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## Economic Policy Uncertainty and the Credit Channel in the United States

Evidence over Several Decades

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Recent literature emphasizes how uncertainty matters for economic decision-making. In recent models, for example, uncertainty results in a central region of inaction for hiring and investment, with this zone of inaction expanding when uncertainty is higher. New methodologies have also enabled researchers to better measure macroeconomic and economic policy uncertainty, and these measures appear to help predict recessions even after controlling for standard financial variables. Less well understood are the specific channels through which economic policy uncertainty may affect the macroeconomy.

This applies particularly with respect to the recent weak recovery of U.S. bank lending; real total bank loans after the Great Recession grew on a slower path than in earlier recessions. Following the Great Recession, bankers complained that delays in implementing financial reform under the Dodd-Frank Act created regulatory policy uncertainty that restrained lending, which, in turn, slowed the recovery. Indeed, three years after Dodd-Frank became law, rule-writing regulatory agencies had set only about half the new regulations, and reporting requirements have continued to increase. At

the same time, an index of economic policy uncertainty (EPU) based on newspaper wording has been at elevated levels during the Great Recession and the early part of the recovery, generally exceeding the cyclical averages during the first four years following the onset of the five prior recessions.

These developments raise two questions: did economic policy uncertainty restrain U.S. bank lending during the prolonged recovery from the Great Recession, and what role has it played in other periods? To address these issues, we analyze data for the banking industry and for individual banks to assess whether the EPU index contains information about the growth of bank lending, controlling for variables such as interest rates, GDP growth, and banking regulation. We ask whether, conditional on standard macroeconomic controls along with ones for regulation, economic policy uncertainty affected bank-level credit growth and whether the impact relates to banks' balance sheet conditions.

We find that policy uncertainty significantly slows U.S. bank credit growth, consistent with its having an effect on broad loan supply and demand. Lagged changes in the EPU index are negatively and significantly linked to the

growth rate of bank lending both at the aggregate and cross-sectional levels.

In the aggregate data, economic policy uncertainty is highly significant in models of real per capita bank loan growth spanning 1961 to 2014. This result is robust to the inclusion or exclusion of macroeconomic controls (lags of GDP growth and changes in the real fed funds rate), direct regulatory controls (a measure of the effects of deposit regulations and an episode when the Federal Reserve implemented credit controls in 1980), lags of the forward-looking (expectations) index of consumer sentiment from the University of Michigan, and other macro variables which may be correlated with economic policy uncertainty.

A robust impact of EPU on loan growth also arises when we analyze individual banks in cross-sectional data that allow us to examine how bank asset characteristics are linked to the impact of economic policy uncertainty.

In particular, three statistically and economically meaningful results arise using indices of individual bank asset characteristics. First, the negative effects of economic policy uncertainty on loan growth are greater for larger-sized banks. This may reflect a greater importance of national uncertainty for larger banks that tend to be more geographically diversified. Second, the negative effect of economic policy uncertainty on bank-lending growth is smaller in magnitude for more highly capitalized banks. This suggests that the shock-absorbing effects of greater capitalization in reducing the impact of economic policy uncertainty is partially outweighed by banks with higher capitalization rates exhibiting greater risk aversion. Third, the depressing effect of economic policy uncertainty on bank lending is significantly but quantitatively only somewhat smaller at banks with more cash assets, with no significant correlation with different levels of securities holdings. These three results are robust to the inclusion of relevant control variables.

These results have several implications. First, this evidence suggests that economic policy uncertainty has affected bank lending in the United States, which our results and other studies also find to have important effects on economic activity. This could have implications for Europe, where a key index of economic policy uncertainty rose more than in the United States during

the post-crisis slump and where economies are more bank dependent. More recently, this uncertainty index has not recovered as quickly in Europe as in the United States, where the subsequent recovery in bank-lending and GDP growth have both been stronger.

Second, we find that economic policy uncertainty is associated with larger declines in bank loan growth at larger U.S. banks, weakly capitalized banks, and at banks holding less cash. This provides evidence of loan supply-side effects at the level of individual banks and suggests somewhat mixed evidence on the impact of recent financial reforms. On the one hand, higher capitalized banks and to a lesser extent those with more cash tend to reduce lending less in response to greater economic policy uncertainty. On the other hand, the effects do not significantly differ in magnitude across banks with different portfolio shares in securities.

Together, our findings are consistent with the view that the elevated economic policy uncertainty contributes to weak bank loan growth in recessions and that the implications of financial reforms for financial stability should be evaluated from a holistic perspective.

Because other studies have found important effects of bank-lending growth on the macroeconomy, this may help account for the delayed and weak recovery of U.S. bank loan growth following the Great Recession. It is also consistent with more recent signs of an upturn in bank lending that has followed the recent decline of U.S. economic policy uncertainty to levels predating the Great Recession and the transition to a more highly capitalized banking system.

## NOTE

This research brief is based on Michael D. Bordo, John V. Duca, and Christoffer Koch, "Economic Policy Uncertainty and the Credit Channel: Aggregate and Bank Level U.S Evidence over Several Decades," National Bureau of Economic Research Working Paper no. 22021, February 2016, <http://www.nber.org/papers/w22021>. The views expressed are those of the authors and do not necessarily reflect those of the Federal Reserve Bank of Dallas or the Board of Governors of the Federal Reserve System. Any errors are our own.