Credit crunch is over?

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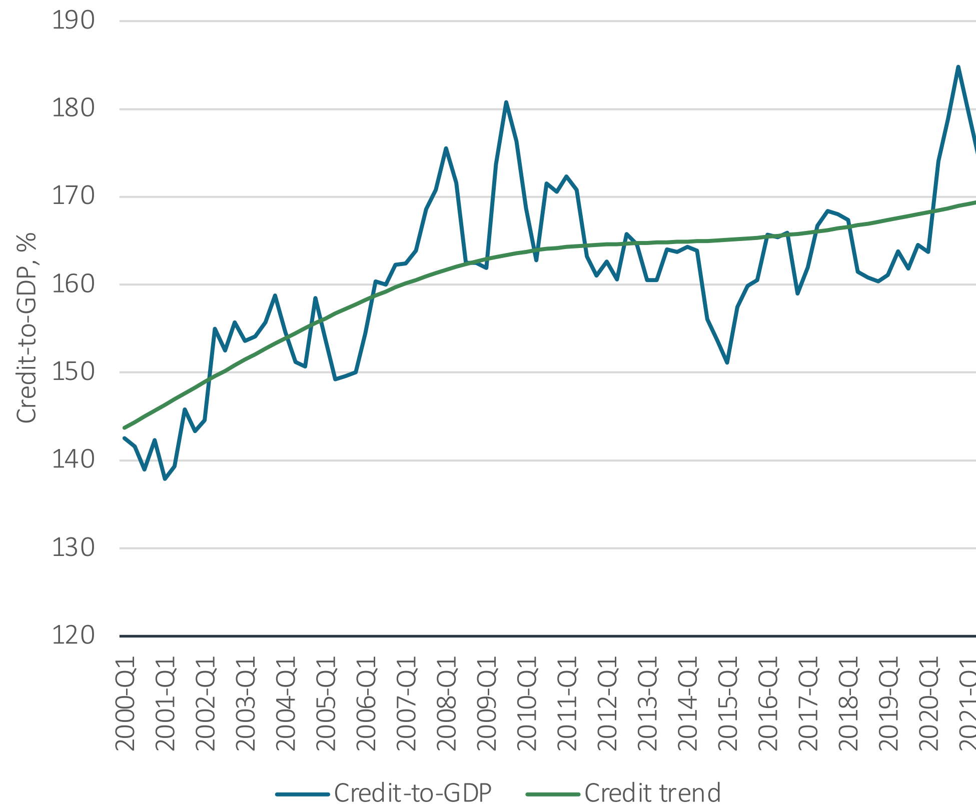
Credit crunch



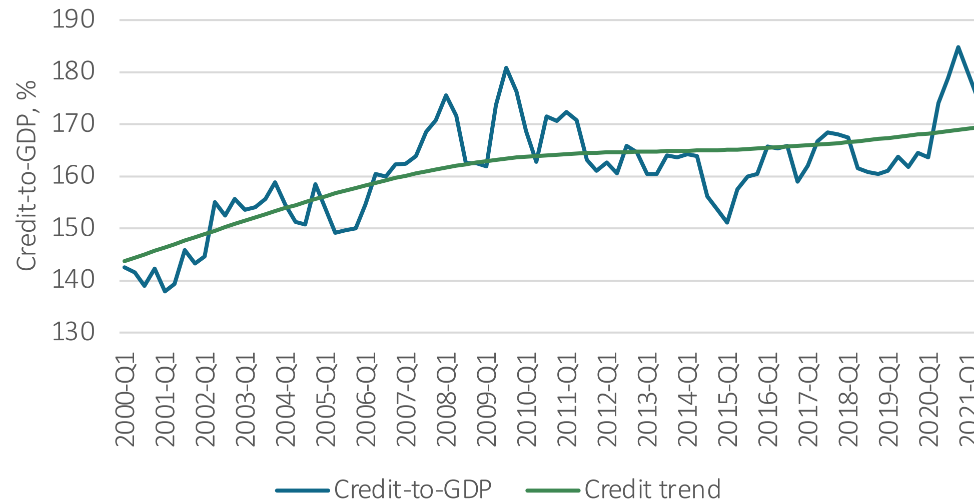
Credit-to-GDP and credit trend dynamic for non-financial sector in the US. Source: BIS

Credit crunch is a reduction in credit activity under an unchanged or declining interest rate [Bernanke, Lown, 1991].

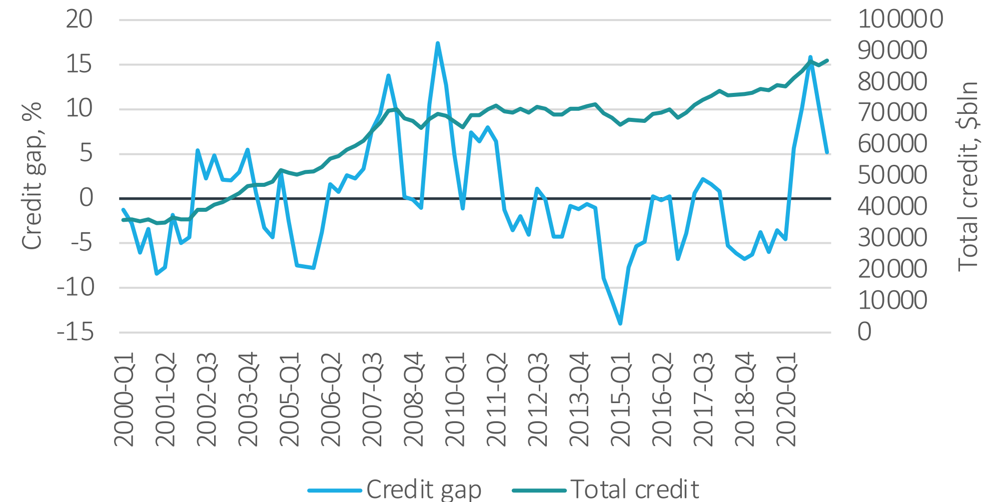
According to the BIS methodology**, the period of credit crunch is the period of a negative "credit gap", the cyclical component of the variable "credit-to-GDP",** estimated with the Hodrick-Prescott filter.

In 2009-2019, the world existed in a **phase of prolonged credit crucnh**: the volume of borrowing did not grow under the declining interest rates. One of the reasons is the tightening of financial regulation of the banking sector.

Credit activity in 2020-2021



Credit-to-GDP and credit trend dynamic for non-financial sector in the US. Source: BIS



Total credit to non-financial sector and credit-to-GDP gap in the US. Source: BIS

The credit gap entered a positive zone after the outbreak of the pandemic. But despite the fact that the absolute volume of loans increased slightly in Q1-Q2 2020, this is mainly the impact of falling GDP. From 2021Q1, the volume of loans begins to fall, the positive gap is shrinking. In general, this is normal - cash flows in companies have partially recovered, but what next?

Loan support measures

Expand bank lending capacity

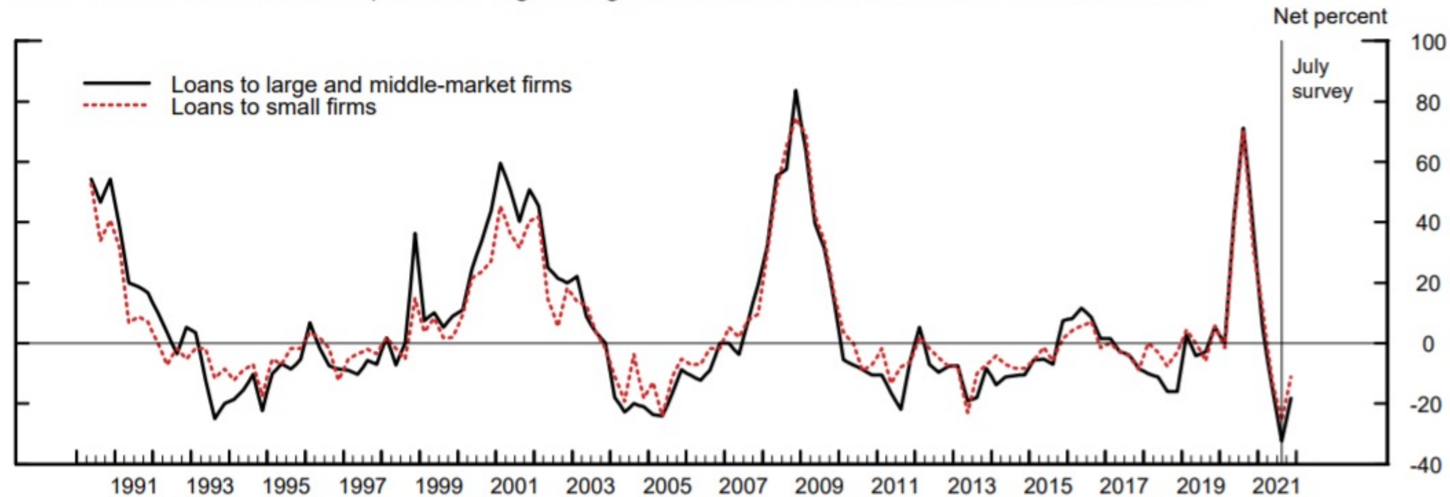
- easing capital and liquidity requirements,
- restrictions on share repurchases and payment of dividends,
- mitigation of measures in respect of overdue debts.

Incentivise banks to increase lending

- government guarantees,
- providing financing at a reduced rate with the condition of increasing the volume of lending to the non-financial corporate sector and households (in particular, the ECB's large-scale program - TLTRO III) or with the condition of increasing lending to industries affected by the pandemic or small and medium-sized businesses (for example, in the UK).

The measures had a positive impact on credit activity in the private non-financial sector, but in the long term such measures create a problem of moral hazard [Casanova et al., 2021].

Credit standards tightening



Senior Loan Officer Opinion Survey on Bank Lending Practices, Federal Reserve

Credit standards – lending non-price conditions (requirements for collateral, guarantors, restrictions on loan terms, etc.) - in the USA and Europe gradually began to tighten after a significant decrease in 2020.

Danger without financial crisis

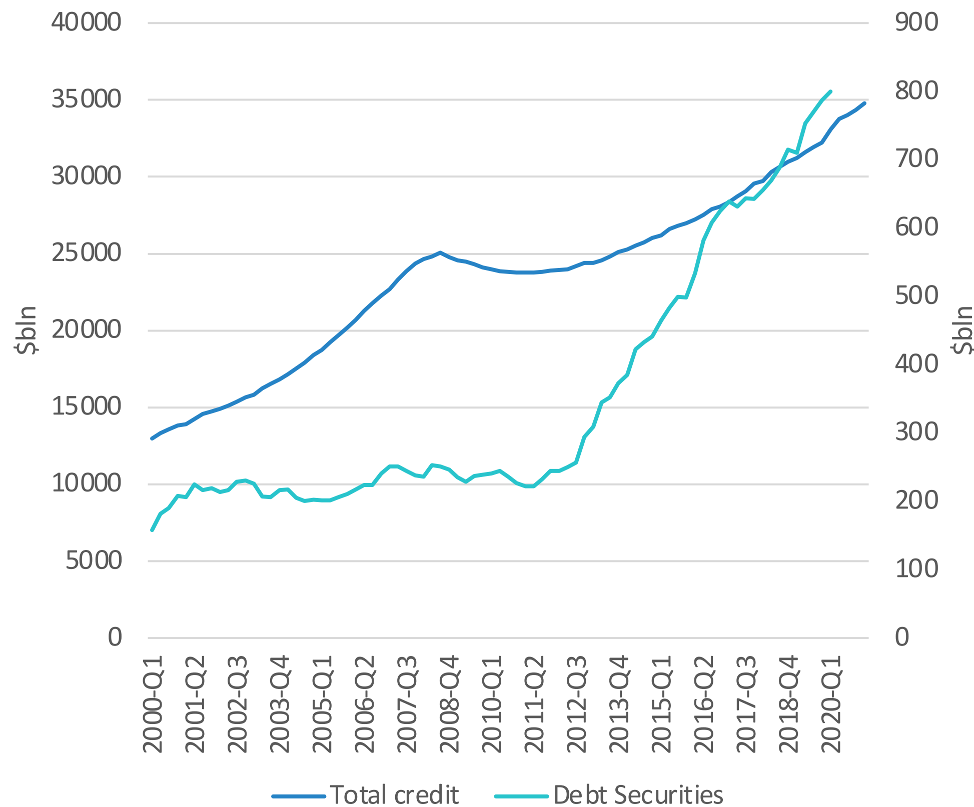
Under the high stable inflation, central banks of developed countries are beginning to switch to "hawkish" rhetoric.

- The Fed has started taping*, announced its readiness to raise the rate in 2022.
- The ECB began to reduce the volume of asset purchases and recognized the non-temporary nature of inflation.

➢ A decrease in bank funding, along with a decrease in other measures to support the economy against the background of the ongoing COVID-19 pandemic, creates risks of a return to the phase of credit crunch and even more sluggish economic growth than in 2009-2019.

*reduction of the central bank's asset purchase program

Debt market in 2009-2019



Total credit to non-financial sector, debt securities in the US. Source: BIS

- The American corporate sector in 2009-2019, under the tighter regulation of the banking sector, partially replaced the bank loan with a debt market.
- The European system is bank-centric, so the tightening of banking regulation in 2009-2019 affected credit activity much more.

Corporate debt under the pandemic

- As part of the support of the economy, central banks of developed countries implemented **asset purchase programs**, including corporate ones.
- The reaction of the debt market to economic support measures **differed for the investment and high-yield segments**. While issuers of investment-grade securities received support through asset purchase programs or a rate decrease, for issuers of high-yield bonds, the cost of borrowing decreased slightly.
- Despite the fact that the share of corporate securities in the portfolios of the ECB and the Fed is small (less than 3% in the ECB, no in Fed), the existence of corporate asset repurchase programs apparently supported corporate spreads by itself.
- Since the announcement of the tapering in the US, the spread* of corporate bonds with a BBB rating has added 12 bps, for high-yield bonds - about 40 bps. Thus, with a gradual departure from soft monetary policy, spreads on corporate debts will increase, and for companies with low credit quality - stronger.

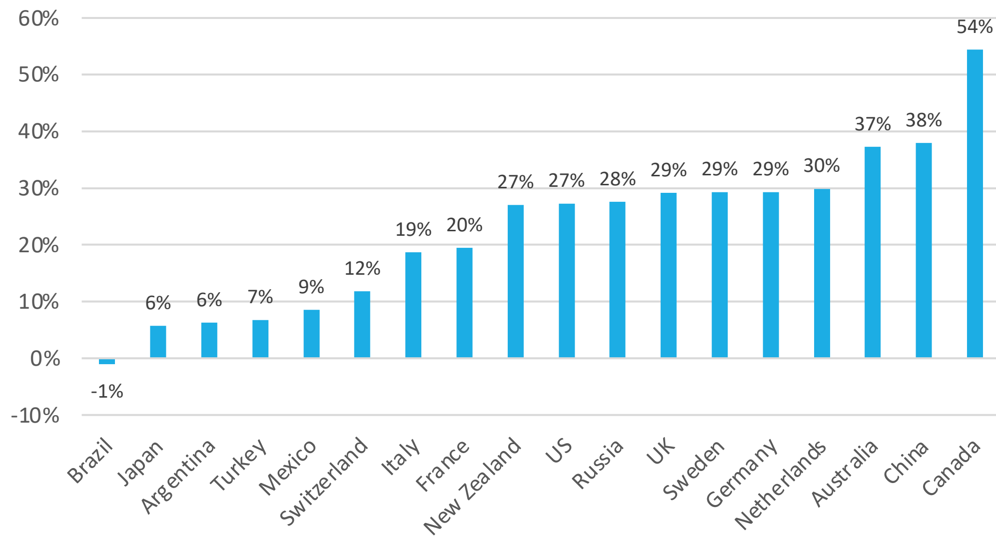
*(based on ICE BofA Option-Adjusted Spreads)

Corporate debt under the pandemic

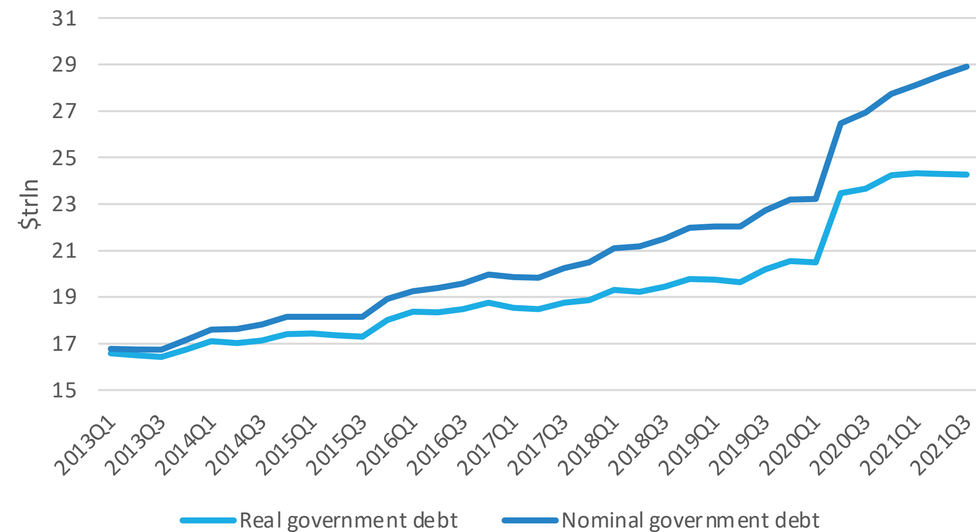
- A decrease in inflation coupled with an increase in interest rates may pose a particular danger in the corporate sector for so-called zombie companies – firms that are able to service their debt but are unable to repay it. After some time, the "zombies" will be forced to refinance their debts at a higher rate in the absence of supporting programs, which can lead to a series of bankruptcies. The danger of such situation for the global financial system is questionable – according to the Fed's assessment of the summer of 2021 [Bodovski et al, 2021], the share of zombie companies in the United States is small, the size of the companies themselves is small, however, with a higher level of rates, this share may grow.

- In Europe the credit crunch under the new conditions is likely to be similar to what happened in 2009-2019. In the USA, the conditions differ significantly from the conditions of 2009-2019.

Government debt under pandemic



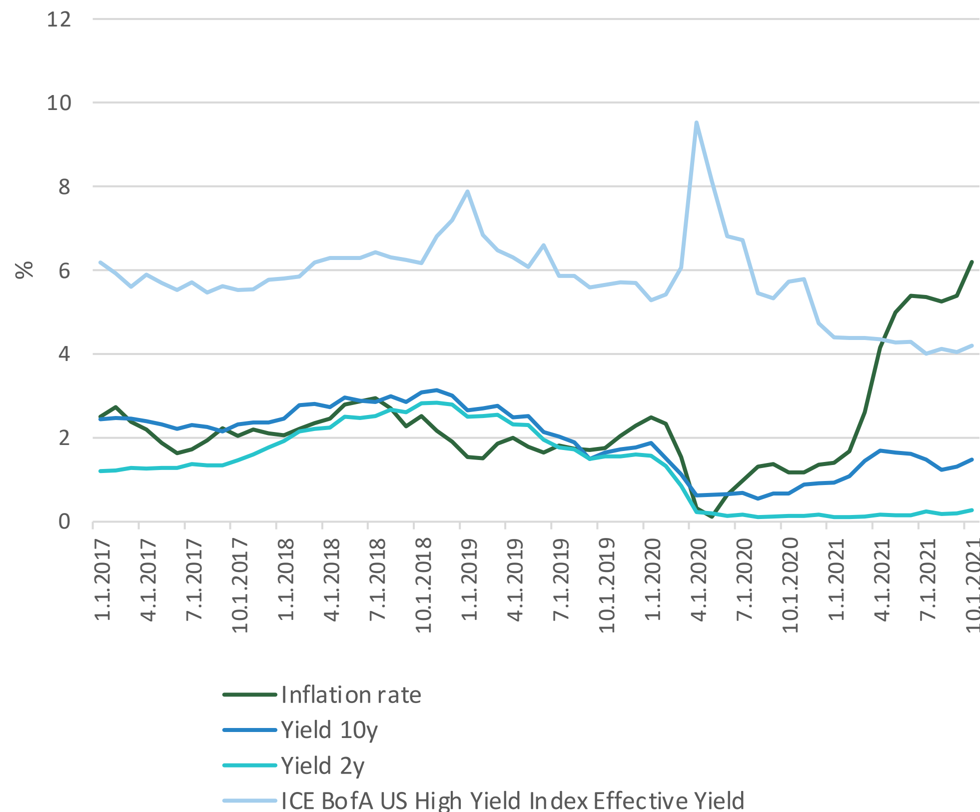
Dynamics of government debt in developed and developing countries (01.07.2021 to 01.01.2020). Source: World Bank



Dynamics of nominal and real government debt in the US: FRED

The unprecedented volume of anti-crisis measures forced both developed and developing countries to significantly increase debt, in servicing which inflation would be a serious ally.

Inflation and interest rates in the US



Interest rates for government and corporate debt, inflation rate. Source: FRED

- In recent years, the level of interest rates on the US government debt roughly corresponded to the level of inflation, that is, the debt depreciated at the rate of interest accrual.
- Since mid-2020, the inflation rate has significantly exceeded the rate level. Returning to the previous ratio will not allow gradually reducing the level of public debt.
- In the high yield corporate sector, the level of debt servicing has been higher than inflation in recent years, but the new ratio of the interest rate level to inflation may become critical for some of the players.

In search of optimal monetary policy

- **It is probably not worth expecting a return to the era of low inflation:** in addition to all the pro-inflationary factors in the form of uncertainty about new strains of coronavirus and bottlenecks in supply chains, there is an additional dimension to this problem: a return to low inflation is fraught with a violation of global financial stability.
- **Thus, most likely a partial solution to the problem of public debt will be its depreciation due to higher inflation.**
- Central banks face the difficult task of finding the optimal combination of the rate level and the rate of inflation, as well as the optimal order for canceling economy support measures.

References

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3. Bodovski D. et al. Bank Lending Conditions during the Pandemic. Federal Reserve. – 2021.