The recovery from the Great Recession, which officially began in December 2007 and ended in June 2009, has been disappointing slow and uneven. Early expectations of rapid economic growth in 2011 have largely dissipated in the face of a multitude of exogenous shocks that have buffeted the U.S. and global economy over the past few months. The supply chain disruptions created by the Japanese earthquake, the commodity market volatility resulting from the “Arab Spring” uprisings in the Middle East, the massive flooding and record number of tornadoes in middle America resulting from extreme weather patterns, the continuing financial risk posed by the euro-zone sovereign debt crisis and the absence of political will to deal with long-term U.S. budget and debt challenges, have all combined to crimp U.S. economic growth in first half of 2011.

Though corporate profits have recovered rather nicely, the labor market and the housing market are still encountering severe doldrums. Fiscal and monetary policy options appear limited. On the fiscal side, massive budget deficits and exploding national debt levels have led to a political backlash and constrained the government’s ability to inject additional economic stimulus. On the monetary side, with the culmination of the second round of Quantitative Easing (QE2), all eyes are once again focused on Chairman Ben Bernanke and the Federal Reserve System. Despite the Federal Reserve (the Fed) having already engaged in historically unprecedented levels of policy intervention, there are calls from certain quarters for the central bank to do more. The Fed, however, faces a few serious policy dilemmas that may hinder its ability to undertake further bold actions.

In the face of a once-in-a-century financial crisis that was characterized by severe illiquidity problems and a massive credit crunch, the Fed ejected its standard playbook and engaged in innovative policy actions aimed at unclogging the financial system. Initially, determined to emphasize its lender of last resort role, the Fed undertook several rounds of rate cuts that pushed the Federal Funds Rate target down to 0-0.25 percent by December of 2008, and eased the primary and secondary credit lending (also known as discount window) facilities available to depository institutions.

Several new liquidity-enhancing initiatives were unleashed to prevent the seizing up of key credit markets. Table 1.1 summarizes the various new policy steps implemented by the Fed. The Fed aimed to add liquidity to the financial system and tried to stabilize important credit markets (such as the money market and the commercial paper market) by providing new loan facilities and by shifting significant portions of the troubled assets from banks’ balance sheets on to its own. To pay for these measures, the Fed created new reserves (in common parlance, this is termed “printing money,” even though there is only electronic bits of new reserves being deposited in the reserve accounts of various financial institutions by the Fed). As noted in Table 1.1, many of the temporary facilities created were short-run by nature and they were all terminated by the middle of 2010. The above measures were generally supported by economists and considered unavoidable in the face of an extraordinary credit and liquidity crunch. However, a few other recent Fed policies have not been so widely supported.

Faced with the zero interest rate bound, the Fed attempted to stimulate the economy via unconventional measures. Specifically, the Fed decided to implement two rounds of Quantitative Easing (QE), which the central bank prefers to call Credit Easing. The first round was initiated on November 25, 2008, with the announcement by the Fed that it would purchase up to $600 billion worth of Mortgage-Backed Securities (MBS) and government agency debt. Later, in March of 2009, the FOMC announced that the program
WHY ARE FINANCIAL INSTITUTIONS NOT LENDING?

by Donald C. Flagg, Ph.D.

Although the recession in the U.S. ended in June 2009, Florida small businesses continue to report great difficulty in getting banks to lend to them. The 2011 first quarter Small Business Survey published by the Federal Reserve Bank of Atlanta (Atlanta Fed) reveals the struggle small businesses face in acquiring credit is getting worse, not better.

The Atlanta Fed surveyed 182 small businesses in Florida and other southeast states about their financial affairs. Of small businesses seeking credit, only 51 percent of businesses that sought credit in recent months got most or all of the credit they needed. The same survey a quarter earlier reported that 57 percent of small businesses were able to get most or all of the credit they needed. The decline in the provision of credit is a disturbing sign. This measure was much worse for businesses in the real estate or construction business.

Aggregate data for the U.S. supports the view that credit remains constrained. This is especially true in the case of commercial real estate. Table 2.1 displays bank-lending data from the Federal Reserve Bank (the Fed). Commercial real estate loans have declined in each period between 2009 and April 2011. The average drop in each of the last four months is just under 10 percent. Commercial and industrial loans have also witnessed a drop in both 2009 and 2010, with only a modest improvement in the first few months of 2011. The recession in the U.S. may be over, but an expansion in the provision of credit is non-existent. Credit is essential for economic growth, as firms (especially small ones) cannot fund expansion without the access to funds.

Small businesses have reported the difficulty they’ve experienced in trying to acquire credit from banks has translated into an inability to expand operations and hire new employees. The booming real estate market in Florida led to a historically low unemployment rate of 3 percent in 2006. However, after the collapse of the real estate market, Florida’s unemployment rate has soared to 10.6 percent in June 2011. Florida’s dependence on the real estate market is obvious and it appears as if no immediate help is on the horizon to assist this struggling sector. The Atlanta Fed’s Small Business Survey reports that companies in southeastern states within the construction and real estate sectors are still expecting negative growth in terms of hiring and capital spending. Relative to the fourth quarter of 2010, the first quarter survey reveals that even more firms plan to decrease employees and reduce capital expenditures. Given Florida’s economic dependence on the real estate market, it is a disturbing trend to see negative growth rates for new hiring and capital expenditures persisting.

To add a local perspective to the regional and national statistics, I spoke with small firms in Tampa seeking credit from banks. A local real estate development firm sought credit to take on an expansion project to improve real estate they owned in order to lease out currently unused buildings. The buildings are 100 percent owned by the firm’s investors and the loan to value was between a 30 to 40 percent. Two of the largest tenants had already signed tentative leasing agreements. Nevertheless, the developer found it impossible to acquire traditional bank funding for their project. Such a loan would have been considered conservative before the financial crisis of 2008. However, today a vast majority of financial institutions in Tampa Bay simply will not make commercial real estate loans of any kind.

During a recessionary period, financial institutions become so fearful of the possibility of insolvency that they actively change their portfolio from risky loans to safer assets, such as U.S. Treasuries securities. The data in Table 2.1 provide evidence of this behavior over the last three years. The percent of money that banks placed into U.S. Treasury securities has increased year-on-year, while the percent of money placed in commercial lending has decreased year-on-year. Thus, because banks are fearful they have attempted to make their portfolio less risky. As a result, banks lend less.

On the other hand, as economic conditions improve banks should want to switch their portfolios back into riskier assets to earn a higher rate of return relative to what is earned on U.S. Treasuries. If the recession in the U.S. is over, what is holding back the typical financial institution from switching away from U.S. Treasury securities to marginally riskier

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Failed Banks</th>
<th>Total Assets of Failed Banks (billions)</th>
<th>Loss to the FDIC’s Deposit Insurance Fund (billions)</th>
<th>Number of Failed Banks in Florida</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>3</td>
<td>$2.60</td>
<td>$0.10</td>
<td>0</td>
</tr>
<tr>
<td>2008</td>
<td>25</td>
<td>$373.60</td>
<td>$15.70</td>
<td>2</td>
</tr>
<tr>
<td>2009</td>
<td>140</td>
<td>$170.90</td>
<td>$36.40</td>
<td>14</td>
</tr>
<tr>
<td>2010</td>
<td>157</td>
<td>$96.50</td>
<td>$22.40</td>
<td>29</td>
</tr>
<tr>
<td>2011</td>
<td>46</td>
<td>$18.90</td>
<td>$3.60</td>
<td>6</td>
</tr>
<tr>
<td>Total</td>
<td>371</td>
<td>$662.50</td>
<td>$78.20</td>
<td>51</td>
</tr>
</tbody>
</table>

Table 2.2: Bank Failures

Source: FDIC

Table 2.1: Credit, Securities and Loans: U.S. Banks
(Period-on-Period Percent Change)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Securities in bank credit</td>
<td>0.9</td>
<td>7.7</td>
<td>6.4</td>
<td>0.0</td>
<td>-4.0</td>
<td>8.1</td>
<td>16.3</td>
</tr>
<tr>
<td>Treasury and agency securities</td>
<td>9.4</td>
<td>16.0</td>
<td>15.0</td>
<td>3.5</td>
<td>-4.4</td>
<td>12.9</td>
<td>30.0</td>
</tr>
<tr>
<td>Commercial and industrial loans</td>
<td>13.0</td>
<td>-18.5</td>
<td>-8.7</td>
<td>5.3</td>
<td>2.3</td>
<td>11.3</td>
<td>7.4</td>
</tr>
<tr>
<td>Real estate loans</td>
<td>0.2</td>
<td>-5.5</td>
<td>-5.6</td>
<td>-5.7</td>
<td>-10.5</td>
<td>-11.1</td>
<td>-12.5</td>
</tr>
<tr>
<td>Commercial real estate loans</td>
<td>6.4</td>
<td>-4.5</td>
<td>-9.1</td>
<td>-9.7</td>
<td>-6.3</td>
<td>-9.3</td>
<td>-10.4</td>
</tr>
</tbody>
</table>

Source: Federal Reserve
Treasury markets have benefitted from the Federal Reserve’s 
QE2. In practice, while U.S. equity markets and U.S. 
Treasury bonds increased, the private sector, 
and thus boost aggregate economic activity. 
When the central bank purchases of assets 
from the maturing debt that it already holds. 
The basic theory behind QE programs is 
as follows. Central bank purchases of assets 
such as government securities are expected to 
rise asset prices, lower yields and add money 
into the economy. Increase in asset prices is 
supposed to cause a positive wealth effect 
and propel consumer spending. The addition of 
money and reserves into the financial system 
is supposed to lower interest rates, cause 
increased borrowings by the private sector, 
and thus boost aggregate economic activity. 
In practice, while U.S. equity markets and U.S. 
Treasury markets have benefitted from the 
Fed actions, some fault QE for recent dollar 
weakness and high commodity prices. 

As a consequence of the measures detailed 
above, the Fed’s balance sheet exploded. As 
shown in nearby Figure 1.1, the asset side 
of Fed’s balance sheet has more than tripled 
since late 2007. On the liability side, the 
reserves held at the Federal Reserve banks 
have reached unprecedented levels as well 
(see Figure 1.2). Until now the impact has been 
muted as depository institutions have devoted 
their attention to reestablishing adequate 
capital levels and hoarding excess reserves. 
The continuing labor market weakness and 
concerns regarding the credit worthiness of 
potential borrowers have prevented a 
significant rise in new lending. Additionally, 
the recently introduced Fed policy of paying 
interest on reserves has encouraged banks 
to maintain high levels of excess reserves. 
There is growing concern among some about 
medium to long-term inflation risk, which is 
motivated by the fear that if significant 
quantities of excess reserves were to enter 

<table>
<thead>
<tr>
<th>Table 1.1: Crisis Driven Federal Reserve Policy Initiatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source: Federal Reserve</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Term Auction Facility (TAF) awarded 28-day or 84-day loans for depository institutions through an auction process</td>
</tr>
<tr>
<td>Primary Dealer Credit Facility (PDCF) offered overnight loans secured against appropriate collateral to primary dealers</td>
</tr>
<tr>
<td>Term Securities Lending Facility (TSLF) provided loans to primary dealers Treasury Securities for up to a month against eligible collateral</td>
</tr>
<tr>
<td>The Term Securities Lending Facility Options Program (TOP) offered primary dealers the option to obtain fixed rate short-term TSLF loans in exchange for eligible collateral</td>
</tr>
<tr>
<td>Asset-backed Commercial Paper Money Market Mutual Fund</td>
</tr>
<tr>
<td>Liquidity Facility (AMLF) financed purchases by U.S. depository institutions and bank holding companies of high-quality asset-backed commercial paper (ABCP) from money market mutual funds to generate liquidity in the ABCP and money markets</td>
</tr>
<tr>
<td>Money Market Investor Funding Facility (MMIFF) was aimed at unclogging the money market by providing liquidity to U.S. money market mutual funds and few other money market investors</td>
</tr>
<tr>
<td>Commercial Paper Funding Facility (CPFF) funded a specially created limited liability company (LLC) that offered as a liquidity backstop to U.S. issuers of commercial paper by purchasing 3-month unsecured and asset-backed commercial paper directly from eligible issuers</td>
</tr>
<tr>
<td>Term Asset-backed Securities Loan Facility (TALF) issued loans of up to five year maturity to holders (consumers, small businesses, etc.) of eligible asset-backed securities</td>
</tr>
</tbody>
</table>

Figure 1.1: Federal Reserve Balance Sheet – Assets 
Source: Federal Reserve Bank of Cleveland

Is Federal Reserve Facing a Policy Dilemma?

continued from page 1
By Brian T. Kench, Ph.D.

The Tampa Bay metropolitan statistical area (that is, Hernando, Hillsborough, Pasco and Pinellas counties) continues to slowly recover from the Great Recession. After 42 months of declines, Figure 3.1 shows that Tampa Bay has experienced year-on-year increases in nonfarm payroll jobs for six continuous months. A similar trend exists for Florida and the U.S.

Figure 3.2 illustrates the duration of job loss in Tampa Bay in the 2007-2009 recession relative to the 1990-1991 and 2001-2003 recessions. The figure vividly illustrates how hard the recession hit Tampa Bay’s labor force. In the 1990-1991 recession, it took 32 months to claw back to the level of nonfarm payroll jobs that existed prior to the recession. In the 2001-2003 recession, it took 46 months. As of June 2011, 42 months have passed since the recession began and the area remains net negative 130,000 jobs (just 10,700 jobs away from Tampa Bay’s worst reading). At the time of this writing, Tampa Bay is slowly adding nonfarm payroll jobs. However, the sad truth is that it will be many months, if not years, before Tampa Bay observes the number of nonfarm payroll jobs that existed prior to the recession.

The unemployment rate in the Tampa Bay was 11.1 percent in June 2011, which is higher than the national unemployment rate by 1.9 percentage points and 0.5 of a percentage point higher than the unemployment rate for the state of Florida. In the same month, the unemployment rate was 13.8 percent in Hernando County, 11.0 percent in Hillsborough County, 12.0 percent in Pasco County, and 10.6 percent in Pinellas County.

The Standard & Poor’s Case-Shiller housing price index (HPI) for Tampa Bay is based on observed changes in home prices in the area. The Tampa Bay HPI hit its maximum value of 238 in July 2006. Since that time, the HPI has dropped 47 percent to its lowest post bubble reading of 126 in May 2011.

Figure 3.3 shows the absolute number of privately owned, one-unit residential permits for new homes in the Tampa Bay area. The peak of 2,908 permits occurred in June 2005 and the trough of 234 permits occurred in January 2009. After a minor uptick in permits, likely the result of the federal homebuyer tax credit in 2009, initial permits have again slowed. New permits for May 2011 totaled 377.

The Price-Rent Index (PRI) for Tampa Bay measures the price of area homes relative to their implicit rental value. The price component of the PRI is the Standard & Poor’s Case-Shiller HPI for Tampa Bay. The rent component of the PRI is the owner’s equivalent rent index (OWRI) for Tampa Bay, published by the Bureau of Labor Statistics. Each series is adjusted to one in 1980 and the PRI computes the HPI/OWRI ratio. A PRI greater than one means that home prices are high relative to rents in Tampa Bay, while a PRI less than one means that home prices are low relative to rents in the Tampa Bay. Figure 3.4 informs the reader that from 2003 to 2007 home prices were high relative to rents – in retrospect, a clear sign of a housing bubble. During the great recession, the PRI declined dramatically. By the end of 2010, the price-rent ratio reached a level not seen since 1998. Currently, the PRI reveals that in Tampa Bay an individual could purchase a home and maintain a monthly payment for less than what would be required to rent the same home.

Figure 3.5 illustrates the year-on-year percent change in Tampa Bay’s gross sales. In the first month of the great recession, December 2007, gross sales in Tampa Bay totaled $8.6 billion, which was 4.6 percent

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Why Are Financial Institutions Not Lending?

continued from page 2

investments? The answer is: too many bad real estate loans remain on the balance sheets of banks and increased financial regulation.

Banks continue to be in very bad shape. Non-performing assets have filled up the balance sheets of banks. Bank holdings in foreclosed real estate and delinquent loans have hit alarming heights. The Federal Deposit Insurance Corporation (FDIC) reports in its quarterly banking report that insured banks have around $341 billion in non-current (90 days past due) loans. Such poor asset portfolios make it impossible for banks to consider switching back into riskier loans. David Feaster, chief executive of Cornerstone Community Bank in St. Petersburg, Florida, has stated that “banks want to lend money, but many can’t because they have to reserve so much money for potential loan losses”.

Indeed, asset portfolios are so poor that many banks have failed. The number of failed banks in the U.S. increased to 12 percent between 2009 and 2010. At the time of this article, 46 banks have already failed in 2011 with 6 coming from Florida and 2 banks from the Tampa Bay area as compared with 3 from the previous year. Table 2.2 shows the number of failed banks during the financial crisis as well as the cost of bank failures to the FDIC fund. This fund currently has a negative balance and maintains its solvency with a credit line from the Fed. In addition, 888 banks are listed on the problem list of the FDIC for the first quarter of 2011, meaning they are being closely watched for failure. This compares with 775 banks in 2010 and only 305 in 2009, for the first quarter.

In addition to poor balance sheets, bank lending continues to be anemic because banking regulations have recently changed. Banks are being held to tighter capital requirements as recent Basel requirements have increased the amount of capital banks must hold. Banks must hold a higher percentage of equity for each dollar they loan out. Thus, banks that would have been considered to be in good shape under the old regulations are now might be undercapitalized. Thus, increased capital requirements induce banks to lend less and / or raise more capital through the sale of stock.

Even in this difficult banking environment, small businesses do have a lender of last resort: the Small Business Administration (SBA). The trend in commercial banking has turned to the use of government guaranties. As many commercial loans can now only be done through SBA programs. In the SBA program, the SBA provides a guaranty up to 75 percent of the total loan value. So, the local bank makes the loan and enjoys guaranteed payment in the case of default from the SBA. The SBA helped the Tampa firm, discussed earlier, ultimately get a loan. Jim Parrish, who counsels businesses through the University of South Florida’s Small Business Development Center, has made the same conclusion. He is quoted in Tapped into Treasury, “In the past, a number of businesses were approved without getting a government guarantee”. “Now, [banks] are sending these same loans to get the government guarantee.” At the end of the day, if SBA loans are the primary source for small business lending because banks remain fearful and regulations have become tougher, then businesses will continue to struggle in their quest to expand capacity and thus job growth will remain depressed.

The Tampa Bay Economy

continued from page 5

higher than in December 2006. During the recession, the trend in year-on-year changes to gross sales was negative. Tampa Bay’s worst month was the last month of the great recession, June 2009, where year-on-year gross sales declined by 19 percent. From April 2010 and thereafter the trend in Figure 3.5 has been positive, which means that total gross sales in Tampa Bay are larger in a given month relative to the same month one year ago. Gross sales for Tampa Bay in April 2011 were $9.6 billion, which was 9.9 percent higher than a year earlier and $0.3 billion below April 2007 (the last April data point prior to the recession).

In summary, recent data point in a positive direction, suggesting an important corner has been turned. First, the year-on-year change in Tampa Bay nonfarm payroll jobs turned positive in January 2011 and it has remained in positive territory since that date. Second, purchasing a home in Tampa Bay is now less expensive than renting the same sized home. Third, gross sales in Tampa Bay began increasing on a year-on-year basis in April 2010 and a positive trend continues. Although the path will be uneven, the Tampa Bay economy has begun to travel the long road to a recovery.

Write to Professor Flagg at dflagg@ut.edu.

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**Figure 3.4: Price-Rent Index: 1987 – 2010**

Source: Standard & Poor’s Case-Shiller HPI and Bureau of Labor Statistics

**Figure 3.5: Gross Sales: January 2007 – April 2011**

Source: Florida Department of Revenue
the broader economy, the money supply would increase dramatically and cause a sharp rise in inflation expectations.

Besides the risks inherent in the creation of trillions of dollars of new reserves, the Fed also faces challenges from international developments. First, elevated commodity prices when combined with rapid increase in wages in emerging markets are likely to put upward pressure on import prices. Second, the Fed’s extraordinary expansion of its balance sheet when coupled with exploding national debt levels has generated concerns regarding the dollar’s long-term viability as the pre-eminent reserve currency and its ability to act as a reasonable store of value. A downward trend in the dollar will generate further inflationary pressures in the U.S. Given these challenges and risks, the Fed may find it prudent, even in the face of continuing labor market weakness, to limit further large-scale stimulus measures that may jeopardize the long-term health of the American economy.

Write to Professor Jayakumar at vjayakumar@ut.edu.

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