

## When "Credit Crunches" May Be Sensible

*The Federal Reserve eased credit "slightly" last month, reportedly to counter an alleged credit crunch. According to Fed surveys, there have been widespread complaints from small and medium-sized businesses that banks recently have reduced credit lines and tightened lending standards. In our view, surveys of current borrowers might be expected to yield such complaints. On the other hand, the pertinent financial-market indicators of credit conditions largely fail to reveal any regulatory-induced credit pinch. Rather, "other things being equal," the trend since January in the interest-rate spread (a widely used measure of credit availability) actually would seem to favor credit expansion. In the wake of the S&L debacle and commercial bank weakness, however, it would appear that "other things" are not equal. To the extent that banks are becoming more sensibly reluctant to lend to troubled borrowers, they may be relatively immune to Fed interest-rate policy and thus the Fed may be "spinning its wheels" in efforts to forestall the next recession. In any event, as during past business cycles, the Fed's recent actions to combat a perhaps imaginary threat would seem to suggest that the monetary authorities are becoming less concerned about monetary stability than they are about managing the business cycle.*

Credit crunches often are associated almost exclusively with tight money and "high" interest rates, and in today's highly politicized money-credit regime are almost universally viewed unfavorably. These episodes usually are said to be the result of "overly restrictive" monetary policy. The proposed relief for such credit contractions usually requires that the Federal Reserve expand the money supply and/or lower interest rates. For some months, the Administration reportedly has pressured the Fed to do so and Fed Chairman Alan Greenspan last month announced a modest reduction in interest rates. Although no one can know Mr. Greenspan's motives, his action would appear to be a classic endorsement of the notion that monetary authorities have the capacity to fine tune the economy.

However, not all credit contractions are the result of supposedly off-target monetary policy or are necessarily bad for the economy. In present circumstances, for example, somewhat tighter credit may simply reflect market considerations. At times, some borrowers, individual or corporate, may be denied credit *even* if some of them are willing to pay a higher rate and credit restraint may *not* be associated with higher interest rates, or with monetary policy.

Banks may not satisfy all credit demands for many reasons. For example, they may already be nearly overextended. As much as they might like to lend more, they may be unable to attract new deposits or raise additional loanable funds from nondeposit liability sources. Alternatively, they may have ample funds, but view business conditions as adverse for further lending. Banks then may prefer the safety and liquidity of short-term but low-return money-market investments (e.g., T-bills) over, say, medium- or long-term business loans. Or

they may already have reached their desired lending limit in one type of investment or geographic area. Since no additional loans may be channeled to such specific sections of their portfolio, certain classes of borrowers may be refused credit.

From an economic perspective, the refusal of credit in such situations reflects banking prudence in the face of market conditions — and is not detrimental to the long-term health of the economy. The tightening of credit to some borrowers provides important information to producers and directs resources to enterprises whose prospects are deemed more favorable. From the perspective of the analyst of credit conditions, however, it complicates the measurement of "credit crunches."

### *The Spread as an Indicator of Credit Crunches*

Many analysts view short-term interest rates as "natural" indicators of credit conditions. Among the available money-market rates, there is a preference for the Federal funds rate — the rate at which depository financial institutions lend unsecured, "overnight money" to one another. The Federal funds rate, which is competitively determined, is widely considered as a useful reference rate for the interest rates of other money-market financial instruments (T-bills, commercial paper, short-term CDs, etc.) mainly because movements in the former generally precede those in the latter. In addition, some analysts consider it as *the* sole indicator of the Fed's current and future monetary policy stance, despite recent uncertainties associated with its predictive ability.

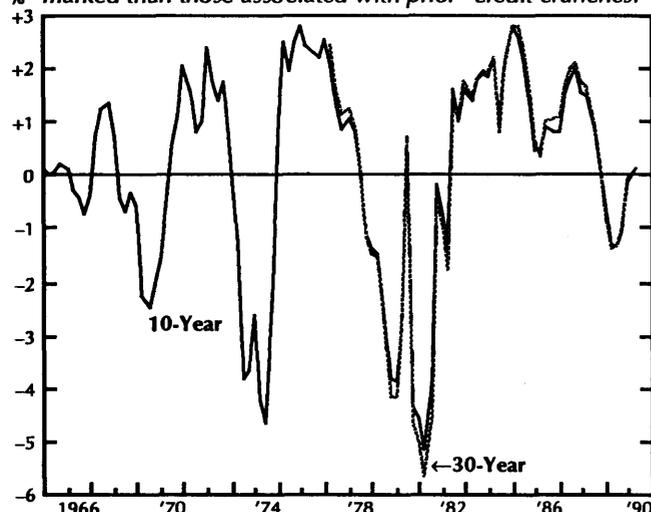
However, inasmuch as bank credit restraint may not be reflected in higher interest rates, particularly short-term interest rates, a credit condition indicator consisting of a short-term rate or a composite of short-term rates may not be sufficient to gauge the extent of contractionary credit conditions. Compounding this is the fact that credit rationing could occur independently of changes in the Fed's monetary or credit policy, suggesting that broad monetary aggregates also are inadequate measures of credit conditions.<sup>1</sup>

Practical considerations have led to the use of an additional indicator — a long-term interest rate — in conjunction with a short-term rate to measure tightness or looseness in credit markets. Financial instruments with short-term maturities possess characteristics that are different from those with long-term maturities, and their yields respond differently to changes in economic conditions. Both types of financial assets are found in the portfolios of most, if not all, depository

<sup>1</sup> The volume of commercial and industrial loans can serve as an indicator of credit conditions. However, as currently reported by the Federal Reserve, this data series appears to be understated to a significant degree due to the existence of commercial loan sales. Commercial loan sales (or secondary loan participations), which are off-balance sheet items, have grown to over \$50 billion as of June 1988 according to a Federal Reserve survey of bank lending practices. That same survey revealed that about a third of loans sold by the survey respondent banks were not included in the bank credit data published by the Fed. For more on this, see "Commercial Loan Sales: Problem or Opportunity?" *AIER Research Reports*, November 21, 1988.

## QUARTERLY INTEREST-RATE SPREADS

Recent interest-rate spread fluctuations have been far less marked than those associated with prior "credit crunches."



Source: Federal Reserve Board.

and nondepository financial institutions (mutual funds, pension funds, insurance and finance companies). The relationship between their returns would mirror these assets' relative desirability in their holders' portfolios and reflect their holders' current and future perceptions of the overall credit and business environment.

Consider the following situation. Suppose the Fed raises the level of reserves in the banking system. This has the effect of lowering short-term interest rates, including, of course, the Fed funds rate. Depository and other financial institutions then compare the returns from money-market instruments with those of alternative longer-term assets such as loans and Treasury bonds. For a given investment horizon and future expectations, they have to decide which asset holdings would be most profitable. In the case of banks, if it turns out that the new level of returns on short-term securities is lower than returns from loans or long-term securities, they will likely make more loans and purchase long-term securities. This will tend to expand credit in the economy, raise the money stock, and eventually stimulate economic activity.

Similar results can take place even without the prodding of the central banking authority, if lenders want to increase loans and hold long-term securities in their portfolios rather than short-term assets. Historically, the returns for long-term securities often then rise. Whether short-term rates come down or stay the same, the spread between long-term and short-term rates then widens, indicating a loosening of credit conditions in the economy.

Conversely, the Federal funds and other money-market rates increase when the monetary authority lowers the level of reserves in the banking system, other things equal. If the increase is such that Federal funds and other short-term financial instruments begin to look more favorable compared to longer-term securities, then depository financial institutions with excess reserve levels are likely to lend in the Federal funds market or purchase T-bills. At the same time, they will tend to make fewer business loans and shun long-term securities. This tends to bring about a contraction in aggregate credit, deceleration in monetary growth rate, and sluggishness in business activity.

Again, this outcome is possible even in the absence of a Fed-induced tightening of reserves. For example, in the past, news of current or impending recessions often has driven down bond yields and prodded lenders to be cautious about

extending more loans. But regardless of the source, contractionary credit environments seem to be associated with a narrowing of the spread between long-term and short-term rates.

### Interest Rate Spreads and Credit Crunches Since 1965

The accompanying chart illustrates the performance of the "spread" since 1965, which includes the past four business-cycle contractions. The interest-rate spread used is the difference between the long-term rate on Government bonds and the Federal funds rate. For the longer-term rate in particular, two measures are employed on a constant maturity basis — 10-year Treasury notes and 30-year Treasury bonds. The 30-year Treasury bond yield maximizes the distinction between short-term rates, which are heavily influenced by the Fed's monetary policy, and long-term rates, which are most insulated from it.<sup>2</sup>

The cyclical behavior of the spread is readily apparent from the chart. It shows a tendency to narrow and turn negative before peaks in the business cycle. Prior to an upturn in business-cycle activity, it widens and turns positive.<sup>3</sup> The table below identifies four credit crunches since 1965. These credit squeeze episodes may be considered as severe because the lowest average quarterly spread for a given period for either measure is no less than (minus) 200 basis points.<sup>4</sup>

#### What Credit Crunch Anyway?

With respect to the recent news that a "credit crunch" now prevails, perhaps the most striking feature of the chart is that recent interest-rate spread fluctuations have been far less marked than those associated with the four immediately prior episodes. Early this year, the spread was very mildly negative (about 25 to 30 basis points), but the overall trend of the spread since January has been upward — the *opposite* of what is implied by a credit crunch.

To be sure, banks probably have tightened credit to some borrowers. But, in the absence of more persuasive data, it is hard to see how recent credit conditions constitute a "prob-

<sup>2</sup> On this, see Robert D. Laurent, "Testing the 'Spread'," Federal Reserve Bank of Chicago *Economic Perspectives*, July/August 1989.

<sup>3</sup> The sign and magnitude of the spread indicates the shape of the yield curve. The higher the long-term rate is relative to the short-term rate, the bigger (more positive) is the spread. This also means that the yield curve is relatively steep (or has an ascending shape). Conversely, the lower the long-term rate is compared to the short-term rate, the smaller the spread becomes, and may even turn negative. In this case, the yield curve could become inverted (*i.e.*, have a descending shape).

<sup>4</sup> In contrast, from the second to the third quarter of 1966, a period widely regarded as also having experienced a credit crunch, the quarterly spread averaged only about minus 50 basis points.

#### CREDIT CRUNCHES SINCE 1965 AS INDICATED BY INTEREST RATE SPREADS

Period	Average Quarterly Interest Rate Spread:	
	10-Year T-Bonds less Fed Funds Rate*	30-Year T-Bonds less Fed Funds Rate*
1969:Q2-1970:Q1	-2.06%	**
1973:Q3-1974:Q3	-3.81	**
1979:Q1-1980:Q2	-2.62	-2.76%
1980:Q4-1981:Q3	-4.46	-4.94

\* The Fed funds rate has been converted into a bond-equivalent basis. The yields on Treasury bonds are constant-maturity rates.

\*\* The Federal Reserve's data series on yields for 30-year Treasury bonds is available only from March 1977 onward.

Source of basic data: Federal Reserve Board.

lem” that requires regulatory action. Indeed, in view of the S&L debacle and the real estate slump in the Northeast, it might provide some assurance that banks are hesitating before throwing good money after bad.

If anything, the Fed’s recent behavior would seem to convey a different message: that when recession actually threatens, the monetary authorities tend to become less concerned about maintaining the purchasing power of the dollar than they are about managing the business cycle to forestall a business contraction, even when the latter may be to the long-term benefit of the economy. That the Fed would move to lower interest rates even though price indications suggest continued historically high rates of price inflation and the conventional data largely fail to reveal a credit crunch may suggest that the monetary authorities may be far less resolute in defending the worth of the dollar than many apparently now believe.

## OCCUPATIONAL LICENSURE LAWS

### A Review of Some Findings

*The plethora of laws regulating various professions ostensibly are passed to protect the public. Yet the evidence indicates that such regulation reduces consumer choice while increasing costs to consumers. Entry barriers also have adverse effects on labor mobility, minorities and the poor. Furthermore, there are strong indications that this regulation has resulted in neither increased quality nor safety. That being the case, the obvious question is: “why do we have these laws?”*

Governments have been regulating professions since ancient times. Even the Code of Hammurabi regulated surgeon’s fees and imposed sanctions for malpractice — such as cutting off the surgeon’s hand if the patient died.<sup>1</sup> Modern licensing laws date from 13th century Sicily, where physicians were required to be educated and tested in both medicine and philosophy. The law required all physicians to be licensed. There were fee schedules and codes of ethics and physicians had to provide free services to the poor. Spain, Germany and Naples enacted similar laws in the following century<sup>2</sup> and the regulation of professions has expanded to the point where some government body in one or more of the 50 states now regulates nearly 1000 occupations.<sup>3</sup>

### Barriers to Entry

Professions and trade groups limit entry in a number of ways. Many require formal schooling, much of which has nothing to do with the practice of the profession or trade. To become a lawyer in most states today requires a 4-year undergraduate degree (in anything) plus 3 years of law school. The 7-year college requirement excludes many otherwise qualified individuals from practicing law. In a few states, working for a lawyer for a few years plus independent study will qualify the applicant to sit for the bar exam, which greatly reduces the cost of entering the legal profession. Modern education requirements would exclude people such as Abraham Lincoln, who never went to law school, from practicing law.

Another barrier to entry is the school itself. In medicine, for example, the American Medical Association has to approve any school before it can offer a medical education. Its accreditation standards require that the education program be full-time days only, which makes it impossible to earn a medical degree by attending a part-time evening program. Anyone who has to work part-time or full-time during the day is denied the opportunity to earn a medical degree.

Numerous other examples could be given. To qualify to sit for the CPA examination, most states require candidates to have a 4-year college degree. But only about one-fourth of the

40 or so classes needed for the degree can be in accounting. The rest must be in unrelated subjects that have nothing to do with the practice of accounting. Were it not for this requirement, individuals would be able to sit for the CPA exam after one year of college instead of four, thus cutting the cost of entering the CPA profession by 75 percent while having little or no effect on technical competence.

Other trades and professions also have requirements that have nothing to do with protecting the public from incompetents. For example, many trades require a high school diploma. Yet how does having or not having a high school diploma affect the quality of work done by a plumber, beautician or barber?

The licensing examination itself may present another barrier to entry. Much of the material that is tested in a licensing exam is only tangentially related to the work that the successful candidate eventually will do. For example, many state bar examinations require mastery of only six subjects — none of which may be used in many areas of later practice. The point is, even though the public apparently feels it is being protected by government “watchdog” or private professional agencies, licensure exams often may have little to do with the ability to practice a trade or profession.

Many trades and professions have apprenticeship or internship requirements. While it generally is a good idea to hire only a surgeon who has some experience, the practice required to gain entry to a trade or profession often has little to do with competence. For example, a plumber in New York City must spend 10 years as a journeyman for a master plumber before being granted a master plumber license. Furthermore, experience gained out of state or from unlicensed contractors does not count.<sup>4</sup> It would seem that this requirement is aimed more at excluding competitors than protecting the public. Many trades can be learned adequately in a few weeks or months of on-the-job training. Any arbitrary experience requirement that requires a longer period than is necessary to learn the required job skills is actually anti-consumer.

Erecting barriers to entry does not necessarily result in perceived “shortages,” but it does tend to limit the number of people who enter a profession, which tends to increase the cost consumers must pay to obtain the service. While the effect on income of those already in the profession depends on the elasticity of demand for the service, a number of studies have indicated that creating barriers to market entry results in higher incomes than would be the case in the absence of barriers.<sup>5</sup>

### Effects on Quality

A major justification for occupational licensure laws is that they keep incompetents off the market. Licensing laws are supposed to enhance quality and some studies have shown that such laws do tend to enhance quality. For example, one study measured quality in optometry based on office equipment, the length of an eye examination and examination complexity and found that a positive correlation existed between quality of service and the restrictiveness of regulation.<sup>6</sup> A study of pharmacists found a similar relationship by correlating the number of malpractice suits per licensee.<sup>7</sup> But most studies show that licensing laws have at best a neutral effect on quality and in many cases actually harm consumers.<sup>8</sup> Licensing laws make entry more difficult, thus limiting the number of individuals offering the service, which tends to raise their price to the consumer. When consumers view the price of hiring a professional as being too high, they tend to “do-it-themselves,” which tends to reduce both quality and safety.

A Federal Trade Commission study found fraud and misrepresentation in the television repair business to be more prevalent in a state where TV repairmen were licensed than where they were not. Prices were 20 percent higher in the regulated state as

well.<sup>9</sup> Another FTC study examined the quality of contact lens fitting done by opticians, ophthalmologists and optometrists. The study found that the quality of the services offered by the less regulated (and less expensive) practitioners (who could advertise) was somewhat higher than the quality offered by the more regulated (and more expensive) practitioners (who were prohibited from advertising).<sup>10</sup> Another study found that lack of regulation in the advertising of legal services led both to lower consumer cost and higher quality of service.<sup>11</sup> Other studies found that houses stayed on the market longer in localities where real estate brokers were tightly regulated; that there is a higher incidence of rabies where strict limits are placed on veterinary practice; and whether radiologic equipment is operated by certified or noncertified personnel makes no difference in the level of radiation exposure.<sup>12</sup> The point is that occupational licensing laws tend to increase the cost to consumers while having questionable, if any, positive effects on the quality of service provided.

### Other Effects

The evidence also indicates that licensure laws may restrict professional mobility and tend to reduce the supply of available practitioners.<sup>13</sup> Sunbelt states are especially notorious for placing restrictions on out-of-state practitioners who want to "semi-retire" in states such as Florida, Texas and Arizona. Limiting mobility hurts consumers because it makes it more difficult for practitioners to relieve shortages by moving to the area in need of the service. One study found that restricting mobility for dentists resulted in higher prices and reduced availability of dental services, which is exactly what one would expect when providers are prevented from offering a service.<sup>14</sup> Other studies have arrived at similar conclusions for a number of other occupations.<sup>15</sup>

A number of professions limit advertising by members, which makes it more difficult for consumers to learn what services are available. An FTC study found that legal fees were 5 to 13 percent lower in states that had relatively few restrictions on advertising, which is what one would expect, since advertising tends to increase competition.<sup>16</sup> Another study found that the price of eyeglasses was 25 to 40 percent higher in states that prohibited eyeglass advertising.<sup>17</sup> This study also found that price elasticity was -1.0, which means that a 40 percent price increase will result in a 40 percent decrease in demand. In short, low-income consumers are especially hard-hit by advertising restrictions, since they are the ones least able to afford to pay higher prices.<sup>18</sup>

Regardless of their original intent, occupational licensure laws may tend to harm the public more than they help. The pressure to regulate occupations historically has come from the groups that stand to lose from competition. Occupational licensure laws raise barriers to entry and prevent many otherwise qualified individuals from entering the trade or profession. These entry barriers reduce consumer choice and increase costs, yet may have little or no positive effect on quality. It would seem that the regulation of advertising may prevent consumers from learning about the options they have and that the accreditation standards of the various professions tend to promote uniformity at the expense of innovation. It is a matter of supposition that consumers could be better off if professional services were subject to market discipline, which historically has fostered the highest quality at the lowest cost.

### Endnotes

<sup>1</sup> See Daniel B. Hogan, *The Regulation of Psychotherapists*, Vol. I (Cambridge, MA: Ballinger, 1979), 223-224 for the early history of occupational licensure. S. David Young also discusses the history in *The Rule of Experts: Occupational Licensing in America* (Washington, DC: The Cato Institute, 1987), 9-14.

<sup>2</sup> Young, 9.

<sup>3</sup> Young, 4.

<sup>4</sup> Young, 35. Also see James A. Cathcart and Gil Graff, "Occupational Licens-

ing: Factoring It Out," 9 *Pacific Law Review* (January, 1978), 147-163 for a comprehensive study of experience requirements.

<sup>5</sup> For example, see Milton Friedman and Simon Kuznets, *Income from Independent Professional Practice* (New York: National Bureau of Economic Research, 1945); William D. White, "The Impact of Occupational Licensure on Clinical Laboratory Personnel," 13 *Journal of Human Resources* (Winter, 1978), 91-102; Lawrence Shepard, "Licensing Restrictions and the Cost of Dental Care," 21 *Journal of Law and Economics* (April, 1978), 187-201. Also see Young, 49-52.

<sup>6</sup> J. W. Begun, *Professionalism and the Public Interest: Price and Quantity in Optometry* (Cambridge, MA: MIT Press, 1981). Young, Chapter 8 also discusses this topic.

<sup>7</sup> Samuel Martin, "An Examination of the Economic Side Effects of the State Licensing of Pharmacists," PhD dissertation, University of Tennessee-Knoxville, 1982.

<sup>8</sup> Young, 53. For a discussion of this point, see Alex R. Maurizi, "The Impact of Regulation on Quality: The Case of California Contractors," in Simon Rottenberg (ed.), *Occupational Licensure and Regulation* (Washington, DC: American Enterprise Institute, 1980), 26-35.

<sup>9</sup> Young, 53; J. Phelan, "Regulation of the Television Repair Industry in Louisiana and California: A Case Study," (Washington, DC: Federal Trade Commission, Bureau of Economics, 1974).

<sup>10</sup> Gary D. Hailey, Jonathan R. Bromberg and Joseph B. Mulholland, "A Comparative Analysis of Cosmetic Contact Lens Fitting by Ophthalmologists, Optometrists, and Opticians," *Report of the Staff of the Federal Trade Commission* (Washington, DC: Bureau of Consumer Protection and Bureau of Economics, 1983). This study is discussed in Robert B. Ekelund, Jr. and David S. Saurman, *Advertising and the Market Process* (San Francisco: Pacific Research Institute, 1988), 118-122.

<sup>11</sup> Young, 54; Fred S. McChesney and Timothy J. Muris, "The Effect of Advertising on the Quality of Legal Services," 65 *American Bar Association Journal* (October, 1979), 1503-06.

<sup>12</sup> Young, 54; Sidney L. Carroll and Robert J. Gaston, "Occupational Restrictions and the Quality of Service Received: Some Evidence," 47 *Southern Economic Journal* (1981), 959-76. Young, 57, citing a Food and Drug Administration study that was reported in *Professional Regulation News* (August 1981), 3, a monthly newsletter of the National Commission for Health Certifying Agencies.

<sup>13</sup> Young, 59-61; Arlene S. Holen, "Effects of Professional Licensing Arrangements on Interstate Labor Mobility and Resource Allocation," 73 *Journal of Political Economy* (October, 1965), 492-98; Bryan L. Boulier, "An Empirical Examination of the Influence of Licensure and Licensure Reform on Geographical Distribution of Dentists," in Simon Rottenberg (ed.), *Occupational Licensure and Regulation* (Washington, DC: American Enterprise Institute, 1980), 73-97; Leila J. Pratt, "Occupational Licensing and Interstate Mobility," 15 *Business Economics* (May, 1980), 78-80.

<sup>14</sup> Bryan L. Boulier, "An Empirical Examination of the Influence of Licensure and Licensure Reform on Geographical Distribution of Dentists," in Simon Rottenberg (ed.), *Occupational Licensure and Regulation* (Washington, DC: American Enterprise Institute, 1980), 73-97.

<sup>15</sup> Young, 60; Morris M. Kleiner, Robert Gay and Karen Greene, "Barriers to Labor Migration: The Case of Occupational Licensing," 21 *Industrial Relations* (Fall, 1982), 383-91; Jeffrey M. Perloff, "The Impact of Licensing Laws on Wage Changes in the Construction Industry," 23 *Journal of Law and Economics* (October, 1980), 409-28.

<sup>16</sup> William W. Jacobs, et al., "Improving Consumer Access to Legal Services: The Case for Removing Restrictions on Truthful Advertising," Report of the Staff to the Federal Trade Commission (Washington, DC: Bureau of Economics and Cleveland Regional Office, November, 1984). The FTC report is discussed in Robert B. Ekelund, Jr. and David S. Saurman, *Advertising and the Market Process* (San Francisco: Pacific Research Institute, 1988), 142-43 and Young, 66. For a study of the effect of advertising on consumer prices, see Robert L. Steiner, "Does Advertising Lower Consumer Prices?" 37 *Journal of Marketing* (1973), 19-26.

<sup>17</sup> Lee Benham, "The Effect of Advertising on the Price of Eyeglasses," 15 *Journal of Law and Economics* (October, 1972), 337-52. For discussions of the Benham study, see Robert B. Ekelund, Jr. and David S. Saurman, *Advertising and the Market Process* (San Francisco: Pacific Research Institute, 1988), 112-117; Young, 66.

<sup>18</sup> For a general discussion of the effects of advertising restrictions on price, see Robert B. Ekelund, Jr. and David S. Saurman, *Advertising and the Market Process* (San Francisco: Pacific Research Institute, 1988).

### PRICE OF GOLD

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