Why just expanding credit might not be enough for U.S. monetary policy

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The prevailing U.S. monetary policy during and after the Great Recession remains the Federal Reserve’s zero-interest-rate policy, lowering rates in any way possible to enable financial institutions in turn to make more loans to businesses and especially to consumers. The cheaper it is for financial institutions to get capital, the more loans they should be able to make. And if more households in particular have access to credit, then they will borrow more, increase consumption, and thus boost economic growth.

Without question, zero interest rates helped the U.S. economy recover from the Great Recession, but the extent of the recovery over the past six years is not as large as economists expected given the extraordinary steps taken by the U.S. central bank. How exactly did a policy that was previously considered extremely stimulative not result in a much larger and swifter bounce-back in economic growth? A new paper by Sumit Agarwal of the National University of Singapore, Souphala Chomsisengphet of the Office of the Comptroller of the Currency, Neale Mahoney of the University of Chicago, and Johannes Stroebel of New York University provides some insight into why simply expanding credit during and after the Great Recession wasn’t as powerful as it might have been.

Agarwal, Chomsisengphet, Mahoney, and Stroebel demonstrate that the transmission of credit between financial institutions and consumers isn’t as fluid or direct as U.S. monetary policymakers would have you believe. They look specifically at the evolution of credit card borrowing from eight major banks from January 2008 to November 2013. The authors show that the pass-through of consumer credit from these banks to household borrowers is dependent upon their credit rankings. Limits on borrowing for credit cardholders go up much more for cardholders with high credit scores (FICO scores above 740) than for holders with low credit scores (below 660). Specifically, a 1-percentage-point drop in the cost of borrowing by these eight banks increased credit limits for borrowers with low scores by about $130 but by about $2,200 for high-score borrowers.

Because there is such a clean break for increases in credit limits for borrowers once
they reach a certain credit score, the authors can use a technique that lets them show a causal relationship between these banks’ cost of capital and their customers’ increased credit limits. This relationship should come as no surprise from the perspective of the banks. After all, they are more likely to extend credit to borrowers with a history of repaying loans. But the relationship poses a problem for monetary policymakers since, as this paper also shows, the low-credit-score cardholders are the ones who are most likely to actually increase their borrowing once credit limits are increased, thus spending more and helping boost demand in the economy and thereby sustaining economic growth.

In fact, the four authors find that credit cardholders with high scores didn’t increase their borrowing at all between January 2008 and November 2013. The end result: Banks proved to be more willing to lend to individuals with high credit scores, yet these are the very individuals least likely to borrow. So pushing down the cost of capital for financial institutions in order to boost borrowing by consumers limits the effectiveness of monetary policy.

This breakdown in the credit transmission is one of several credit mechanisms that began to falter at the onset of the Great Recession in 2007 and never really recovered, as highlighted in a speech by University of Chicago economist Amir Sufi. The rather indirect nature of this approach to monetary policy was definitely not as effective as it could have been. Its flaws are something to consider when the U.S. economy tips into the next inevitable recession, alongside some other policies that might make monetary policy more effective.