



# Economics Group

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## Bank Credit: A Surprisingly Typical Cycle

*Bank credit, through C&I loans and securities, is following a typical cycle contrary to some commentary. What is unusual is the depth of the correction in real estate lending—a product of perceived home values.*

### Business Lending and Inventories

Inventory finance is a staple of short-term bank lending and the link to inventory building is clearly evident in the top graph. As firms build inventories during periods such as 1995, 2002-2004 and now 2010-2011, these firms seek bank financing and, as such, this lending tends to follow a demand-driven model.

Inventories, in turn, tend to follow the business cycle. As firms are more confident of final sales, they will demand more inventories to maintain product on the shelves. This pattern creates a cycle where increases in expected sales induce firms to accumulate inventories to maintain a target inventory-to-sales ratio and that, in turn, requires some firms to seek financing for that inventory from banks. This appears to be the pattern for this economic expansion as well.

### Bank Lending: A Tale of Both Small and Large Banks

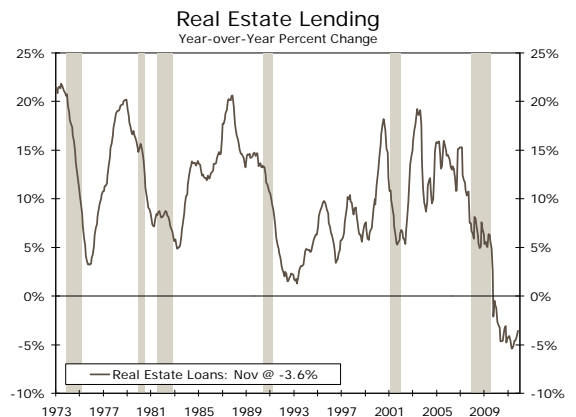
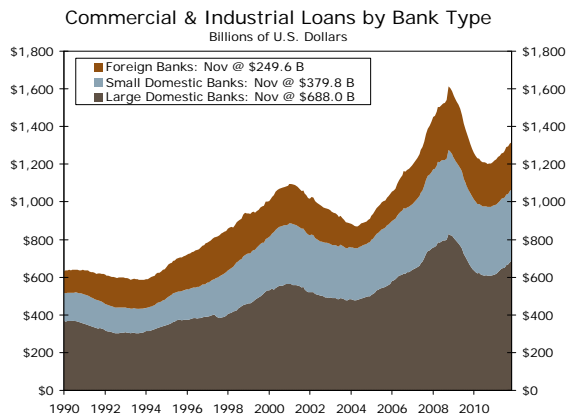
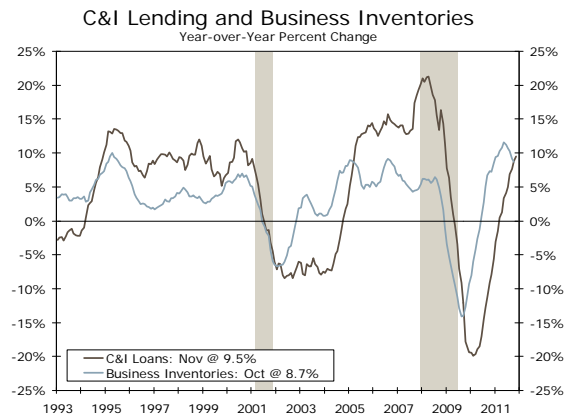
What is also telling about business lending is that large banks have continued to provide the majority of commercial and industrial loans throughout this business cycle (middle graph). Moreover, contrary to some views, the expansion of bank credit requires the participation of both small and large, foreign and domestic lenders to sustain economic growth.

Unfortunately, the role of financial intermediaries is often overlooked as part of the engine for economic growth. Yet, here, it should be obvious during the current cycle that bank lending is an integral part of the economic growth engine and that banks of all types in the United States play a central role. C&I lending is 9.5 percent higher than a year earlier.

### So What Is Different? Real Estate Lending

Retrenchment in real estate lending (bottom graph) has been much greater this cycle and appears to be more sustained than most prior cycles although the experience of 1990-1993 appears to have been of similar length—so far.

It is also interesting to note that the share of real estate lending done by small banks has fallen to 43 percent from a high of 47 percent during the housing boom, closer to the series historical average of 39 percent. Similar to 1990-1993, bank credit quality itself is under question and therefore banks have to improve their balance sheets, as they have in the past. A thinner market for securitization has forced smaller banks to hold new real estate loans on their balance sheets, while questions about the value of the underlying real estate collateral persist. Moreover, the depth of the real estate correction suggests that the drop in lending is consistent with a rise in loan write-offs. Is this a new reality for real estate lending that requires lenders to be more cautious, and lend less, for some time, but not forever? Perhaps once real estate values recover, lending will return to a rapid pace of growth.



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