The US outlook viewed through the credit channel
Integrating credit into the economic outlook

• “When Credit Bites Back: Leverage, Business Cycles, and Crises” by Oscar Jorda, Moritz Schularick, and Alan Taylor
  • Rogoff and Reinhart of private credit (200 cycles in 14 advanced economies), the degree of “excess” credit growth during an expansion has a material impact on the shape and duration of the recession and recovery with or without a financial crisis.

• “Fed Notes: The Role of Financial Imbalances in Assessing the State of the Economy” by David Arseneau and Michael Kiley
  • Forecasting models perform better when augmented with the growth of household and business credit. The output gap was roughly 1pp greater than traditional estimates between 2004-2007 and the negative output gap is currently about 1pp larger.
Credit channels

• Credit allows companies to invest and households to borrow against future income.
• Excess credit growth cannot be justified by growth opportunities and future income.
• Excess credit is a problem:
  • It can lead the economy to grow above potential leading to a possible misallocation of resources that may damage future productivity growth.
  • Greater vulnerabilities to shocks and downturns—procyclical prices can lead to destabilizing debt deflation.
  • A cyclical confidence accelerator? Expectations for income growth and asset returns may becomes unrealistically high in the buildup phase and possibly prone to excessive pessimism during the deleveraging.
• Flow and stock both matter: the amount of buildup prior to the recession, and the real time flow of credit during the recovery
The US recovery has outperformed despite the severity of the crisis
Uses of funds: Perverse patterns of borrowing persist

Borrowing as % of GDP (4qtr avg)

Source: Federal Reserve, Haver Analytics
Sources of funds: shadow banking drove leverage, QE has been a stabilizing force

Source: Federal Reserve, Haver Analytics
The Fed is still the largest source of funding, who will step up in 2014?

Sources of funds for borrowing as % of GDP

- banking system
- shadow banking
- monetary authority
- foreign sector

Nominal GDP growth (% y/y)

Source: Federal Reserve, Haver Analytics
Levels matter too, only back to 2008 overall

Debt as % of GDP

Source: Federal Reserve, Haver Analytics
New normal, secular stagnation, whatever you want to call it

- San Francisco Fed President John Williams noted at a Brookings speech in January that relying on post-war empirical analysis has led us to misunderstand the dynamics of the current recovery.

- New York Fed President Bill Dudley listed a number of headwinds restraining the current recovery, all of which were credit related: the number of households underwater on their mortgages, tight credit standards, low credit quality of borrowers.

- Financial and credit conditions still matter in a way that is not well understood. Conclusions based on post-war econometric models should be taken with a grain of salt. Notions of pent up demand are inappropriate for a deleveraging cycle.
What will come after consumer deleveraging?

- Will household still unsure about future income prospects be eager to take on new obligations?
- Will business invest in new capacity and not just increased efficiency without stronger demand?
Some final comments on the outlook

• A focus on the fading fiscal drag assumes all else is equal, it is not
  • The 1.1pp decline in the savings rate last year with no increase in leverage highlights the boost from a (mainly equity) wealth effect that will diminish in 2014
  • The sensitivity of households to higher mortgage rates highlight the lack of willingness to borrow against an uncertain future
  • Healing is real, but still gradual.

• Financial markets are doubting the cyclical upswing scenario, even with relatively benign data.

• Is the global credit cycle turning to China?