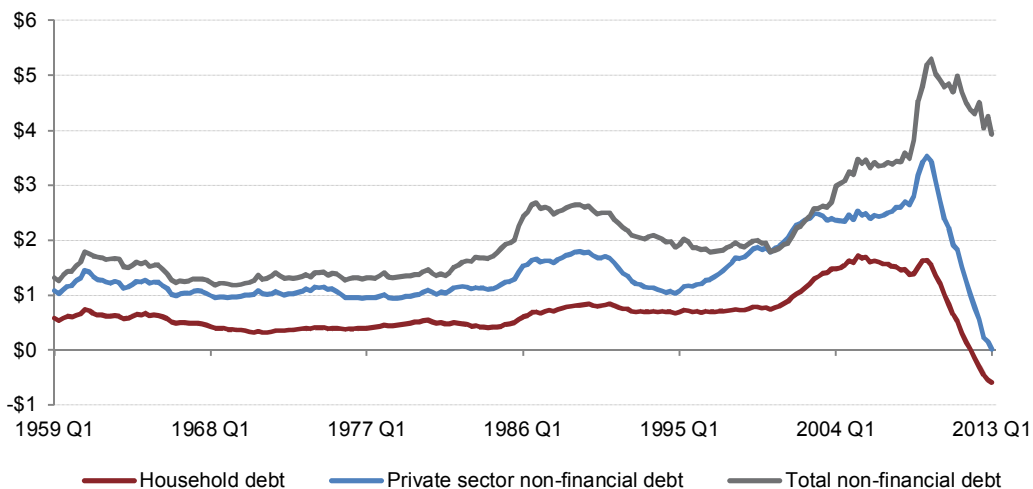


If we shift to non-debt-induced growth, part 2

- **Contrary to received wisdom, non-credit-fuelled output growth is perfectly feasible**
- **The future growth of (notably) household mortgage credit is likely to be slower**
- **One consequence will be banks holding relatively more short-term government paper**

Earlier this month John G Stumpf, the Chairman of Wells Fargo, warned that the Fed should not try to make banks shift from short-term funding (ie, mainly retail deposits) to long-term (ie, by issuing debt). Doing so would force banks to switch from a cheaper form of funding to a more expensive one. In fact, one of the results of the financial crisis is that the humble retail depositor is back in fashion.¹ Of course, the financial crisis focused our attention all sorts of issues with banks' balance sheets, more on assets as than on liabilities. What this Comment aims to do is to return to a topic visited in November last year (*If we shift to non-debt-induced growth*, 14th November 2012). That Comment mainly looked at the consequences for residential real estate, suggesting that one likely development in the future is a return to a larger share of rental as opposed to owner-occupied housing. Obviously, however, a move away from credit-fuelled growth also has an impact on banks' balance sheets.

Incremental debt/GDP ratio
(five-year moving average of the dollar change in debt per extra dollar of GDP)

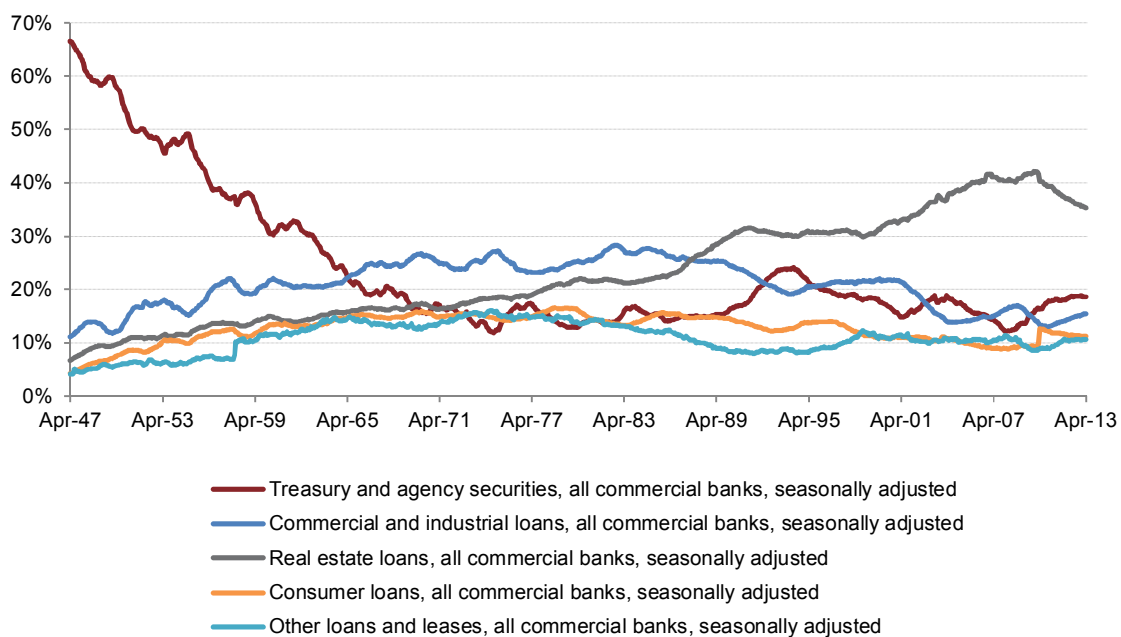


First, it is perhaps necessary to ask whether it is possible to have growth that is not credit-fuelled. After all, much of central bank (and government) policy since the financial crisis began has been aimed at kick-

¹ How different from the mid-1970s, when I worked in a Swedish bank and the monthly newsletter from the CEO always tended to include something along the lines of 'Hurrah! We've lost another 5,000 depositors!'

stating credit growth. The answer – based on history – is, yes, we can. For much of forty years from the early 1950s to the early 1980s, each incremental dollar of US GDP was over a five-year moving average accompanied by/based on an increase in total non-financial sector debt of between \$1.25 and \$1.60, with an average (Q1 1952 to Q4 1981) of \$1.40. Looking solely at household sector debt, the figure tended to be between 30 and 70 cents, averaging 40 cents. GDP growth during this period averaged 3.5% per annum. From Q1 1982 to Q3 2007 (the beginning of the financial crisis), each incremental dollar of GDP was over a five-year moving average based on \$2.30 of total non-financial sector incremental debt or \$1 of household sector incremental debt. The numbers peaked in 2009 with \$5.30 of non-financial sector debt and \$.1.60 of household debt per extra dollar of GDP. Average GDP growth was 2.8%. The latest figure – and bear in mind that these are five-year moving averages – is \$3.93 extra dollars of total non-financial debt per extra dollar of GDP; but 60 cents /less of household debt. Almost all the increase in non-financial debt is of course public sector. Looking solely at extra private sector debt, the number is 1 cent per extra dollar of GDP.

Various loan categories as % of total loans and leases in bank credit



Memories of debt deflation have historically been very powerful. If there is indeed a shift towards slower debt/borrowing growth in the future, it is likely to come on the household side, specifically on housing loans. In contrast to governments, households need to repay their debt and in contrast to companies, usually out of current income (or, alternatively, by selling assets).

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In both the United States and in the euro area, loans (excluding securities) to the non-bank sector make up about 50% of total bank assets. Loans to household constitute 45% of total loans in the United States and 43% in the euro area. Housing loans were 35% of total loans in the US and 32% in the EA. Looking at the US – where the longer data series are available – the mid-2000s saw the culmination of a long development where real estate loans rose from less than 10% of total loans in the immediate post-war era to more than 40% at the peak of the bubble, before coming down again. They are still almost as large as the other main loan categories (commercial & industrial loans, consumer loans and other loans & leases) put together. While all loan categories have risen – unsurprising, given that the credit market was at a standstill during World War II – the rise in real estate loans is by far the most important. Its counterpart change on the asset side of banks' balance sheet is a reduction in holdings of Treasury and Agency securities, from close to 70% of total loans to around 12% in 2007 and 2008 and a recovery to close to 20% by 2013.

If the relative importance of housing loans in banks' balance sheets diminishes, one of two things must happen. Either banks' balance sheets will grow less rapidly (we are not talking about an actual reduction in loans, rather a slower pace of growth in the future); or the composition of assets has to change, with some other asset growing in importance. Judging by developments since the financial crisis began, the more likely development is an increased relative importance of (mainly) short-term government paper, ie Treasury Bills in the case of the United States.

Bearing in mind the post-crisis concern about the safety of banks' balance sheets, this should be good news for banks. It is clear that one key development that made the banking system in most advanced economies more fragile in the run-up to the crisis was the erosion of banks' holdings of cash and instruments that could be (almost instantaneously) transferred into cash. This change – which took place over a long period of time – is understandable, since neither cash, nor near-cash instruments, provide much of an attractive return. However, they do provide safety, which for the time being is a crucial consideration.

A second consequence is that this development, if it takes place, will reinforce the primacy of broad money over credit. I am not going to go into the whole issue of broad money versus credit; that has repeatedly and comprehensively dealt with by Professor Tim Congdon of International Monetary Research (www.imr-ltd.com). Nevertheless, there are still those, notably, but not exclusively the Federal Reserve, who assign primacy to credit developments and little or no importance to broad money. They are wrong. Although broad money and credit tend to move together (credit is after all the most important counterpart to broad money) they do not have to do so. A slower growth in household credit without necessarily a corresponding slowdown in the growth of household consumption should confirm that what matters more is the liquid holdings of households (and companies), ie, broad money, rather than their borrowing, ie, credit. This could only improve monetary policy decision-making.

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