Private Credit, Public Debt, and Financial Crises

Prepared for FRBSF Seminar: Understanding the Slow Recovery

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140 years, 17 countries: Lessons

1. The long view and emerging trends

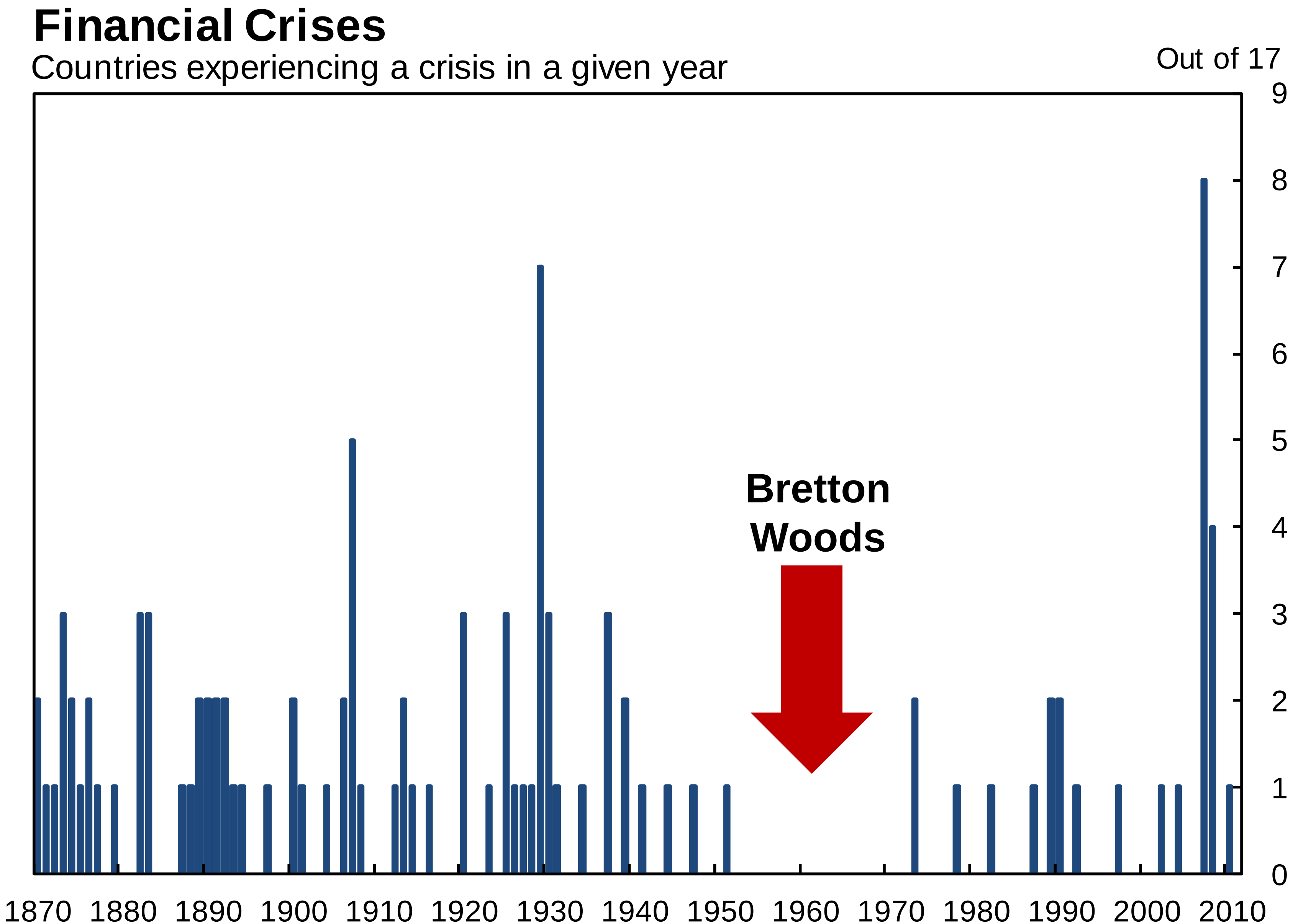
2. Credit and financial crises

3. Public debt and the recovery

4. Implications for policymakers

The long view and emerging trends

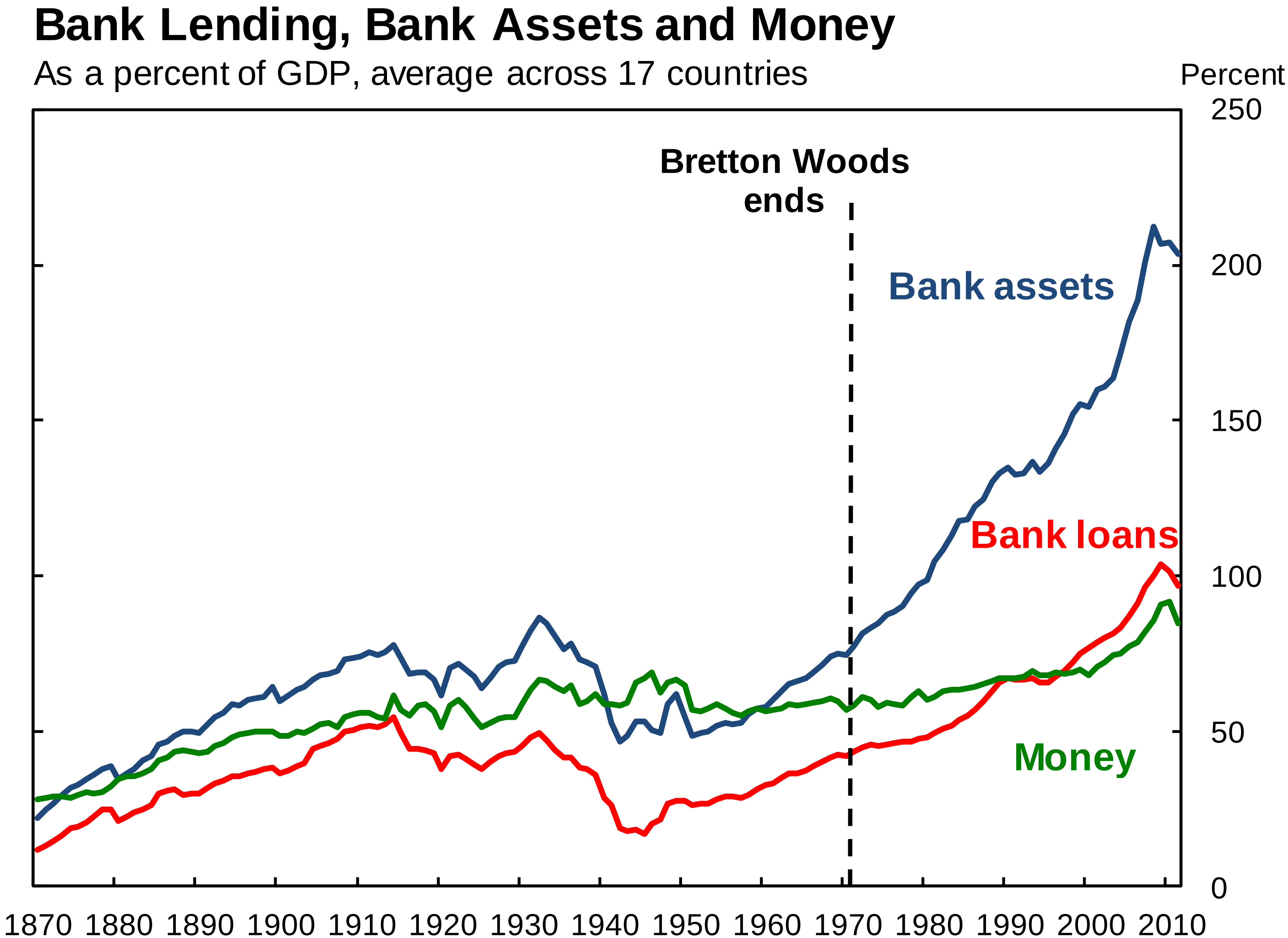
Financial crises return…Why?



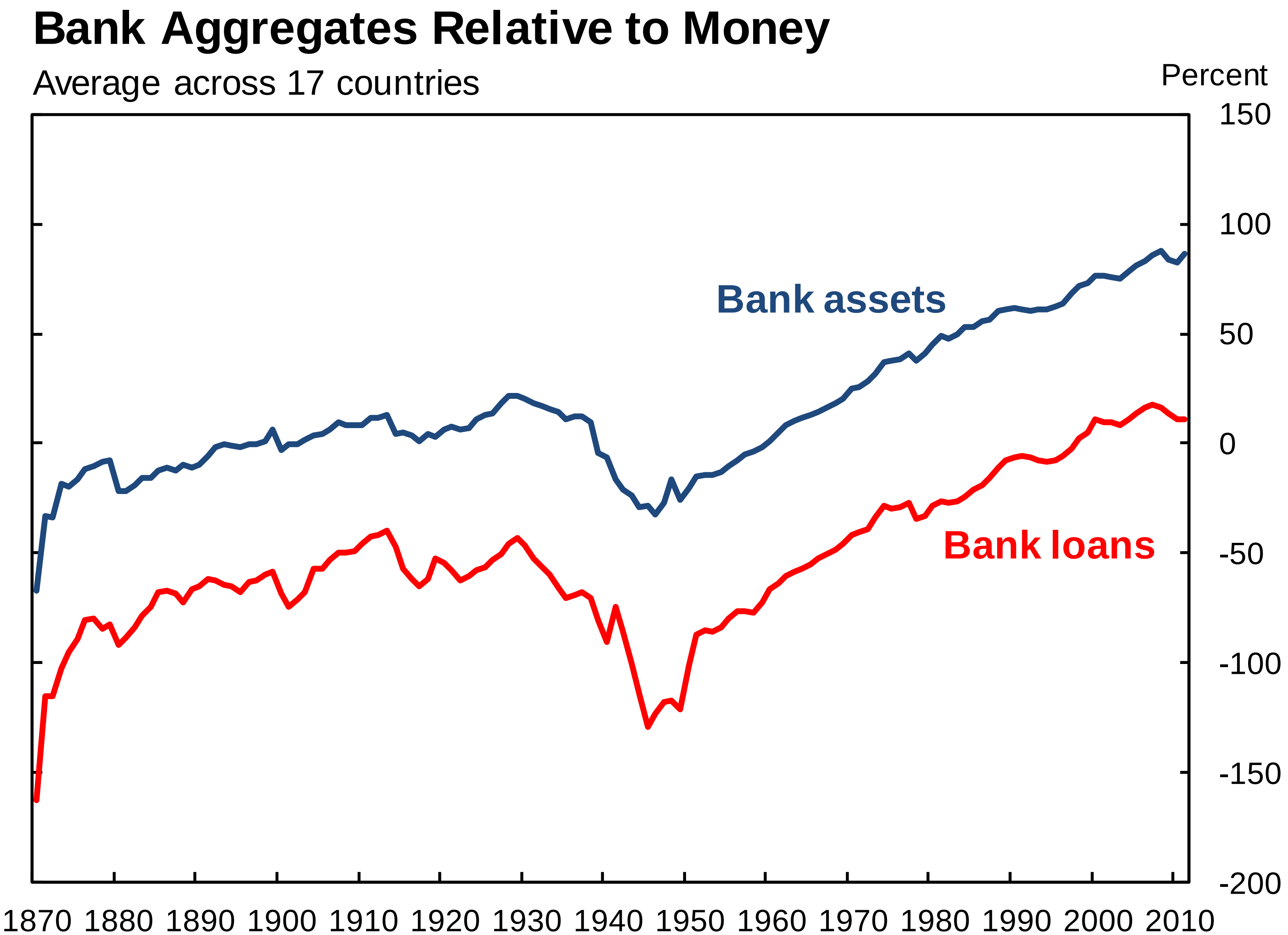
Bretton Woods: what was different?

- Capital controls
- Fixed exchange rates
- Low leverage banking
- Govt. securities a much higher proportion of bank assets (less portfolio risk)
- Primitive finance did not hinder investment: Average growth = 3.8% in 1947-1970, 3.2% in 1971-2007
- BW eventually collapsed

Banking sector explodes since Bretton Woods

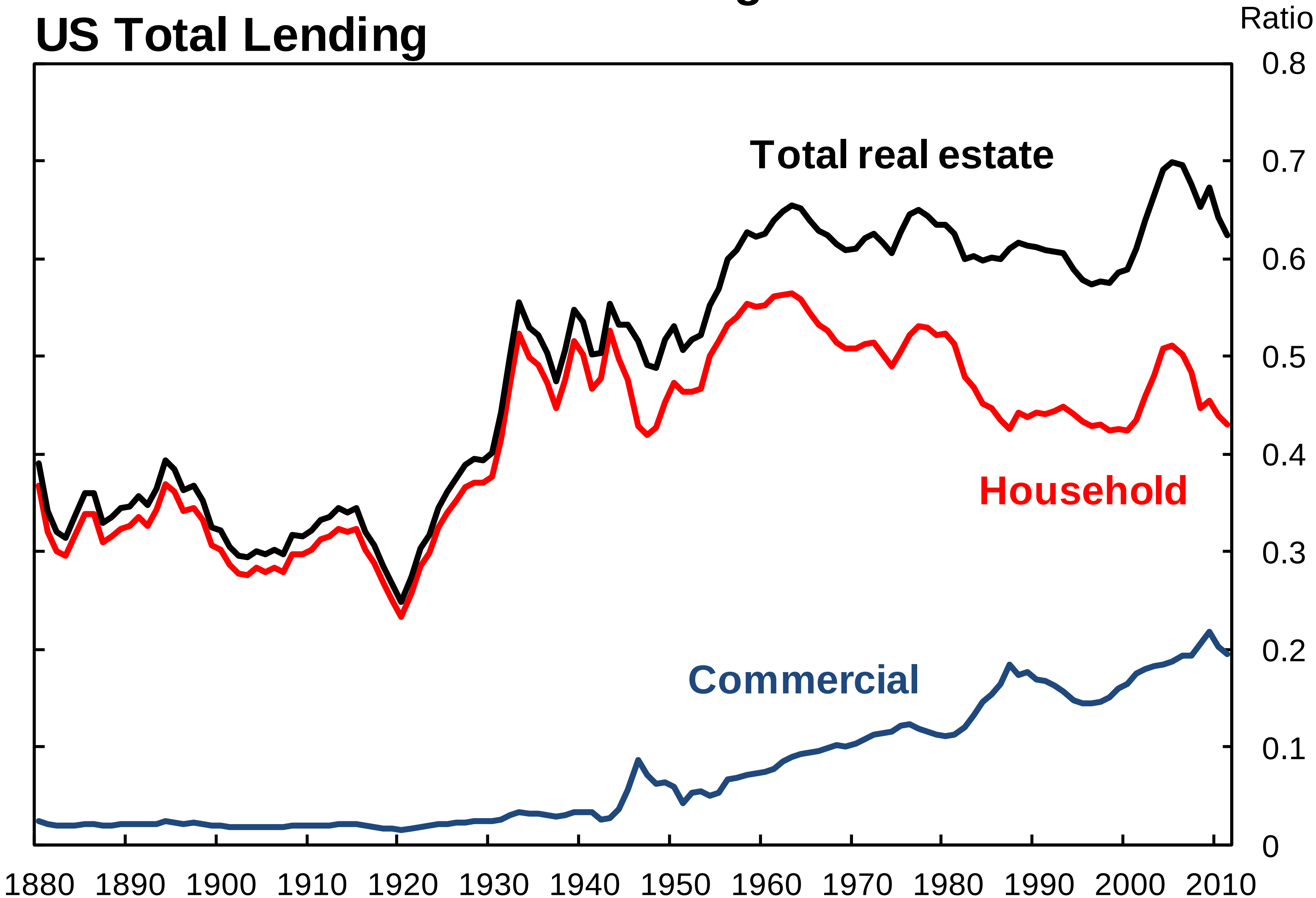


Age of money ushers the age of credit

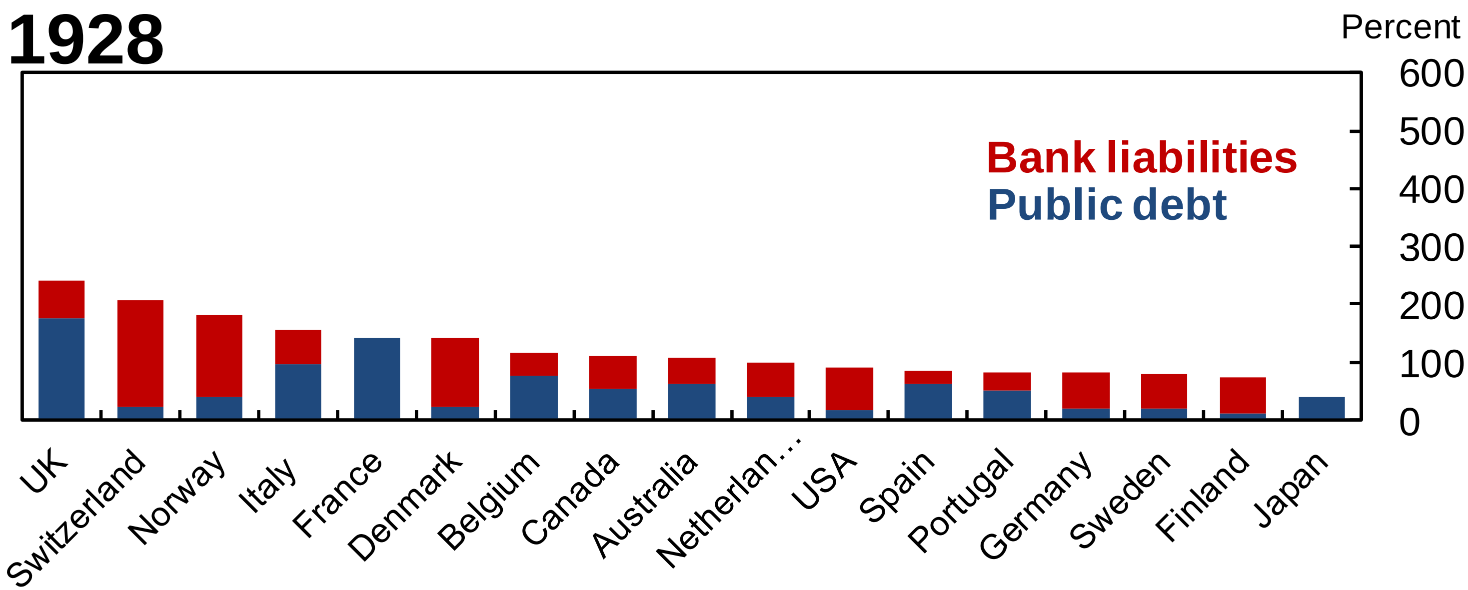


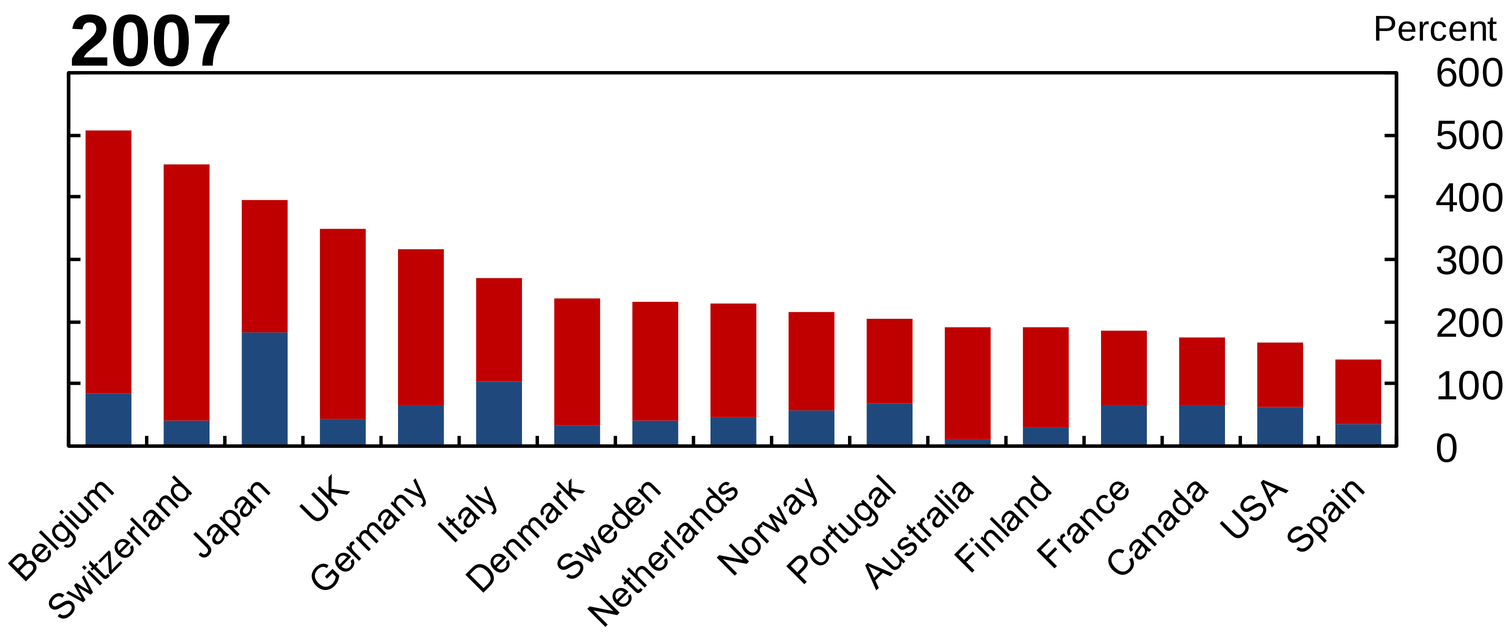
From nuts and bolts to bricks and mortar

Ratio of US Real Estate Lending to US Total Lending



Total Liabilities then and now





Unprecedented reversal of reserves

- Lesson of 1990s emerging markets (EM) crises:
  - Crisis more painful w/o foreign reserves

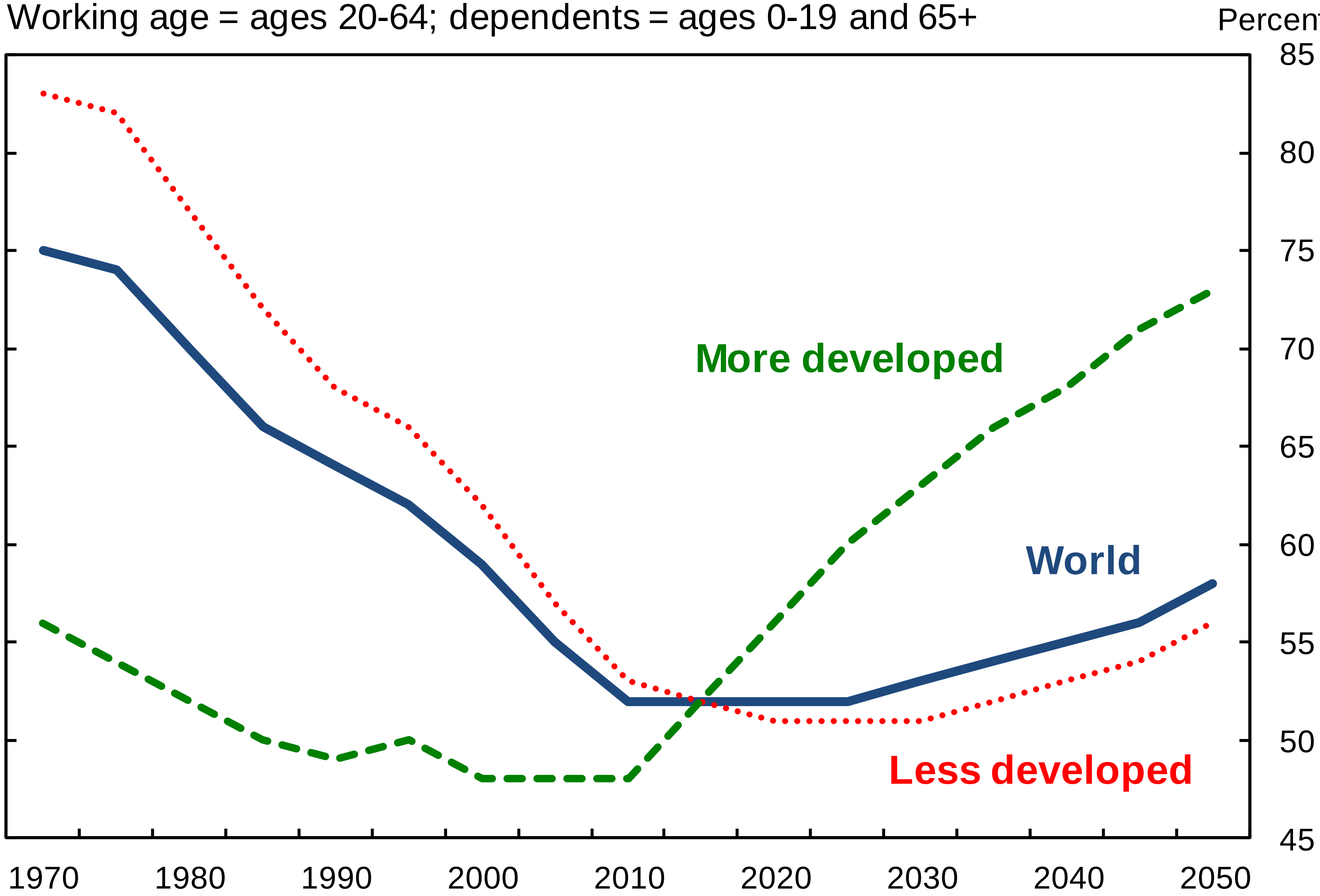
- Since:
  - Globalization = expansion of balance sheets
  - Private capital flows from DM to EM
  - Official capital flows from EM to DM

- *Great Reserve Accumulation*: $10T officially + $4T in sovereign wealth funds

Demographic trends reversing: Savings?

Dependents as a Percentage of Working Age

Working age = ages 20-64; dependents = ages 0-19 and 65+



Source: U.N. Population Statistics; see Pradhan and Taylor (2011)

Recent trends are game changers

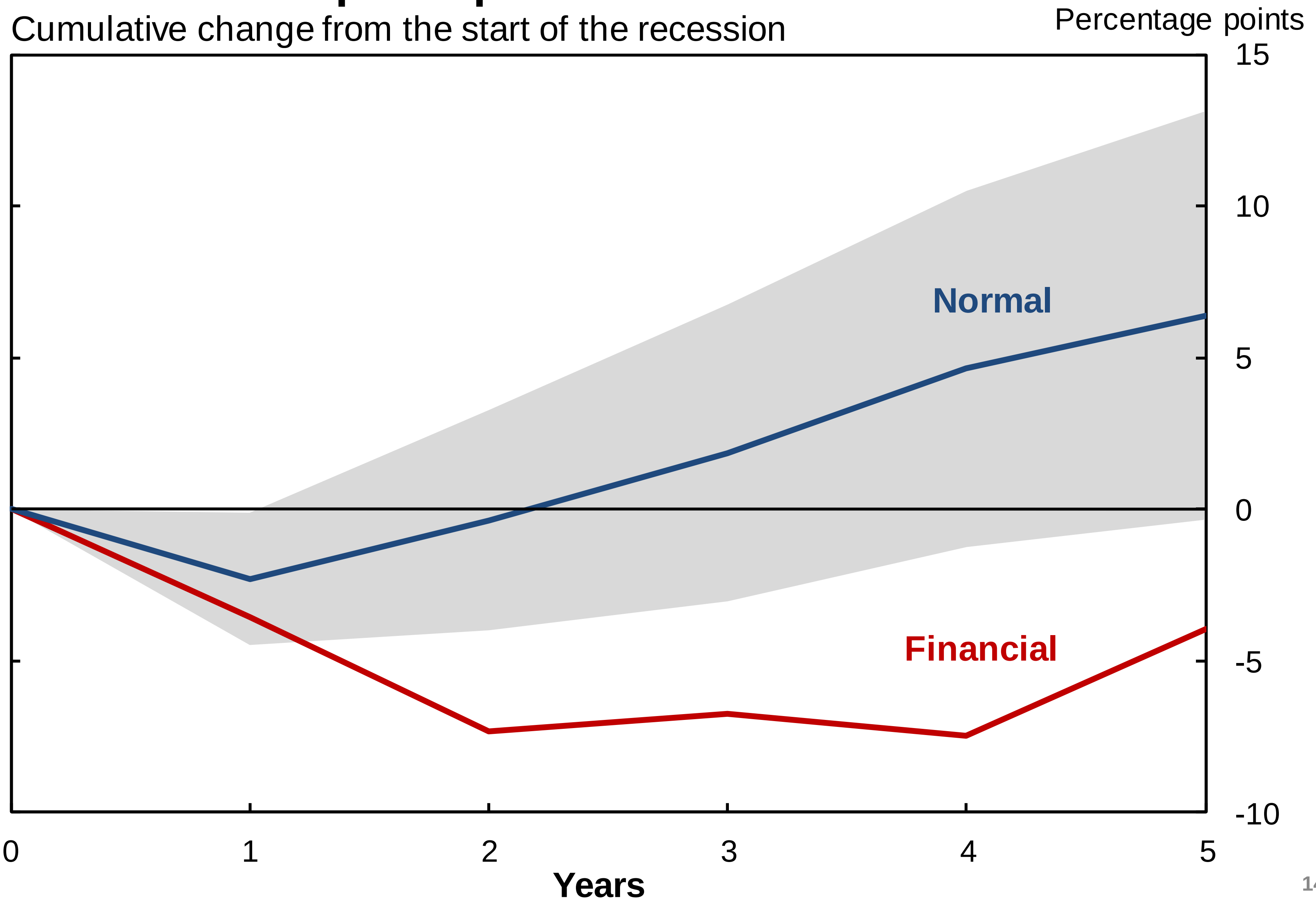
- Unprecedented expansion of credit: financial assets/GDP = 150% in 1975 → 350% in 2008. Bank loans/GDP doubled.
- The banks' asset mix: govt. securities 60-70% in 1950; 0% in the 2000s
- Switch to wholesale funding (uninsured) from deposits (insured): Shadow banking
- Public debt growing globally before the crisis

Credit and financial crises

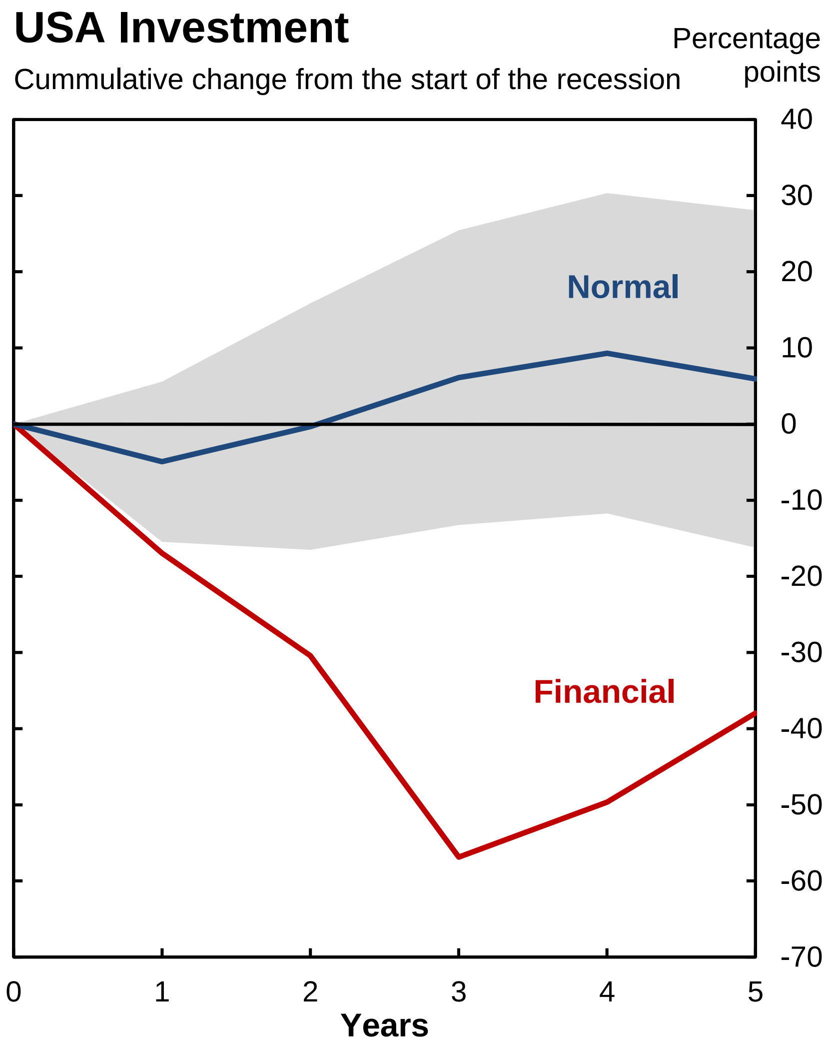
Financial crises are different

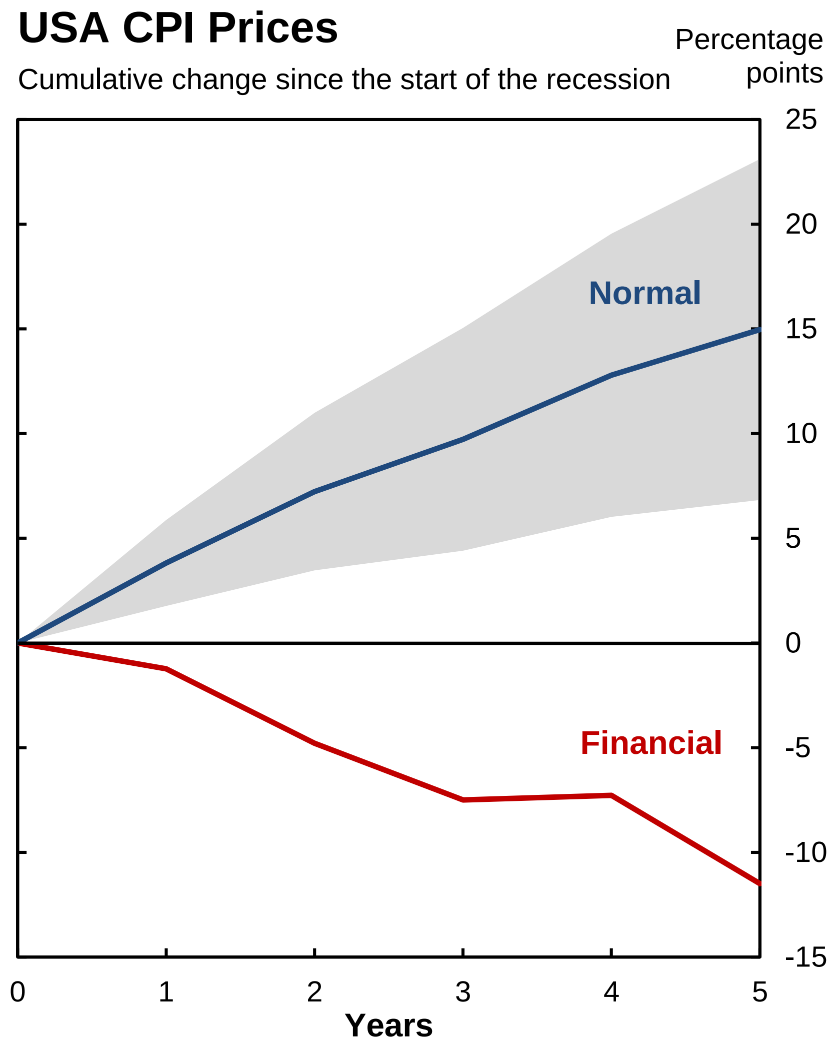
USA real GDP per capita

Cumulative change from the start of the recession



Financial crises: disinvestment and deflation





Private credit predicts financial crises

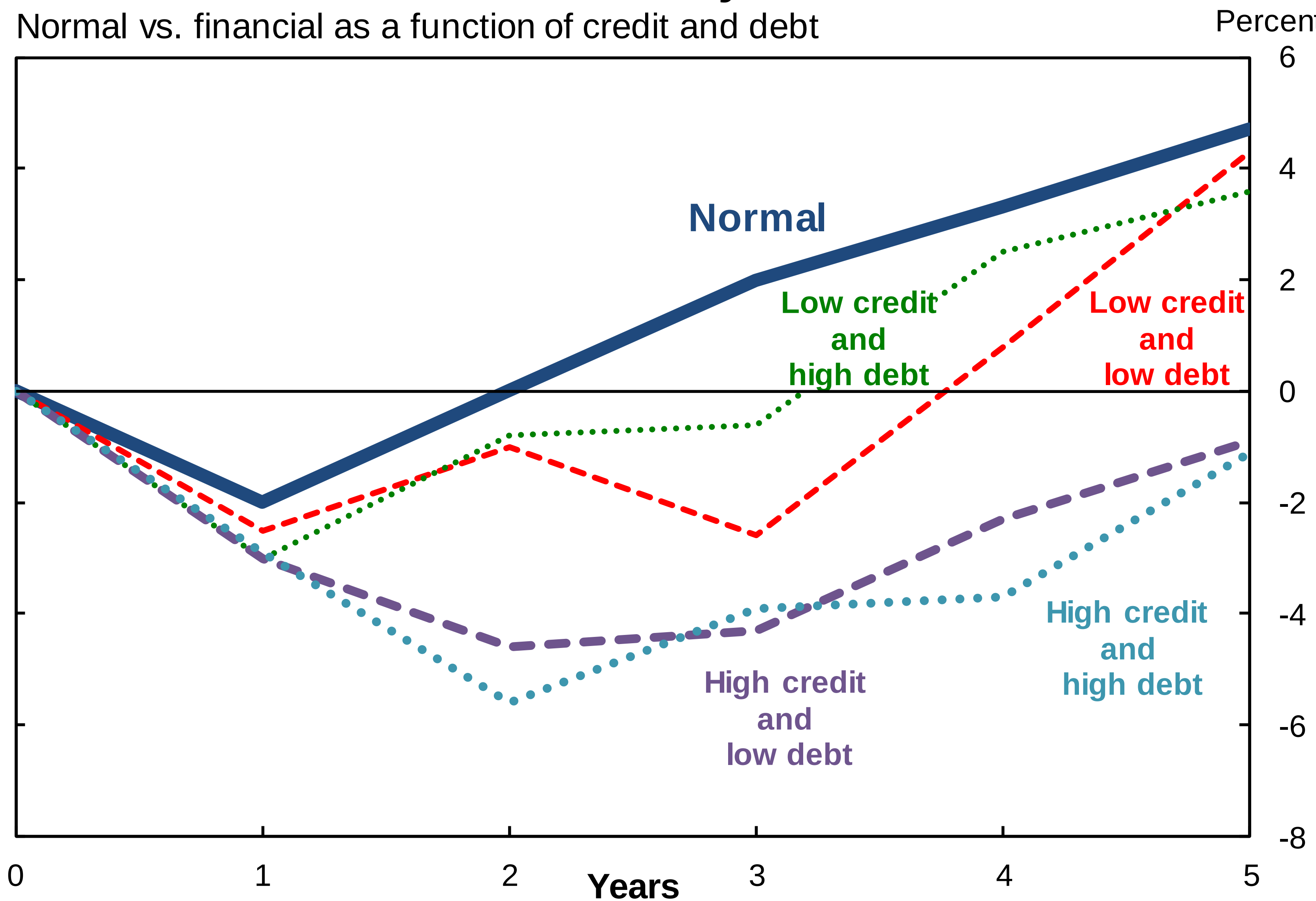
Predict financial crises with:	(1)	(2)	(3)	(4)	(5)
Change in private credit	✓	-	✓	✓	-
Change in public debt	-	✘	✘	-	✘
Level of credit/GDP	-	-	-	✘	-
Level of debt/GDP	-	-	-	-	✘
Both interacted	-	-	-	✘	✘
AUC	0.72	0.61	0.71	0.71	0.62

- Public debt does not work
- External imbalances (not shown) do no work
- Let’s not kid ourselves, financial crises are difficult to predict

Excess credit trumps debt accumulation

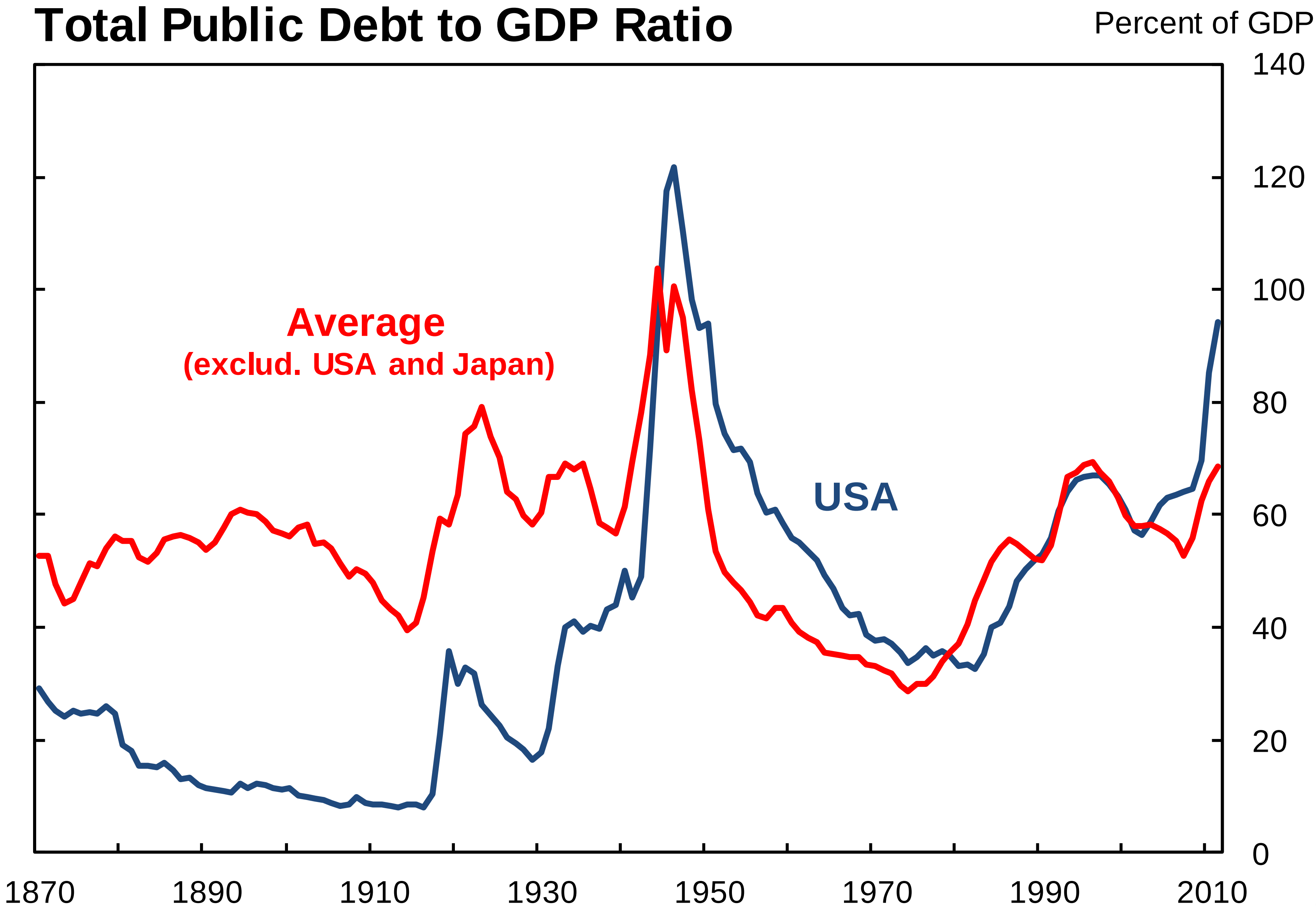
The Recession and the Recovery

Normal vs. financial as a function of credit and debt

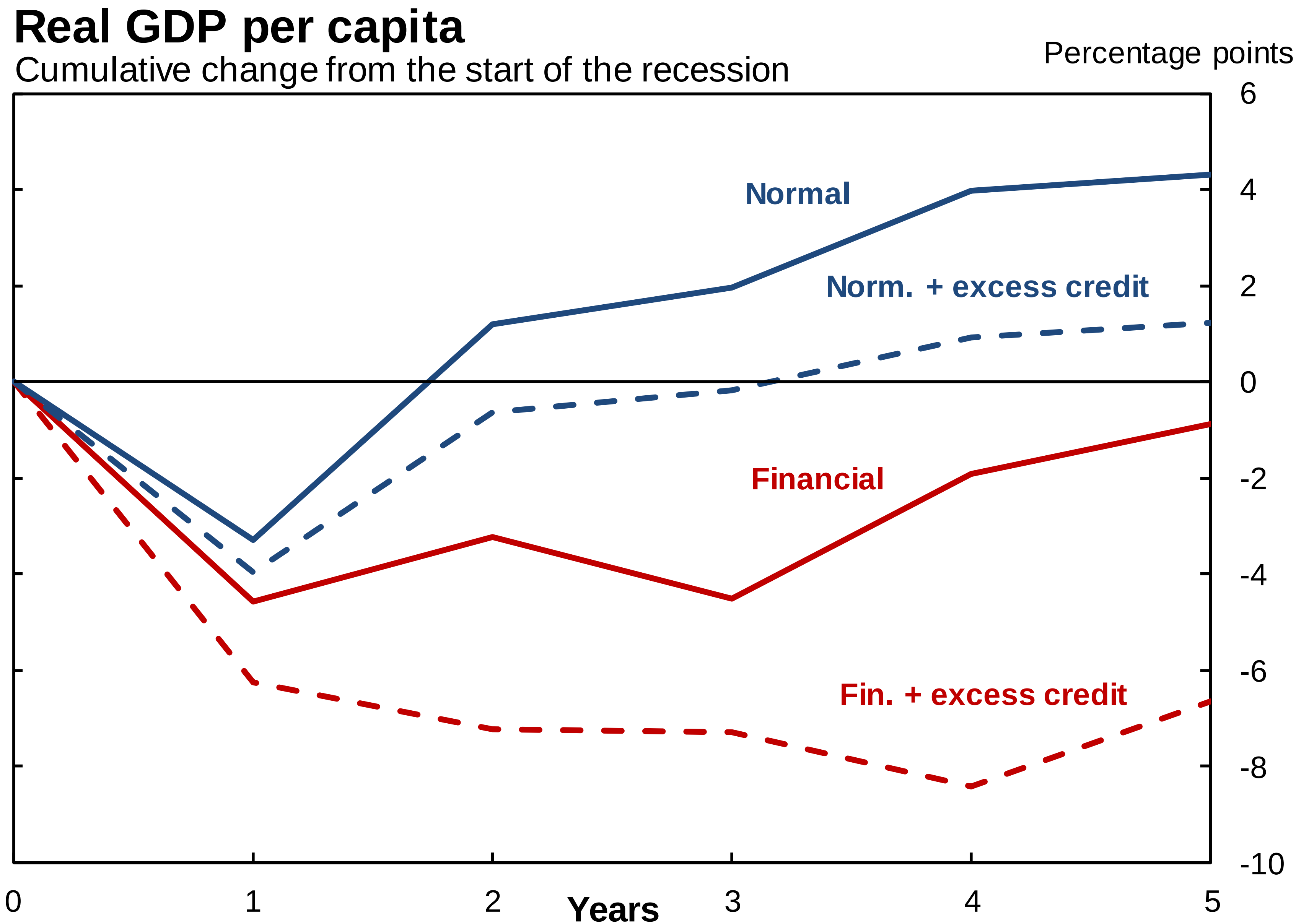


Public debt and the recovery

Public debt growing again…



Excess credit buildup hurts in the downturn



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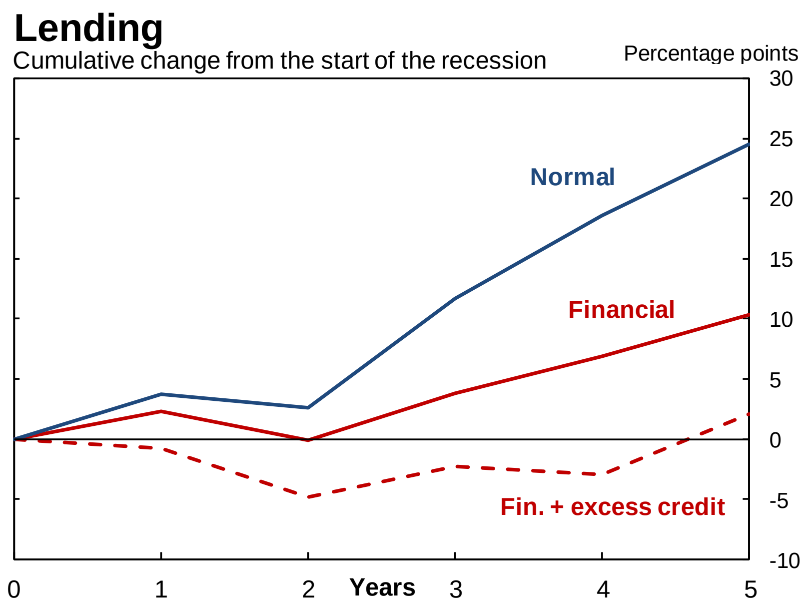
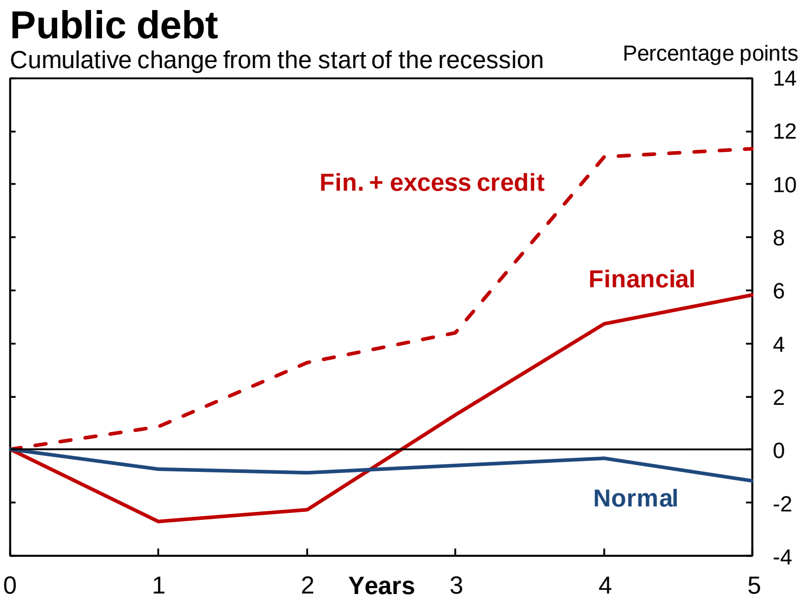
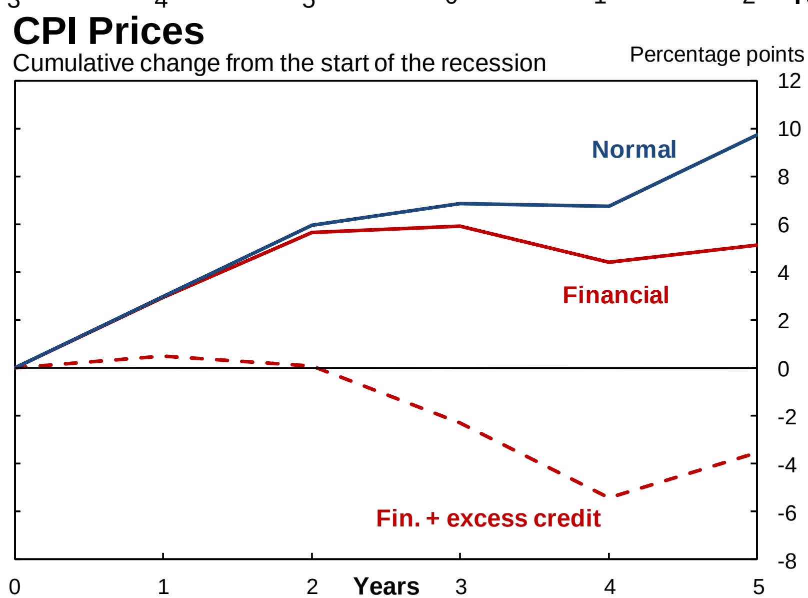
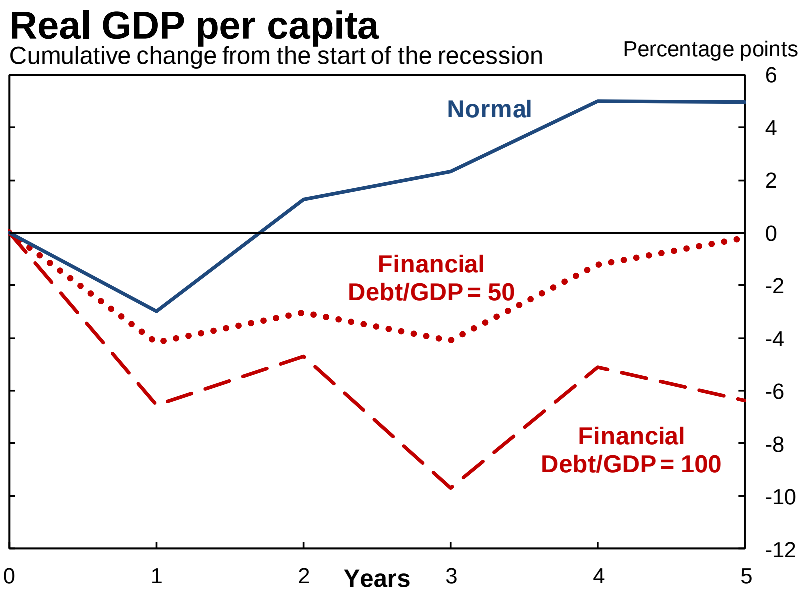
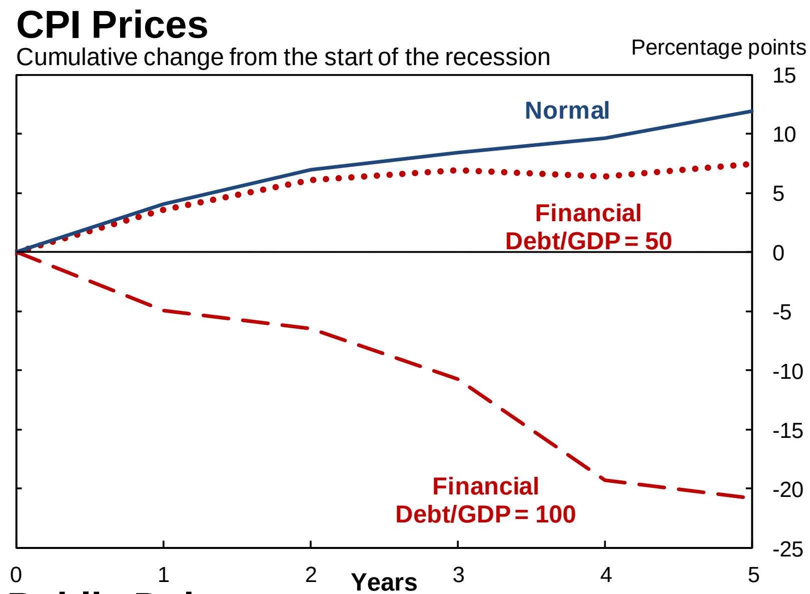


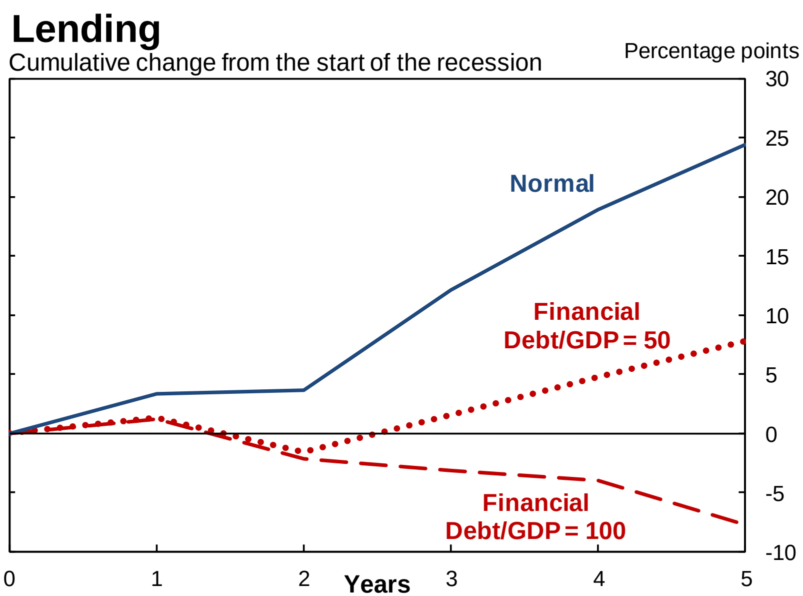


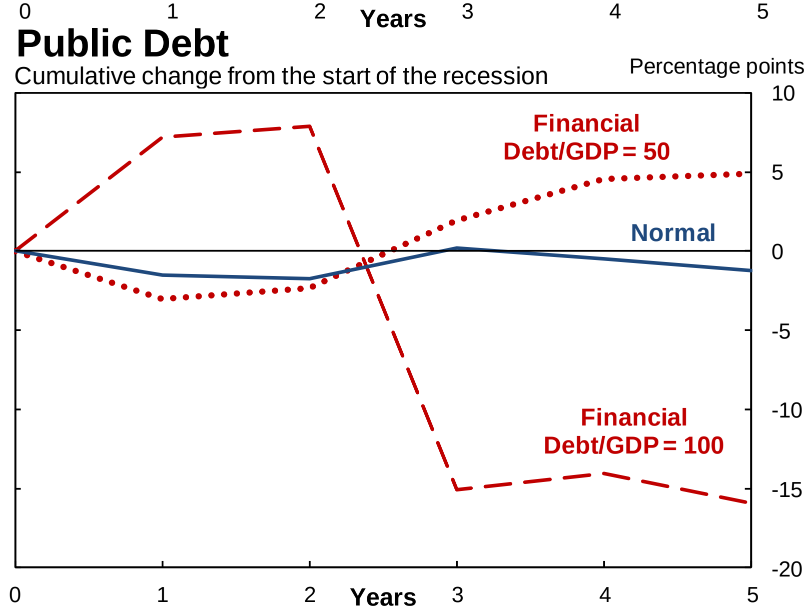


The level of debt matters in the downturn

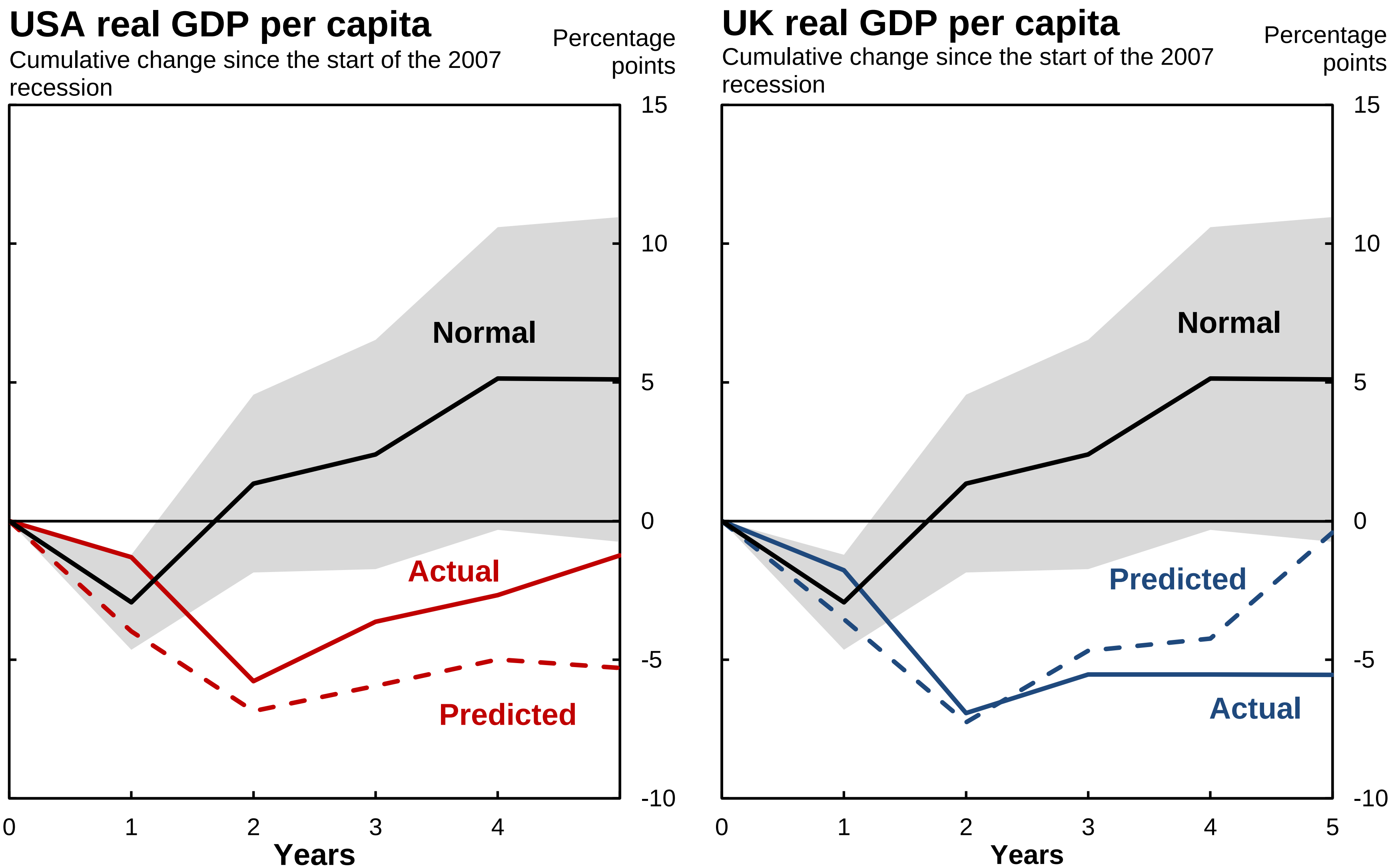








US vs UK recovery (± shadow banking)



Implications for policymakers

Maybe this time is different

- Monitor credit and leverage. New age of credit:
  - Excess credit makes recessions worse, recoveries slower
  - Turns some into financial crises
- Excess public debt:
  - Not the same as credit
  - But high levels complicate recoveries from financial crises
- New EM and demographic trends

Further reading

Useful References

- Jordà, Òscar. 2012. Credit: A Starring Role in the Downturn. FRBSF Economic Letter, 2012-12.
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