Credit Cycle

A credit cycle describes the phases of access to credit by borrowers. Credit cycles first go through periods in which funds are relatively easy to borrow; these periods are characterized by lower interest rates, lowered lending requirements, and an increase in the amount of available credit, which stimulates a general expansion of economic activity. These periods are followed by a contraction in the availability of funds. During the contraction period of the credit cycle, interest rates climb and lending rules become more strict, meaning that less credit is available for business loans, home loans, and other personal loans. The contraction period continues until risks are reduced for the lending institutions, at which point the cycle troughs out and then begins again with renewed credit.

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BREAKING DOWN 'Credit Cycle'

Credit availability is determined by risk and profitability to the lenders. The lower the risk and greater profitability to lenders, the more they are willing to extend loans. During high access to credit in the credit cycle, risk is reduced because investments in real estate and businesses are increasing in value; therefore, the repayment ability of corporate borrowers is sound. Individuals are also more willing to take out loans to spend or invest because funds are cheaper and their incomes are stable or on the rise.

When the peak of the economic cycle turns, the assets and investments generally begin to decrease in value, or they do not return as much income, reducing the amounts of cash flow to pay back loans. Banks then tighten lending requirements and raise interest rates. This is due to the higher risk of borrower default. Ultimately, this cuts down the available credit pool and at the same time decreases demand for new loans as borrowers
deleverage their balance sheets, bringing the credit cycle back to the low access point.

**Causes of a Long Credit Cycle**

The average credit cycle tends to be longer than the business cycle in duration because it takes time for a weakening of corporate fundamentals or property values to show up. In other words, there can be an overextension of credit in terms of amount and period, as spectacularly demonstrated last decade. Also, since the financial crisis, in the U.S. the traditional relationship of the Federal Reserve's interest rate policy and credit cycle has become more complex. The changes in the nature of the economy have had an impact on the inflation rate that policymakers are still trying to understand. This, in turn, complicates interest rate policy decisions, which have implications to the credit cycle.