can then look toward the sustained economic growth that we have all been striving to achieve.