Summary for non-specialists
Economic Papers No. 509 / December 2013
Economic Papers index

The flow of credit in the UK economy and the availability of financing to the corporate sector

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This paper analyses the flow of credit in the UK economy in the years before and after the 2008 financial and economic crisis, with particular emphasis on the corporate sector and the SME segment. Section 1 carries out a comparative analysis highlighting the parallelisms and differences between the sterling and euro currency areas. In both cases, the pre-crisis period was characterized by dynamic and continued increases in the loans-to-GDP ratio, with 2008 marking a reversion in this trend. Notwithstanding unprecedented monetary activism exemplified by the sharp drop in base rates and the introduction of unconventional monetary policies, a breakdown in the loans-to-money transformation process has meant a marked retrenchment in loan amounts in the post-crisis period. The UK experience was not unlike the euro area's, but the pre-2008 financial exuberance and the subsequent backlash appear to have been more pronounced in the UK. Section 2 analyses the two main private recipients of credit: the household and the non-financial corporation sectors. As regards the household sector, the post-crisis deleveraging trend appears well justified given the very high level of debt, notably mortgage debt, which UK families accumulated in the run-up to the crisis. However, a similar deleveraging trend in the corporate sector can hinder the recovery prospects of the UK economy as, at the current juncture, non-financial corporations represent the institutional sector with the greatest leeway to take on more financing and to drive growth through investment and exports. The combined results of a number of different surveys analysed in detail in the Annex show that loan rejection rates increased markedly in the post-crisis period for small and medium companies, something which does not appear entirely justified on the basis of changes in the characteristics of the loan applicants. While large firms can finance themselves directly in wholesale markets and profit from the well-developed financial services offer of the UK, SMEs largely rely on banks to obtain their external funding. There is, however, creative scope for new policies to be envisaged that promote the non-bank lending channel for SMEs. For instance, the Bank of England transmits its policies of quantitative easing by purchasing government bonds or those of large and highly creditworthy companies, which face no difficulties in accessing finance. Unorthodox measures could be devised to kick start a market for securitised SME loans from the demand side by harnessing the existing credit rating expertise of banks, the Basel II/III framework and the funds of the quantitative easing programme. Section 3 explores the issue of the relative importance of negative supply and demand shocks in driving the reduction in the amount of credit offered in the economy. The crisis years saw the banking sector become more reluctant in lending to corporations that do not offer sufficient security and collateral. While this increased reluctance can be partly understood as a reaction to a riskier environment, new regulatory requirements and the need to boost capital ratios, forbearance and the comparatively low degree of competition in the UK banking sector may also mean that credit is not being allocated in a fully efficient manner. In particular, the UK banking industry experienced a government-led consolidation wave in the wake of the 2008 financial crisis which reinforced its oligopolistic structure. Initiatives aimed to increase banking competition should have a positive effect on access to finance and the UK authorities have so far considered or implemented a number of measures improving market structure and functioning. The creation of new challenger banks by means of divestitures of assets belonging to government-intervened banks is underway. However, in order to inject significant competitive

pressure into the market it is crucial that the resulting new banks be financially balanced, operationally sound and dispose of sufficient assets and size. Also, the introduction of full bank account portability would likely have a significant impact in lowering customer switching costs. Both a qualitative and quantitative analysis of credit supply and demand factors suggest that the observed retrenchment in credit can be understood as a combination of negative shocks to demand and supply. This idea is further explored in Section 4, which provides evidence from an econometric model suggesting that the UK corporate credit market experienced a bout of sustained negative supply shocks starting at around the time of the collapse of the Lehman Brothers bank in September 2008 and which lasted until mid-2012. Demand shocks were also mostly negative throughout this period, but turned positive already in 2011. The second half of 2012 and 2013 witnessed the re-emergence of positive supply shocks, possibly on account of further unorthodox measures, such as the Funding for Lending Scheme and the outright monetary transactions programme, as well as an improvement in economic outlook in the euro area and in the UK. Finally, Section 5 presents and assesses the main initiatives undertaken by the UK authorities to re-establish lending in the economy. While these initiatives have been generally positive and have helped to alleviate the negative effects of the post-crisis credit crunch, they have not been successful in reversing the negative financing trends. Also, some recent initiatives may result in rechanneling funding to mortgages rather to corporations and to SMEs. Finally, the myriad of existing initiatives makes them harder to navigate by firms and consolidating them under one institution, such as the future Business Bank, appears to be desirable in order to increase their visibility and take-up. The flow of credit in the UK economy may be close to turning a corner in connection with recent improvements in the macroeconomic outturns and outlook, and as banks finish adapting to a new regulatory environment. Improving access to finance for firms and SMEs is set to remain a crucial element for driving the desirable rebalancing of the UK economy, fomenting investment and fostering the reallocation of resources to the most productive sectors of the economy throughout the on-going recovery.