



Credit conditions and economic growth: Recent evidence from US banks



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HIGHLIGHTS

- Growth of post-crisis US bank lending has been dismal.
- We apply a new technique to parse the supply and demand of bank loan flows.
- The results imply fairly robust loan demand and lackluster supply in recent years.
- As such, loan supply appears to have exerted a notable drag on economic activity.

ARTICLE INFO

Article history:

Received 13 July 2016

Received in revised form

15 August 2016

Accepted 18 August 2016

Available online 24 August 2016

JEL classification:

G2

E2

E44

Keywords:

Loan supply

Loan demand

Great recession

ABSTRACT

What explains the slow recovery of US bank lending since the financial crisis? We apply a new technique to disentangle loan supply and demand shocks. Lackluster supply in recent years played a key role against the backdrop of recovering demand.

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Accelerating bank lending is a bellwether of faster economic growth and an integral part of the healing process for the US economy after the Great Recession. Faster loan growth signals higher demand for credit by households and firms, and also suggests that some of the adverse legacies of the financial crisis – notably excessively tight credit conditions – have dissipated. These legacies, in turn, have been cited as persistent headwinds to US potential growth and the trajectory of the Federal Reserve's policy stance.

On its face, post-crisis bank lending growth has been dismal (Fig. 1), with growth in 2015 still below its pre-crisis average. Excluding the exuberant mid-2000s from the average does not change this fact. The dynamics of bank lending also appear to be quite different this cycle due to the failure of loan growth to

attain an above-trend rate amidst recovery. This break from history hints at a particular change precipitated by the financial crisis, that despite an emergent recovery in demand the *supply* of loans has remained persistently depressed.

How much has tight credit constrained economic growth? In this paper, we provide preliminary answers by parsing the supply and demand of US bank lending. What emerges is a picture of fairly robust demand driven by multifamily residential mortgages, commercial and industrial (C&I) loans and farm borrowing. In contrast, the supply of loans – particularly from large banks – remains mired at growth rates considerably lower than normal. The results of our analysis support the idea that the supply side of the lending market has been a drag on economic activity.

1. The evolution of US bank lending

US bank lending growth has been lackluster and highly heterogeneous across sectors (Fig. 2). Commercial and industrial

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<http://dx.doi.org/10.1016/j.econlet.2016.08.017>

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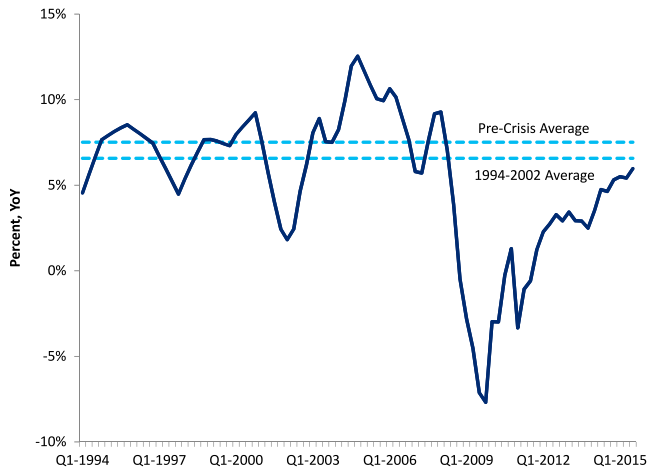


Fig. 1. Lending growth of commercial banks and savings institutions. Note: break-adjusted.
Source: Federal Reserve Board.

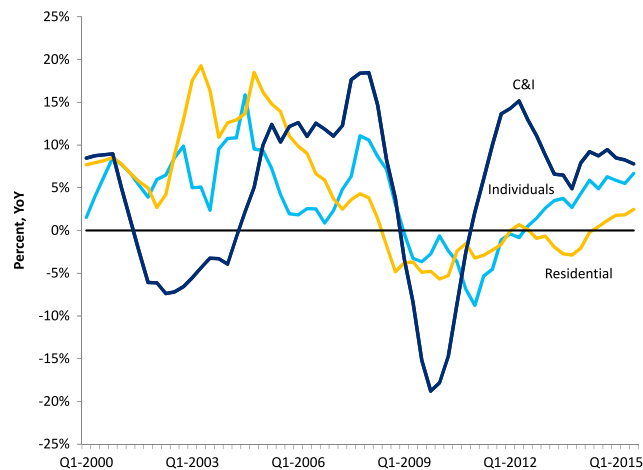


Fig. 2. Lending growth by use. Note: break-adjusted.
Source: Federal Reserve Board.

(C&I) lending – i.e., loans to firms to finance working capital and capex – has had the most typical recession–recovery dynamic, with a pronounced bounce-back in lending activity in 2011/2012 following a deep decline in 2009. In contrast, loans backed by single-family residential property have shown very gradual improvement since 2008. Loan growth to individuals – including credit cards, auto loans and other revolving credit – carved out an intermediate path.

Are these dynamics a symptom or cause of what has been by most accounts a disappointing economic recovery? In all likelihood, they are both. A shortage of demand translates into lower growth rates for borrowing, as seen in the low volume of mortgage applications for home purchases (Fig. 3) which are still less than half of their 2005 peak level. The supply side of the lending market also contributed. Credit conditions for mortgages have been tight, as evidenced by a surge in average FICO credit scores for single-family loans (760 in 2012, up from 700 in 2007). The supply of C&I loans was also battered as measured by tighter conditions in the Fed's Senior Loan Officer Opinion Survey (SLOOS). Banks have been easing C&I credit conditions moderately since 2010 (Fig. 4).

2. Sorting out supply and demand in the market for loans

The task of quantifying the drag due to tight credit is beset with significant measurement issues. While both of the commonly cited

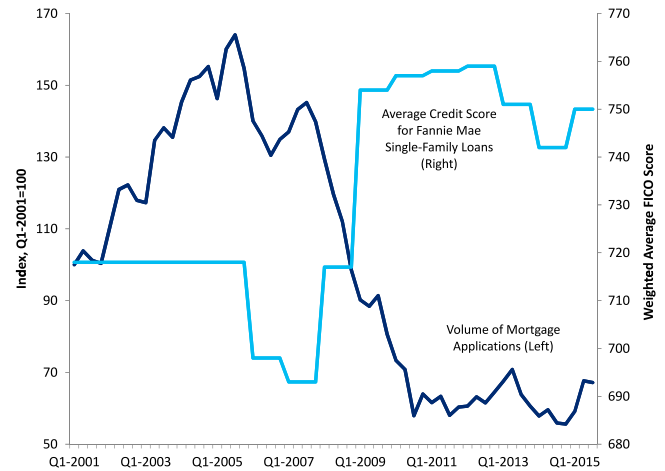


Fig. 3. Factors affecting single-family loan growth.
Source: Mortgage Bankers Association and Fannie Mae.

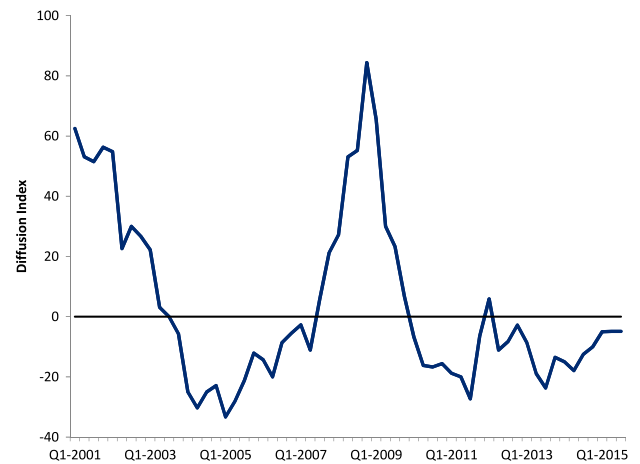


Fig. 4. Fraction of banks Tightening C&I credit conditions.
Source: Federal Reserve Board.

measures of credit supply (FICO and SLOOS) have been improving, how much they account for of loan growth is unclear. In this section, we adapt a framework developed by [Amiti and Weinstein \(2013\)](#) for disentangling supply and demand in the market for bank loans. The intuition for the methodology is as follows. A change in bank lending that is common to all the borrowers of a particular lender is counted as a change in supply by that lender; a change in lending that is common among all lenders of a given borrower counts as a change in the demand for loans by that borrower.

Fig. 5 provides an illustration of how it works. In this stylized representation of the banking sector, a big bank and a small bank provide loans for C&I and mortgages. The arrows show that in a given period total lending increases by \$1000, with bilateral loan flows denoted by the arrows. The methodology allocates the increase to demand and supply according to the average changes for borrowers and lenders, respectively. The big bank and small bank increased average lending by \$300 and \$200, which are their respective supply shocks. Meanwhile, the C&I and mortgage sectors increased their average borrowing by \$400 and \$100, which are their respective demand shocks. Thus, total loan supply increased by \$500, driven primarily by big banks, while demand increased by \$500, driven primarily by C&I. These allocations solve the system of four equations (two each for sector and bank size) in four unknowns (their respective demand and supply shocks).

More generally, changes in loan supply for banks of different sizes are denoted by β and changes in loan demand by sector are

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