Lending During Recessions

Beginning in the fall of 2008, the United States Treasury along with other government agencies put in place a series of financial initiatives to help lay the foundation for economic recovery. One of these initiatives is the Capital Purchase Program (CPP). Through the CPP, Treasury purchased shares of preferred stock from qualifying financial institutions. By strengthening the capital bases of financial institutions through the CPP, Treasury aimed to increase CPP participants' capacity to lend to U.S. businesses and consumers and to support the U.S. economy. Bank lending tends to be pro-cyclical, contracting with an economic slowdown and rising with an expansion, and this has been the case in the current environment. In addition, in the current recession, most of the securitization markets have greatly contracted, as has the availability of many types of nonbank credit. Thus the CPP, along with other agency actions such as the Term Asset Liquidity Fund, and the Temporary Liquidity Guarantee Program, will be critical to staving off a greater contraction in the economy.

A recent question has been whether the broad array of financial stabilization policies put into place by the Treasury, the Federal Reserve, and others has led to more lending than would have been the case had nothing been implemented. Although it is too early to determine with precision the influence of policy on the economy's evolution through the financial crisis, recent studies from two leading government agencies released today examine different dimensions of lending activity during current and prior recessions. The Federal Reserve Board's article *U.S. Credit Cycles Past and Present* examines how credit volumes have evolved in the current economic downturn relative to previous business cycle downturns using the Federal Reserve's Flow of Funds data. Significant among the Federal Reserve's findings was that, despite many unprecedented aspects of the current financial and economic turbulence, movements in credit volumes in the current recession are similar to historical patterns. The evidence shows (1) For all categories of lending with the exception of home mortgages, there are at least two other downturns that experienced more pronounced declines in lending than that following the business cycle peak of 2007:Q4 and (2) Lending over the current downturn does not appear especially weak relative to past recessions with the exception of home mortgages. The Federal Reserve attributes these findings to the government's active policy response, particularly with respect to the banking sector. The study states "the likely path of the lending in the current downturn without any policy response would have been notably more contractionary than after 1990:Q3."

A key difference in this recession compared to past recessions is the greatly increased importance of credit extension by non-bank entities, sometimes referred to as the shadow banking system. In a study that complements the Federal Reserve's more general consideration of credit market conditions, the article from the Office of the Comptroller of the Currency, *What is Different about this Recession? Nonbank Providers of Credit Loom Large* investigates the

growth and importance of nonbanks in overall credit provision. Of particular importance in the current financial environment are structured finance markets, that is, credit extension based on the issuance of mortgage-backed securities (MBS) and consumer-credit and business-credit asset-backed securities (ABS). These markets have become an essential component of lending in the financial system, particularly for credit extension to households. Key findings in the study are: (1) in the MBS market, credit provision supported by government sponsored enterprises' MBS issuance is currently the only meaningful activity, and (2) in non-mortgage consumer credit markets, the anemic rebound of ABS issuance leaves a large gap in credit provision to households. The article finds that revivals of both the MBS and ABS markets are critical to the overall recovery of credit extension to households, and hence economic growth.