Governments, Deficits and Banking

"Some part of the reduction in U.S. bank lending may be attributable ultimately to the federal budget deficit."

Despite the improving financial condition of U.S. banks, as illustrated by the industry's record profits in 1992, bank lending activity has remained stagnant. The absence of a rebound in loan volume casts a cloud over an otherwise bright picture of bank performance and has led to continued concerns about the industry's longer term prospects.

In this article, we depart from the familiar litany of supply and demand factors behind the so called "credit crunch" and analyze an alternative set of forces that may have reinforced other incentives for banks to move away from lending. In particular, we examine a potential role of government budget deficits in shaping bank lending trends. The case of Mexico during the mid-1980s provides an extreme example of what can happen to private-sector bank lending when large government budget deficits spiral out of control. We also examine the relationship that may exist between the high U.S. federal budget deficit and reduced lending activity at U.S. banks.

Performance of U.S. Banks

Profitability. Banks throughout much of the country continued to generate record earnings in early 1993. The analysis of bank profitability in the first quarter is complicated by changes in accounting rules that had a large impact on reported earnings. We filter out most of the impact of these changes by focusing on the return on assets before extraordinary items. As shown in Chart 1, District banks earned a return on assets before extraordinary items of 1.06 percent in the first quarter of this year, compared with 1.07 percent for the same period last year. Banks elsewhere also reported high profits, with a return on assets before extraordinary items of 1.04 percent in the first quarter of this year.
pared with 0.85 percent last year. Continued high net interest margins and low loan loss provisions, as well as increased noninterest income, were primary contributors to banks' profitability.

**Capital.** High profitability has helped banks bolster their capital positions. Chart 2 shows the trend of improvement in recent leverage, Tier 1 and total capital ratios for the U.S. banking industry. Also, as of March, less than 1 percent of the industry's total bank assets were held by banks that were undercapitalized based on the prompt corrective action provisions of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), compared with 26 percent at year-end 1990.

**Lending Activity.** Despite the improvements in banking conditions, lending activity has remained weak. The amount of securities held by U.S. banks has grown rapidly in recent quarters, while the volume of loans outstanding has contracted (Chart 3). The dollar amount of securities held by U.S. banks rose 36 percent during the three-year period ending in March 1993. Much of this increase involved banks' holdings of U.S. government securities, which rose 58 percent. In contrast, loan volume declined 2 percent over this three-year period.

Many factors have contributed to the portfolio shift from loans to securities. Weak economic conditions, the overall movement to reduce corporate debt levels and an increased reliance on nonbank sources of financing have worked to reduce loan demand. On the supply side, the regulatory environment, including the new capital requirements, greater federal oversight and uncertainty surrounding the implementation of FDICIA, have been cited as contributing to the stagnation in bank lending.

An additional factor that has received only limited attention is the potential impact of the high U.S. federal budget deficit on bank lending. The spread between long-term and short-term interest rates has been quite large in recent quarters. And some evidence suggests that the high government budget deficit may have contributed to the steep yield curve. If the large spread between long-term and short-term interest rates has interacted with other factors to reinforce incentives for banks to shift into government securities and away from loans, then some part of the reduction in U.S. bank lending may be attributable ultimately to the federal budget deficit.

The argument that the high federal deficit has contributed to weak loan growth through the channels just described is both novel and controversial. While it is beyond the scope of this article to provide a quantitative assessment of the empirical importance of the potential negative relationship between the U.S. government deficit and bank lending, recent financial trends appear to be consistent with such a linkage. Moreover, an examination of the relationship between government deficits and bank lending in Mexico provides an extreme example of the impact that large government deficits can have on bank lending to the private sector.

**The Case of Mexico**

High levels of government spending interacted with falling oil prices and rising world interest rates to produce a dramatic increase in Mexico's borrowing needs during the early and mid-1980s. The extraordinary magnitude of the budget deficit in Mexico contributed to numerous economic difficulties, including rampant inflation and a stagnation in bank lending to the private sector. Mexico has since brought its deficit under control, and the problems of high inflation and stagnant bank lending to the private sector have eased as well.

**The Government Deficit, Monetary Base and Inflation.** The primary effect of the government deficit on inflation involves the deficit's potential influence on growth in the money supply. Mexico's large deficit exerted pressure on the government to finance part of the deficit by printing money, which, in turn, intensified inflationary pressures. To help gauge the potential effect of Mexico's deficit on money growth, we scale the federal budget deficit for a given 12-month period by the level of the monetary base, which includes both bank reserves and currency held by the nonbank public at the beginning of the period. The size of the 12-month deficit relative to the beginning-of-period monetary base measures how much growth in the monetary base would be required for the deficit to be financed totally by printing money.
Chart 4 depicts the relationship between Mexico's government deficit, the monetary base and inflation. By late 1987, Mexico's 12-month deficit had grown to four times the size of the monetary base. And a substantial part of Mexico's deficit was financed by printing money, as growth in the monetary base rose to 85 percent in late 1987 and early 1988. At its peak in 1987, the 12-month inflation rate exceeded 160 percent, and short-term interest rates increased to more than 150 percent.

Both money growth and inflation subsequently subsided as the deficit was brought under control.

The Government Deficit and Bank Lending. In addition to the impact on money growth and inflation, the available data suggest that the deficit also may have affected bank lending to the private sector. Chart 5 shows both the Mexican government deficit and bank loans to the private sector, each adjusted for inflation. From 1984 through 1987, when Mexico's government deficit was high and growing, a combination of high inflation, interest rate controls and various portfolio restrictions designed to channel bank funds to the government contributed to a stagnation in bank lending to the private sector. Also, Mexico's commercial banks were nationalized in 1982 and were not returned fully to the private sector until 1992.

The economic effects of the tight loan market were particularly severe because Mexican capital markets were not well-developed and other sources of financing were not readily available, although a black market for credit did develop.

Beginning in 1988, the Mexican government dramatically cut its budget deficit and thereby paved the way for the reduction of many of the controls and regulations previously imposed on the banking sector. The reduction and eventual elimination of Mexico's budget deficit was achieved primarily through reductions in government expenditures. Chart 6 shows the gap between Mexico's government spending and tax revenues, after adjusting for inflation, with the red area representing a budget deficit and the gray area indicating a surplus. From the end of 1988 through mid-1992, there was a gradual rise in inflation-adjusted tax revenue, but the elimination of the deficit occurred mostly through reductions in government spending. And the Mexican economy was able to grow about 3 percent per year during this period of fiscal adjustment. As Chart 5 shows, the reduction and eventual elimination of the government deficit were accompanied by a resurgence in bank lending to the private sector.

Chart 5 The Government Deficit and Bank Loans to the Private Sector in Mexico

Billions of 1978 pesos

NOTE: 12-month centered data.
DATA SOURCE: SIE Economic Database.

The U.S. Government Deficit and Bank Lending

A somewhat similar but much more subtle relationship may exist between the high U.S. federal budget deficit and reduced lending activity at U.S. banks. Mexico's monetization of the deficit contributed to high inflation and high interest rates. Although the U.S. federal deficit has remained much lower than Mexico's deficit, recent trends in U.S. interest rates suggest that the size of the U.S. deficit has been an important factor in influencing the slope of the yield curve.

The Federal Deficit and the Yield Curve. During the past decade, high U.S. government budget deficits have been associated with steep yield curves. In Chart 7, the federal budget deficit for a given 12-month period is scaled by the level of the monetary base at the beginning of the period. As in our analysis of Mexico, the size of the 12-month deficit relative to the beginning-of-period monetary base measures how much growth in the monetary base would be required if the deficit were to be financed totally by printing money. Also shown in Chart 7 is the spread between the 30-year and one-year yield on U.S. Treasury bonds. As indicated by the association between the deficit and spread, investors seem to demand higher
yields on long-term bonds relative to short-term bonds when the deficit is high relative to the monetary base.

One potential explanation for this pattern is that the high yields on long-term bonds compensate investors for the potential inflationary consequences of the deficit. A high deficit today may increase concern over additional deficits in the future and the resulting growth in the government debt. If increased money growth were used, at some point, to help retire the growing government debt, then higher inflation would follow. Such inflation concerns are one possible motivation for the buyers of long-term bonds to demand higher spreads when the deficit is high.

**The Federal Deficit and Bank Lending.**

The data shown in Chart 7 are consistent with a positive linkage between the government deficit and the slope of the yield curve, which provides a potential channel through which the deficit might affect bank portfolios. Because long-term interest rates currently are high relative to short-term interest rates, a desire to increase current profits may have helped induce banks to shift out of loans and into government securities, many of which offer relatively long maturities.

Both the yield curve and U.S. banks’ holding of U.S. government securities relative to loans are shown in Chart 8. From 1990 through recent quarters, the period most associated with the credit crunch, the spread between long-term and short-term rates has grown dramatically, while banks have increased sharply their holdings of U.S. government securities relative to loans. These trends are consistent with the view that high U.S. government deficits have contributed to the steep yield curve, which, in turn, has helped reinforce incentives for U.S. banks to move away from loans and to securities investments.

**Concluding Remarks**

Lending activity has remained unusually weak at U.S. banks, even as financial conditions have continued to improve. In this article, we have moved beyond the factors commonly cited as contributors to the stagnation in bank lending and have focused on the potential effects of high federal budget deficits on bank lending decisions. We think this analysis addresses a potentially important, but thus far under-emphasized, effect of high federal budget deficits on economic activity.

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