

Where Credit's Due

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It's all about credit. Although amplified or muffled by monetary and fiscal policy actions, U.S. recessions are essentially caused and cured via the credit creation process. In the early stages, credit growth slows reflecting rising interest rates (higher cost of credit), more cautious spending by consumers and businesses (lower demand for credit) and the tightening of bank lending standards (less availability of credit). The degree of credit deceleration helps determine the depth and duration of a recession. Subsequently, credit growth picks up owing to lower interest rates, the unleashing of pent-up demand and the easing of lending standards. The typically rapid transition from decelerating to accelerating credit growth results in a v-shaped credit cycle, a critical characteristic that effectively fuels economic recovery (*Chart 1*).¹

However, the global credit crisis has impaired credit creation processes around the world, particularly in the U.S. and the U.K. The cost of credit to consumers and businesses was initially hoisted higher than it otherwise would have been because of bank funding costs. And, as global financial institutions began racking up what now amounts to more than US\$1 trillion in losses, less capital was allocated to lending. In the U.S., the increased cost and reduced availability of credit augmented a housing correction already underway, resulting in outright recession (and a second reason to tighten lending standards). As spending (and the demand for credit) ebbed in the world's largest economy, recessions rippled around the world, accentuated by each nation's version of the credit crisis.

Just as the global financial crisis unfolded in four waves (*Chart 2*), with the latest surge the most damaging, the policy responses by central banks and governments have had four distinct themes, all designed to repair and prime their local credit markets, with the latest tactics targeting the asset root

¹ At first blush, it appears that U.S. bank lending has proved resilient to the global credit crisis, with slower but still positive growth displayed. However, just as the initial stability in loan growth at the onset of the crisis can be explained by technical factors (CP-issuers backing into their bank lines of credit and the banks themselves supporting their SIVs), current positive growth is being propped up by recent bank hook-ups with non-banks (JPMorgan and WaMu, BoA and Merrill Lynch) and the conversion of non-banks into banks (Goldman Sachs, Morgan Stanley). Adjusting for these structural changes, current bank lending growth would be negative, which is a rare and worrisome event.

CHART 1
"V" IS FOR RECOVERY

United States (y/y % chng)

Bank Lending

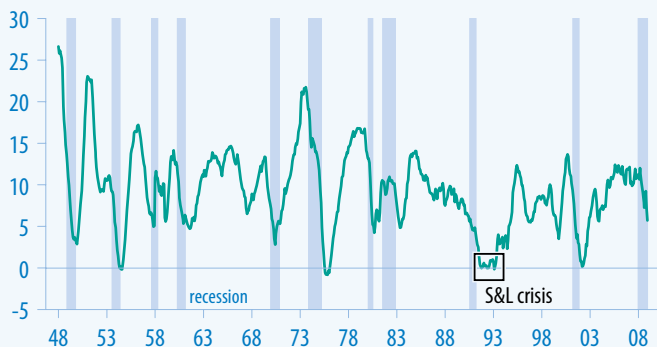
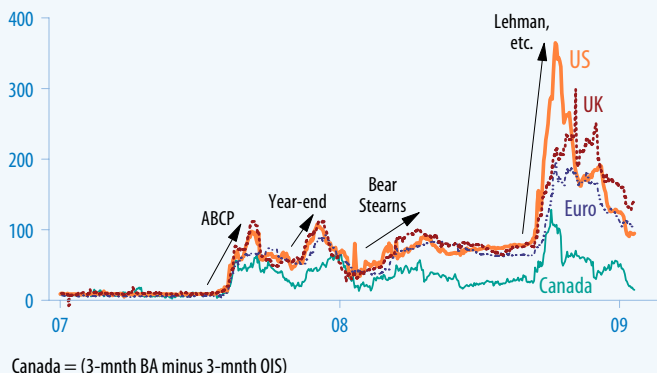


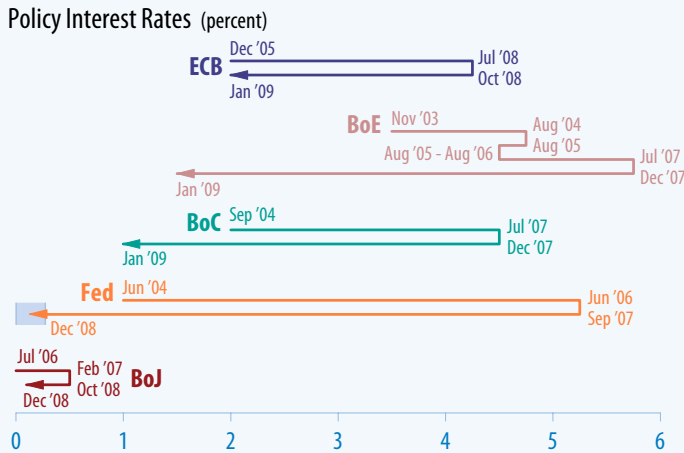
CHART 2
FOUR WAVES OF CRISIS

(3-mnth LIBOR minus 3-mnth OIS : bps)

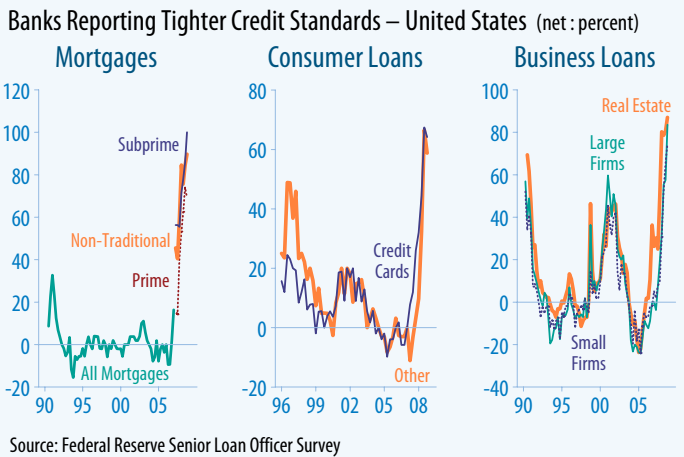
Money Market Spreads



**CHART 3
MONETARY POLICY RATES PLUMMET**



**CHART 4
LENDING STANDARDS STAY TIGHT**



of the problem. First, policy rates have been cut to historic lows (*Chart 3*). In cases where rates are already effectively zero (e.g., U.S., Japan), central banks are providing much more liquidity than required to prod banks into loaning out the excess—the essence of “quantitative easing”.

Second, some central banks (Fed, BoJ, BoE) are participating directly in local commercial paper markets—which were among the first casualties of the global credit crisis—and purchasing mortgage-backed and other securities. In a recent speech, Fed Chairman Bernanke dubbed these “credit easing” measures. While the above two policy themes have been effective in lowering the cost of credit (e.g., U.S. 30-year fixed rate mortgages recently slipped below 5% for the first time in history), they do not necessarily increase the willingness of banks to make loans. Indeed, U.S. bank lending standards remain as tight as ever, as balance sheet concerns continue to encumber the credit creation process (*Chart 4*).

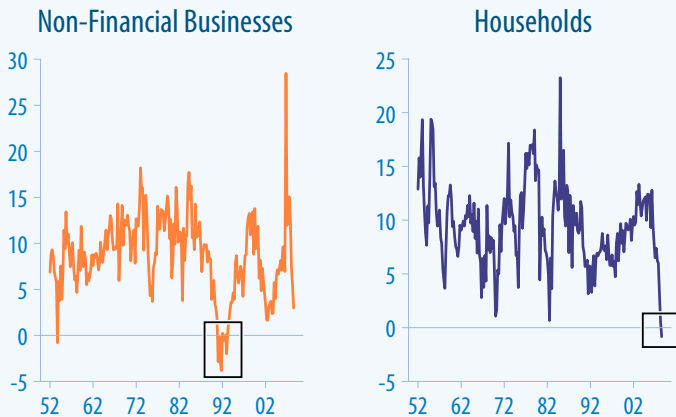
The third policy theme has been to ensure banks have adequate access to capital and other funding at reasonable rates. Governments are guaranteeing bank liabilities and, in some cases, directly injecting capital. The latter enhances the power of governments to get banks to make more loans (ranging from moral suasion to outright edict in the case of 100% nationalization), but it does not deal with the root cause of the hesitancy: concerns about additional losses on currently-held troubled or toxic assets—concerns that are actually intensifying as recessions cause regular loan losses to rise.

Thus, the fourth policy theme is to bolster the asset side of balance sheets. This week, the U.K. government introduced an “Asset Protection Scheme” designed to partially protect financial institutions against future credit losses. In the U.S., there’s growing talk of establishing an “aggregator” bank that would purchase troubled assets from banks, as the new Obama Administration is promising action on a “dramatic scale” to strengthen banks and revive credit markets. Interestingly, the second half of TARP funds may end up doing what it was originally intended to do, buying troubled assets (as opposed to capital injections). Once these new programs are in place, balance sheet concerns could begin ebbing—increasing the willingness of banks to make loans—but the supply of credit is only half the story, there is still the demand for credit.

Among the past 10 U.S. recessions, the early 1990s was the only occasion in which credit supply and demand did not rebound rapidly to create a v-shaped cycle (*see Chart*

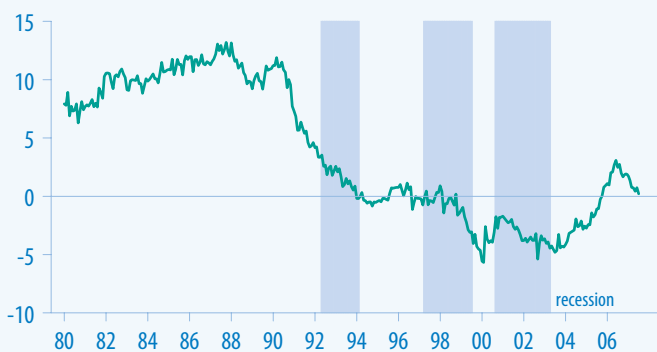
CHART 5
DELEVERAGING REDUX

Credit Market Debt – United States (q/q % chng)


CHART 6
JAPAN'S "LOST DECADE"

Japan (y/y % chng)

Domestic Credit



1 again). This sole u-shaped credit cycle, which contributed to the slowest economic recovery up to that point, was caused by factors on both the supply and demand fronts. The 1980s' savings and loan crisis resulted in some \$153 billion in losses and a prolonged period of balance sheet constraints on credit supply (partially alleviated by the establishment of a \$394 billion asset aggregator, Resolution Trust). And, in the wake of the 1990-91 recession, non-financial businesses embarked on a period of balance sheet restructuring, reducing indebtedness to improve their global competitiveness (Chart 5).

The current global credit crisis also coincides with an episode of deleveraging, this time among U.S. households. For the first time in history, in 2008 Q3, household debt contracted, and has likely continued if not deepened since then. In the wake of the huge erosion of household net wealth owing to falling home and equity prices, along with the recession's mounting job losses, consumers have begun to save more (partly by paying down debt) and spend less. Baby-boomers, in particular, are probably feeling the pressure to augment their retirement savings. Meantime, the mortgage loan amounts being written off owing to foreclosures and the various foreclosure-avoidance programs are also paring debt levels. We judge that current household balance sheet restructuring is more than just a cyclical fad, and represents a fundamental shift in U.S. consumer behaviour. So, even if household debt contraction proves short-lived, any rebound in net household borrowing will be muted.

A return to rapid credit growth is not required for economic recovery, a moderate positive pace is sufficient... but there is a clock ticking. The longer the economy stays starved of credit, the greater the risk of a deflationary outcome, with Japan's "lost decade" quickly coming to mind (Chart 6). Indeed, this image is probably burned in Ben Bernanke's brain, which is why the Fed has shifted its role from lender-of-last-resort to the banking system to lender-of-last-resort to the entire economy. Whether the Fed's liquidity-providing and credit-easing measures will tide over the U.S. economy until the private credit creation process is repaired and fully functional remains a key risk to the U.S. outlook.

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