AIER | Business-Cycle Conditions, January 2010

More Lending Isn't the Answer

Despite improvements in the labor market and a rise in industrial production, record-breaking debt continues to hold back the recovery.

by Polina Vlasenko, Research Fellow

AIER's primary leading indicators continue to suggest that a recovery is likely. The percentage of leaders expanding increased from 82 last month to 90 this month (nine out of ten indicators with a discernable trend). The cyclical score of the leaders, which is based on a separate, purely mathematical analysis, increased from 57 last month to 62. For each of these measures, a value above 50 indicates that an expansion is more probable than a contraction.

The deterioration in the labor market may be coming to an end. *Initial claims for state unemployment insurance*, one of our leading indicators, decreased in November for the third straight month, signaling that fewer people are being laid off. The series, inverted for analysis, remains appraised as expanding. Another leader, the *average workweek in manufacturing*, increased for the third straight month. In November, it stood at 40.4 hours.

Even the three leaders that are not appraised as expanding—*new orders for consumer goods*, *new housing permits,* and the *change in consumer debt*—have been improving in recent months. But they still remain low.

We cannot say that a broad economic expansion has begun until the primary roughly coincident indicators

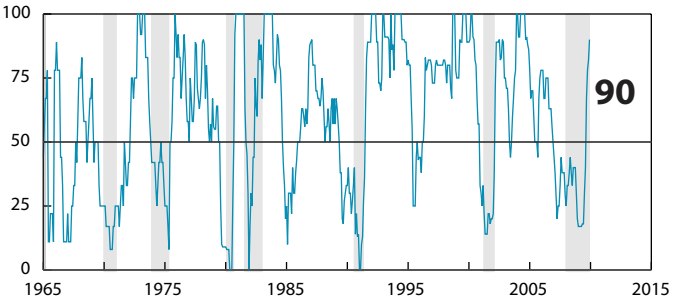
Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Aug.	*Sep.*	*Oct.*	*Nov.*	***Primary Leading Indicators***	*Oct.*	*Nov.*	*Dec.*
-	+	+	+	M1 money supply	+	+	+
+	+	+	+	Yield curve index	+	+	+
+	-	+	-	Manufacturers' supply prices	+	+	+
-	+r	+		New orders, consumer goods	-	-?	?
-	+	-		New orders, core capital goods	?	+?	+?
+	-	-	+	New housing permits	?	?	?
+	+			Ratio of sales to inventories	?	+?	+?
+	+	-	-	Vendor performance	+	+	+?
+	+	+	+	Index of common stock prices	+	+	+
nc	+r	+	+	Average workweek, mfg.	+?	+?	+
-	+	+	+	Initial claims, unemplmt. insurance*	+	+	+
+r	-r	+		Change in consumer debt	-	-?	-?
				Percentage expanding cyclically	*78*	*82*	*90*
				Primary Roughly Coincident Indicators			
-	-	-	-	Nonag. employment	-	-	-
+	+	nc	+	Index of industrial production	+?	+?	+
-	-	-		Pers. income less transfer payments	-	-	-
-	-			Manufacturing and trade sales	-	-?	-
-	-	-	+	Civilian emplmt. to population ratio	-	-	-
+	+			Gross domestic product	-	+	+
				Percentage expanding cyclically	*17*	*33*	*33*
				Primary Lagging Indicators			
+	-	-	-	Avg. duration of unemployment*	-	-	-
-	-			Manufacturing & trade inventories	-	-	-
-	-	-		Commercial & industrial loans	-	-	-
-	-	-		Ratio of cons. debt to income	-	-	-
-	-			Chg. in labor cost/output, mfg.	+?	-	-
-	-	-	-	Short-term interest rates	-?	-	-
				Percentage expanding cyclically	*17*	*0*	*0*

nc No change. r Revised. * Inverted. Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

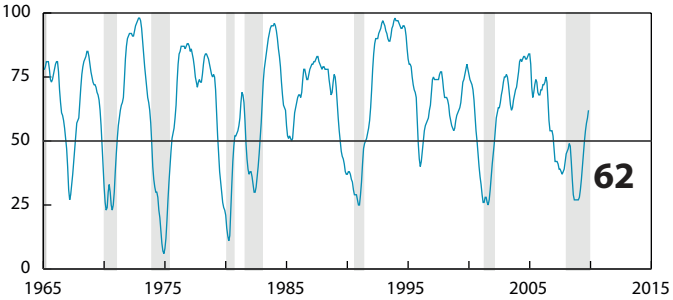
AIER Leaders Expanding and Cyclical Score Charts

Percentage of AIER Leaders Expanding



The percentage of leaders expanding is based on the analysis of 12 statistical series that move reliably in advance of general business activity. The cyclical score is based on a separate, purely mathematical analysis. For each measure, a score above 50 indicates an expansion is likely.

Cyclical Score of AIER Leaders



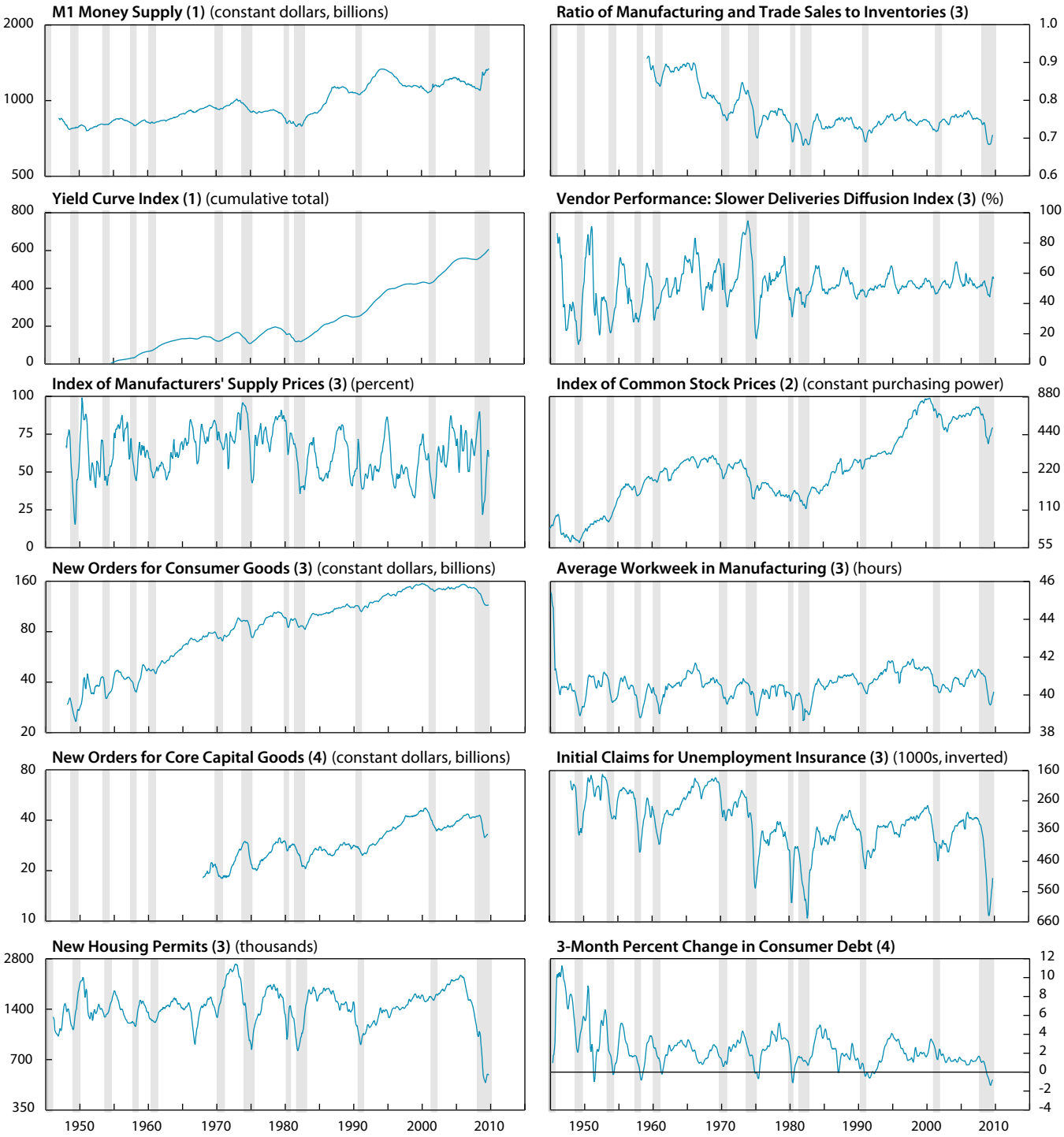
show more than feeble signs of life. At present, they do not.

Two out of six coinciders are appraised as expanding. The *index of industrial production*, which measures the output of manufacturing, mining, and utilities industries, has been rising since July. In October, slightly more than half of the industries reported an increase in output compared to six months before. This is a significant improvement from the series' trough last January, when 16 percent of industries reported increased output.

Gross domestic product also increased, although its estimate was again revised downward. The final estimate puts GDP growth for the third quarter of 2009 at a seasonally adjusted rate of 2.2 percent, down from an earlier estimate of 2.8 percent.

Despite improvements, the labor market remains

Primary Leading Indicators



weak. As the historical charts below show, both *nonagricultural employment,* and the *ratio of civilian employment to population* remain far below their peaks. The *average duration of unemployment,* one of the primary lagging indicators on page SI—4, reached 28.5 weeks, the longest since the data began to be collected in 1948.

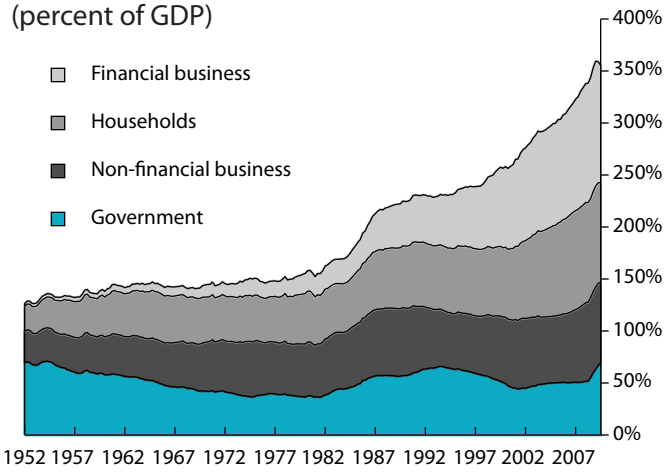
The rest of the coinciders continue to decline. *Personal income less transfer payments*, a key measure of consumers' ability to spend, has been contracting for more than two years. It is not surprising, then, that *manufacturing and trade sales* also have been on a long-term downward path. Until consumers see their incomes rise and begin to increase their spending, any recovery would be tenuous.

Economic activity remains lackluster because of imbalances built up during the boom years. One of the major imbalances is the massive debt acquired by households and businesses during the years of reckless lending. The chart above illustrates the evolution of total U.S. debt—credit market funds borrowed by individuals, businesses, and governments from both domestic and foreign sources.

The level of debt relative to GDP began to increase rapidly in the 1980s, but it exploded in the late 1990s. The invention of new financial instruments and proliferation of creative mortgages made it possible for businesses and households to carry ballooning amounts of debt. The economic "prosperity" built on this ever-rising level of indebtedness turned out to be unsustainable.

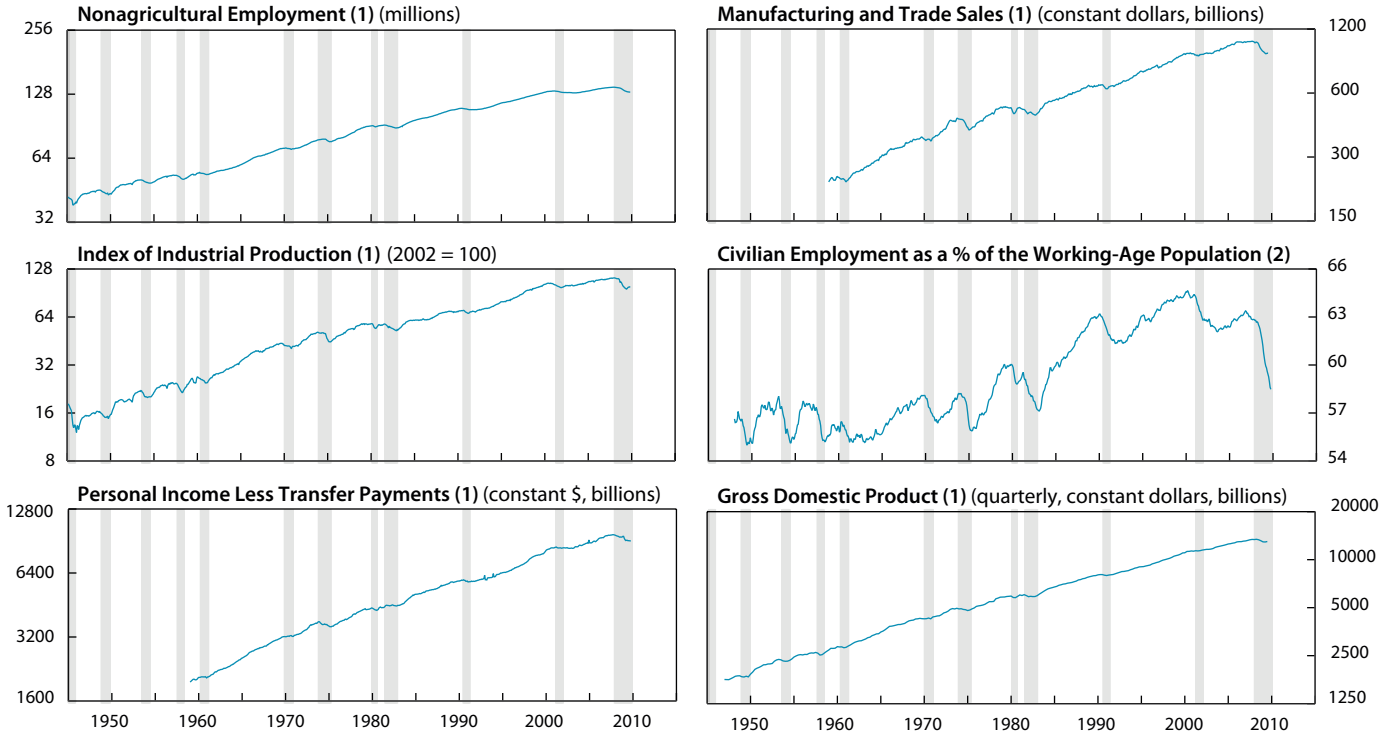
A correction to a more reasonable rate of debt growth was inevitable. The correction began during the current recession, when the private sector began to deleverage and reduce its outstanding debt. Banks became less willing to lend and consumers and businesses became less

Total U.S. Debt Outstanding, by Borrower Type
(percent of GDP)



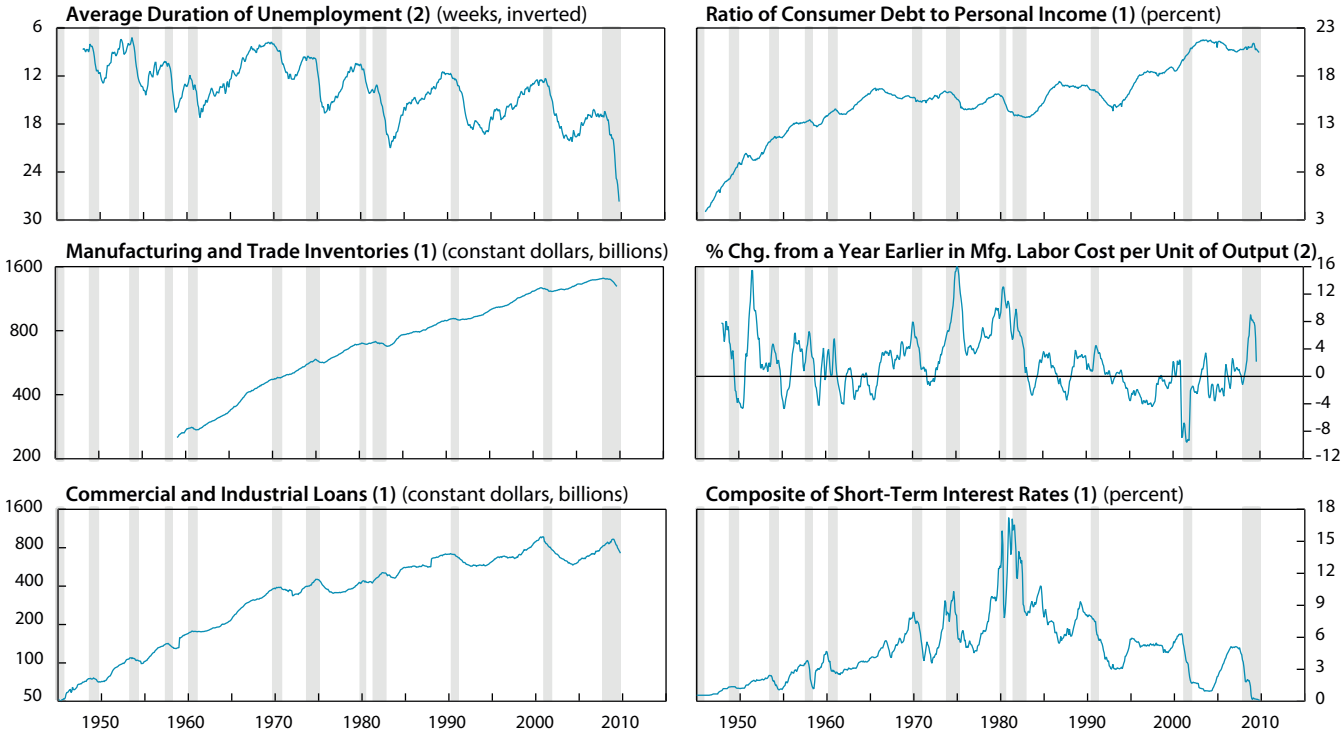
Source: Federal Reserve; *Flow of Funds Accounts of the United States*.

Primary Roughly Coincident Indicators



Notes: 1) Shaded areas indicate recessions as dated by the National Bureau of Economic Research. 2) The number in parentheses next to the name of a series is an estimate of the minimum number of months over which cyclical movements of a series are greater than irregular fluctuations. That number is the span of each series' moving average, or MCD (months for cyclical dominance), used to smooth out irregular fluctuations. The data plotted in the charts are those MCDs and not the base data.

Primary Lagging Indicators



eager to borrow. Consumer debt has fallen every month since October 2008. Commercial and industrial loans to businesses have been falling since January 2009.

These changes come after unprecedented debt accumulation. At its peak in the first quarter of 2009, total debt reached nearly 360 percent of GDP—almost $51 *trillion*. Since then total debt fell, but not by much. Households reduced their debt by $141 billion, nonfinancial businesses by $133 billion, and financial businesses by $951 billion. At the same time, the government sector increased its debt by $895 billion, with almost all of it due to borrowing by the federal government. The increase in government debt is likely to continue. It will make the correction more difficult.

Banks do not need any convincing to lend to sound businesses with profitable projects. The profit motive is usually sufficient.

The high level of outstanding debt constrains spending and curbs the pace of the recovery. Following the financial crisis of 2008, refinancing became more difficult for businesses and households. When people have to spend an increasing portion of their income on servicing debts that they can no longer restructure, growth of consumer spending suffers. This impediment to recovery is captured by the *ratio of consumer debt to personal income*, which remains high. When businesses cannot roll over their debts, their spending similarly will be curtailed.

This reduction in debt cannot, and should not, be avoided. It is a necessary reaction to an unsustainable pace of debt growth in recent decades. In the past year, banks have tightened their lending standards and stopped lending to marginal and risky borrowers. Most have gone back to the good old practices of requiring detailed documentation, collateral, or co-signers before extending credit. Even borrowers with good credit histories can expect to face more scrutiny when applying for credit. Such "credit stringency" should be a welcome change after years of reckless lending, which culminated in the financial crisis.

Recently, politicians have been saying that more lending is necessary for the economy to recover quickly. While meeting with bank CEOs in December, President Obama urged them to "take a third and fourth look" at their lending practices and announced that the administration's focus over the next several months will be "geared towards catalyzing and spurring additional lending, particularly to small businesses."

These political inducements to increase lending may do more harm than good. In a market economy, banks do not need any convincing to lend to sound businesses with profitable projects. The profit motive is usually sufficient. What politicians typically want is for banks to lend for projects that are not necessarily sound or profitable. Urging the banks to lend more than they would choose pushes them towards the risky practices of the past. More lending is unlikely to be a solution to the crisis brought about by excessive debt levels. Excesses are not overcome by still more excesses.