LEADING INDICATORS OF, AND POLICY OPTIONS ON CREDIT CRUNCHES

An address to the Victoria University of Wellington Money and Finance Association Conference on 16 August 1991,"Credit Crunches" - Causes and Cures", by Dr Don Brash, Governor, Reserve Bank of New Zealand.

May I first say how honoured I am to join the distinguished panel of international speakers that the Money and Finance Association has attracted to this conference on "Credit Crunches - Causes and Cures". I trust overseas visitors will take away pleasant - and positive! - memories of New Zealand.

My role is to talk about "Leading Indicators of and Policy Options for Credit Crunches". I would like to focus on the New Zealand experience and in particular the role of the Reserve Bank as New Zealand's central bank.

Is There a Credit Crunch?

There is much talk overseas about credit crunches, both on a regional level and a global level.

Governor LaWare, (of the United States Federal Reserve Board), earlier offered two definitions of a credit crunch. One described the condition which exists when the demand for credit far outstrips the capacity of the financial system to supply it. As I recall, Governor LaWare said that this definition did not tally with the recent experience in the United States.

Let me say here that I don't believe it applies to New Zealand either. There are no signs that the New Zealand financial system is *unable* to meet demand for credit.

Our registered banks have, in fact, been building up their capital ratios to an extent that the aggregate total risk-adjusted capital ratio in March 1991 was 10.5 per cent. All but one bank recorded capital ratios above the current 7.25 per cent minimum requirement and above the 8 per cent minimum requirement they are expected to meet by the end of 1992 - and that bank has, for a variety of reasons, subsequently converted to branch status.

Some critics have said New Zealand banks are prevented from extending credit by the Reserve Bank's large exposure limits. I would like to make two points on this issue.

First, recognising the characteristics of the New Zealand scene, with a small number of very large corporates, the Reserve Bank consciously chose a relatively high limit of 35 per cent on large exposures. It is worth noting that the Basle Committee recommended that countries reduce that limit to 25 per cent, though at this stage we have no intention of doing so.

Secondly, almost all New Zealand registered banks that are involved in lending to the corporate sector are branches of, or are owned by, much larger international banking groups. This clearly gives banks scope to transfer the risks associated with their exposure to large New Zealand corporates to the extent required by a New Zealand limit on large exposures.

Happily, there are in fact very few bank exposures which currently exceed the 35 per cent limit.

Governor LaWare's second definition described the situation where the demand or need for credit outstripped the *willingness* of the financial system to lend. He believed that that was the case in the United States. Is it the case in New Zealand?

I would have to say that, here, the picture is not so clear.

Many New Zealand companies borrow overseas, and there can be several reasons why they might find it difficult to raise finance on *overseas* markets. Foreign banks may be having difficulty raising capital themselves or grappling with strains on their existing capital because of loan loss provisions, or a local recession.

Overseas experience shows that through much of the 1980s, capital was not an immediate constraint for banks. The sharp rise in lending, due partly to deregulation, generated bouyant profits; new forms of capital were available; and profits were overstated by the failure to make sufficient provisions. But studies overseas suggest that, in some countries, capital is likely to become a more binding constraint on banks than was the case in the early 1980s.

Capital markets have tightened for various reasons. Europe is faced with a new set of circumstances, following on from Germany's reunification and reforms in Eastern Europe.

Japanese banks have pulled back, partly because of the constraints they faced after the stock market decline there last year, and partly because capital is apparently being diverted more into domestic demand for infrastructure.

Finally, on overseas markets, the creditworthiness of New Zealand and Australian borrowers *may* be an issue, following the corporate failures that have occurred on both sides of the Tasman.

Credit Growth

Turning to the borrower who wants to raise finance on New Zealand markets, there is a feeling that banks in *New Zealand* are too averse to taking risks and that this is imposing a credit squeeze on borrowers.

Given the persistence of these stories, it will probably sound odd to question whether there is a credit crunch in New Zealand. But again the picture is far from clear.

For one thing, statistics on growth in credit and bank assets do not tend to point to a credit crunch.

The year-on-year rate of growth in Private Sector Credit (PSC) reached a peak of 35 per cent between 1984 and 1987. It slowed to around 6 per cent by the first half of 1989. However, over the second half of 1989, PSC growth accelerated again so that in the year to May 1990 PSC growth reached 14.6 per cent.

Year-on-year rates of PSC growth have fallen slowly since then, dropping back into single figures. In the six months to June PSC grew at an annualised rate of about 7 per cent.

These rates of credit growth are higher than the rate of growth in the domestic economy, as measured by gross domestic product. But they are consistent with what we know of spending and investment patterns. Official statistics suggest that 1989/90 was a year of very bouyant spending - even if New Zealand firms did not produce a lot of what it was spent on.

In nominal terms, final domestic expenditure - that is, the total of consumption and investment spending - is estimated to have risen by 8.3 per cent in the year to March 1990 (or 3.8 per cent in real terms). Meanwhile gross domestic expenditure (which includes stockbuilding) rose by a phenomenal 12.2 per cent (6.7 per cent in real terms).

The strongest source of growth in 1989/90 was investment, both capital formation and (largely involuntary) stockbuilding, undertaken by the corporate sector and having to be financed by them.

Raising new equity has, until recently, been a rare phenomenon since the crash in 1987, so new investment had to be financed out of retained earnings or increased borrowings.

Data on private sector credit growth, therefore, suggests there has not been a credit crunch in New Zealand - or at least not a universal crunch.

Other Bank data lends credence to this proposition. Between March 1990 and March 1991, the total assets of M3 financial institutions, excluding the DFC, increased by 10.5 per cent. This is consistent with the KPMG survey of financial institutions, which reported median growth in assets of just under 9 per cent in the year to June 1990 and also in the year to December 1990.

That is a far different picture from the United States one that Governor LaWare gave us earlier, where total assets of the 50 largest US bank holding companies remained essentially unchanged in the period March 1990 to March 1991.

Individual banks' lending shows another facet of the recent growth in credit. There have been very wide variations between individual banks' lending growth. In the year to March 1991, three banks recorded asset growth of more than 20 per cent; two more showed growth between 10 and 20 per cent; and the remainder recorded positive growth of less than 10 per cent.

Competition for market share can account for the variations. But clearly, individual banks have made quite different assessments of conditions and, presumably, of clients.

With evidence like this, it is difficult to support any contention that there is a generalised credit crunch in New Zealand.

What, then, of the anecdotal evidence that some companies have found it difficult to raise credit? I have already addressed the question of large corporates looking to borrow overseas. Much of the remaining anecdotal evidence seems to relate to companies in the most vulnerable sectors in the domestic economy, for example small manufacturers and retailers.

I have no doubt that banks are treading quite warily in lending to these sectors. That is hardly surprising, given the restructuring which the economy is going through.

But let me make two basic points. First, banks should not become totally preoccupied with avoiding all risk. Banking is by its nature a business which involves taking risks, and it is in nobody's interests, certainly not a bank's, to put the shutters up at the first sign of trouble.

But equally, I do not believe that *easy* credit is the stuff of which strong banking systems or economies are made. I doubt that many here would argue that the rapid credit growth of 1985-87 contributed to an allocation of resources which has helped New Zealand's growth prospects.

Should We .....

Whether or not severe credit rationing is occurring, it is worth canvassing the options which the Reserve Bank has if there was indeed a credit crunch.

The options that occur to me are:

- For the Bank to loosen monetary conditions, making credit easier and/or cheaper to obtain.

- For the Bank to impose further rules and regulations on financial institutions, such as directing them to lend to particular sectors, or to meet credit growth targets.

- For the Bank to liberalise banking supervision, for example by reducing capital requirements and freeing up limits on large exposures.

Let me take these possibilities in turn. First, monetary policy.

Loosen Monetary Policy?

It is my firm conviction that it would be dangerous to react to perceived credit problems by an easing in monetary conditions that was inconsistent with the price stability goal.

The Bank noted in its August 1991 Six-Monthly Monetary Policy Statement that inflation in New Zealand has fallen to a 25-year low. That was the reward of seven years of firm monetary policy - seven years in building up the Bank's credibility as committed to eliminating inflation.

Damage that reputation, and not only would the last seven years' pain have been futile, but regaining our credibility would take a long time and more needless pain.

It should be remembered that it is the inflation of the past which led to the asset price cycles we have seen, and it is these cycles that present us with many of our current problems.

While inflation was running high, the optimism of borrowers knew no bounds. It was fuelled by high, unsustainable profits, and unbridled expectations that property and other asset prices would move in only one direction.

With these considerations in mind, I find the option of an undue loosening in monetary policy to make credit easier and cheaper to obtain an unpalatable one.

. . . Re-regulate?

A second option might be to re-regulate the banking industry.

I would acknowledge that the collapse of financial institutions in a number of countries, including New Zealand, has coincided with a period of economic deregulation and restructuring. To some, that may suggest that deregulation is to blame for tight and expensive credit, and that closer supervision of banks - and even directives that they lend to particular sectors or meet credit growth targets - might alleviate a perceived problem.

What deregulation did, however, was to expose risks which previously had been disguised.

Operating in a newly deregulated environment required a substantial learning phase. The heavy losses suffered by some of our financial institutions, and the collapse of DFC, suggest that the banking skills learned during the period of regulation were found wanting in the new environment.

The root of the problem, however, was not deregulation but rather the previous excessive *regulation*, which masked business risk, and correspondingly masked the need for banks to carefully scrutinise and control their lending and other risks.

Under financial deregulation and economic restructuring, risks which had previously been shouldered by taxpayers and consumers, in the form of the cost of subsidies and protection, became business risks.

While perhaps not widely understood at the time, the corollary was an increase in the lending risks of banks. Indeed, the initial banking reaction to deregulation was to lend more, not less, freely than before.

For supervisors, too, deregulation has required a learning phase. Under regulation, banks were so constrained by quantitative and qualitative controls that there was little scope or incentive for them to engage in excessively risky behaviour.

In a heavily regulated environment, banks could readily fill their books with relatively secure propositions, though not without the occasional difficulty. In those circumstances, supervision did not need to be all that sophisticated.

Should this sound attractive, it is worth reflecting on the fact that banks' customers faced a high price under regulation. Credit was rationed and many borrowers were forced into fringe markets to get any finance at all. Deposit interest rates scarcely compensated for inflation, let alone provided a real reward for saving.

. . . Liberalise?

That brings me to the third proposition: should the Reserve Bank liberalise its prudential supervision standards?

This option would be based on the contention that banking supervision standards are placing undue constraints on banks. Could we lower the minimum capital requirements we ask of banks, and so free up further capital? Could we relax the limits on banks' large exposures?

In response, let me raise another question. In the current environment, would banks *prudently* choose lower capital standards than we are asking of them?

I believe there should be some minimum standards and that those that we apply in New Zealand are no more than are required to underpin the soundness of the financial system.

But I would go further and say that the responsibility for the sound and efficient operation of banks properly lies with banks themselves.

Banks need to examine their own business, determine the risks they are prepared to take, and structure their business appropriately. Many, indeed most, of them could be expected to exceed our minimum requirements given the nature of their business.

What the Reserve Bank provides is a minimum framework for banks. We look to banks to respond by operating within prudent standards.

If there is one thing I cannot stress too much it is our firm belief that responsibility for any individual bank's business rests squarely with its directors and management, not with the Reserve Bank or the Government.

Conclusion

To sum up. To go to one extreme and regulate everything would be mistaken. We in New Zealand can legitimately say that we've been in an environment where we have tried to regulate everything and seen people spend time trying to get around regulations, rather than concentrate on operating profitably and prudently. We do not want to get into that again.

It would be equally wrong, however, to go to the other extreme and remove or dilute prudential requirements entirely. There is a role for supervision of banks. That role is parallel to our monetary policy role, which is to provide stability to the economy and by doing so to contribute to economic well-being and growth.

Ultimately, the role of a central bank is to promote the soundness of money.

Monetary policy and prudential supervision work towards this goal through different channels.

Evidence suggests there is no universal credit crunch in New Zealand. But where there are constraints on credit, it would be quite wrong for the Reserve Bank to respond by loosening the money supply, imposing further regulations on banks, or liberalising the prudential supervision framework.

We will advance further in economic growth by relying on sound commercial judgements and stability in the financial system rather than on regulation and protection.