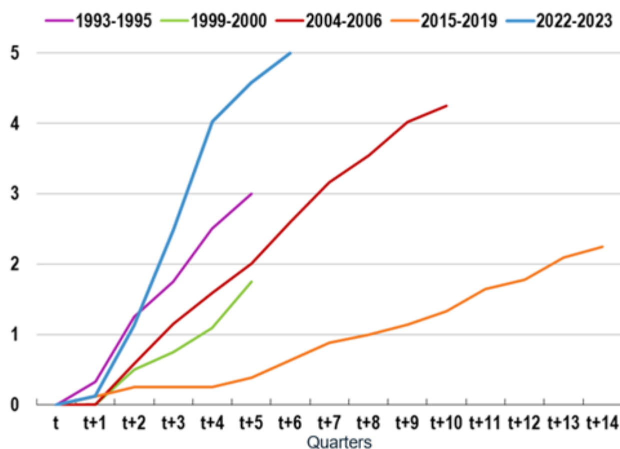
Monetary policy and credit standards: this time it’s different

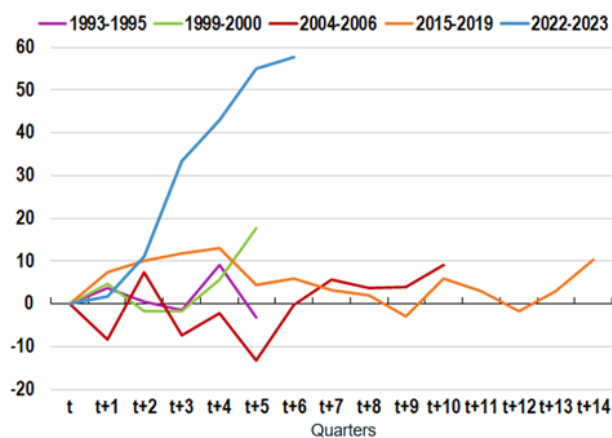
by Almira Enders and Dennis Dlugosch, OECD Economics Department

The current monetary policy tightening cycle observed in many countries stands out for several reasons. In particular, it is rapid, globally synchronised and accompanied by an equally rapid tightening of credit standards (OECD, 2022).

Since February 2022, the US Federal Funds Target Rate has risen by 500 basis points (Figure 1 Panel A). No tightening cycle since the mid-1980s has seen such a big increase in policy rates in such a short period of time. Central banks in other main advanced economies have acted comparably aggressively in their fight against high inflation. The European Central Bank, for example, has raised its policy rates by 400 basis points since June 2022. The increase of policy rates has been quickly transmitted to money market and bank lending rates over the past year (OECD, 2023).

Figure 1. Policy rates and credit standards have tightened in sync





Note: Starting on Dec 16, 2008, the fed funds target rate contains the average of the upper and lower limits of the target range of the fed funds rate. Prior to Dec 16, 2008 the fed funds target rate was a fixed rate. Credit standards refer to net percentage of US domestic banks reporting tightening of standards for commercial and industrial loans to small firms (in percent, not seasonally adjusted).
Source: Federal Reserve Board; OECD calculations.

While the tightening of credit conditions is a standard transmission channel of monetary policy, the synchronised increase in interest rates and tightening of credit standards is eye-catching in comparison to previous tightening cycles (Figure 1 Panel B).[1] Credit standards are non-price measures that determine access to credit, such as collateral requirements, employment status or income situation. Credit standards can restrict access to credit in addition to sheer the changes in lending rates which affect the supply and demand for credit through their impact on cost of debt and banks' and borrowers' balance sheets.

The net share of banks reporting tightened credit standards in the current monetary policy tightening cycle has increased, in step with the increase in policy rates. In March and April 2023, the net share of banks tightening lending standards to small firms over the previous three months reached 47% in the

US.[2] While this share is still below the peaks reached during the Covid-19 crisis (70%) and the Global Financial Crisis (about 75%), the current rapid tightening of credit standards is similar to the dynamics seen during the last two severe economic downturns. In the euro area, as well, the current monetary policy tightening was accompanied by the tightening of credit standards, although less rapidly than in the US. The corresponding net share of banks tightening credit standards in the euro area increased to about 24% recently, only a fraction below the last peak reached during the euro area sovereign debt crisis at 28%. In the UK, the share of lenders reporting worsened availability of unsecured credit to households and small businesses widened rapidly to almost 40%, approaching the peak reached during the Covid-19 crisis of about 63%.[3]

Bank lending surveys also provide information on the reasons behind changes in lending standards. In the US, most banks have reported tighter lending standards because of a less favourable or more uncertain economic outlook and a reduced tolerance for risk. In the euro area, we observe similar patterns, as higher risk perception and a lower tolerance for risk of banks were the main reasons behind the recent tightening of credit standards.

Focussing on small firms and households is interesting because they are usually more exposed to tighter credit standards given that they rely more on bank loans as external source of finance. In the US and the euro area, the evolution of lending standards to small firms appears representative for the overall corporate sector. While in the US more banks have also reported tighter standards for credit card loans; in the euro area, the net share of banks reporting tighter credit standards for households, which includes but is not limited to credit card loans, has receded from their recent peaks over the past two quarters. In the UK, credit availability remains favourable for corporate sector and for secured lending for

households.

In the past, banks rapidly tightened credit standards during severe economic downturns, mainly due to the expected deterioration of borrower’s balance sheets (Ciccarelli et al., 2015). In contrast to the current juncture, at that time monetary policy accommodated these economic downturns, by lowering interest rates in response to a slump in aggregate demand and declining inflation. The combined tightening of policy rates and credit standards has several implications for policy makers. First, it adds to the uncertainty over the impact of monetary policy on the real economy and thus makes the transmission channel for monetary policy difficult to gauge. Central banks will need to maintain restrictive monetary policy to curb inflation durably. However, monitoring financial stability and clear communication will be needed to minimise uncertainty about apparent conflicts between the pursuit of price stability and financial stability mandates. Finally, keeping an eye on competition in financial services will be critical to ensure that small business and households continue to benefit from a vibrant financial sector.

References

Ciccarelli, M., A. Maddaloni and J.-L. Peydró (2015),”Trusting the bankers: A new look at the credit channel of monetary policy”, Review of Economic Dynamics, Vol. 18 (4).

OECD (2022), OECD Economic Outlook, Volume 2022 Issue 2, OECD Publishing, Paris, https://doi.org/10.1787/16097408.

OECD (2023), OECD Economic Outlook, Volume 2023 Issue 1, OECD Publishing, Paris, https://doi.org/10.1787/ce188438-en.

Footnotes

---

[1] The figure shows the synchronized tightening of policy rates and credit standards in the US. The euro area bank lending survey was launched in 2003. This limits a comparison over several monetary policy tightening cycles.

[2] Based on a survey of lending practices of major US banks conducted by the Federal Reserve Board System. The number refers to the net percentage of banks that have tightened lending standards over the previous three months. The net percentage is equal to the difference between the sum of banks answering “tightened considerably” and “tightened somewhat” and the sum of banks answering “eased somewhat” and “eased considerably” in percentage of the total number of banks.

[3] Based on the Bank Lending Survey conducted by the Eurosystem of Central Banks for the euro area and based on the Credit Conditions Survey conducted by the Bank of England for the UK.