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Shadow-Credit Rise Is Good Sign

Seven years after the financial crisis, a key form of lending among financial institutions finally appears to have bottomed out, a reversal that could presage a long-awaited uptick in U.S. economic growth.

HORIZONS
MICHAEL J. CASEY

The New York-based Center for Financial Stability says that February showed an increase in the short-term credit that circulates among investment banks like **Goldman Sachs Group** Inc. and big nonbank managers of money-market funds such as **Vanguard**. That is after 82 months of decline in this measure of market finance, dating to the March 2008 panic over the failure of Bear Stearns & Co.

The CFS defines market finance as the total stock of money-market funds, commercial paper and security repurchase, or repo, contracts held by financial institutions. The figure totaled $4.124 trillion in February, up from $4.111 trillion in January but 46% below its peak seven years ago.

The CFS data show that market finance has routinely declined with every economic recession since the late 1960s, when this credit system first emerged as an alternative to the regulated, commercial-banking sector. But on those prior occasions the average decline was 10% and 13 months from peak to trough.

The pre-2008 excesses in what has become known as shadow banking fueled the housing bubble and subsequent meltdown. That required a much bigger unwind of market finance after the last recession. But that unwind has clearly overshot, said CFS President Lawrence Goodman, who calls it a "devastating collapse in a critical piece of the economy."

February's rise coincides with the Federal Reserve's gradual preparations to raise its federal funds rate, a rebound in the dollar and some tentative signs of U.S. economic acceleration. Perhaps it is laying the path toward more "normal" financial conditions.

One way in which a pickup in demand for these kinds of credit instruments could help boost the economy is via the commercial-paper market.

Bloomberg News

An uptick in shadow credit may give the Fed more leeway on rates.

Companies traditionally issue commercial paper to raise money short term, using it to cover payrolls and other day-to-day operations. But in the postcrisis years, many relied on large pools of cash accumulated in bank accounts—the proceeds of long-dated bonds sold at the record-low yields fostered by the Fed's easy monetary policy.

Now, if financial institutions were to increase secondary-market demand for commercial paper, it should feed through to direct demand for companies to increase their issuance of those promissory notes. That way, they could borrow money for day-to-day needs and free up some of their idle cash for investment in plant, machinery and new hires.

> Pre-2008 excesses fueled the housing bubble as well as the following meltdown.

In theory, improvement in market finance should also give the Fed leeway to raise rates since it could now let banks play a more direct role in expanding the flow of credit and money. It would take us closer to a longed-for "normal" state where private credit markets stand on their own feet and drive growth without support from the Fed or other government institutions.

Still, bulls can't yet use this data to challenge the bears who have posited that Western economies are locked in an intractable period of "secular stagnation" and perpetually low interest rates. They need to consider the sheer extent of the shrinkage since 2008.

Extrapolations from CFS data show that the level of market finance is significantly below where its post-1967 trend would predict. In other words, a great deal of expansion is needed to bring this market back even to a level projected by its prebubble state. Until then, it will continue to do far less of the heavy lifting in credit creation than it used to.

The contraction can in part be blamed on postcrisis regulations principally via the Dodd-Frank Act and rules to limit banks' risk taking such as the "Volcker rule" on proprietary trading. Mr. Goodman says these have constrained banks' ability to put up credit and act as market makers.

It is worth remembering the policy changes were implemented to shrink what had become an excessively large shadow-banking system that operated largely unregulated. The precrisis explosion of the in financial institutions' mutually interconnected debt exposures had meant that banks and other financial institutions became "too big to fail." Federal authorities were compelled to rescue them during the 2008 panic lest the entire system go under.

One could argue that the slower credit growth fostered by Dodd-Frank was the price we had to pay for creating a system in which taxpayers aren't on the hook. It is important that market finance recover if the U.S. economy and financial markets are to grow without the crutch of easy monetary policy. Given the cautionary tale of 2008, there should be limits on the extent of that recovery. We might just have to accept slower but safer growth.