Not A Blown Fuse

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The paper by Cantor and Wenninger, and indeed the very theme and place of this conference, are welcome signs that the Federal Reserve Bank of New York tradition thrives and is regaining confidence and respect. It is a tradition that has steadfastly held that credit and financial markets matter, and matter a great deal, whether or not that view happens to be in academic favor. Yes, there is a credit cycle such as they sketch, although they are guilty of an important omission to which I will call attention later. The credit cycle replicates itself because in matters financial human beings irrationally but predictably repeat, albeit never quite exactly, the errors of judgment about which we read in our history books. In our decision making, recent and salient experience tends to crowd out the past, and disproportionately so among the gambling spirits attracted to the financial markets. But we should be grateful for that forgetfulness, because probably few if any great enterprises or industries would exist today if in the critical early stages they had been held to truly hardnosed credit standards, not to speak of today's austere criteria.

Notwithstanding the title of today's colloquium ("The Role of the Credit Slowdown in the Recent Recession"), nor the generosity of Cantor and Wenninger in citing my 1980 Brookings paper on the cyclical role of credit crunches—which has attracted more notice in the 1990s than it did in the 1980s—the current credit problem is not primarily cyclical. Although I was among the first to call attention to the post-1988 regulatory credit strangulation and to point out its parallels with the 1930s, I also emphasized from the start that there has been no credit crunch in the generally accepted sense of a widespread, sudden, sharp, indiscriminate, and rather brief credit shutdown. Unlike some earlier occasions, the credit lights did not go out because an overload blew an easily replaced fuse. Rather the lights have dimmed because of an insufficient supply of current due to serious and progressive damage to the generator. Like the examiner-enforced credit liquidations of the 1930s, the present credit squeeze did not figure prominently in triggering the business downturn, but it is insidiously sapping the vigor of the ensuing recovery. I can empathize with the sense of relief my friends at the Federal Reserve must be feeling now that the intensity of the "crunch" they helped to make has peaked and economic recovery is well established. But it would be a serious error, I believe, to declare the problem ended along with the recession, and to regard today's discussion as a mere post mortem on a closed episode in history.

Pretend we were observers from a distant planet who only bothered to look at the earth every five years or so. In 1988, we recorded that the earth's leading economic powers stipulated at Basle that henceforth their then most important financial institutions, the commercial banks, would be authorized to lend boundlessly to those governments, but would have to back with sizable capital any loans to the private sector. What changes in the relative size of the government and private sectors would we expect to observe on subsequent flybys?

In 1993, we would note that, at least in the United States, substantial additional restrictions on risk-taking had been and were being placed on banks. These include tough capital constraints on the extent to which short-term deposits can be used to acquire longer term assets (such as more-than-three-year government securities), as well as many new restrictions on the acquisition of other-than-prime assets. We would also note steps to limit the scope of, and increase the charges for, deposit insurance. Meanwhile, public access to fully guaranteed government-issued deposit substitutes such as U.S. Treasury securities (or, in

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Japan, postal savings accounts) is facilitated and promoted. The public also has more reason to expect that the value of deposit substitutes such as money market funds will be protected and that governments will intervene strongly against major stock price declines.

The extraterrestrial observer must conclude that government obligations and/or private instruments free-riding on implicit government guarantees will expand at the expense of the traditional deposits. Issuers of deposit liabilities—banks, that is—will shrivel. Since banks are also important lenders, clearly there is need, incentive, and opportunity for new mechanisms to assume the lending role that banks are being forced to vacate. At least in the transition, problems are faced by those borrowers, especially small, young, or novel enterprises, for which an alternative and cheap credit source is not readily at hand. Relief of these problems is vital to the survival of an enterprise economy in the United States.

The financial institutions being phased out, the observer would also note, happen to be those most intimately connected with the earth's payments systems. These payments systems, the observer would be aware, are among the greatest of human inventions, hugely broadening the extent of the market and the division of labor. Important as was the invention of money in the form of coin and, later, currency, their substantial replacement by transferable deposits has provided even more dramatic benefits. When we receive a check we do not need to concern ourselves with the identity of the bank on which it is drawn. The smooth operation of this system, which although relatively recent is by now taken for granted, is the province of banks under the supervision and with the help of central banks.

Owing to the decline of the banks, the organization of the payments system, too, will have to change. Perhaps the checking account function could all be handled by and through the Federal Reserve, much as in some countries (and to an extent here in the United States) it used to be done through the post office. Alternatively, we might create special "banks," obliged to keep 100 percent reserves, solely for this purpose. The public would pay them for operating a state-of-the-art safe deposit, message, and bookkeeping system. Or, as Litan has suggested, we could establish so-called narrow banks allowed to invest, but only in safe (mostly government-backed) assets. The interest earnings would reduce or eliminate explicit charges to the checking account customers. In fact, sterilizing banks in this manner seems to be the conscious or subconscious intent of the current regulatory thrust. But among undesirable side effects would be the enlargement of the government's already preferential credit access and the creation of a dangerous potential for huge disruptive shifts out of uninsured into insured deposits and deposit substitutes whenever whispers of credit weakness were heard.

Continuing along this spectrum of payments system possibilities, we would come next to the banking structure that we now have but that, as already indicated, is unlikely to survive. Moving along further, one might visualize payments systems operated by financial institutions newly formed to evade the official restrictions that are driving banks out of the business, or by industrial firms that do not have to answer to the monetary authority at all.

Indeed, some earthlings appear to believe that securities can take the place of deposits in the payments system. "Sorry, honey," purrs your supermarket checker, "but you can't take these groceries because, according to this computer, your mutual fund just dropped .1 percent, and your account is overdrawn." In such a world, political realities would eventually make it the government's job to stabilize a broad range of government security and other asset prices. Actually, it is mainly the governmental backing of the instruments, most issuers, and when necessary the primary dealers that has made possible the principal form of securitization, that of mortgages. More dramatically, would the New York Stock Exchange be alive today if the Crash of 1987 had gone unheeded and unmitigated by the Federal Reserve Bank of New York and much higher authorities? Suppose, further, that every balance sheet had been marked to market that night and that in the morning all the auditors and examiners had followed to the letter the rules to which they were sworn? It is the many such instances of ad hoc governmental intervention and forbearance, not any articulated policy, that explain why Cantor and Wenninger's missing credit crisis hasn't happened.

To this earthbound observer, the most likely path of least resistance in filling the banking vacuum, in both its lending and payments dimensions, is for these functions to be assumed by major nonfinancial enterprises operating through captive finance companies in conjunction with (possibly also captive) money market funds. The money market funds hold the paper of the finance companies and/or their parents. Whatever the merits or drawbacks of such an arrangement, it would have in common with the existing banking system that a risk-taking lending institution was financing itself, directly or at short remove, with liabilities that are regarded by their owners, as well as by Federal Reserve statisticians, as part of the stock of money. In principle the difficulties in providing implicit or explicit insurance for the liabilities, modulating their quantity and quality, and ensuring the integrity of the payments

mechanism would remain the same. But in practical terms, they would be far more daunting because of the likely industrial, employment, and political linkages, international as well as domestic, of the giant companies involved We may be sure from current and past examples that such companies would be prone to the same frailties, including abuse of power, as their financial precursors "Too big to fail" would take on an even more literal and much larger meaning

The consequences of the direction we take extend far beyond the financial sector Critical changes in the financial machinery can affect the chief dimensions of society Alternative outcomes with respect to the split between the governmental and private credit machinery, the extent of bias in favor of large or established borrowers, and the lodging of economic control will have profound repercussions A universal banking system of the German stereotype, in which large banks hold influential equity positions in industry, produces a very different power structure from the Japanese stereotype, in which the large industrial empires dominate the banks Either path would diverge sharply from American tradition, which is highly suspicious of concentrations of power in both finance and industry and anxious to preserve regional and even local autonomy

Historically, our payments, deposit, and credit systems have been joined together in banks The revenue from credit has paid for the deposits and the checking account operations But competition for assets from securitization, and for deposits from de jure and de facto government-guaranteed instruments such as Treasury bills and money market funds, has reduced the revenues. Now, on top of this, the new regulatory capital and other constraints, by eroding traditional earning opportunities in lending and maturity transformation, are taking a further big bite No wonder so many banks are exiting the banking business, both voluntarily and involuntarily (Tables 1 and 2 present some further pertinent data)

My views on these matters are clear, I do not pretend to be impartial. Both the payments and the credit systems have been and should continue to be regarded and treated as public utilities Banks should not be required, encouraged, or even allowed to withdraw from lending and maturity transformation, any more than an electric utility would be permitted to withdraw service from part or all of its territory For banks as for other utilities, we should limit competitive access, ensure adequate but capped returns, and restrict ventures in unrelated fields Of course the specific rules, like any living institution, must change and adapt The "credit crunch" that is the subject of this meeting has important cyclical and monetary ramifications, but it is fundamentally and most importantly a complex problem in public utility regulation

Let me add one more quotation from the 1980 paper

Table 1

Depository Institutions' Managed Liabilities

Annual Average Percent Change

1960-64	11 6
1965-69	8 9
1970-74	13 5
1975-79	11 9
1980-84	10 0
1985	8 4
1986	6 7
1987	5 6
1988	6 8
1989	4 1
1990	−0 1
1991	−1 9
1992	−4 5

Source Board of Governors of the Federal Reserve System, H 6 statistical releases (Money Stock, Liquid Assets, and Debt Measures)

Notes Liabilities include overnight and term repurchase agreements and Eurodollars, savings and money market deposits, and small and large time deposits Entries in table are based on annual averages of monthly data. For January-February 1993, preliminary data show a decline of 3 1 percent from the 1992 average, 5 2 percent from January-February 1992, and 8 4 percent (at an annual rate) from the fourth quarter of 1992

Table 2

Growth of Private Sector Credit by U.S.-chartered Commercial Banks and by Foreign Banking Offices in the United States

Percent Increase to Year-End

	Domestic Banks	Foreign Banks
1983	9	0
1984	13	12
1985	11	26
1986	11	31
1987	7	20
1988	8	19
1989	8	13
1990	3	15
1991	−2	21
1992	1	7

Sources Board of Governors of the Federal Reserve System, Flow of Funds Accounts and G 7 statistical releases (Loans and Securities)

Notes The above data include small amounts of loans to foreigners In December 1992, business loans to non-U S addressees plus loans to foreign banks amounted to only 4 3 percent of their total loans of $274 billion The corresponding figure for domestic banks was 0 3 percent of $1,384 billion

cited by Cantor and Wenninger. I asserted that following each crunch, "the authorities ... and the private markets ... have deliberately reshaped the financial structure so as to prevent the recurrence of that particular form of credit supply interruption." In the current context, I would put that a bit differently. Whenever the world embarrasses the authorities, they try to reshape the world in a fashion that, they believe, will make it impossible for them to be embarrassed that way again.

Whatever the many justifications, good and bad, for the abolition of the Regulation Q interest rate ceilings, the dominant impetus came from the determination of the authorities to prevent the recurrence of disintermediation-provoked credit crunches. To dismantle the ceilings, without serious plans to deal with the inevitable bloodbath in the overpopulated financial zoo, was an act of recklessness. As a matter of sheer survival, most financial institutions urgently had to expand their credit volume to make up for shrunken profit margins. That response is what caused the overexpansion of credit and subsequent failures. Now, surprised and embarrassed by these failures (how could the exalted free market make such huge mistakes?), the authorities have reacted by making it difficult, perhaps impossible, for the firms under their sway to assume the risks necessary to remain profitable as financial intermediaries in the long run.

This returns me to the critique I promised at the outset. For all their cordial review of Minsky's thought, still missing from Cantor and Wenninger's ten-step credit cycle chronology is any admission that organizational, technological, and regulatory change in finance can and does move the world. All that the authors grant to credit is a reactive role, one that may amplify but cannot initiate change beyond the financial sector.

That attitude lets the authorities off the hook. Their obligation remains only to follow the correct rulebook on monetary aggregates and the federal funds rate. But the fact that most Fed economists do not wish to be public utility regulators—because that confers little academic prestige?— does not excuse the institution from its responsibility.

Recently a football star was paralyzed by an injury sustained on the field of play. The whole country is surprised and delighted to see him regaining the use of his limbs. But he will never play ball again. The same for the damage done by the so-called credit crunch. Although the banks are walking again, the long-range consequences are beginning, not ending.