The Role of the Credit Slowdown in the Recent Recession

Introduction

On February 12, 1993, the Federal Reserve Bank of New York held a colloquium on the recent slowdown in credit. Two papers were prepared for the colloquium and each paper was reviewed by three discussants. A brief overview of the papers and the comments of the discussants is presented below The full text of the two papers and of the discussants' comments follows the overview

In the first paper, "**Perspective on the Credit Slowdown,**" **Richard Cantor** and **John Wenninger** examine the slowdown in credit from three points of view: (1) a discussion of the events that led up to the credit slowdown, (2) a comparison of recent events with earlier credit crunch episodes, and (3) a consideration of the credit cycle model developed by Irving Fisher and Hyman Minsky and its applicability to the recent slowdown. Each of these approaches provides some perspective on the events of 1989-91 and highlights how demand and supply side factors can interact over the business cycle to produce a slowdown in credit. The discussants for the paper were Benjamin Friedman, Allen Sinai, and Albert Wojnilower.

Benjamin Friedman concludes that while it is possible to document the sequence of events in the 1980s and early 1990s, economists have not adequately explained why the large shifts in leverage ratios occurred As a result, economists are put in the uncomfortable position of having to resort to an explanation that emphasizes changes in attitudes toward debt. Friedman contends that much of what happened in the 1980s could not have resulted from the financing of a large increase in new investment, but rather resulted from a massive increase in leverage that poured billions of dollars "into acquisitions, leveraged buyouts, stock buybacks, and other forms of equity paydowns" for reasons, as noted earlier, that have yet to be clearly articulated.

In his remarks, **Allen Sinai** argues that this recent episode followed the conventional credit cycle pattern set by earlier credit crunches. He observes that tight money in 1988, strong demand for loans, accumulating debt, speculation and speculative finance, and subsequent asset and debt deflation—all elements of previous credit cycles—were present this time as well. Sinai also emphasizes that the credit crunch should be viewed as part of an endogenous process, with each episode differing from its predecessors only in its superficial features. A sophisticated financial system, according to Sinai, can amplify and extend the business expansion as well as contribute to the weakness in economic activity during the recession phase

Albert Wojnilower, in contrast, argues that the recent "credit problem" was not mainly due to cyclical factors Rather, he takes the position that regulatory actions have played an important role in the present credit squeeze, although there has not been a credit crunch in the traditional sense of a sharp credit shutdown, the type of event that often occurred in earlier business cycles Wojnilower also outlines his views of the historical and future evolution of the banking system as a provider of payment, credit, and deposit services in a changing regulatory environment.

In the second paper, "**Credit in the Macroeconomy,**"

Ben Bernanke examines the theoretical reasons why credit creation can have implications for macroeconomic variables such as output, employment, and investment. His paper (1) surveys the literature on imperfect information in credit markets, (2) reviews the credit view of monetary transmission, (3) looks briefly at the phenomena of credit crunches and overleverage, and (4) concludes with a discussion of bank loans and recent economic performance. The discussants for this paper were David Jones, Hyman Minsky, and William Poole.

David Jones considers this latest "credit crunch" to be a new version of the phenomenon. Unlike earlier episodes, it was not triggered by a Federal Reserve move to raise interest rates above Regulation Q ceilings, a move that in the past induced disintermediation. Rather, this latest version reflected, Jones argues, the savings and loan debacle, the toughening of bank capital ratios, the debt excesses of the 1980s, the stock market collapse, and the bankruptcy of Drexel in February 1990. The puncturing of the financial bubble provided a fertile environment for a credit crunch and produced a "balance sheet" recession. Jones contends that this latest credit crunch demonstrates how powerful the credit channel can be when borrower confidence is shattered by a credit crunch that is "arbitrary, sudden, and unpredictable."

In his remarks, **Hyman Minsky** expresses doubt that any macroeconomic theory based on assumptions that money, credit, and finance are neutral or irrelevant can be of use to policy makers. He is also skeptical that the asymmetrical information approach is capable of producing a consistent model of the interaction of credit and economic activity at the micro and macro levels. Rather, Minsky stresses that a capitalist economy should be modeled in terms of interrelated balance sheets, payment commitments, and expected cash flows that link the past, the present, and the future. Capital assets are an important part of this process, in his view, because they yield income flows over time and can be pledged to obtain credit, and because demand for them often depends on external financing terms.

William Poole questions whether credit is an important determinant of the business cycle. In his comments, he argues that the credit view of the business cycle tends to confuse surface appearances with basic economic forces. He is critical of the tendency of some analysts to assume that the credit effects on individual agents have macroeconomic implications when in fact the credit effects may cancel out at the aggregate level. Poole concludes that it is difficult to make a convincing case that credit effects are a significant cause of the business cycle; in his view, the cycle is driven by unexpected changes in inflation and revisions in forecasts of future expected income flows.