

Credit Conditions: Crying Wolf or Crying Time?



Based on a presentation by Jeffery W. Gunther,
Research Officer, Financial Industry Studies Department,
Federal Reserve Bank of Dallas

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Credit Conditions:

Crying Wolf or Crying Time?

Regulators have sounded the alarm regularly over the past five years, warning of an impending decline in banking conditions. In much the same way, each year one economist or another has predicted a sharp slowdown in the national economy. But as the economy continued on its steep upward path, both the financial and economic doomsayers only earned the title of the boy who cried wolf. Until, perhaps, now. Recently, the voices of gloom have become a chorus, as each day brings fresh signs of a dramatically slowing economy. Everyone now accepts that the economy has begun a substantial correction. Corporate boards across America are cutting investment plans. Many are uttering the “R” word. Even those observers harboring the most ardent faith in the economy’s growth potential and inherent stability have had to ask themselves whether perhaps the wolf is really here this time. In the words of Buck Owens and Ray Charles, maybe it really is “cryin’ time,” and the economic expansion, like a lost love, is now walking out the door.

I will first go over some of the most noteworthy causes for concern regarding the economic outlook, focusing mostly on credit conditions. Some observers feel the current economic cycle may be different from previous post-war cycles, in that the length of the expansion and the prolonged absence of rising inflation have allowed credit levels to grow too high.

After reviewing some troubling statistics, most of which have been vividly portrayed in the media, I will present a case for the hope that it is not crying time, at least not yet. Given that

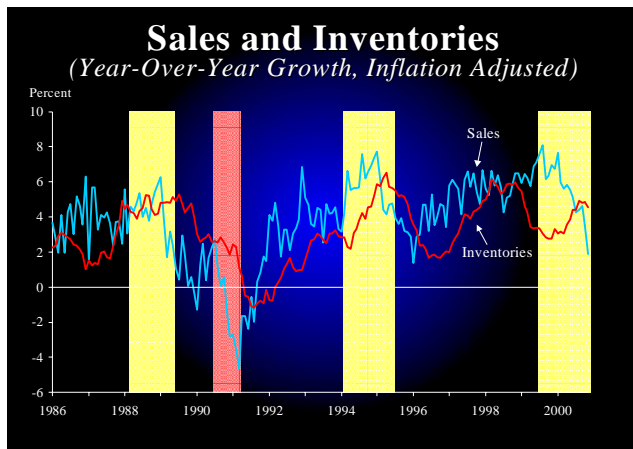
business conditions have faltered, the possibility arises that the credit markets might pull back sharply and for an extended period, thereby exacerbating economic difficulties. However, another possible outcome is that problems in the credit markets might be resolved without too much disruption. Stability in the process of financial intermediation could then help sustain economic growth. This latter scenario appears to be the most likely. If we have a recession, the banking sector in particular will not be to blame.

Causes for Concern

Sales and Inventories

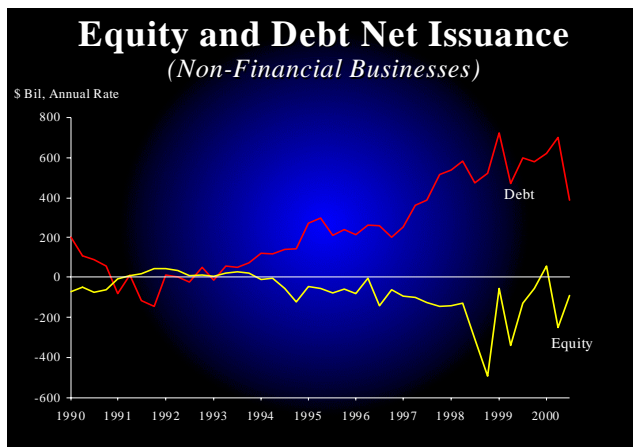
Perhaps the starkest portrayal of the current economic challenge is offered by the data on business sales and inventories. In the accompanying chart, the yellow areas correspond to periods of monetary tightening, while the red area denotes the last recession. Near the end of the tightening that began in March 1988, growth in business sales slowed dramatically, falling substantially below growth in inventories. With inventories growing much more rapidly than sales, production growth slowed so that the excess inventories could be eliminated. Similarly, the monetary tightening that began in February 1994 also led to a sharp reduction in sales growth, which again fell below the growth in inventories. And more recently, with the tightening that began in July 1999, sales growth has once again slowed, again falling below the growth in inventories. In particular, sales growth in November of last year was absolutely dismal, leading to an ominous gap between growth in sales and inventories. Moreover, November was

the last month for which these inflation-adjusted sales and inventory data are available, and the situation may have deteriorated further since then. The implication is that production will slow considerably. This notion is consistent with the low levels in January of the National Association of Purchasing Managers indices of manufacturing and non-manufacturing activity.



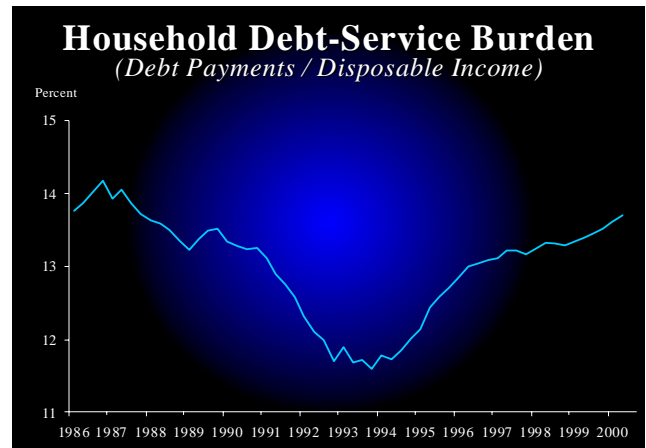
Equity and Debt Net Issuance

Some have said the current slowdown will be exacerbated by credit difficulties. The last few years saw an explosion in corporate debt, as firms shunned equity financing in favor of debt. Many feel this situation has created a debt trap for U.S. corporations.



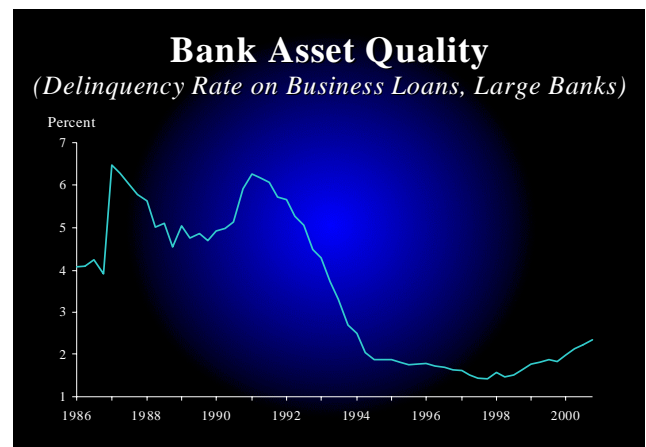
Household Debt-Service Burden

In addition, households have taken on debt aggressively, to the point where the proportion of their disposable income devoted to interest and principal has risen to levels similar to those prior to the last recession. And the payment burden is even higher, once you include auto lease payments.



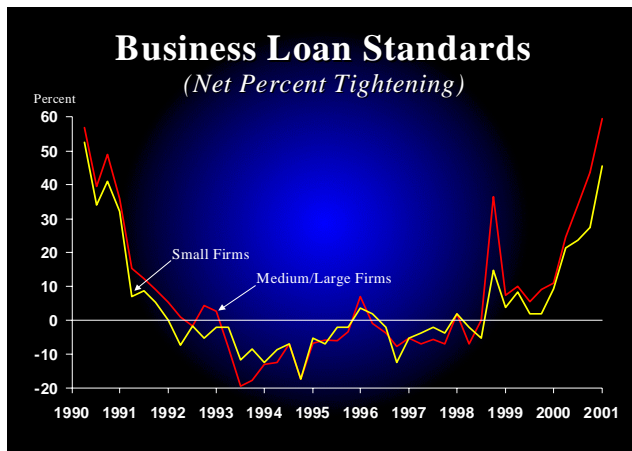
Bank Asset Quality

You do not have to look far to see that credit conditions are deteriorating. The delinquency rate on loans extended to businesses has been rising since 1998, especially for large banks. While the delinquency rate is still low compared with the heights reached during the last recession, its three-year upward trend is nevertheless disturbing. The delinquency rate rose substantially in the fourth quarter of last year and is likely to continue rising.



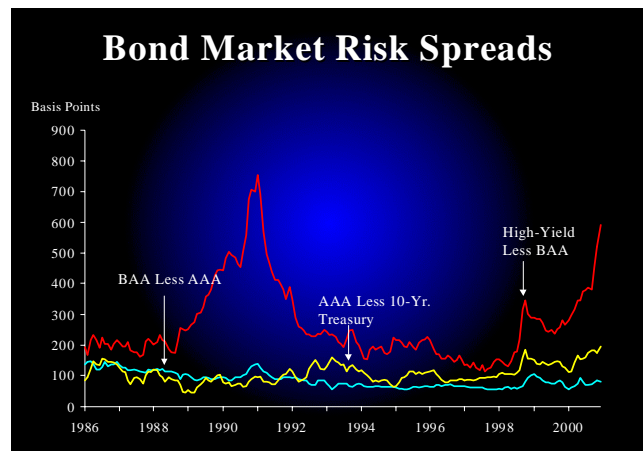
Business Loan Standards

Accompanying the increase in problem loans has been a tightening of the standards banks use in extending business loans to firms of all sizes. Based on the Fed's Senior Loan Officer Opinion Survey for January, almost 60 percent of domestic banks are tightening their standards on business loans to large and middle-market firms, and 45 percent report tighter standards for small firms. Banks are also strengthening loan covenants and charging higher premiums for riskier loans. The move to a more conservative lending posture is a natural response to deteriorating credit quality and a worsening economic outlook. Banks are also tightening standards on commercial real estate loans.



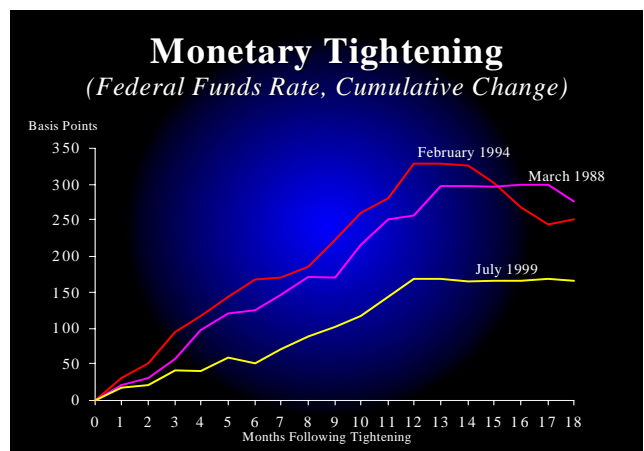
Bond Market Risk Spreads

This tightening of the standards on bank loans to businesses is part of a broader movement in the credit markets toward a lower tolerance of risk. This chart shows the spread between the rates on bonds of various grades. The spread between yields on low-grade and high-grade bonds reflects a premium for risk. Rising risk premiums are associated with tighter credit conditions and increase the price firms pay for financing. AAA-Treasury and BAA-AAA spreads began rising in 1998. And the spread between high-yield, or junk, bonds and BAA bonds has risen dramatically, reflecting growing concerns over the creditworthiness of relatively weak or less established firms.



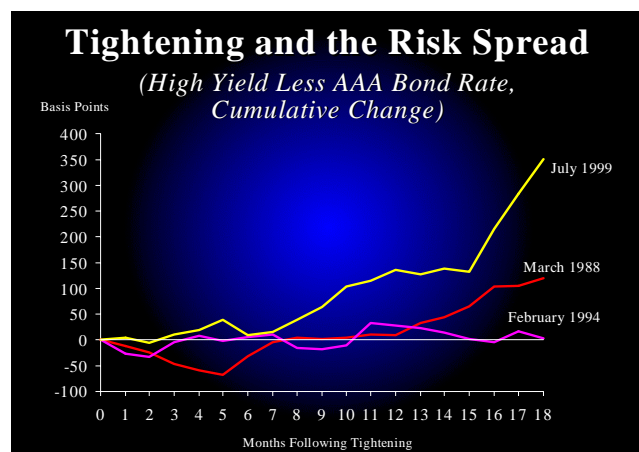
Monetary Tightening

One possible factor behind the deterioration in credit conditions is the monetary tightening engineered by the Fed beginning in July 1999. However, the increase in the fed funds rate during this most recent tightening was smaller than the increase that occurred over the same amount of time during the monetary restrictions that began in March 1988 and February 1994. By this account, the most recent monetary tightening was relatively mild. Admittedly, this is a simple characterization based solely on changes in interest rates, thereby abstracting from, among other things, the level of interest rates at the beginning of each tightening episode. Nevertheless, the most recent tightening appears relatively mild, whether changes in nominal or real interest rates are examined.



Tightening and the Risk Spread

Now contrast the mild nature of the recent tightening with its relatively severe associated developments. The spread between high-yield and AAA bonds rose by a relatively large amount from the time the Fed began tightening in July 1999 to the end of last year. In contrast, the response of this spread was subdued during the first 18 months of the previous two monetary restrictions. The recent rapid widening of the spread points to the existence of additional contributing factors besides monetary tightening alone.



Behind the Slowdown

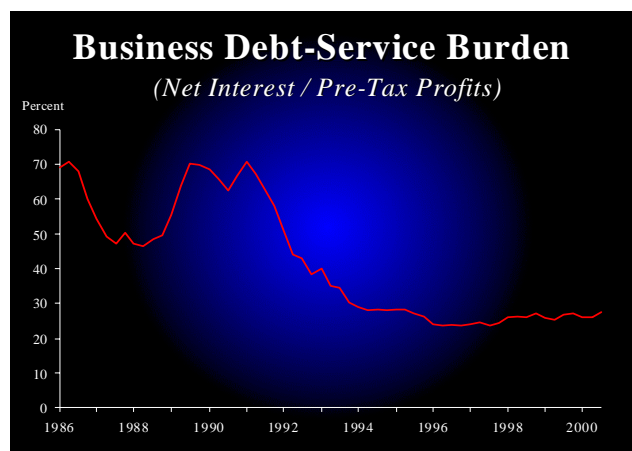
A number of factors may have contributed to slower growth, lower profits, and tighter credit conditions. Potential factors include high oil prices, an extremely cold November-December, a sifting effect as firms attempt to gain the upper hand in a changing environment, and media doom and gloom.

Reasons for Optimism

While we obviously cannot afford to be sanguine about the economy's potential lack of near-term strength, there are good reasons to believe the adjustment we are going through currently may be less severe than some would have us believe.

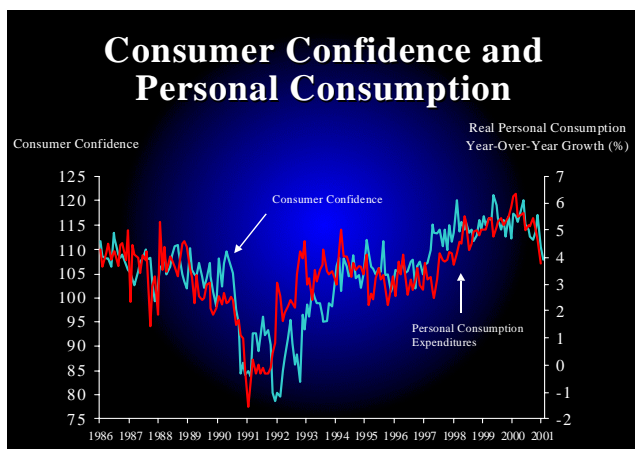
Business Debt-Service Burden

One reason for optimism is that by some measures the debt-service burden of U.S. corporations is only moderate, a fact that most media sources will not tell you. For non-financial businesses, net interest payments as a percent of pre-tax profits fell during the early 1990s and have remained relatively low. In other words, the coverage of interest payments by profits is now much higher than before the last recession. These data are not consistent with the notion of a debt trap. Admittedly, these are aggregate data, and the debt-service burden for many firms is much higher. Nevertheless, the relatively low level of interest expense relative to profits in the aggregate suggests the debt-trap scenario is not widespread.



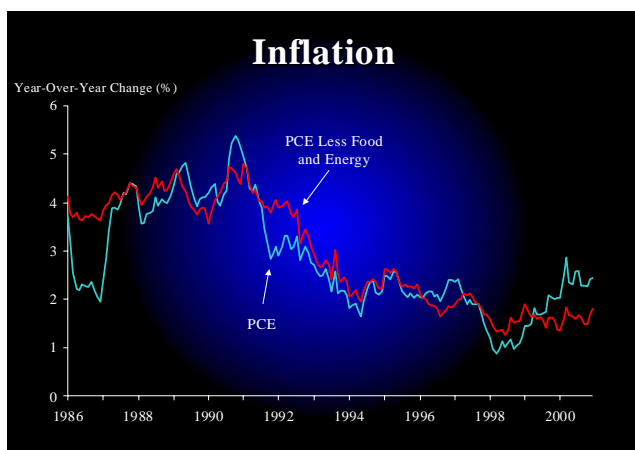
Consumer Confidence and Personal Consumption

A second reason for optimism is that consumer confidence, while falling, has not yet reached critical levels. Confidence has taken a big hit, but it still compares favorably with most of the last 15 years. Personal consumption expenditures track consumer confidence fairly closely. If confidence does not slip too far, a prolonged slowing of consumer spending most likely will be avoided.



Inflation

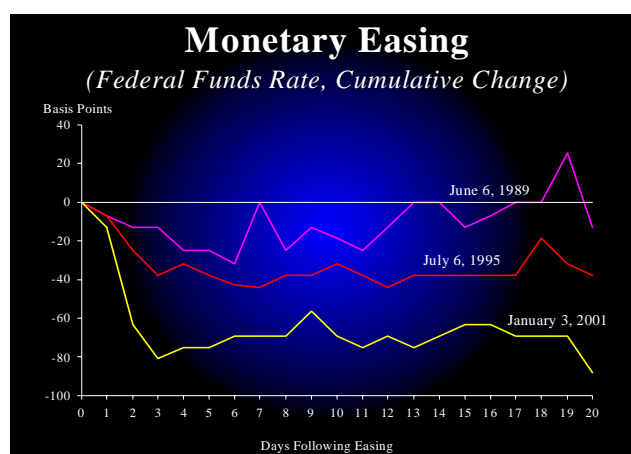
A third reason for optimism is the inflation picture. The recent increase in inflation as measured by the price index derived from personal consumption expenditures (PCE) has leveled off. Moreover, inflation as measured by the core PCE, with volatile food and energy prices taken out, is performing even better. Core inflation has risen relatively little, reflecting the impact of rising energy prices on the overall price level. The relatively low and stable rate of inflation gives the Fed much more room to lower borrowing costs than it had prior to and during the last recession, which was characterized by high and rising inflation rates.



Monetary Easing

A fourth reason for optimism is monetary easing. The Fed has lowered the target fed funds

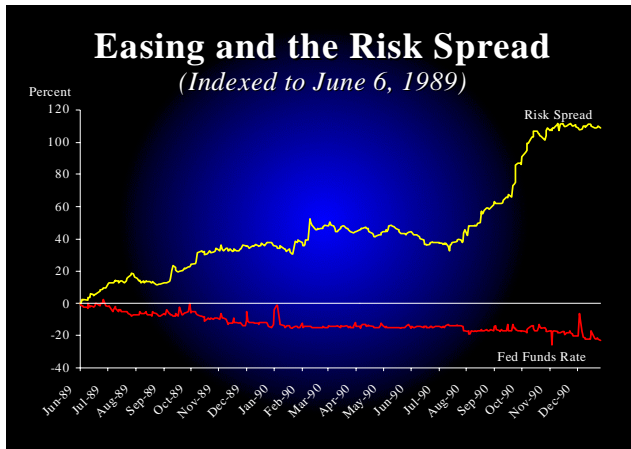
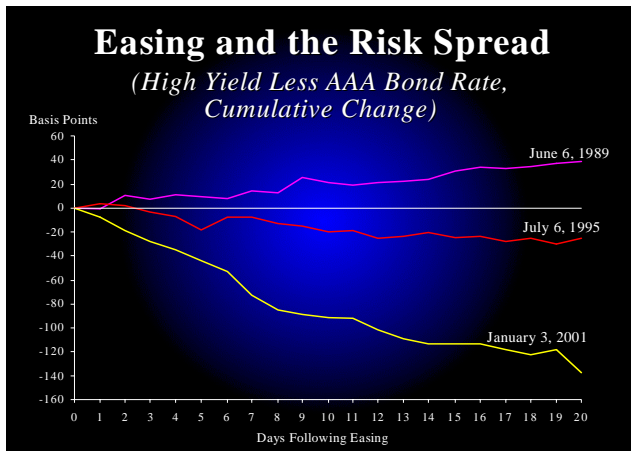
rate 50 basis points twice this year. These aggressive moves to lower borrowing costs are already resulting in important distinctions between credit conditions currently and those that existed prior to the last recession. The accompanying chart shows the magnitude of the three episodes of monetary easing that followed the three periods of monetary tightening we have already examined. The reduction in the fed funds rate during the current easing has been larger than the reductions that occurred over the same amount of time during the previous two episodes of monetary easing.



Easing and the Risk Spread

A fifth reason for optimism is that the securities markets have responded favorably to the monetary easing that has occurred so far, as reflected in a substantial reduction in the spread between high-yield and AAA bonds. While the risk spread is still high, it is moving in the right direction. And the reduction in the spread compares favorably with the early phases of the previous two periods of easing.

An examination of the entire period of easing that began prior to the last recession reveals that the risk spread never really declined much and, in fact, continued to rise. This is in sharp contrast to what we have seen in recent days.

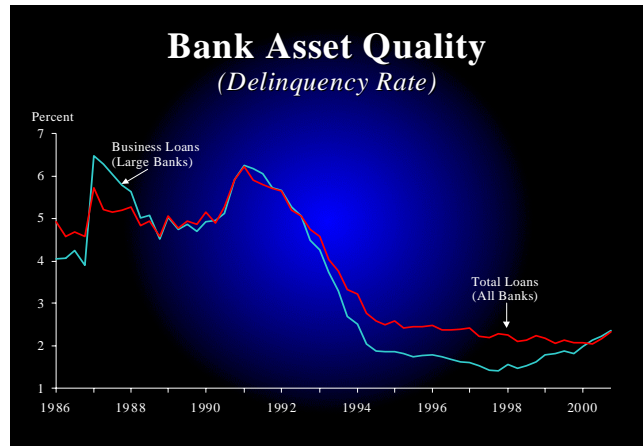


Overall Bank Asset Quality

A sixth reason for optimism is that, despite the tightening in standards, banks are in good shape and are in the position to continue lending to viable firms and consumers. While the delinquency rate for business loans at large banks has been rising for three years, the worsening in overall loan quality has been relatively mild. For the banking system as a whole, with the smaller banks included, the delinquency rate for total loans has been relatively stable and increased only in the last year.

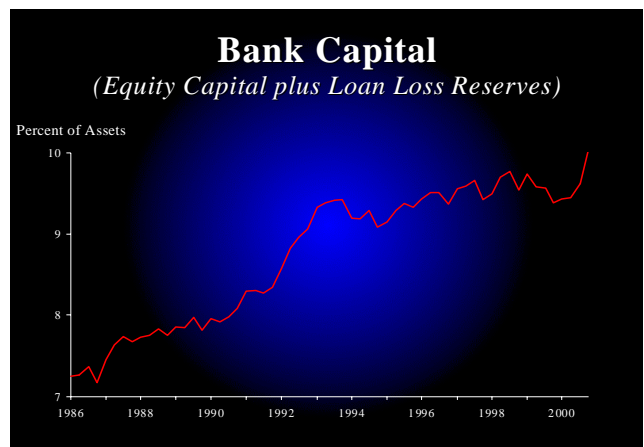
There is likely to be some continued deterioration in loan quality going forward, but it is moving off a very favorable base. The banking system is sufficiently healthy to continue lending. This situation contrasts sharply with conditions just prior to the last recession, when the banking

system was burdened with high levels of delinquent loans.



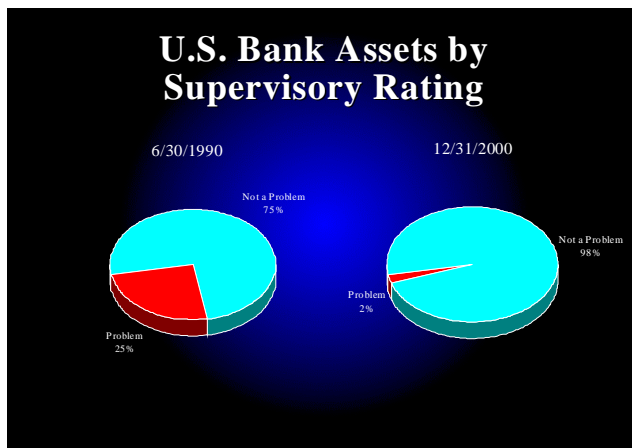
Bank Capital

A look at bank capital provides an even more favorable comparison. The ratio of capital to assets at U.S. banks currently compares very favorably with that of the last 15 years. Most notably, the aggregate capital ratio is considerably higher than it was entering the last recession, when banks, already carrying a heavy load of troubled assets, were struggling to improve their capital positions under the newly adopted risk-based guidelines. Whereas the adjustment to higher capital requirements worked against any expansion of lending activity during the last recession, the current high levels of capital provide banks with the financial standing necessary to support a continued expansion of lending activity.



Bank Assets by Supervisory Rating

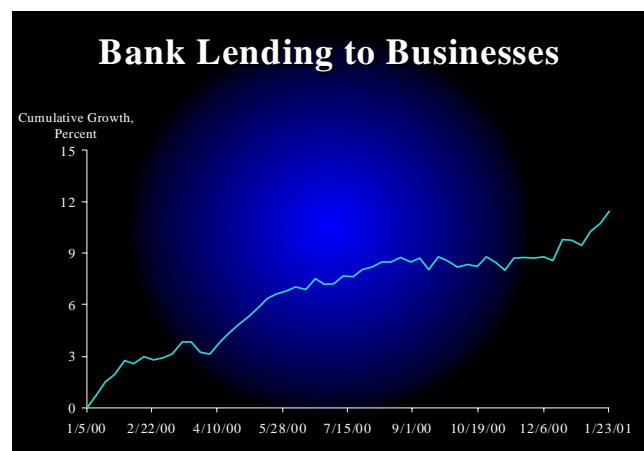
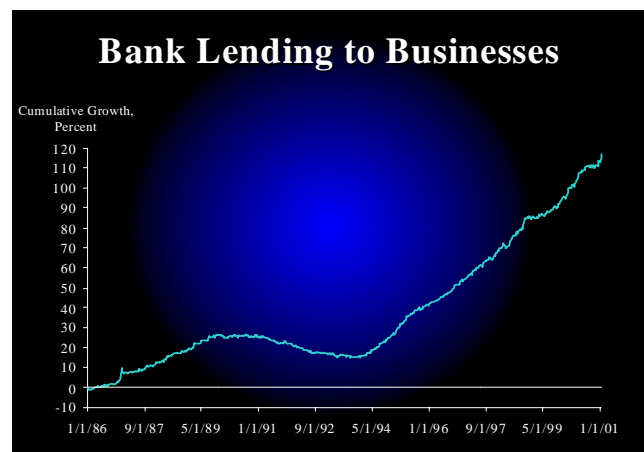
The strong position of banks currently is summarized in the ratings assigned by supervisors after an on-site exam. In June 1990, just prior to the last recession, banks that had been assigned a problem rating accounted for 25 percent of the banking system's assets. In contrast, as of the beginning of this year, only 2 percent of the banking system's assets were held by problem banks. Because on-site exams occur only infrequently, the Fed employs a statistical model based on financial ratios to predict the supervisory rating each bank would receive if it were examined. The results from this model are available quarterly, the same frequency at which the banks submit financial statements. The results of this model suggest problem banks may have accounted for 5 percent of the banking system's assets at the end of last year. This still compares favorably with the banking situation going into the last recession.



Bank Lending to Businesses

Business loans flattened prior to the last recession before falling substantially, even in nominal terms. However, since 1994 loan growth has remained high, reflecting both favorable banking conditions and strong economic growth.

Looking more closely at last year and January 2001, the weekly data on business loans show continued strong growth. Given the tightening of loan standards, together with weaker demand for loans to finance capital expenditures or mergers and acquisitions, the continued increase in lending activity most likely reflects a shortage of internally generated funds at businesses and an increased need for inventory financing. In addition, some businesses have responded to tightness in the securities markets by switching to bank loans.



So why has loan growth remained strong, even as credit standards and terms have been tightened? Banks obviously like to see their loans repaid. As a result, they may be willing to help borrowers through bad times, if doing so will prevent writing off loans. In addition, the

value of borrower relationships may prompt banks to renew maturing loans, even when the condition of borrowers has temporarily worsened. These considerations suggest banks may provide more of a cushion to borrowers than the media stories would lead one to believe.

Conclusion

Nobody doubts the economy has entered a significant correction. The suddenness of the slowdown is cause for concern. However, there are also reasons for optimism. Very important among those I have mentioned is the combination of aggressive monetary easing and a healthy banking system. The Fed's quick and strong response to emerging economic weakness has been made possible by a favorable inflation picture, especially when compared with the periods preceding previous recessions. As for the banks, they are not without some significant problems, but the financial status of the banking system overall is very good, and the process of financial intermediation should continue on course.

A final reason for optimism, and probably the chief one, is the remarkable performance of the U.S. economy in recent years. U.S. businesses have proven themselves adept at harnessing new technology to raise productivity. The pace and size of technology's strides have led to the introduction of all sorts of new businesses and new business models, some of which have failed or will fail. But the surviving businesses are made stronger. Taking all these considerations into account, the economic situation may not be so dismal after all. Our love's suitcase is packed, but we may yet convince her (or him) to stay a while longer.