

Box 1

IS WEAK CREDIT HOLDING BACK THE ECONOMIC RECOVERY IN THE UNITED STATES AND THE UNITED KINGDOM?

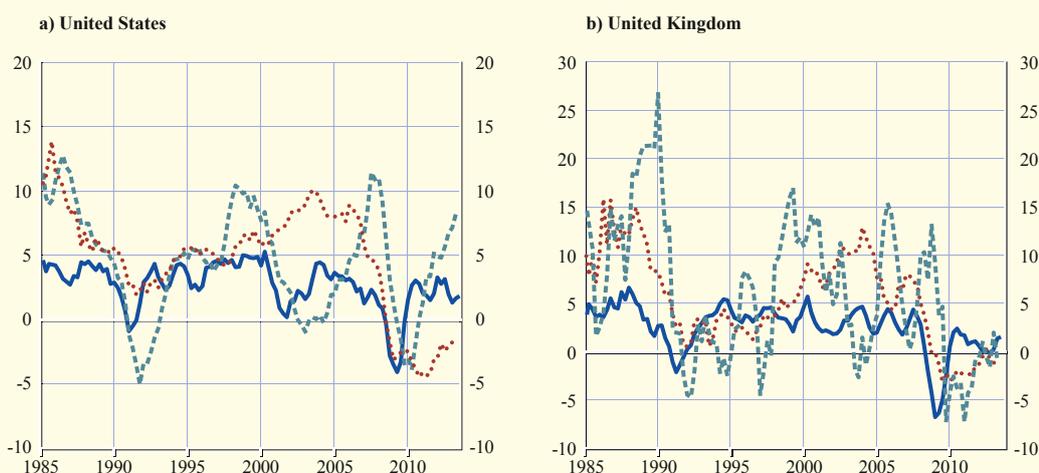
The dynamics of credit to the non-financial private sector, defined as market and bank sources of credit, tend to be closely associated with the business cycle, as economic downturns and subsequent recoveries coincide with strong movements in the growth rate of credit to the private sector.¹ This box looks at regularities of credit and its relationship with the business cycle in two of the euro area's largest trading partners, the United States and the United Kingdom.

¹ For evidence on the relationship between money/credit and the business cycle in the euro area, see the box entitled "Stylised facts of money and credit over the business cycle", *Monthly Bulletin*, ECB, October 2013.

Chart A Dynamics of real GDP and credit

(year-on-year percentage changes)

— real GDP
 real credit to households
 - - - real credit to NFCs



Sources: Federal Reserve System, Haver Analytics and Office for National Statistics.
 Note: Real credit has been calculated using the GDP deflator and refers to market and bank sources of credit.

Credit to the non-financial private sector and the business cycle

Growth rates of real GDP and real credit to non-financial corporations (NFCs) and households have historically been positively correlated in both the United States and the United Kingdom (see Chart A). However, the correlation does not appear to be very tight, and in both countries credit dynamics have been more volatile for the non-financial business sector than for the household sector. During the current cycle, overall credit has been weak in both countries. As in previous cycles and in line with the stylised facts for the euro area, corporate credit growth slowed after household credit growth and economic activity. More recent dynamics suggest that in the United States the growth of credit to NFCs has picked up, while credit to households may be bottoming out. In the United Kingdom, credit growth in both sectors has stabilised in recent quarters at very weak levels.

Correlations between real GDP and real credit growth at different leads and lags confirm that credit growth is highly pro-cyclical in both countries. GDP growth appears to lead growth in credit to NFCs, with the highest correlation between the two series being for a three-quarter lead in the United States and a one-quarter lead in the United Kingdom. While GDP growth also appears to lead household credit in the United States (by around one quarter), the series are more coincidental in the United Kingdom. For the United Kingdom, the strongest correlation of GDP growth with corporate credit (at 0.29 over the period 1967 to 2013) is much lower than with household credit (at 0.54 over the same period), and also lower than the strongest correlations for the United States (0.57 for NFCs and 0.56 for households over the period 1953 to 2013).

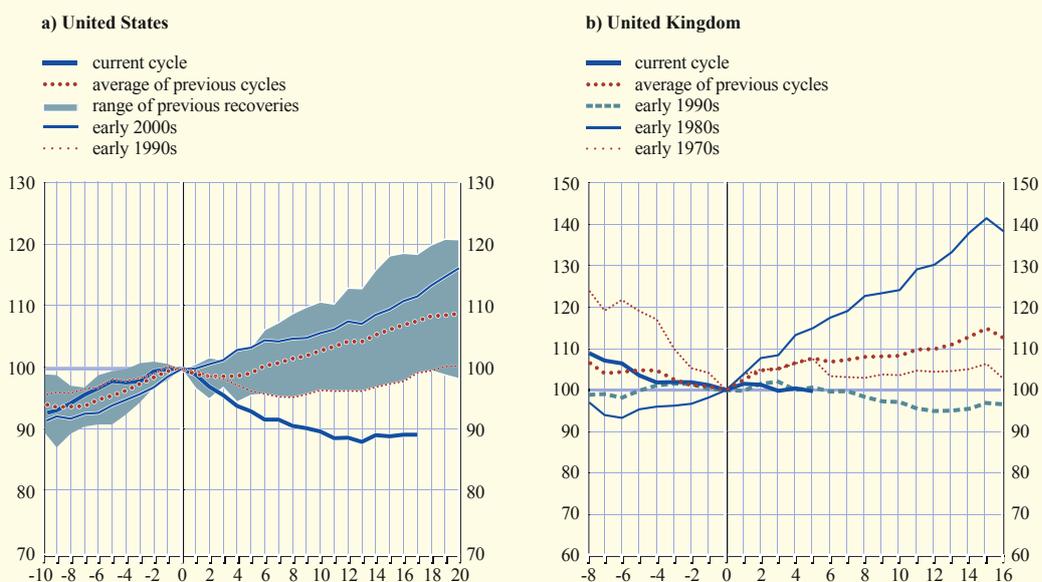
Comparison with previous cycles

A comparison of the ratio of market and bank sources of credit to GDP with previous cycles helps to assess whether credit has been exceptionally weak in the current recovery. Chart B points to slightly different situations in the two countries. In the United States, the ratio of credit to the non-financial private sector to GDP declined from the end of the latest recession, and has increased modestly since mid-2012. The ratio of household credit to GDP has been particularly weak and continued to decline until the third quarter of 2013 with the ongoing adjustment in US household balance sheets following the bursting of the housing bubble.² In the United Kingdom, by contrast, credit dynamics have been somewhat weaker than in previous recoveries but do not stand out as having been exceptionally weak. In particular, market-based funding for NFCs has developed relatively positively, suggesting that businesses have been more able than in previous episodes to replace bank borrowing with other forms of finance. Overall, however, the ongoing weakness of credit dynamics in the United Kingdom probably partly reflects the still fragile state of the banking sector.

For businesses, it appears that the weakness in credit growth may not be a major factor holding back the recovery in the two economies. Evidence from the composition of NFC financing indicates that firms with access to the capital markets have been able to offset some of the sharp drop in loans by issuing debt securities and – in the case of the United Kingdom – equities.

Chart B Ratio of real credit to GDP, comparison with previous recoveries

(index: end of recession = 100; x-axis: quarters)



Sources: Federal Reserve System and ECB, Haver Analytics, Office for National Statistics and ECB.

Notes: Zero marks the end of each recession. According to the National Bureau of Economic Research, there have been ten recessions in the United States since 1950, with the latest starting in the fourth quarter of 2007 and ending in the second quarter of 2009. According to the Economic Cycle Research Institute, there have been four recessions in the United Kingdom since 1960, with the latest being a double-dip recession starting in the first quarter of 2008 and ending in the first quarter of 2012.

² For more details, see the box entitled “How much progress has been achieved in household deleveraging in the United States?”, *Monthly Bulletin*, ECB, November 2013.

US corporations have even bought back shares for a number of years, indicating little need for external finance. This is also reflected in the financing gap of US businesses (i.e. capital expenditures less internal funds and inventory valuation adjustment), which has been negative since early 2009 and only recently started to close, indicating that the bulk of US NFCs have sufficient cash to cover investments. On average, UK companies also have large cash balances, although it cannot be ruled out that some firms face financing constraints.

Conclusion

Overall, although it is difficult to disentangle the causes and effects between credit and GDP growth without resorting to more structural frameworks, the stylised facts presented in this box show that credit dynamics have been relatively subdued during the recovery in the United States and to a lesser extent also in the United Kingdom. As regards the household sector, credit is still weak in both countries. However, recent balance sheet repair by households in the United States together with rising housing and financial wealth in both countries should lead to better fundamentals that will support private consumption. Turning to the business sector, non-financial corporations in both countries seem to have been able to use market-based funding when loan growth turned negative. More recently, business surveys have improved in the United Kingdom and the United States. This, together with the comfortable cash balances held by US and UK companies, suggests that the preconditions for an investment recovery are in place.