The Rise of Credit Policy

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SFS Cavalcade
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The rise of credit policy in the U.S.

Source: Federal Budget 2023 Analytical Perspectives

Traditional credit programs ≈ $5 trillion in 2021

Including these other federal credit activities brings total to > $20 trillion

Note: Excludes Fannie & Freddie, deposit insurance, pension benefit guarantee corporation, federal home loan banks
The IMF reports that the amount of credit support made available in advanced economies ("credit envelope") is about equal to size of traditional fiscal policies.

This credit envelope > USD 5 trillion (11% GDP)

But this measure is a very imperfectly correlated with the credit extension that took place.

Credit

- Importance for economic growth, capital allocation, wealth formation, entrepreneurship...
- Channel for monetary policy (financial accelerator)
- Susceptible to moral hazard, adverse selection, incomplete contracting, asymmetric information...
  - Market imperfections can cause too much or too little credit provision, multiple equilibria

Credit policies

- Can counter private market imperfections
  - Increase access to credit for SMEs, young, poor
  - Protect consumers
  - Control systemic risks
  - Limit risk-taking by private financial institutions

Focus is primarily on private markets and gov’t regulation of private markets
Focus has been primarily on private markets and gov’t regulation of private markets ... but **government’s are the world’s largest financial institutions and credit allocators**

As such, the **same fundamental issues arise as for private financial institutions**...

- How should a government assess its cost of capital?
- How should its financial activities be accounted for?
- What are the fiscal and macroeconomic effects of its financial activities?
- Are the institutions well-managed?
- Are its financial products well-designed (e.g., conforming mortgages, student loans)?
- Are there adequate consumer protections?
- Does it create systemic risks?
- Are the resulting allocations of capital efficient/welfare-enhancing?
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A more **behavioral approach to policy analysis** than is typical
- Gov’ts are often modeled as benevolent, purposeful, well-informed….or incompetent and wasteful
- Observed gov’t actions appear at odds with either a benevolent or incompetent framework

The insights of behavioral finance can be applied to policymakers in the role of financial decision makers
- Tendency to act based on rules of thumb and long-standing policies
- Inconsistent and time-varying objectives
- Limited attention, limited financial knowledge, limited information

=> Potential for research and education to improve outcomes
Credit policy

**Definition:** A credit policy affects the terms or availability of credit to households, firms, or sub-national govt. entities

- **Examples:**
  - Loan guarantees (e.g., mortgages, agriculture)
  - Direct lending (e.g., airlines, student loans, critical industries)
  - Loan moratoria or forbearance (e.g., Italian SMEs, U.S. student loans)
  - Regulations (e.g., govt’s credit program eligibility; risk-based capital requirements)

Credit policies have **aspects that are monetary, fiscal, and regulatory**

- There is a *fiscal element* when policy involves subsidies
- There is a *monetary element* when policy originates from central banks
- There is a *regulatory element* when policy based on administrative rules or legal restrictions
- Policies can be passive (standing policies) or active (enacted in response to a shock)

**However, to be understood, credit policies need to be evaluated in their own right**
Mechanisms for credit policies to affect macro-economy

- Credit policies can block, amplify or complement the effects of other policies

- Examples:
  - During Great Recession, mortgage policies blocked monetary policy; but standing credit programs provided huge stimulus
  - During Covid-19, credit policies amplified and complemented monetary & fiscal policies

- Credit policies affect the quantity of borrowing on two margins:
  - **Intensive margin**
    - Reduced rates => higher demand
  - **Extensive margin**
    - Increased availability of credit for firms and households that banks would not lend to without support
    - Likely to be especially important during periods of financial distress
Transmission of Fed rate cuts in recessions is impeded by credit spread increases

Credit guarantees reduce credit spreads, increasing the impact of monetary easing.
Transmission of Fed rate cuts in recessions is impeded by tighter lending standards

Credit policies can offset tighter lending standards, increasing the impact of monetary easing.
What were macro/fiscal consequences of credit policies during Covid-19 (and during the Great Recession)?

Governments globally deployed credit polices during the Covid-19 pandemic on a historically unprecedented scale

- **Focus on credit policies which, like traditional fiscal spending, provided incremental resources to households and firms**
  - loan guarantees and direct government lending to firms
  - large-scale forbearance programs (e.g., mortgages, and bank loans to SMEs)
  - Relaxation of regulations that accommodated these policies

An important goal is measurement—how to size credit programs to evaluate their macro effects alongside fiscal policies?

Empirical analysis covers credit policies for seven large advanced countries

- France, Germany, Italy, Japan, Spain, United Kingdom, and United States
- In dollar terms accounts for > 90% of pandemic credit support globally
- Developing countries expanded fiscal and credit policies much less
Measurement issues

- How to size credit policies to be comparable to fiscal policies for macroeconomic analysis?
  - Unifying concept of “incremental resources provided”
  - Focus is primarily on extensive margin effects: relaxation of borrowing constraints

- How to measure subsidy (budgetary) costs?
  - At market or fair value of loan concessions from gov’t

- How should governments account for credit support? How does that compare to current practices?
  - Budgetary cost recognition upfront at fair value; subsequent tracking of take-up, performance, etc.
  - Often off-balance-sheet with no upfront cost recognition; inconsistent reporting of ex post outcomes

- Pros and cons of different credit policies versus traditional fiscal policies?
  - See papers...
• “Incremental resources provided” measured by principal take-up (Hong & Lucas, 2023)
• Predominantly loan guarantees, many to SMEs
• 80% to 100% guaranteed
• Typical maturities of 3 to 7 years
• Authorized “Envelope” often far exceeded “take-up”

• Fiscal costs (from Hong & Lucas, 2023) totaled $330 billion ($1.1 trillion including the U.S. PPP)
• Dividing total fiscal cost by total take-up, the average subsidy rate is 37 percent (67 percent including PPP)
• The subsidy rate varies widely across programs as a function of riskiness of target borrowers; size of rate concessions; loan maturity; fees; and other features
Credit forbearance policies (payment holidays)

- “Incremental resources provided” equated to estimates of payment amounts skipped
  - May be some offset when implemented with mandates on private sector lenders
- Very(!) limited data => may be underestimating
- Largest programs for residential mortgages and bank loans to SMEs; also student loans, auto, …
  - (Rent payment holidays are either fiscal or unfunded mandates on private sector)
- Typically for < 1 year initially; many were extended but most have ended
To encourage participation in forbearance and loan guarantee programs, certain rules and regulations were temporarily relaxed.

- E.g., in EU application of qualifying moratoria did not automatically trigger forbearance classification or non-performing status of the exposure.

Despite influx of risky borrowers in guarantee programs, banks’ reported risk-weighted-assets fell

- EU banks reported average RWAs to be 18% of the exposure value for loans made under public guarantee schemes, whereas the average RWA was 54% for banks’ loans to non-financial corporations.

Reduction in risk weights was appropriate from a bank regulatory perspective because the guaranteed loans were in fact low-risk for the banks

However, a naïve reading of bank health metrics could have given some policymakers the false impression that credit risk in the economy was much lower than it actually was.

- Sharply rising default rates now reported in EU
- Inflated credit scores in US from student loan moratorium
Gov’t interventions were much larger on average, and much more uniform across countries, when credit and forbearance policies are taken into account.

Average Fiscal 14.5%
Average Fiscal+credit+forbearance 22.0%
Relation between growth real GDP and alternative policy measures

GDP growth is between Q4 2020 and Q4 2021, ex Japan
Increased saving is the difference between gross private saving in 2020 and in 2019, divided by 2020 GDP.
Relation between inflation & alternative policy measures

Inflation is the ratio of CPI in October 2022 to the CPI in October 2021 (minus 1)

Correlations (ex Japan)

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<th>Inflation</th>
<th>Savings</th>
<th>Real GDP</th>
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<td>Fiscal + credit + forbearance</td>
<td>-0.1</td>
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Relation between inflation surprises & alternative policy measures

Inflation surprise is the difference between realized and IMF forecast inflation in 2021.
Critical for evaluating fiscal cost of gov’t credit, cost-benefit analysis of regulatory policies

- E.g., the social cost of carbon, real investment decisions in infrastructure

Government’s often use risk-free rates for discounting (or simple static assumptions) ignoring the cost of priced risks

- Mistakes own borrowing cost gov’t for cost-of-capital
- Neglects cost of risk-bearing by taxpayers and other stakeholders that act as equity holders
- Creates huge distortions in decision-making

In U.S., “OMB Circular A-4” sets the rules for discounting by federal agencies

- It is currently under revision; proposed revision does not embrace the principals of financial economics.
- Public comments are due by June 6
Concluding remarks

- Governments around the world increasingly rely on credit support policies, particularly in times of financial and economic stress

- **Credit policy deserves the standalone status accorded to monetary and fiscal policy**
  - It is much to the detriment of effective policy decisions that the costs and other information about credit policies are poorly and inconsistently measured and reported on in official statistics

- **The size, cost and effects of these policies are poorly measured by governments and routinely overlooked by economists**

- That omission is a mistake, but it is also an opportunity for researchers

- **If credit and discounting policies are so important, why don’t they get more attention?**
  - **Lack of data.** Governments report standardized statistics on monetary and conventional fiscal policies, but credit falls through the accounting cracks. There is no common international reporting framework for credit, and its “below-the-line” treatment make it opaque; gov’ts have incentive to preserve opacity
  - **Complexity.** Multi-year time horizons, contingent nature of liabilities, cost assessment, heterogeneous program characteristics
  - **Lack of generally-accepted theoretical frameworks** e.g., to map credit support into aggregate demand