

credit, interest rates rise, rationing increases, and the economy suffers a *credit crunch*.

Past credit crunches

The economy experienced credit crunches in 1966, 1969-70, 1973-74, and 1978-81.¹ These crunches resulted from a confluence of factors that operated to reduce the supply of bank credit.²

An important factor contributing to the crunches in the 1960s and 1970s was regulated ceilings on bank deposit rates. Although ceilings were imposed in the 1930s, deposit rates did not bump against the ceilings until market rates reached record heights in 1966. When market rates rose still higher, savers withdrew deposits from banks and thrifts to invest in higher yielding market assets. The loss of deposits, called disintermediation, forced banks and thrifts to slow their lending. Disintermediation also figured in the crunches of 1969-70 and 1973-74 after market rates again rose above deposit rate ceilings.

Legal and regulatory ceilings on loan rates also reduced the supply of bank credit in some of these crunches. Ceilings on loan rates prevent borrowers from competing for loans, just as ceilings on deposit rates prevent banks from competing for funds. For example, a prime rate ceiling of 6 percent was imposed briefly during the 1973 crunch.³ After market rates topped this ceiling, banks were unable to make profitable loans.

Direct prohibitions against lending also have been a contributing factor in crunches. For example, during the 1966 crunch the Federal Reserve discouraged banks from excessive lending in hope of controlling inflationary pressure. More formal credit controls, enforced briefly in 1980, aggravated the 1978-81 credit crunch.

Deterioration in the financial condition of banks probably also contributed to past

crunches. When the loan portfolio of a bank deteriorates, the bank must slow lending to set aside more capital for loan losses. Banks may also reduce lending if their capital-asset ratios decline. To increase their ratios banks may shrink their assets by selling existing loans and by not making new loans. Deteriorating loan quality and declining capital-asset ratios are commonly mentioned in explaining recent tightening in lending standards.⁴

Rationing during credit crunches

Borrowers may experience a credit crunch through two distinct channels: higher loan rates and rationing. These channels can be illustrated with Figure 1, which represents the market for bank loans. The curve labeled *D* is a demand curve relating the quantity of loans demanded by borrowers to the interest rate on loans. The demand curve slopes downward because borrowers will want to take out more loans at lower lending rates. The other side of the loan market is represented by the supply curve, labeled *S*. The supply curve relates the quantity of loans banks are willing to make to the interest rate on loans. The supply curve slopes upward because banks will lend more only at higher loan rates, in part because banks themselves must pay higher rates to depositors to attract funds to lend. The market for bank loans is said to be in "equilibrium" at point *A*, where supply equals demand.

Next, suppose banks take action to reduce their lending, perhaps because some past loans appear to be unprofitable. The reduction in the supply of credit would appear in Figure 1 as a leftward shift in the supply curve from *S* to *S**. Banks are now willing to supply fewer loans at the same interest rate.

Borrowers initially feel the crunch through the loan rate channel as banks begin to charge higher loan rates. As the loan rate rises toward *R_B*, borrowers reduce their borrowing from

Chart 1
Loan Commitments at Large Commercial Banks

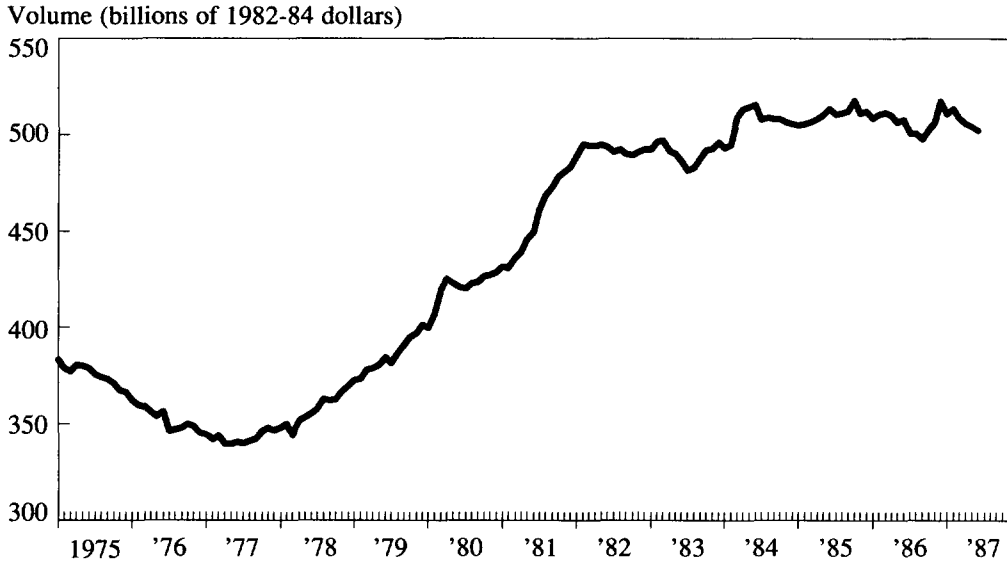
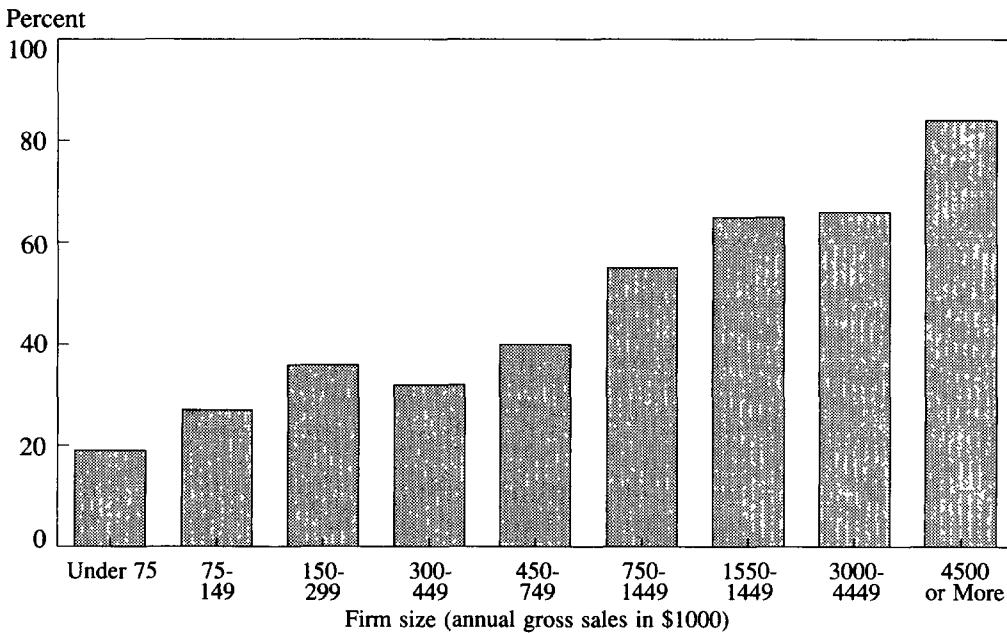


Chart 2
Percent of Firms with Credit Commitments, 1988



Source: Chart 1, Federal Reserve Board. "Commercial and Industrial Loan Commitments at Selected Large Commercial Banks" various issues.

Source: Chart 2, Dennis, Dunkelberg, and Hulle 1988.

