The Profit-Credit Cycle

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Bank profitability leads the credit cycle. An increase in return on equity of the banking sector predicts rising credit-to-GDP ratios in a panel of 17 advanced economies spanning the years 1870 to 2015. The pattern also holds in bank-level data and for the global financial cycle. It is only partially explained by a balance sheet channel where higher retained profits relax net worth constraints. Turning to alternative explanations, we find evidence consistent with behavioral credit cycle models in which agents extrapolate past defaults to expected future credit outcomes. Using recent US data, we show that survey-based profitability expectations and provisions for loan losses are tightly linked to past profits and loan losses, leading to predictable forecast errors. These errors are also reflected in the aggregate credit cycle. Decreasing loan losses not only predict credit expansions, but also elevated crisis risk a few years later.