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The Credit Crunch: Myth or Reality?, Part I

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However we interpret the so-called "credit crunch" *economically*, there is little doubt that it has been increasingly *politicized* over the past year. In general, there has been a dearth of sound economic analysis of the phenomenon.† Instead there has been a good deal of equivocation about the meaning of credit crunches. We have also witnessed posturing by an alliance of bank lobbyists, the Bush Administration, the Fed, and inflationists, all decrying the so-called evils of a credit crunch.

This politicization was symbolized in early October, when the President called all the parties into his office and issued highly publicized statements about how bankers should lend, how regulators should oversee that lending, and how quickly the Fed should print money for the bankers to lend. Who could ever say that this country follows free markets, when the President himself is seen issuing such directives from his own desk?

In my view, the parties just mentioned have exaggerated the severity of the credit situation beyond all sensibility. Each has played a role. The banks, of course, would like their bad loans to perform better — and believe inflation can do the trick. The Bush Administration would like to get re-elected next year, but fears recession will still be with us then. The Fed is afraid of losing its control and power, as always. One writer in *Euromoney* magazine put it this way: "a full-scale credit crunch removes control of monetary policy from the central bank and puts it in the hands of the lending system; no matter how expansionary monetary policy is, lending does not increase." Finally, there are the omnipresent *inflationists*, whether economists or financial writers, who are always thrilled by a nice fresh run of currency, no matter what the scenario.

What Is a Credit Crunch, Precisely?

A credit crunch is defined as a *non-price rationing of credit*, a situation in which lenders refuse to extend credit *regardless* of the underlying creditworthiness of the borrower and *regardless* of the price offered. Since the price of credit is the interest rate, this means that a credit crunch is the *unavailability of credit at any price*.

This phenomenon should be no mystery to the economically literate. In fact, we've all seen examples of rationing in recent memory. In the mid-1980's we had the insurance liability crisis, where insureds could not get certain types of coverage at any price. In the 1970's we had oil and gas shortages — again, as a consequence of price controls. The last genuine credit crunch occurred in the late 1970's, when President Carter and the Fed imposed credit controls. In each of these cases — whether they involved insurance coverage, oil and gas, or credit lines — for a time their supply was being rationed. Price was not playing its usual allocative role. But in every case this non-price rationing was due to Government intervention, to price controls, usually price ceilings. In the case of credit rationing in the late 1970's, record-high interest rates bumped up against old usury laws with interest ceilings of 6 percent.

A shortage is *not* a free market phenomenon but reflects a contravention of free markets, a manipulation of the price system. In credit markets, the price mechanism is interest rates. Today there is no price in the economy that is more manipulated by Government than interest rates. Here is where we must look for the origins of credit rationing. Now strictly, we do not have interest rate ceilings today (although there are always constant rumblings to impose them, especially in the area of consumer credit), but we do have a central bank bent on artificially lowering interest rates. Considering this one policy alone, it is difficult to believe banks could be induced to lend money when the interest they would earn on such loans is diminishing. Consider some facts about today's credit markets.

Are We Suffering from a Credit Crunch?

Total debt in the U.S. economy, public and private, has grown from $4 trillion in 1980 to $11 trillion today. Moreover, it has grown faster than GNP. Total debt was 1.7 times GNP in 1980, but 1.9 times GNP a decade later. In the 1950's, it was only 1.2 times GNP. If anything, the growth rate of debt has been increasing, not diminishing. By any reasonable definition, this would seem to represent a credit *flood*, not a credit crunch. Even more recent growth rates defy the conventional wisdom. Last year total debt grew by $540 billion, and economist Edward Hyman predicts it will grow by $600 billion next year.

So where is the problem? An examination of the *composition* of all this debt reveals a disturbing trend. The portion of all this debt owed by the Government increased from 30 percent in 1980 to 34 percent in 1984, where it remained for 5 years, a period of unprecedented expansion in the private economy. But in the last 2 years alone, the Government's share has increased still further, from 34 percent to 36 percent. As budget deficits balloon from $220 billion in 1990 to an estimated $380 billion in 1992, that share can be expected to rise still further.

In short, complaints about some allegedly insufficient aggregate level of credit are misplaced. If anything, what merits criticism is the extraordinary shift in the *composition* of that debt, from a productive, private economy to an all-consuming Government. Government debt represented 25 percent of the increase in total U.S. debt in 1989 and 40 percent of the increase in 1990. Conservative estimates indicate that Government debt will be 70 percent of the increase in 1991. The results for the private economy are predictable. Although pri-

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† For one notable exception, see the well-reasoned account, "When 'Credit Crunches' May Be Sensible," AIER ***Research Reports***, August 6, 1990.

vate sector debt is increasing, it is doing so at a decelerating rate. For example, annual growth in private debt has fallen each year in the past 5, from 13 percent growth in 1986, down to 3.5 percent in 1991. The private sector credit market is being crowded out by the Government's insatiable demand for debt.

The deceleration of private credit may create the impression that we are suffering a credit "shortage" today, but only when compared to the massive run-up in *excess* credit during the 1980's. New credit *is* being extended to private borrowers today, though at a slower rate. Creditworthy borrowers can still obtain credit, and strong banks are still lending. Other lenders are picking up slack outside the regulated banking system — consumer and commercial finance companies, mortgage companies, insurance companies, and even foreign banks, have all increased their shares of private credit markets in recent years. But the recession clearly has threatened the revenues of businesses and incomes of individuals, the flow of funds needed to service debts, and debtors are quite understandably restraining their demand for still more debt. They would be crazy to expand their debts further, the President's exhortations to the contrary notwithstanding.

The absence of a technical credit crunch is also confirmed by the spread between short-term and long-term interest rates. A key indicator of credit availability, an interest rate spread that is positive and widening indicates greater credit availability, while a narrowing (or even negative) spread points to diminished credit availability. Although the interest rate spread was negative for a brief period in early 1990, it was only –0.25 percent, compared to the far more stringent spread of –5 percent in the 1980-81 recession, when credit controls were imposed. For most of 1991 the spread has been about +3 percent, representing one of the largest positive spreads in the past 25 years. (See next article.)

Describing today's condition as a "shortage of credit" also makes little sense when we consider both sides of the credit transaction. The other side of the party extending credit is the party incurring debt. If there is a shortage of credit there must also be a shortage of debt. As indicated above, debt levels in relation to GNP have skyrocketed in recent years. Governments, businesses, and individuals in the United States are straining under a mountain of debt incurred in the 1980's, a burden that may well take years to work off. The demand for credit — the "flip side" of the supply of credit — has diminished considerably. No jawboning on the part of demagogues in Washington can alter these facts.

Some Erroneous Causes and Cures of the So-Called Credit Crunch

"Too Little Money"

A widely held notion is that the alleged "credit crunch" is a result of stringent monetary policy, *i.e.*, that "there is not enough money." In fact, the money supply doubled between 1979 and 1986 (at a compounded annual growth rate of 9 percent), even though living standards most assuredly did not double. In the Greenspan years it has grown about 4 percent per annum on a compounded basis, less than half the rate of the Volcker years. I don't need to tell this audience that the Greenspan inflation is still considerable. Mr. Greenspan's rate of printing would double the money supply in 17 years, while Mr. Volcker accomplished a doubling in 7 years. More recently, Mr. Greenspan has increased the money supply at a 10 percent annualized rate. This is hardly a case of too little money. But once again it's a case, until very recently, of a deceleration of its growth rate. Such a change must be accompanied by painful readjustment.

To believe the economy will be benefited by infusions of cash is to confuse cash with saved capital. Money is neither capital nor credit, but a medium of exchange. To create money does not create savings or capital — the two pillars of sound credit and economic growth. Instead, it depreciates the currency, artificially inflates asset values, and raises prices and nominal interest rates. In short, liquidity does not solve problems of excessive indebtedness, low net worth or insolvency.

The condition of most U.S. commercial banks today illustrates the point. Before the Fed was established in 1913, banks had capital-to-asset ratios of 20 percent. Those ratios have fallen steadily under decades of Fed inflation, conducted through bank balance sheets by open-market operations. Today, bank capital ratios are only 5 percent. Citibank's ratio is even lower, at 3 percent and falling. So the problem is that the banks are nearly insolvent, not illiquid — that is why Citibank lowered its NOW account rates to 2 percent recently. The banks do not need liquidity or deposits — they need capital.

The Fed is flooding the banks with reserves all the same, in the hope banks will turn around and lend them. The Fed increased bank reserves 10 percent per annum from 1980 to 1987, then by 2 percent per annum from 1987 to 1990, and in the last year, by 12 percent. The Fed's policy of pumping up bank reserves is futile. Banks will not lend when creditworthiness is falling. What are banks doing with all this liquidity from the Fed? Investing it more and more in Government securities, and less and less in loans to businesses or individuals.

The credit policies of the Bush Administration offer a lesson in futility. Everyone knows the expression, "You can lead a horse to water, but you can't make it drink." The same holds for bankers. The Government can flood the banks with liquidity, but it can't make them lend.

Calls for inflating to dispel the credit crunch have come from economists and bankers alike. Economist John Routledge wrote an article recently in *The Wall Street Journal* titled, "To Revive Economy, Boost Land Prices." He quite rightly described the collapse in asset prices over the past year, but went on to say this can be effectively combated by heavy doses of Fed inflating. He recommended money supply growth rates on the order of 12 percent, as occurred in 1983, and 10 percent, as in 1986. Routledge wrote that "it is the availability of money, not its cost, that is at issue ... The U.S. needs a Roto-Rooter for the banking system." The fallacy of non-price rationing in that remark ought to be obvious. Routledge believes bankers are clogged with liquidity and are simply unwilling to lend it out. Such analysis misses the fact that *they are lending it to the Government*, the only sector of the economy still demanding credit, and still seen as a safe risk.

Prominent economists such as Henry Kauffman also have advocated sharply higher inflating to "cure" the crunch. In a speech to the National Association of Business Economists in October, he attributed the crunch not only to insufficient monetary inflating, but also to the so-called *deregulation* of banks. Economists are not alone in the irresponsible call for more inflating. Bank executives have joined them. Citibank Chairman John Reed has recounted a conversation he had recently with Alan Greenspan. Reed said, "Alan, you know, 3 years of 15 percent inflation would do wonders," and Greenspan is said to have answered, "John, you're not the first to suggest it."

Suffice it to say, calls for continuing the artificial boom of the 1980's by reflation in the 1990's are an invitation to accelerated inflating, and possibly *hyperinflation*. We could well go the way of Latin American countries if some inflationists had their way. Experience has shown that successive waves of accelerated inflating are required to keep an artificial boom going. Eventually, productive economic activity breaks down. To avoid the pain of disinflations requires that we never have the inflations to begin with. Therefore, the question should not be "Why won't the Fed inflate to get us out of this mess?" It should be "Why did the Fed inflate to begin with, encouraging

people and businesses to incur debts that could not be paid when inflation subsided?"

"Too High Interest Rates"

Another fallacy associated with the credit crunch debate is that interest rates are too high, that the Fed must lower interest rates to spur lending and economic recovery. There are many reasons to doubt this argument. First, interest on loans represents revenues to banks; all else equal, banks will not be induced to lend in the face of falling revenues. While wider interest-rate spreads improve bank profits, in many cases these profits have been wiped out by defaulted loans. So even if deposit rates fall due to Fed policy, the loan write-offs that accompany poor economic conditions tend to offset the improvement in bank profits resulting from wider interest-rate margins.

The call to lower interest rates by inflating is also based on the fallacy I mentioned earlier, the fallacy that money is equivalent to credit. In fact, the two are very different. Money is a medium of exchange, while credit is the lending of saved capital. That money and credit are seen as equivalent reflects today's perverse banking system, where the two are dangerously intertwined. Today banks do not make all their loans out of saved capital. In many cases, they make loans (credit) merely by crediting a borrower's demand deposit balances (money). This takes place with the encouragement of the Fed. In effect banks are creating false credit by monetary inflating. If there is a genuine shortage of credit (of saved capital), this cannot be met by printing money.

Still, it is widely believed that interest rates are the price of money, not credit, that therefore the Fed should lower interest rates by printing money, and that availability of credit will follow naturally. If this were so, the inflationary economies of Latin America would have had zero inflation rates and rapidly accumulating savings and capital. Of course they actually have had hyperinflation, triple digit interest rates, and capital flight. Interest rates are not lowered by inflating; on the contrary, inflation premiums are built into interest rates. A sustainable drop in real interest rates can only be achieved when inflation is wrung out of the system and when the supply of genuine credit (saved capital) is increased relative to demand. The supply of genuine credit can only be increased by saving, not inflating.

"Stingy Bankers"

Another mistaken notion surrounding the credit crunch debate is the idea that bankers have become stingy lenders. It is undeniable that bankers have raised their credit standards over the past year. But there is nothing inherent in prudent lending that would deter economic growth. The most stupendous rise in economic growth in the United States occurred between 1865 and World War I, the same period in which bankers were earning their reputation for being conservative, prudent — and yes, stingy. But this credit conservatism did not deter 19th century economic growth.

The view today is different. As economist Henry Kauff-man said recently, "Financial conservatism has the power to stifle economic growth. Stabilization of the economy through monetary policy works through credit crunches ... by limiting or even eliminating access to credit altogether for marginal borrowers. The latest credit crunch is centered entirely on credit quality deterioration." Such analysis ignores the fact that there are always "marginal borrowers" that represent risks to banks. The problem is that a speculative boom fueled by central bank inflation expands credit to an ever greater margin. When the music stops, the marginal borrower can't pay his debts. Unfortunately, we are subjected to Government "monetary policy," not free markets. As such we suffer intermittent waves of euphoria or despair, not properly functioning credit markets. The conventional Government "solution" to the alleged problem of stingy bankers, of course, is to force them to lend.

"Overly Strict Bank Regulators"

Bank regulators have also been blamed for the so-called credit crunch. They are said to have changed audit guidelines from being overly loose to overly strict. In part this is accurate. Regulators whose primary mission is to arrive at a bank after the fact and second-guess lending decisions cannot help but be arbitrary. Political pressures necessitate it. Yet, bad as this arbitrary policy seems, it cannot be said to account for much of today's current stringency. Banks do not need regulators to tell them their loans are going bad. The evidence is overwhelming.

Recall, in fact, that these same bank regulators brought us the previous policy of "forbearance" in the 1980's, a policy of "looking the other way" regarding bad lending practices and depleted capital accounts. Seemingly, regulators relaxed accounting rules in order to hide underlying deterioration. This is hardly the group one would want to rely on to improve our banking system — or our economic prospects, for that matter. But that hasn't stopped President Bush, who told regulators in September to engage in a new round of forbearance. Now, I am no advocate of tough bank regulation — in a free banking context. But I recognize that regulation is in place today because of the subsidies banks receive in the way of bailout mechanisms and deposit insurance. To relax regulations while keeping these subsidies securely in place is the height of irresponsibility — surpassed only by the irresponsibility of providing the subsidies themselves.

[The conclusion of Mr. Salsman's analysis, which considers the actual sources of current credit stringency and recommendations for lasting credit reform, will appear in the next issue of ***Research Reports*** – ed.]

THE OUTLOOK FOR INTEREST RATES

Interest rates have behaved unusually during this business cycle. The present slope of the yield curve suggests that the recovery will continue and that investors expect rates eventually to go up. On the other hand, their perceptions of business conditions and Government policy have encouraged them to seek refuge in short-term debt securities, which could continue to push rates down until fears of a "double dip" recession abate.

Each of the eight recessions that occurred between the end of World War II and 1989 was accompanied by a cycle in interest rates. The peaks in rates occurred an average of 1 to 2 months after the peak in general business conditions and the troughs occurred an average of 7 to 8 months after the economy began to expand. Clearly, cyclical turns in interest rates usually lag the turns in general business activity, which is the reason our composite of short-term interest rates is classified as a primary lagging indicator of business-cycle changes.

The experience during the 1990-91 recession was unusual in that interest rates peaked well before general business activity. Our composite of short-term rates peaked in March 1989 (at 9.9 percent), fully 16 months before the business-cycle peak in July 1990. One possible reason for this early peak was the absence of an inventory cycle in the final stages of the 1982-90 expansion, which mitigated the increase in demand for inventory financing that usually precedes a recession. Prior to the recent recession businesses kept inventories in close balance with sales (although this balance eventually was upset when the recession deepened and sales plummeted).

Interest rates have continued to decrease and in November our composite series of short-term rates was at its lowest level since 1977. The series is appraised as cyclically contracting, which suggests that short-term rates may decrease further before hitting their trough.

Inasmuch as they reflect investor sentiment concerning the future course of interest rates, yield curves can be useful for

assessing the outlook for those rates. That collective opinion can be wrong, but it is worth noting since it may reveal the expectations of those who have put money on the line. Interest-rate theory holds that when investors expect rates to increase, they tend to bid up the prices of shorter-term debt securities to avoid losses from holding longer maturities if rates increase, thereby lowering the yields of the shorter maturities. This behavior results in an upward sloping yield curve.

Oppositely, when rates are expected to decrease, investors tend to bid up longer issues to lock in high yields, and the yield curve slopes downward. If investors expect little change in rates, the yield curve is likely to be slightly upward sloping rather than flat, since investors demand extra compensation for placing their funds at risk for longer periods.

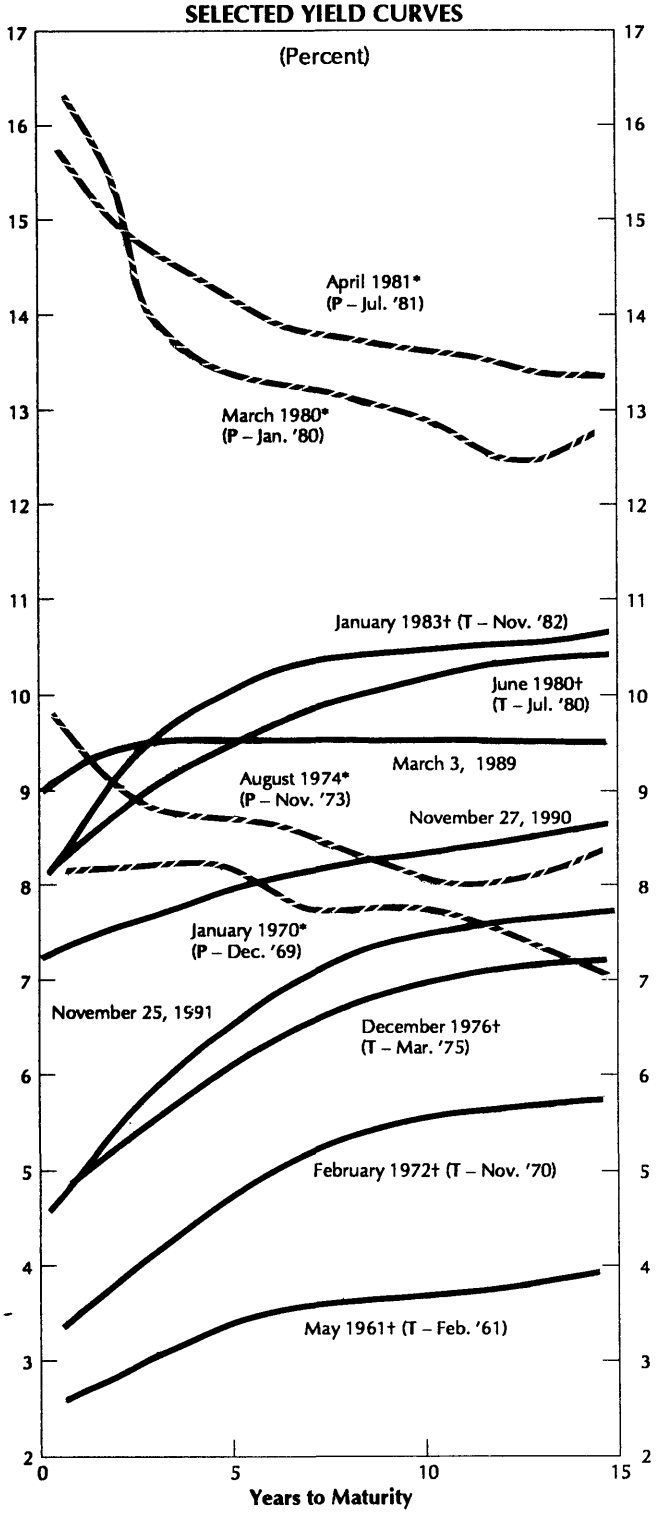
As shown in the accompanying chart, the yield curve for U.S. Government securities is more steeply upward-sloping than it was a year ago. The yields on all securities have decreased, but short-term yields have decreased relatively more and thus the spread between long- and short-term yields has widened. The current shape of the yield curve resembles that observed when short-term rates reached their lows during earlier business cycles, after business activity had reached a low and begun to recover. Moreover, it does *not* have the downward slope that typically reflects the "credit crunch" conditions that have been associated with earlier business-cycle peaks.

In short, the current yield curve suggests that, despite the widespread calls for further interest-rate cuts, investors expect that interest rates will have to *increase* to bring the supply of credit in line with the demand for credit. It also suggests that continued economic expansion (albeit possibly at a very slow rate) is more likely than a "double dip" recession.

The contrary signals being sent by the upward-sloping yield curve and our contracting short-term interest rate series may be evidence that while investors expect the Fed to attempt to keep short-term rates low or even reduce them further, they remain concerned not only about the long-term prospects for "low interest rates" and a "stable dollar" but also the shorter term prospects for alternative types of investments.

Indeed, the current relatively wide spread between long- and short-term rates may suggest the combined effects of Government policy and media reports of business-cycle conditions that have encouraged investors to seek refuge in debt securities with short maturities no matter how low rates go. Given the huge potential credit demands of the Government, which no amount of accounting trickery can conceal, presumably few investors want to bid up prices on long bonds. Similarly, given the present skittishness of Wall Street (revealed in the 120-point spasm in the Dow Jones Industrials Average 2 weeks ago) and the continuing media blitz of "bad" economic news, it is understandable that many investors may be reluctant to take larger positions in equities at this time. For most investors, that leaves short-term Treasury bills and the like, and suggests that short-term rates could stay where they are or move somewhat lower until fears of the "double dip" abate. When that happens (no one can say when) the current shape of the yield curve suggests rates will go up.

SELECTED YIELD CURVES



* Month of peak in short-term rates.
† Month of trough in short-term rates.
( ) Month of business-cycle peak (P) or trough (T).
Note: End-of-month data, except weekly data for March 3, 1989; and daily data for November 27, 1990 and November 25, 1991.

ERRATA

A number of computational errors appeared in the November 18, 1991 ***Research Reports*** article "The Reagan Tax Cuts: A Look at the Facts." Enclosed with this issue is a corrected copy of that article. We apologize for any inconvenience to our readers.

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