

Is there a credit crunch? Possible insights for the conduct of monetary policy

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**This discussion represents my personal point of view
and not necessarily that of the Bank of Italy**

*“The Big Crunch and the Big Bang.
How to get out of the financial mess?”
Cambridge, 21st November 2008*

Outline of the discussion

- 1) **Credit in the euro area: bonds vs bank lending and the effects of securitization**
- 2) **The impact of the financial turmoil on the cost of credit**
- 3) **Results of the October 2008 *Bank Lending Survey* for the Euro area**
- 4) **Possible insights for monetary policy**
- 5) **Conclusions**

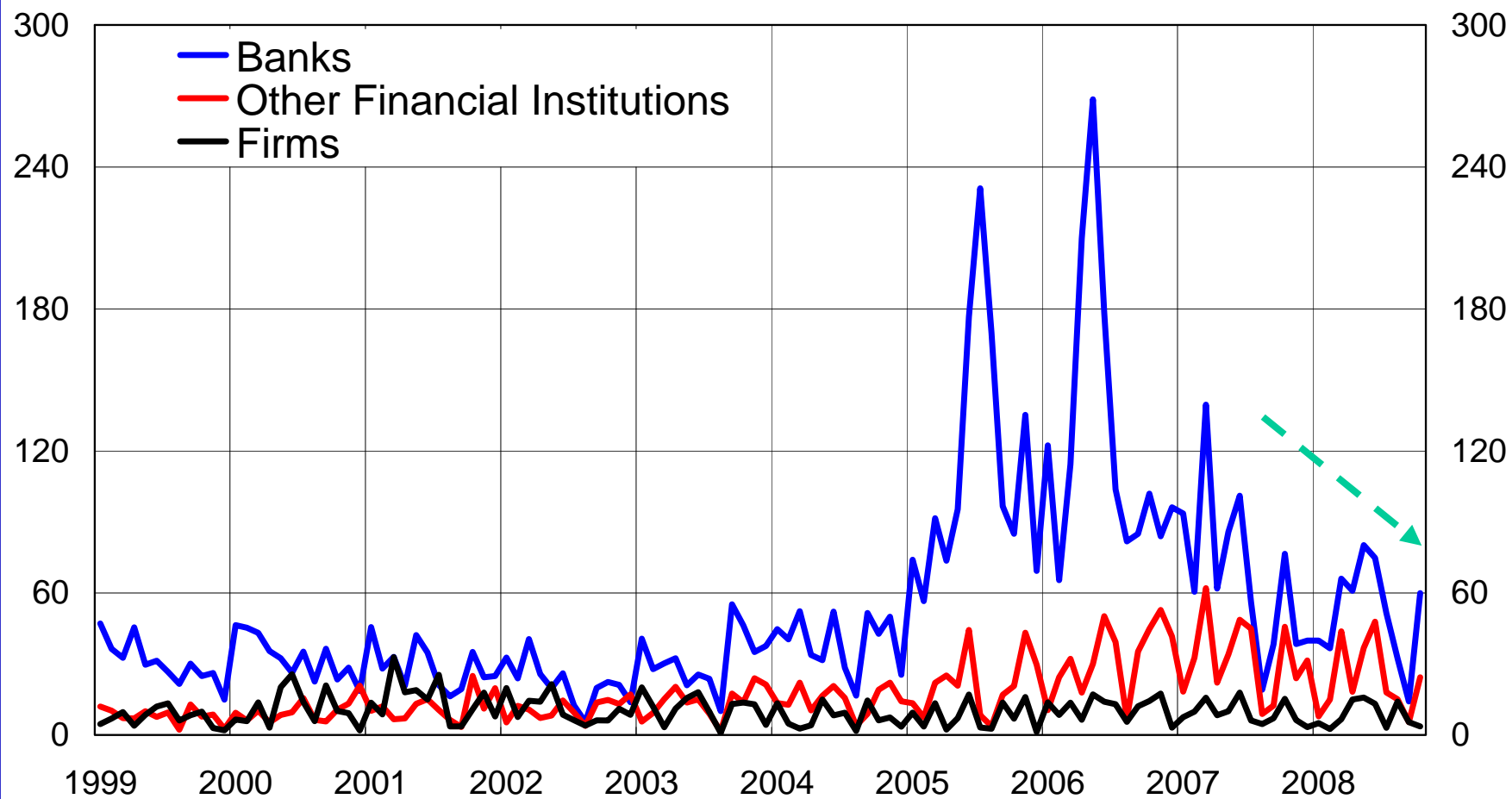
(1)

**Credit in the euro area:
bonds vs bank lending and the
effects of securitization**

Bond issues in the euro area have significantly declined during the crisis ...

Euro area - Bond issues Investment grade

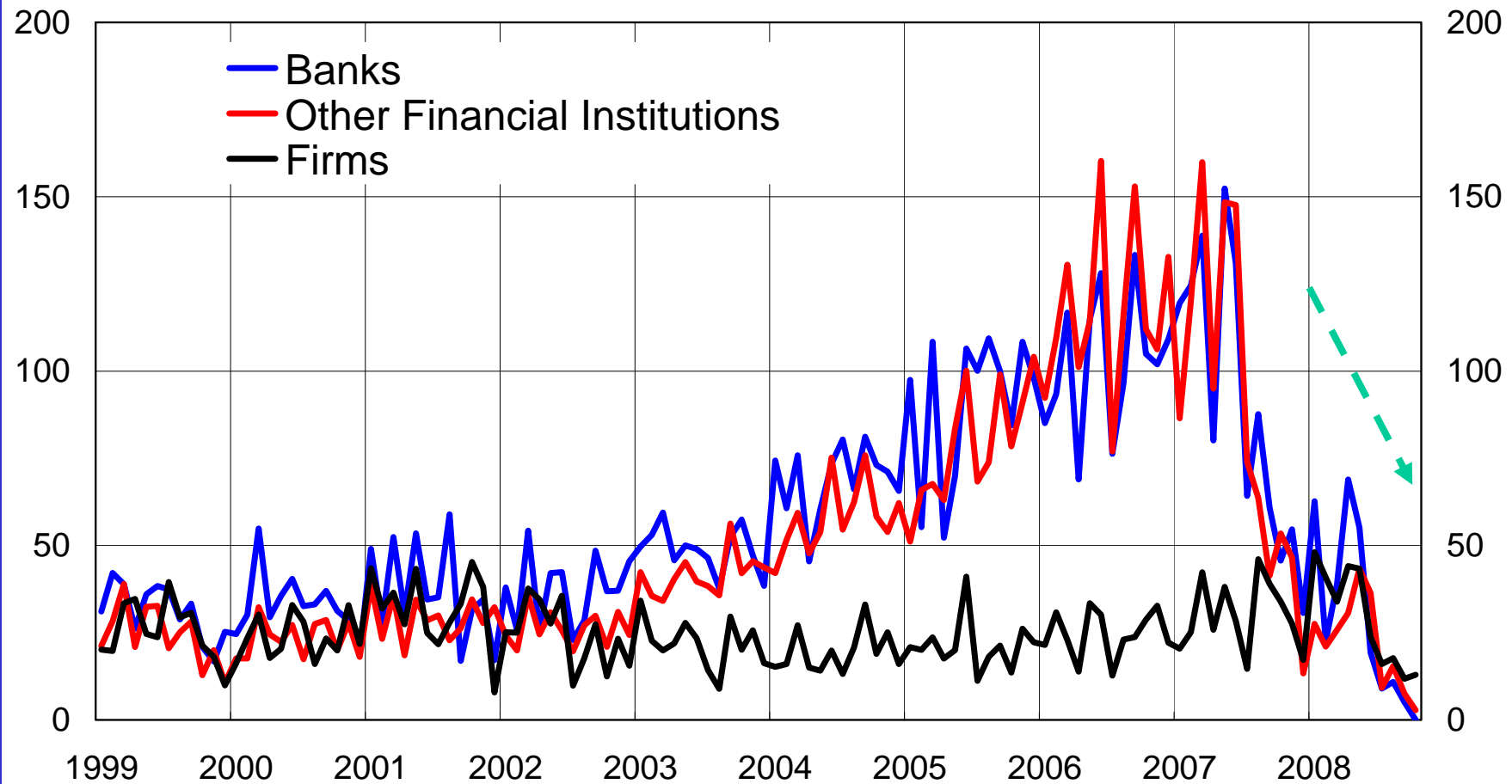
(billions of euros; monthly data)



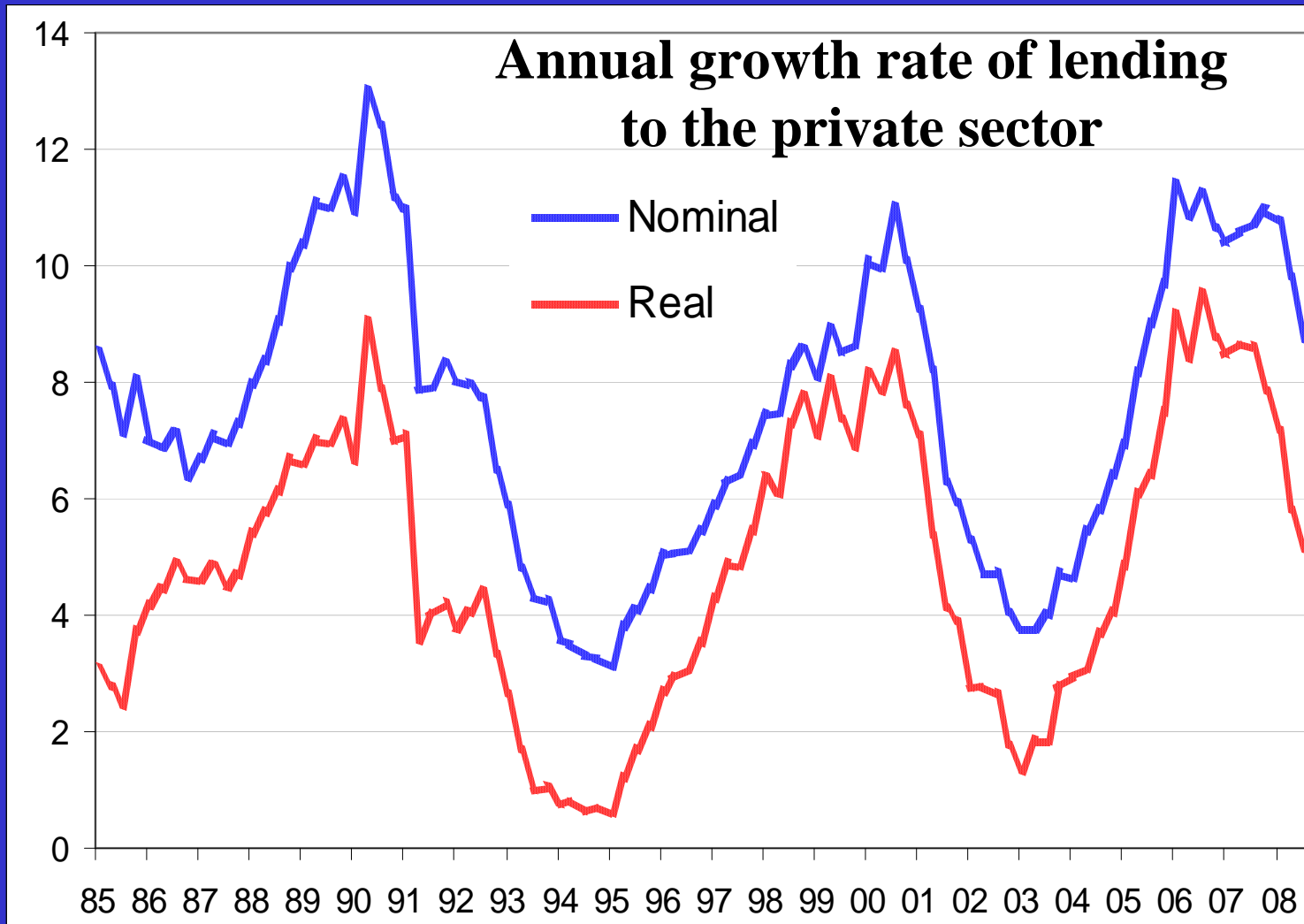
Bond issues in the US, much worse ...

United States - Bond issues Investment grade

(billions of euros; monthly data)

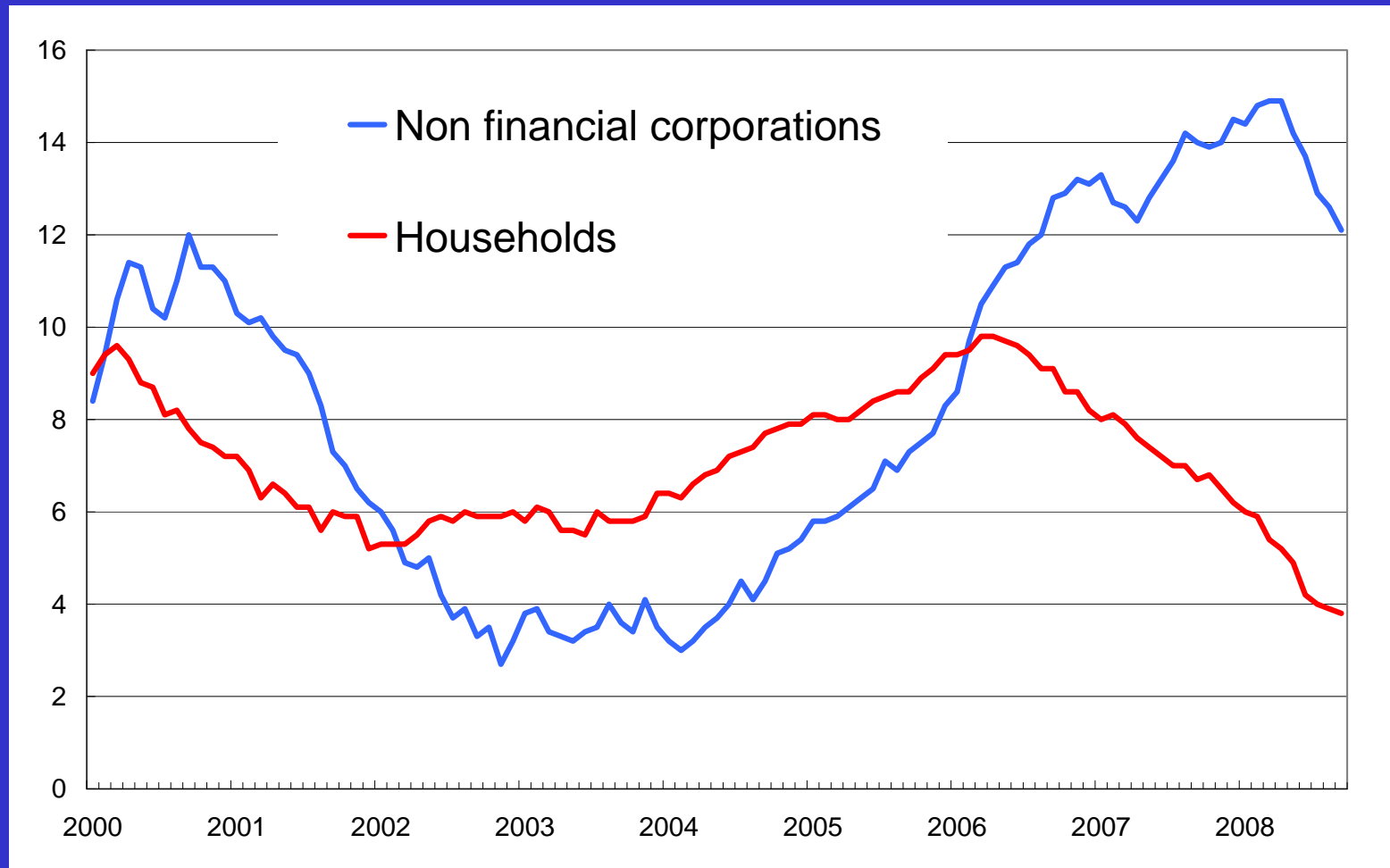


The growth rate of lending declines but remains sustained in the euro area



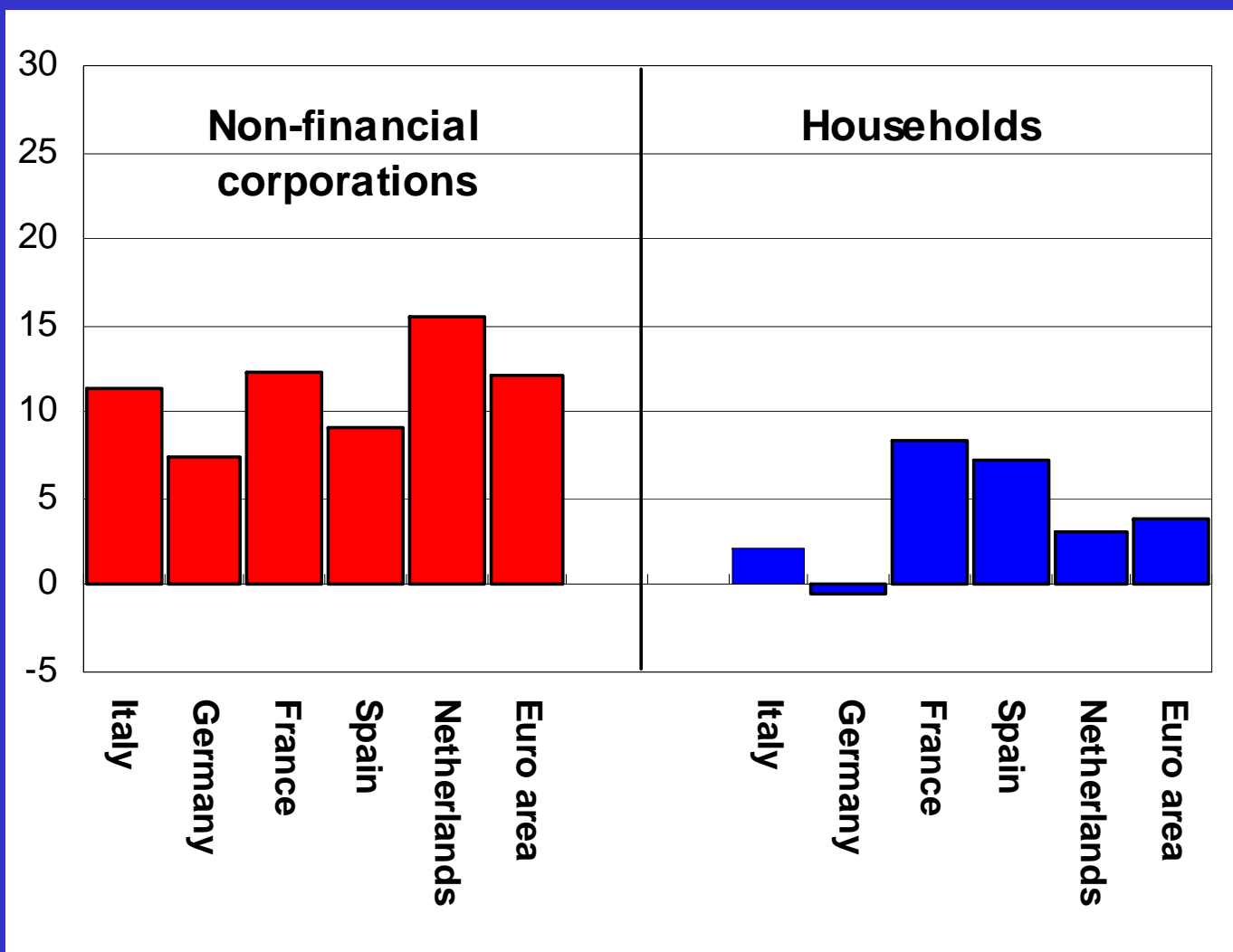
Note: Annual growth rate, percentage points. Times series reconstructions are described in Gambacorta and Rossi (2007).

The deceleration starts also to interest lending to non-financial corporations



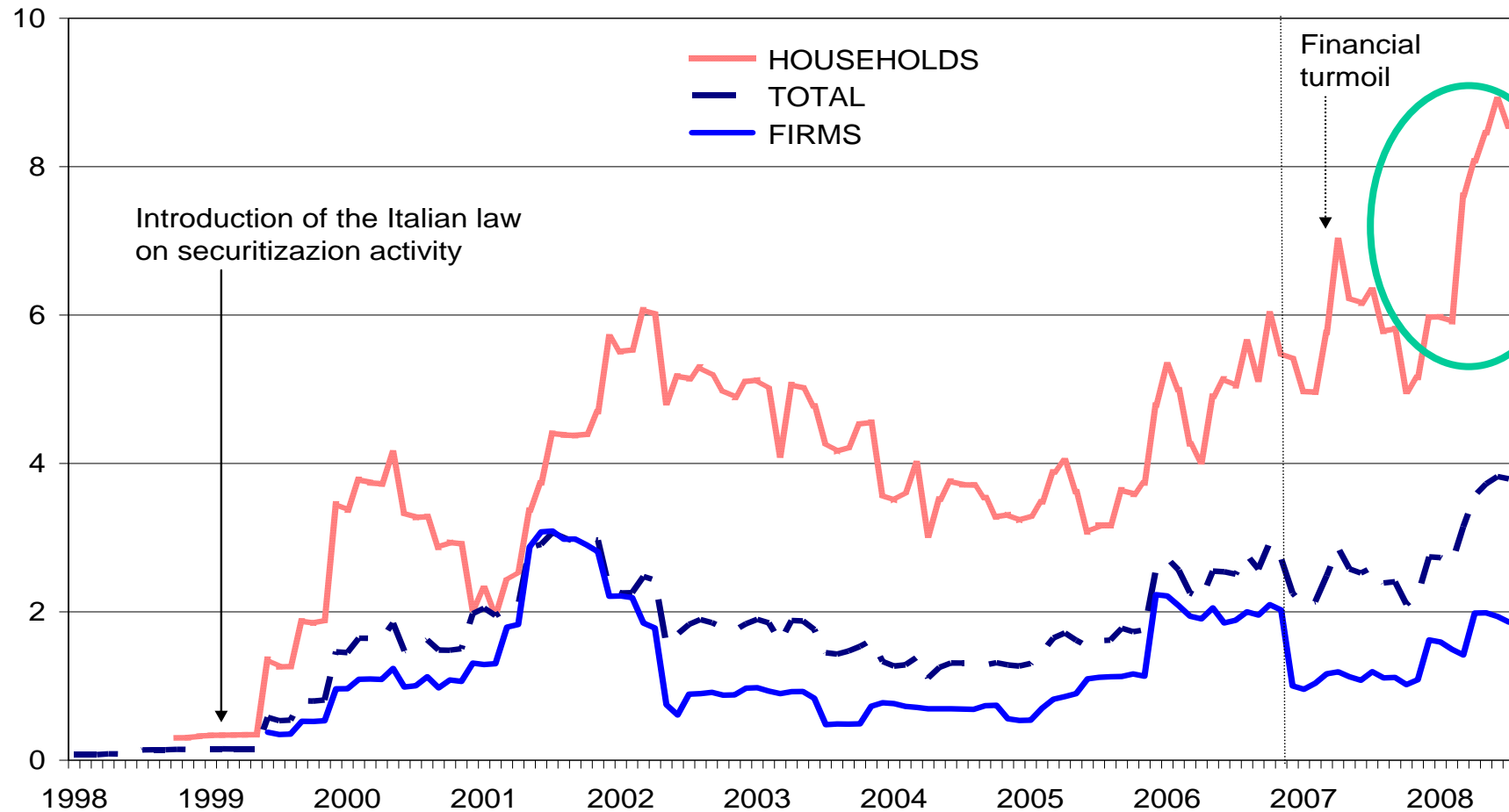
Note: 12-month percentage changes, net of the effects of reclassification, exchange rate changes and other modifications not due to transactions

Heterogeneity in bank lending expansion inside the euro area: September 2008



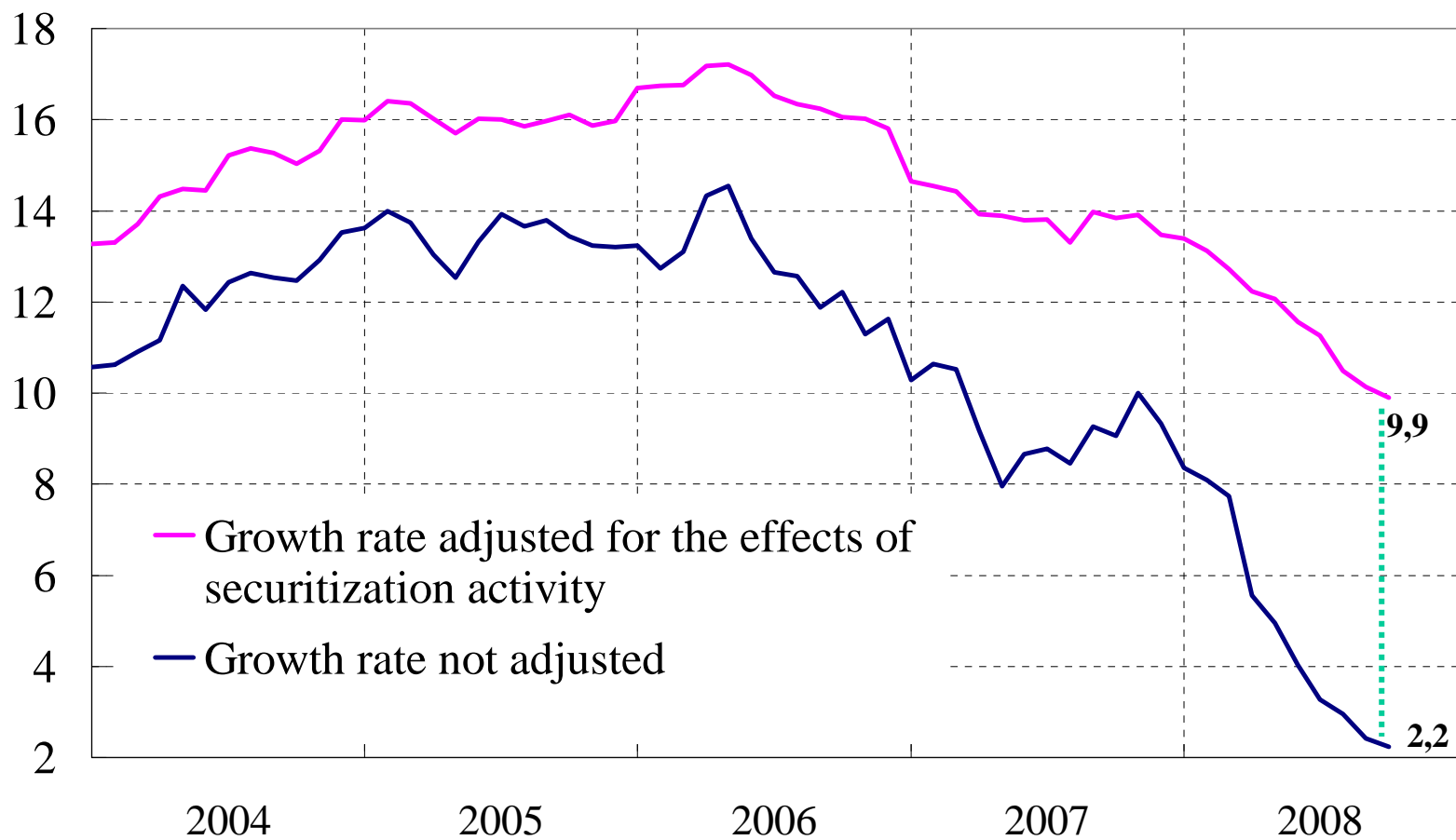
Note: 12-month percentage changes, net of the effects of reclassification, exchange rate changes and other modifications not due to transactions

Securitization market has rapidly changed due to self-retained ABS: the case of Italy



Note: annual flow of securitized lending by sector of economic activity as a percentage of the initial stock of loans at t-1.

Effects of securitization activity on the growth rate of households lending in Italy

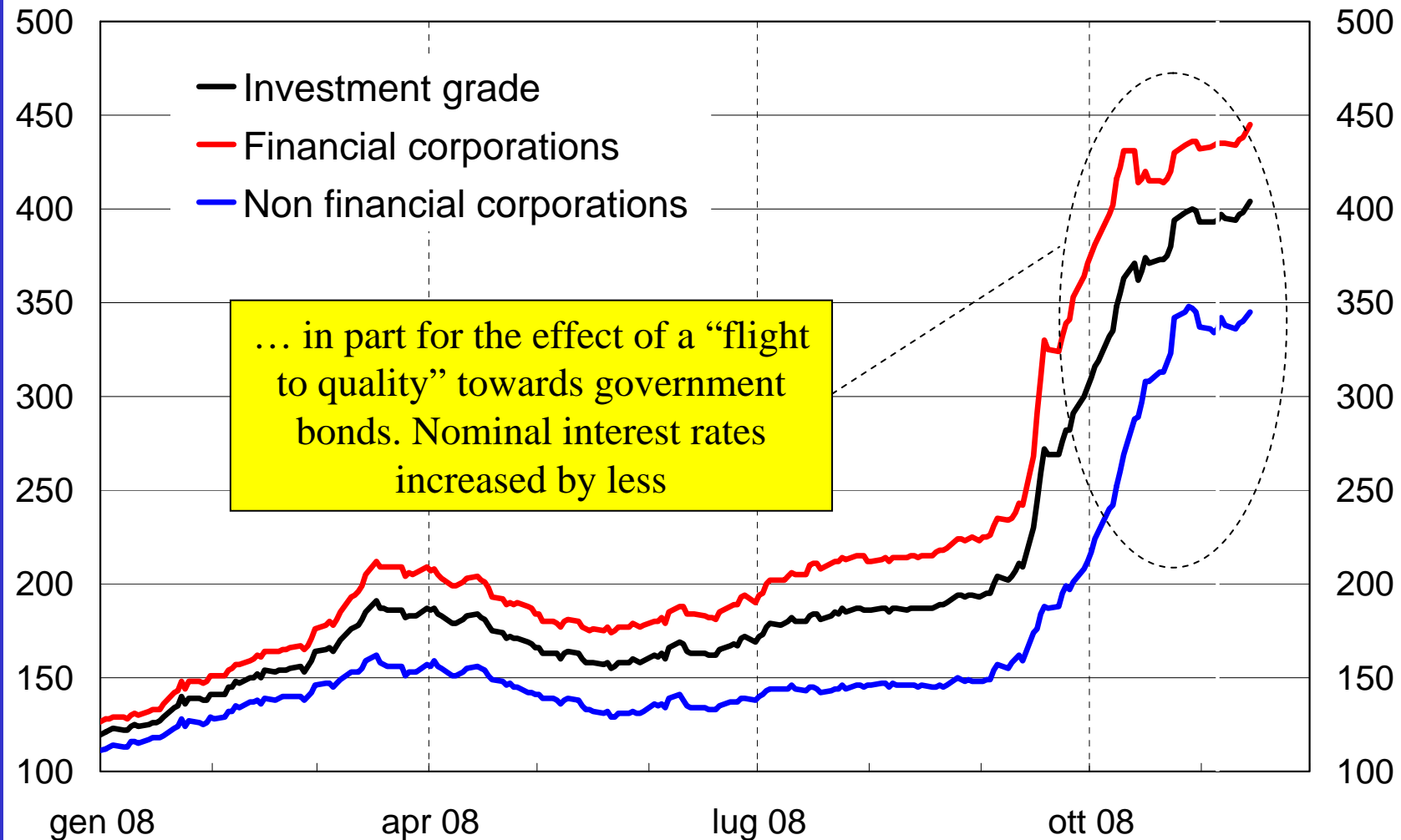


Note: Annual growth rate; monthly data.

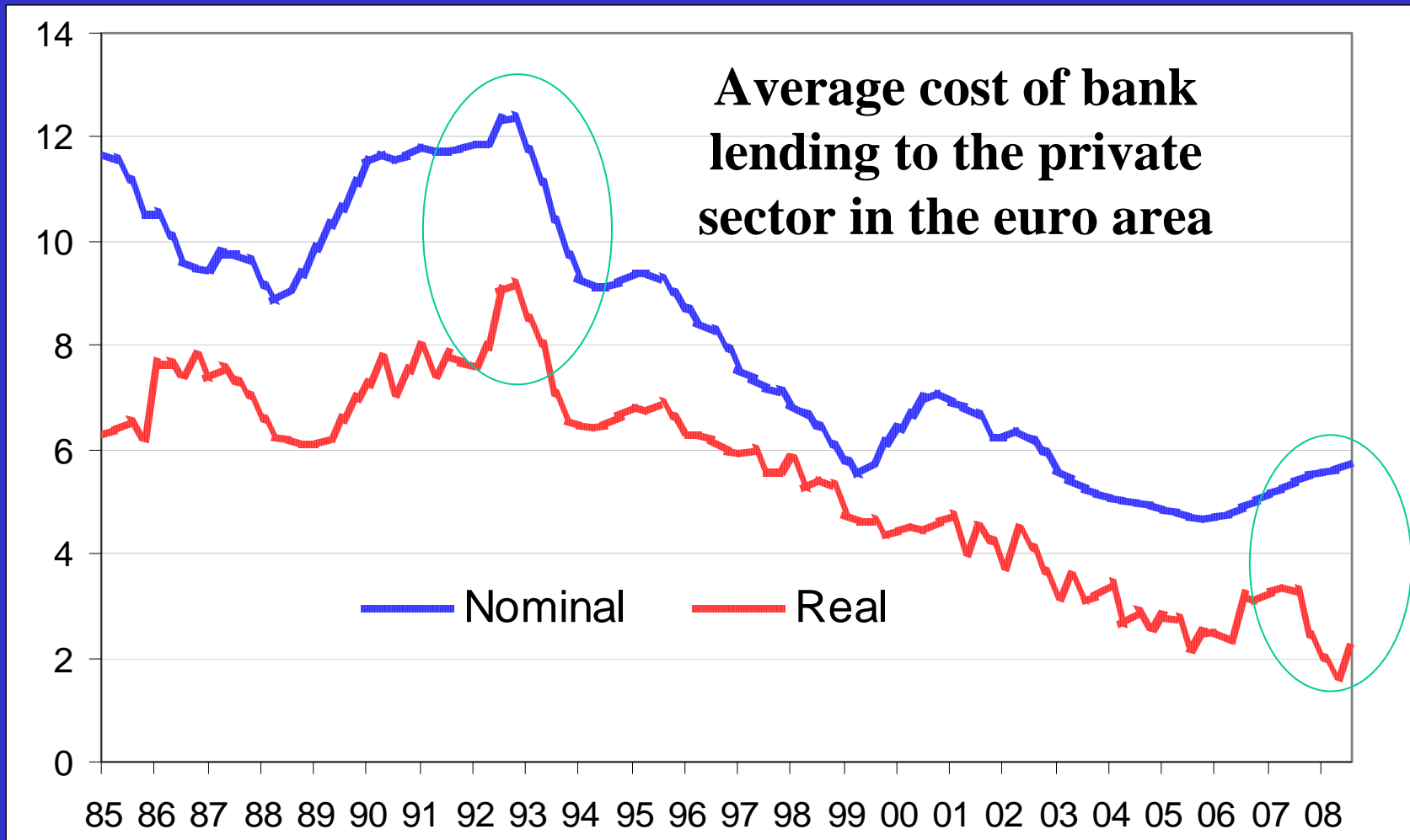
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**The impact of the financial
turmoil on the cost of credit**

Spreads have significantly increased for euro denominated bonds ...



Interest rates on bank lending are increasing but do not show strong signs of tensions

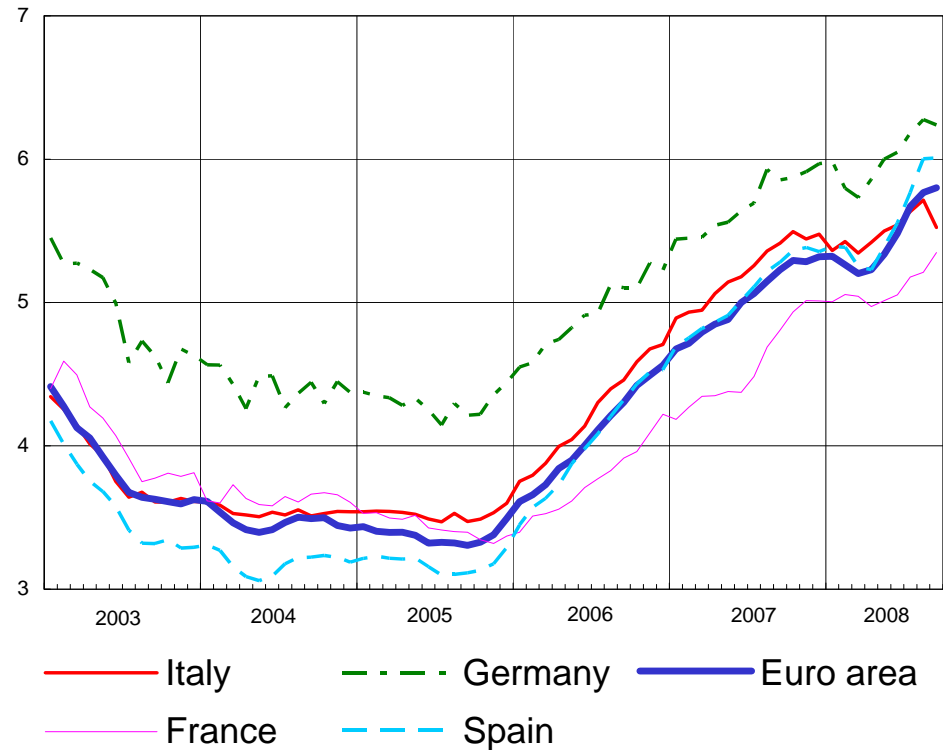
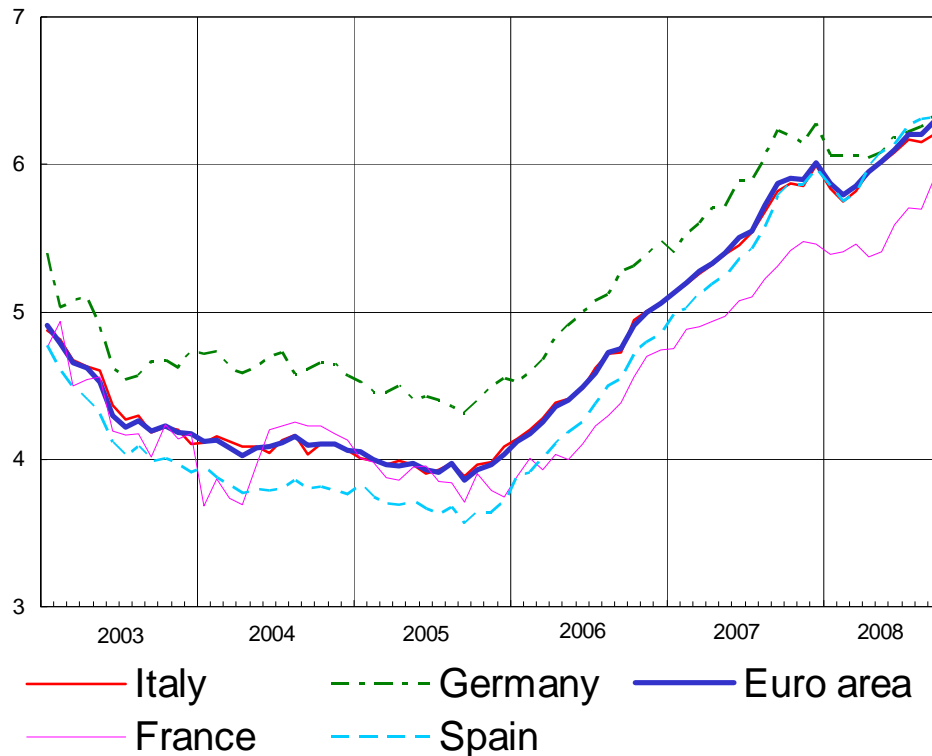


Note: Percentage points. Times series reconstructions are described in Gambacorta and Rossi (2007).

Similar interest rate pass-through among euro area countries before and after crisis

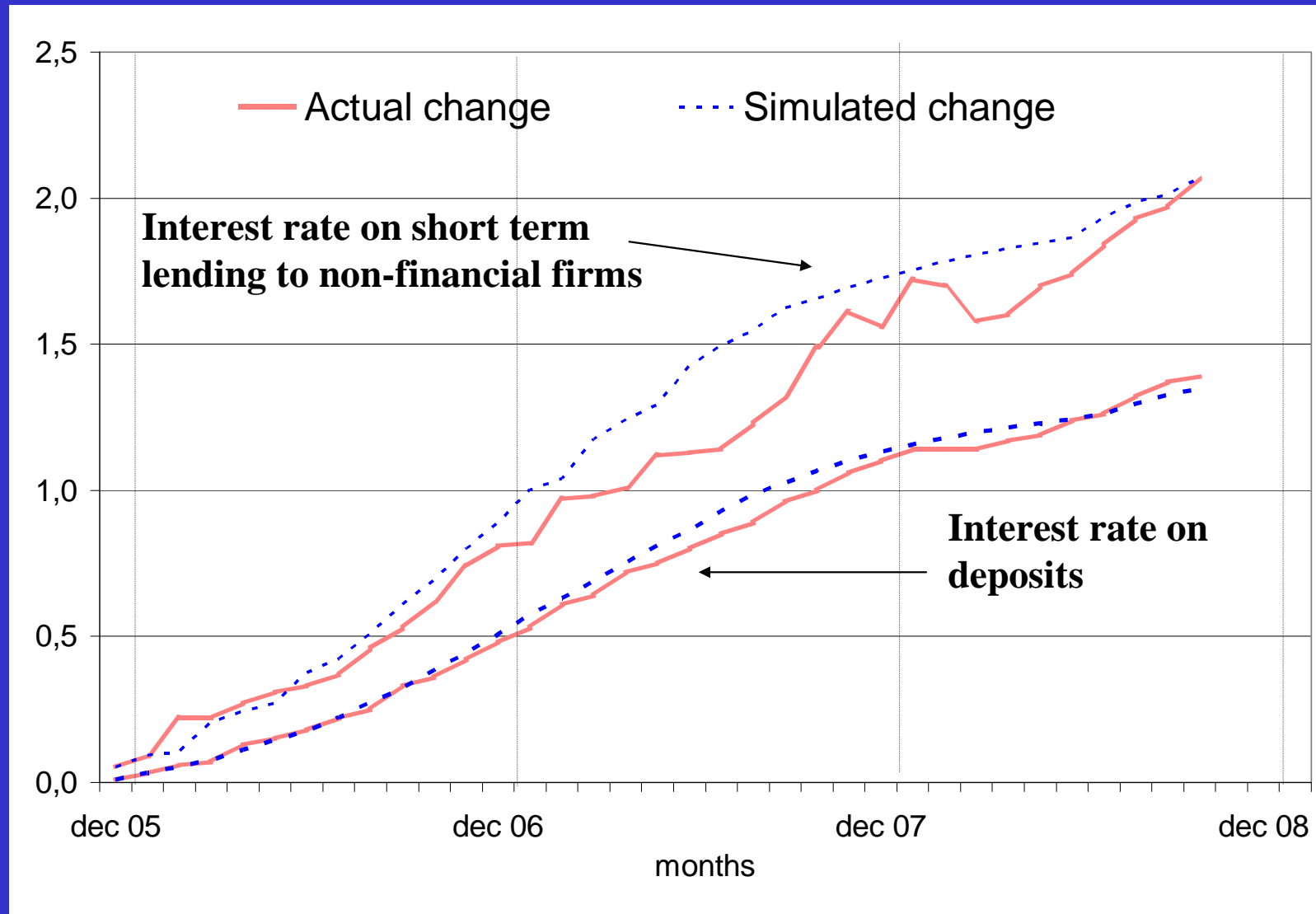
Interest rates on bank loans to non-financial corporations (1)

Interest rates on bank loans to households for house purchases (2)



(1) Loans up to an amount of 1 million euro. Percentage points. New business. - (2) Contracts with a floating rate up to one year. Percentage points. New business.

A simulation exercise of the impact of policy rate changes on bank interest rates in Italy



Note: the model used in the simulation is described in Gambacorta and Iannotti (2008).

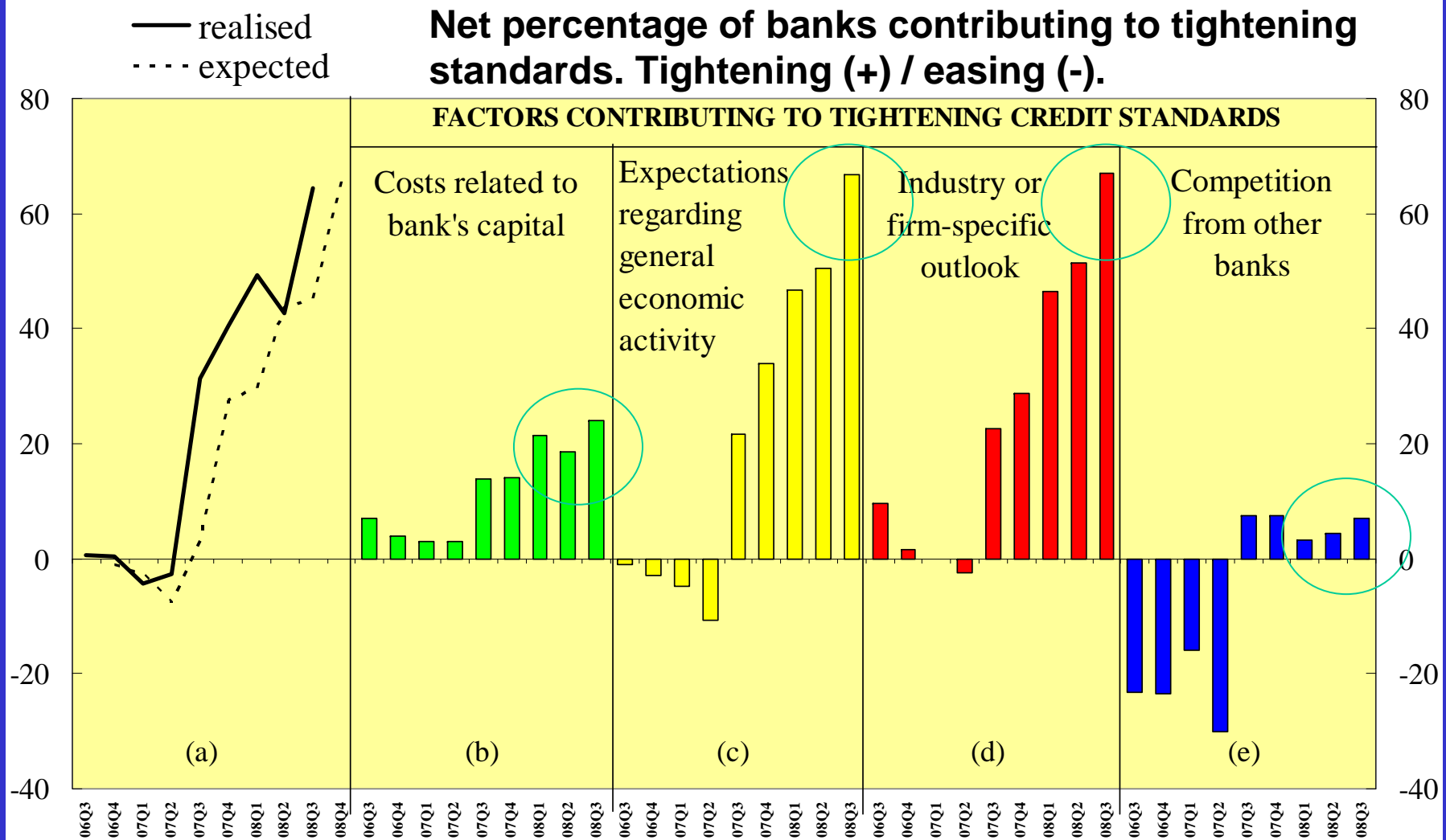
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The October 2008 *Bank Lending Survey* in the euro area

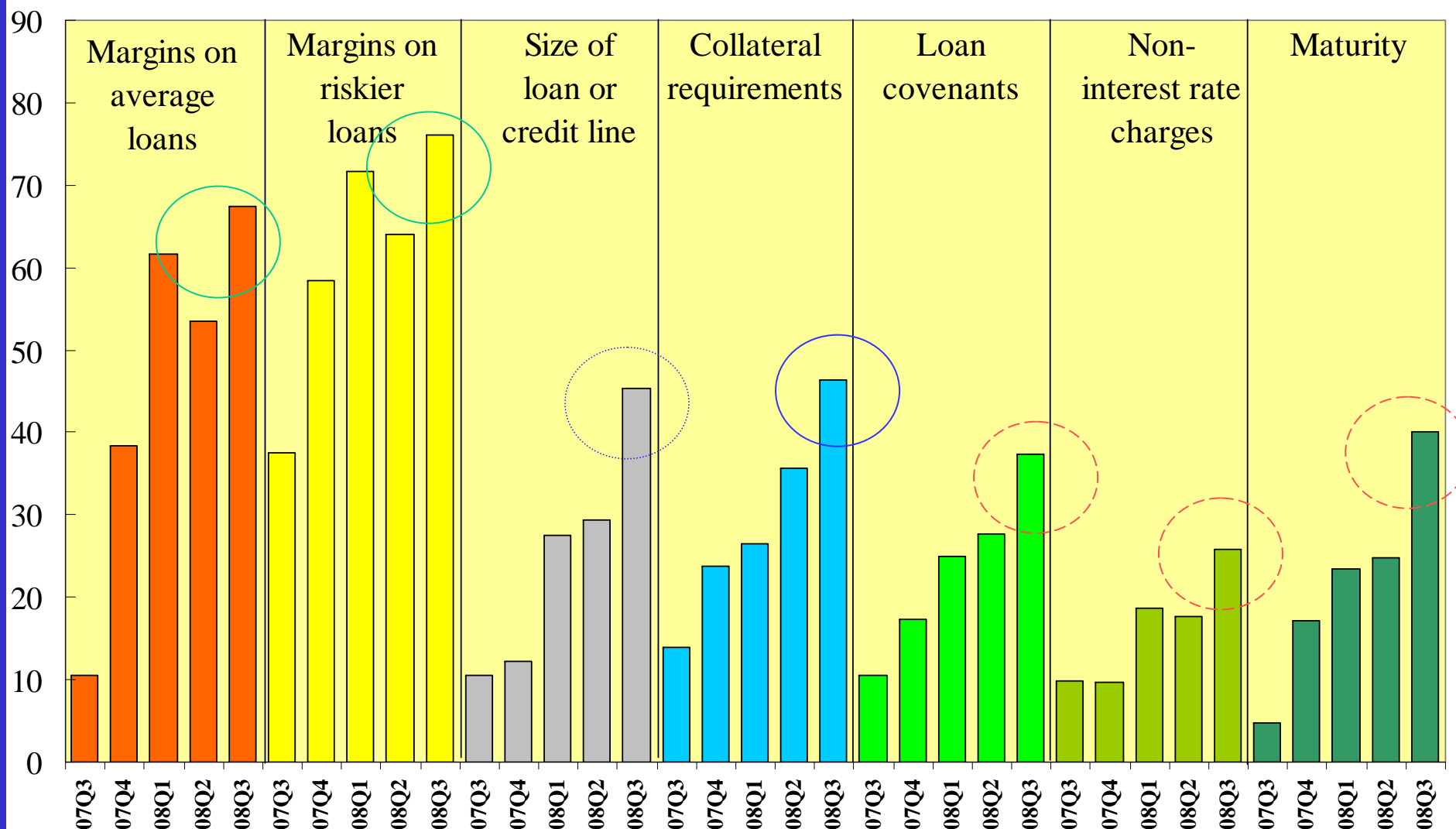
Characteristics of the last Bank Lending Survey in the euro area

- The results reported in the October 2008 bank lending survey relate to Q3 and to expectations for Q4
- The survey was carried out between 23 September, which is after the Lehman bankruptcy and 7 October, before the Paris meeting on rescue measures (majority after 26 September, rumours Fortis)
- 111 banks participated in the survey

Credit standards applied to the approval of loans to enterprises in the euro area

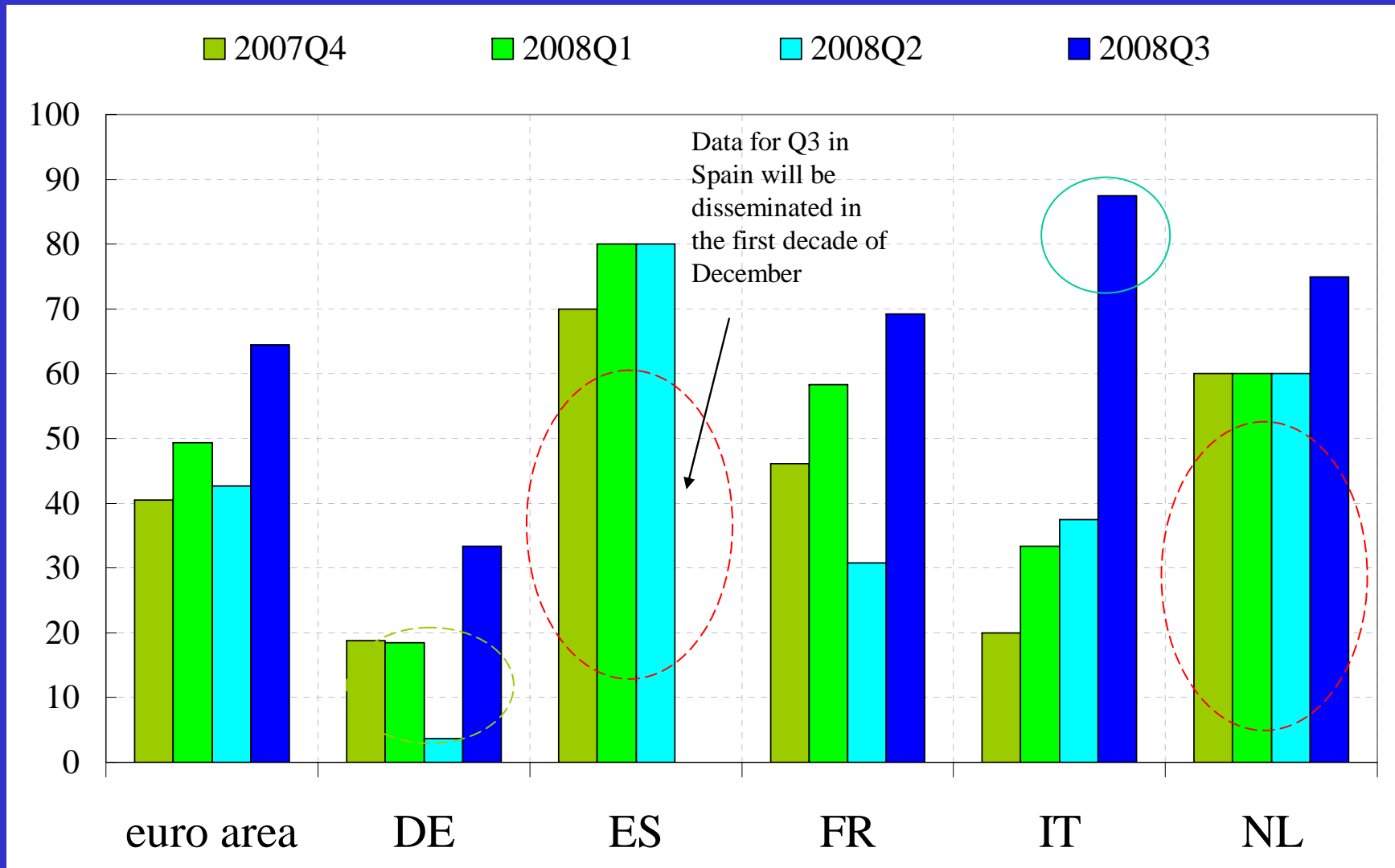


Net tightening in “terms and conditions” for approving loans to enterprises



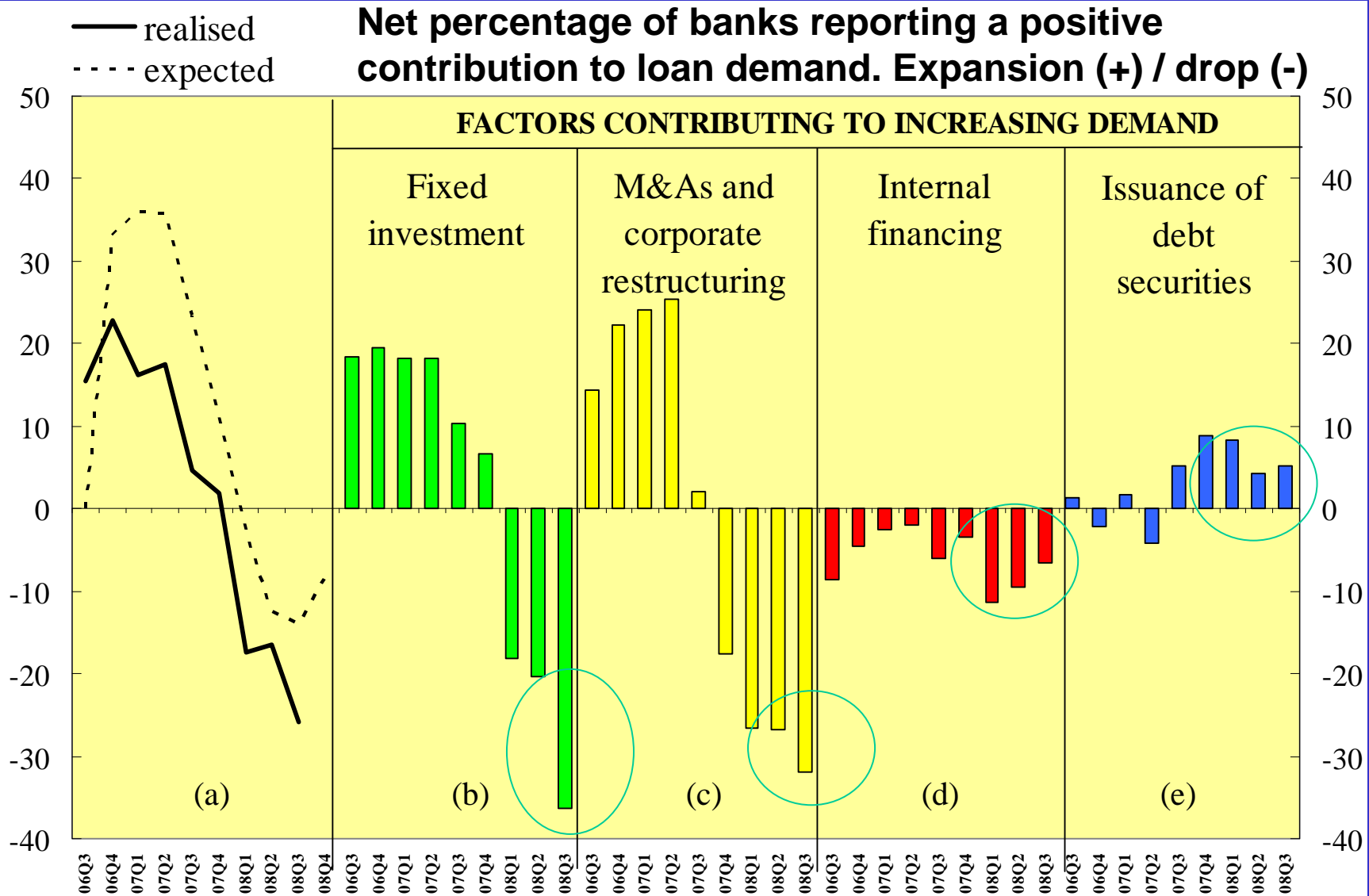
Note: Net percentage of banks contributing to tightening standards.

Net tightening applied to the approval of loans to enterprises at the country level

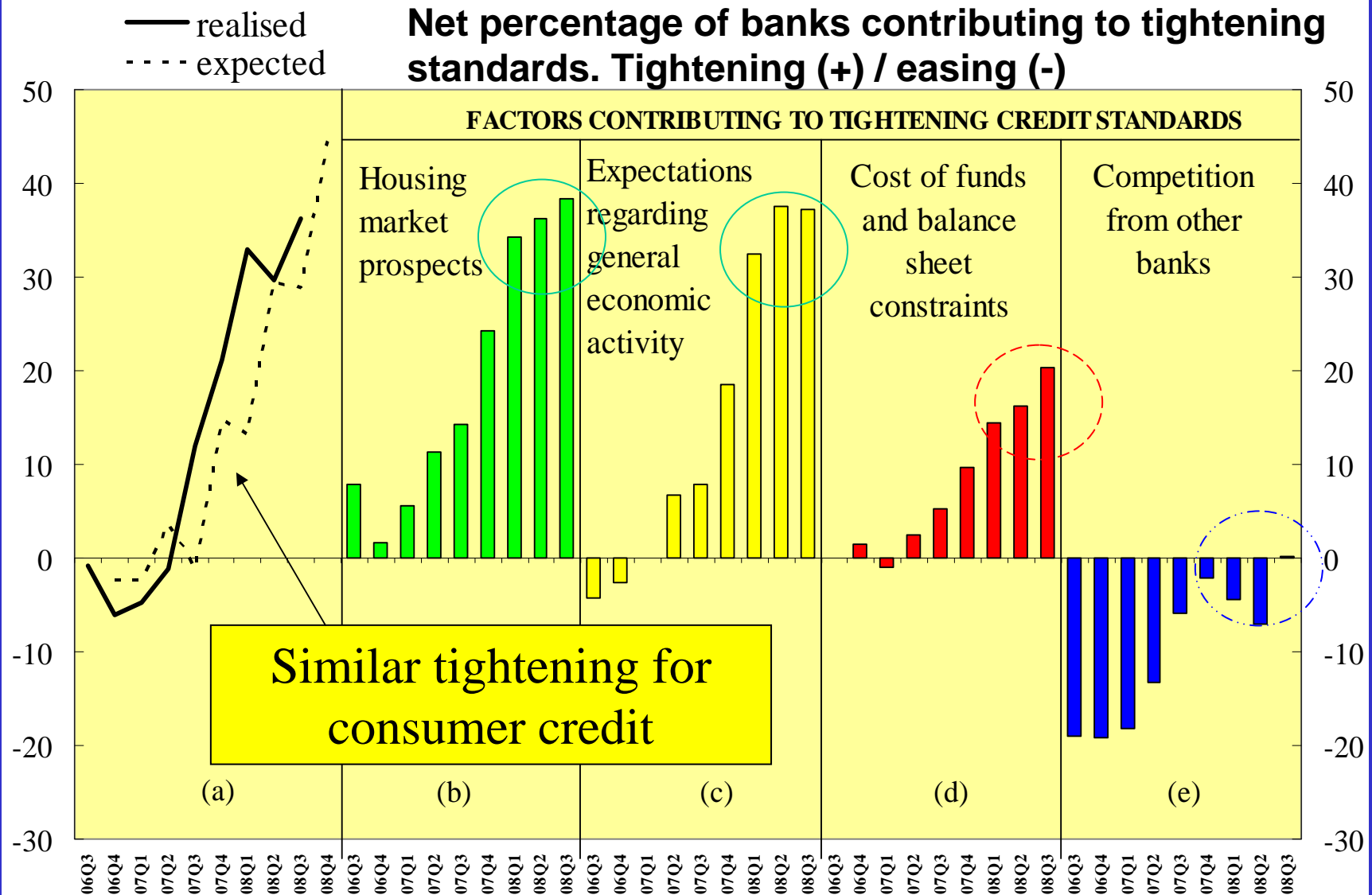


Note: Net percentage of banks contributing to tightening standards.

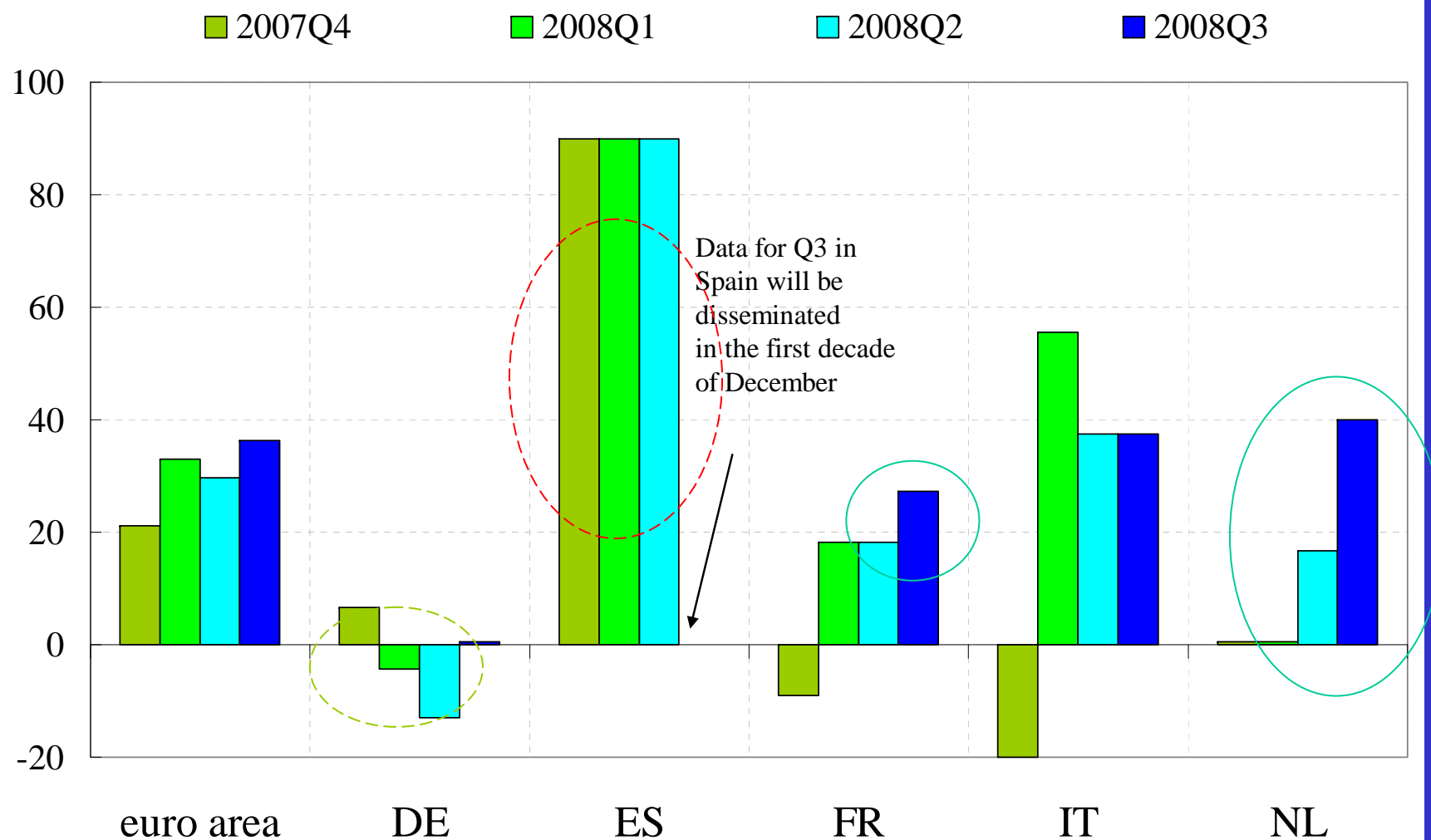
Changes in demand for loans to enterprises in the euro area



Credit standards applied to the approval of loans to households for house purchase



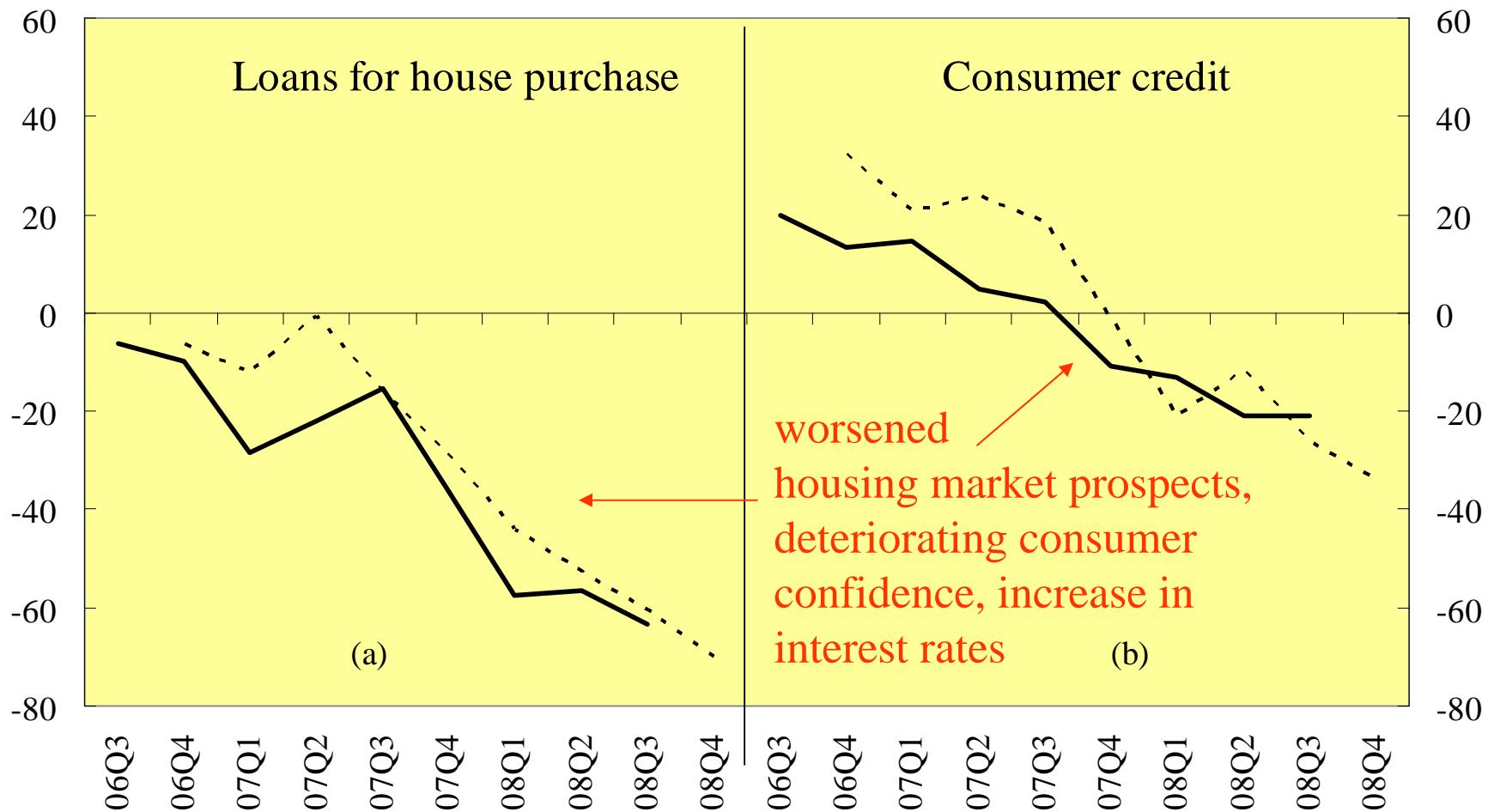
Net tightening applied to the approval of mortgages loans at the country level



Note: Net percentage of banks contributing to tightening standards.

Changes in demand for loans to households in the euro area

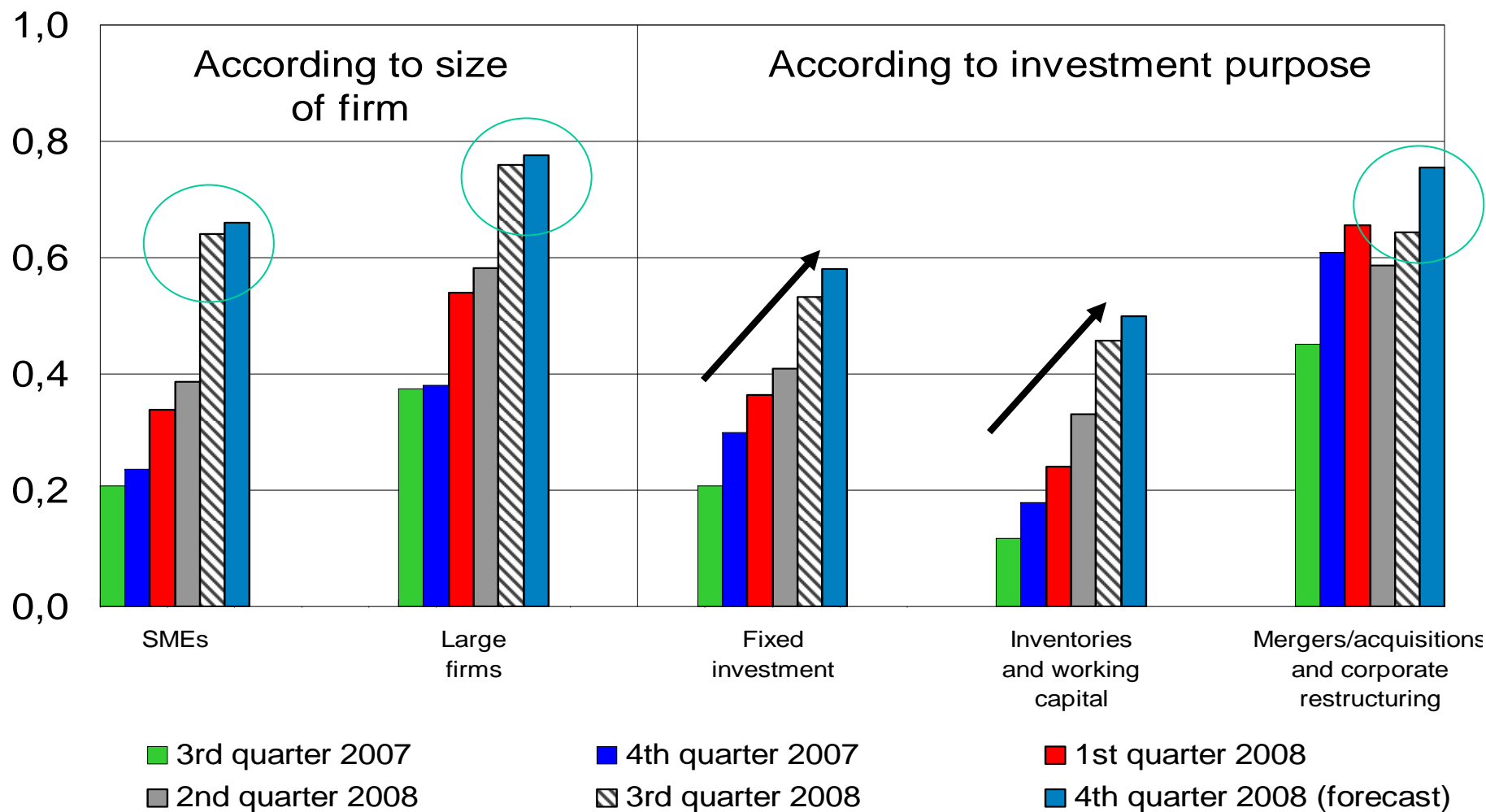
--- expected **Net percentage of banks reporting a positive contribution to loan demand. Expansion (+) / drop (-)**
 — realised



Ad hoc questions on the impact of the financial turmoil

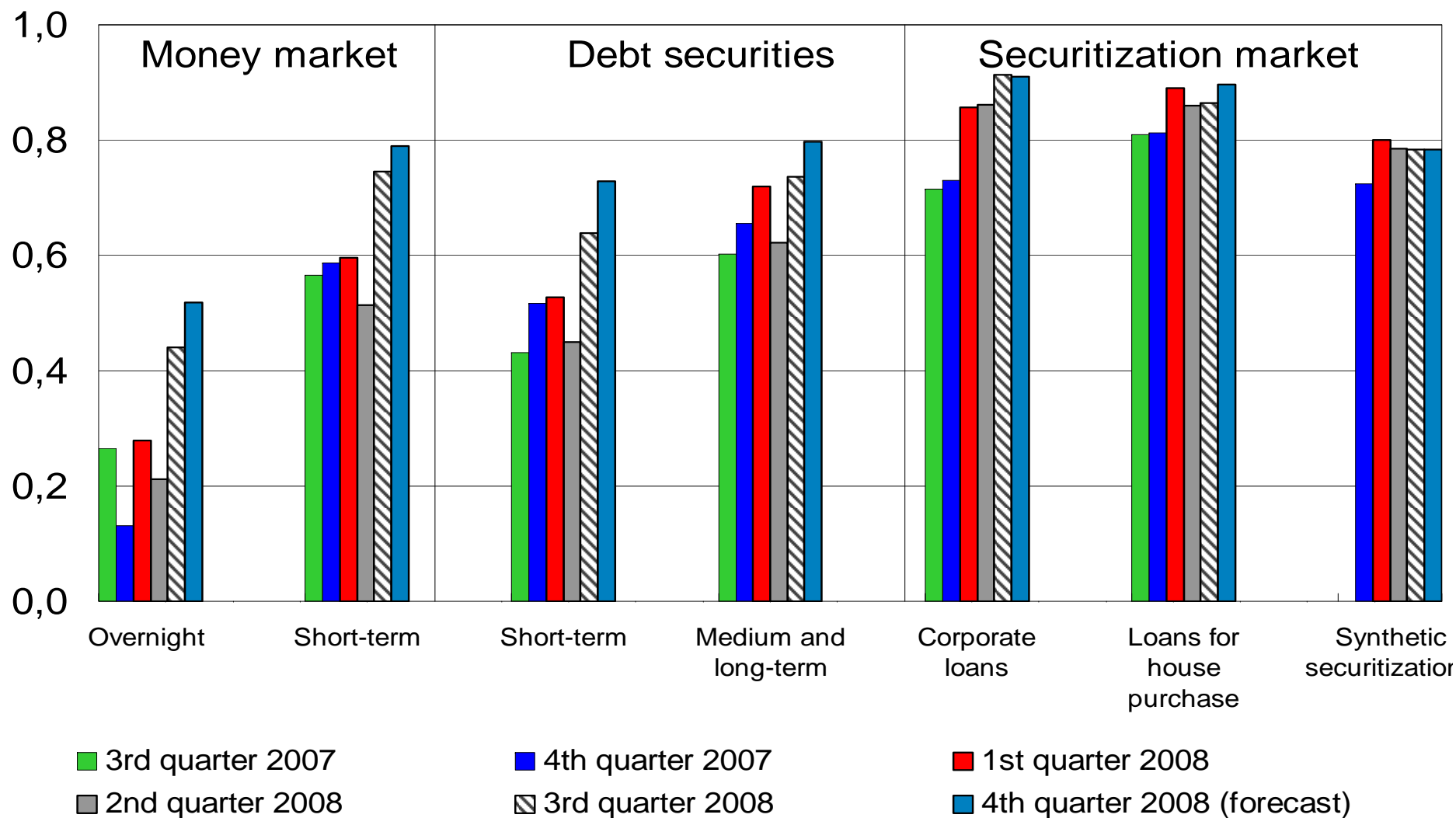
- The October 2008 survey round also contains a set of questions which aims at gauging the extent to which the financial turmoil have affected banks' credit standards for loans to enterprises and households in the euro area
- The questions refer to the impact on:
 - i) credit standards and bank lending*
 - ii) the access to wholesale funding*

Effects of the financial turmoil on banks' credit standards over the past three months



Note: Net percentages of banks contributing to tightening standards.

Index of difficulty in accessing the wholesale funding as a consequence of the turmoil

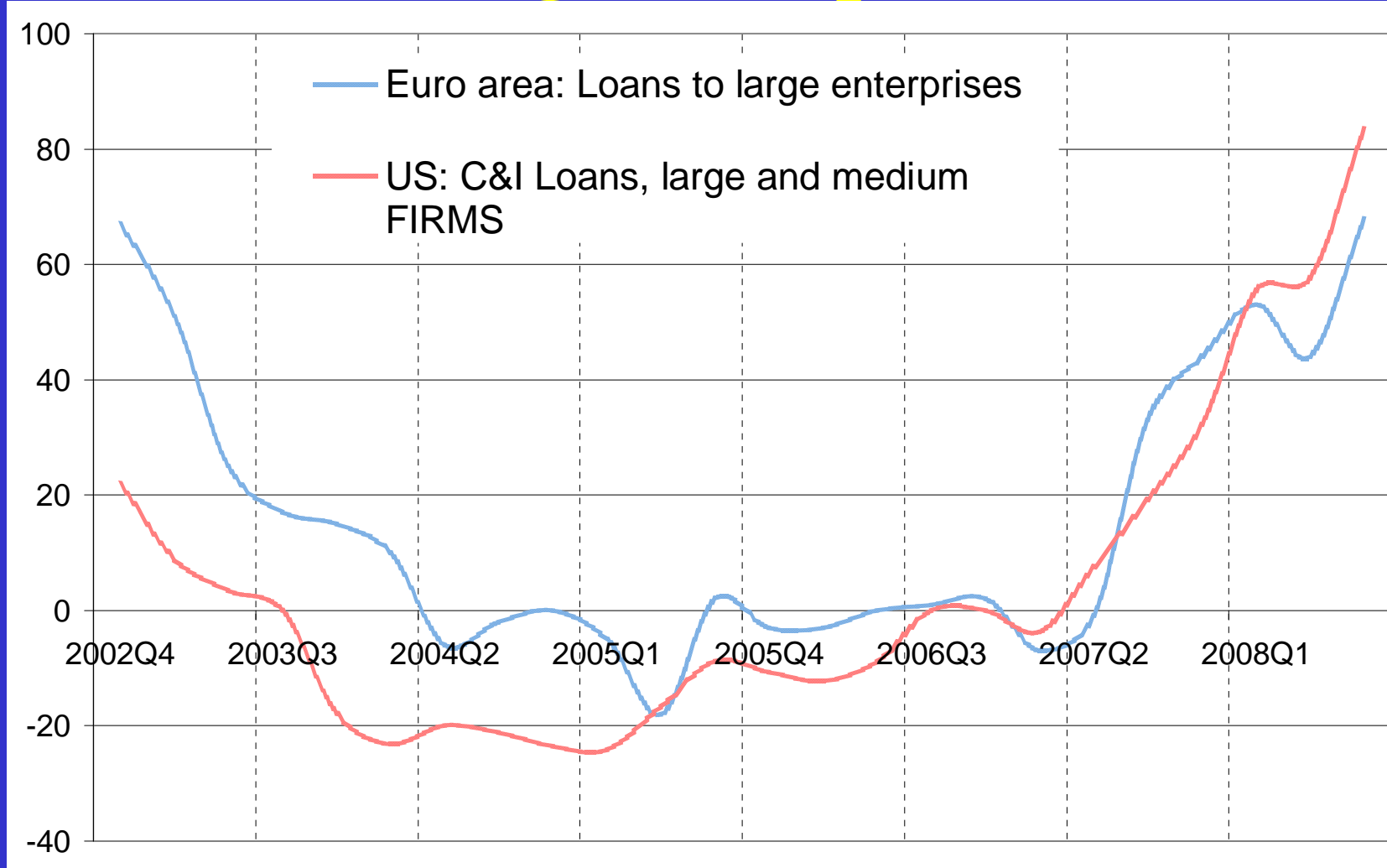


Note: Percentage of banks reporting hampered market access.

A comparison of the Bank Lending Survey in the euro area and the Senior Loan Officer Opinion Survey in the US

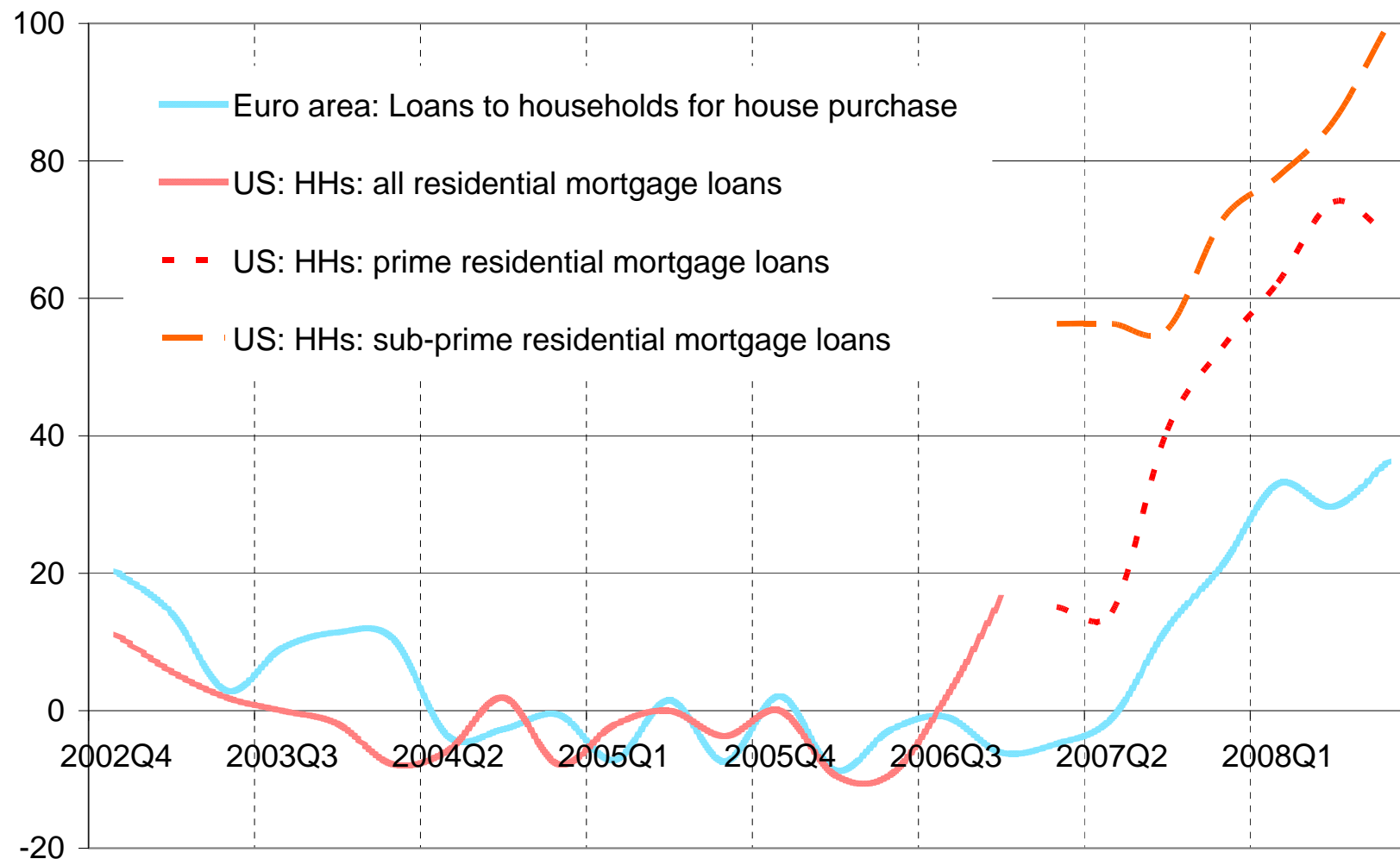
- Both in terms of net percentages
- The surveys are available for 2008Q3
- Some caveats remains for differences in:
 - the sample and kind of questions
 - timing of the surveys:
euro area (23/9-7/10), US (2-16/10)

Changes in credit standards for loans to large enterprises



Note: Net percentage of banks contributing to tightening standards.
Tightening (+) / easing (-)

Changes in credit standards for residential mortgage loans

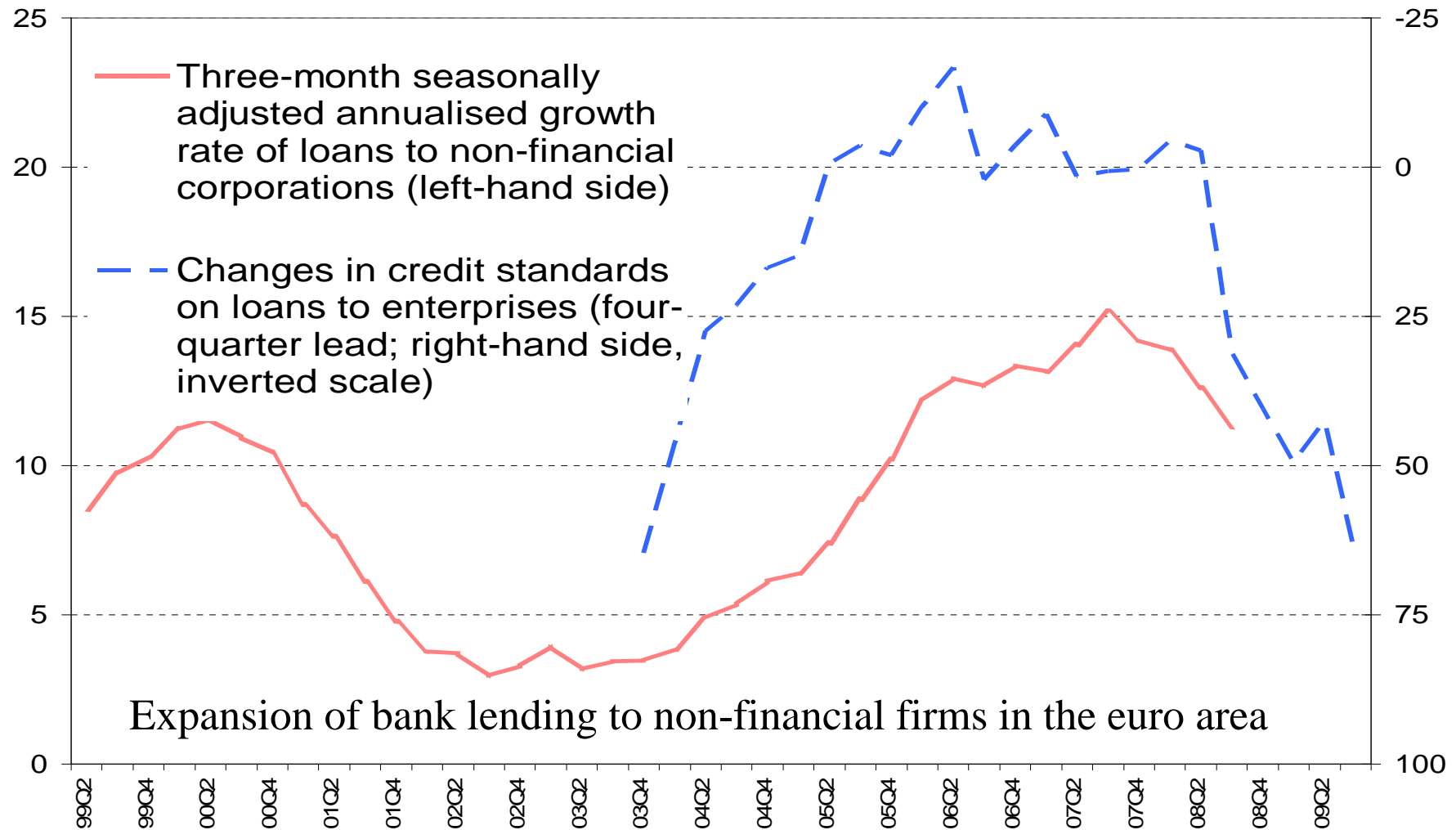


Note: Net percentage of banks contributing to tightening standards.
Tightening (+) / easing (-)

Is there a “credit crunch”?

- **On the base of the surveys there is a clear deterioration of credit conditions. Therefore, even if data up to September 2008 show no signs of a credit crunch in the euro area, the risk of a reduction in lending supply are increasing**
- **More signs of a “credit crunch” in the US (see the debate between Chari et al., WP 2008 Fed Minneapolis and Cohen-Cole et al., WP 2008 Fed Boston)**

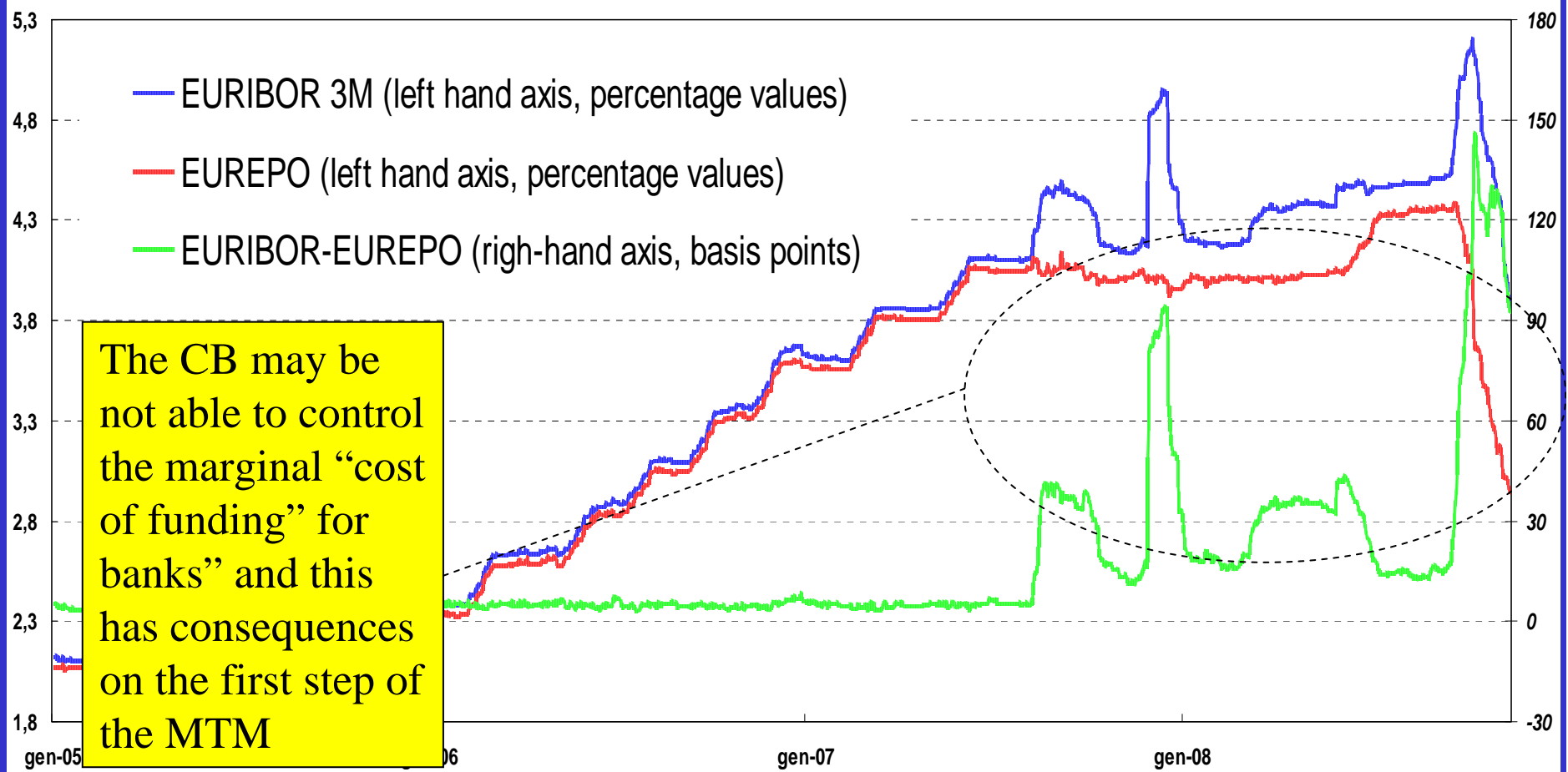
What is going to happen? BLS may be a leading indicator



(4)

**Possible insights for the conduct
of monetary policy**

Lesson #1. The CB can supply liquidity but it may not be able to influence banks' risk perception ...

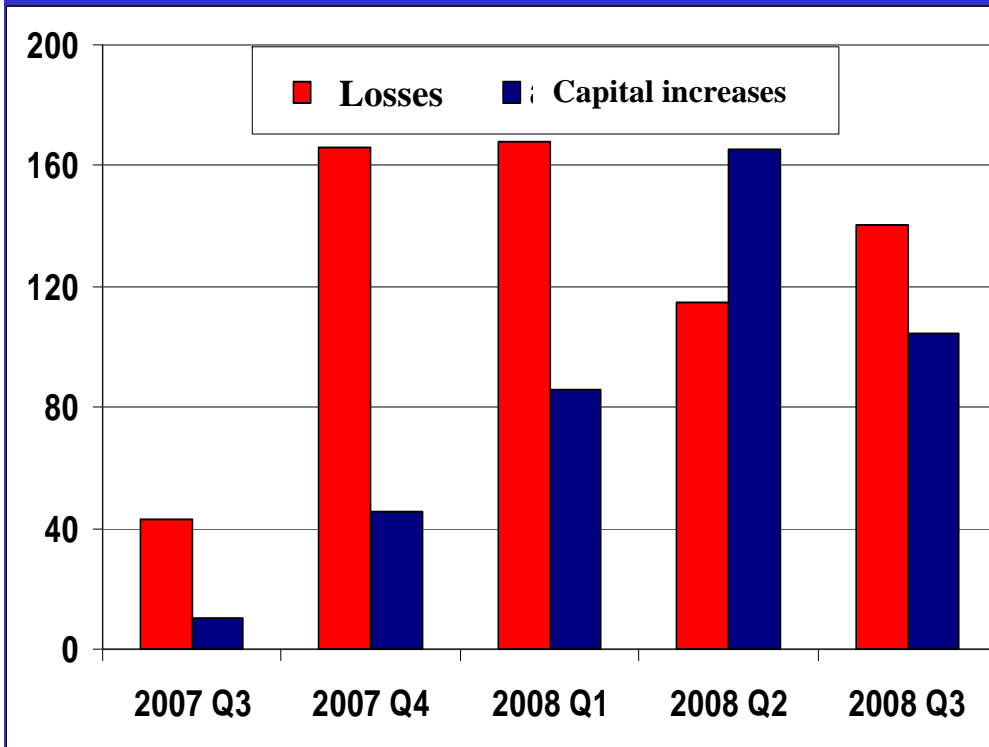


Lesson #2 – Other effects for the Monetary Transmission Mechanism

- High coordination among central banks but some differences in the ways to implement measures, also due to peculiarity in the financial systems (role of money market funds and investment banks). How the new rules have changed the Monetary Transmission Mechanism?
- In a situation of great “uncertainty” Central Banks have in some way replaced the normal functioning of market forces. Now a new challenge arise: how to come back to normality?

Lesson #3 – Bank capital has a central role in the MP transmission mechanism

Losses and capital increases



Source: Bloomberg (dataset of 75 Banking groups in the US, Euro area and Asia)

- The occurrence of a “credit crunch” will strongly depend on a possible shortage of capital (simulations based on *Altunbas, Gambacorta and Marqués, 2007*)
- Bank capital is relevant to assess the monetary policy stance and it has to be constantly monitored in coordination with supervisory authorities

(5)

Conclusions

The risks of a drop in lending supply increase

- Using data up to September 2008, the analysis shows that euro area banks have continued to provide lending. The slowdown of bank credit that we have observed in the third quarter has been mainly driven by a reduction in lending demand
- Now we have a number of signs that a reduction of the supply of lending may be in the pipeline. The drop in the rate of growth in bank lending could be severe in the case of a shortage of bank capital

References

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- Chari V.V., Christiano L. and Kehoe P. (2008), “Facts and Myths about the Financial Crisis of 2008”, Federal Reserve Bank of Minneapolis, WP n. 606.
- Cohen- Cole E., Duygan-Bump B., Fillat J. and J. Montoriol-Garriga J. (2008), “Looking Behind the Aggregates: A Reply to “Facts and Myths About the Financial Crisis of 2008”, Federal Reserve Bank of Boston, WP n. 5.
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- The October 2008 BLS for the euro area (www.ecb.int)
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- The September 2008 UK Credit Condition Survey (www.bankofengland.co.uk)