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Economics Group

Interest Rate Weekly

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Financial Evolution: More Government, More Something Else

Over the past 25 years, there has been an evolution of debt financing. There has been a remarkable gain in government debt, while non-bank loan finance has grown in importance for debt financing.

Credit Market Debt: More Government

Public discussions of debt focus on households and businesses, yet another key aspect of this story is the growth of government debt, especially in the recent economic expansion (top graph). Over the past 25 years, nonfinancial corporate debt has only risen modestly as a share of GDP relative to household and government debt. Household and government debt grew significantly as a share of the nation's output over this period, although households have deleveraged somewhat since the Great Recession.

What makes this development so distinct, and a structural break from the past, is the lack of a true budget constraint on government finance, unlike the budget constraints on households and businesses. What has changed? Two factors have emerged as key to eliminating the governmental budget constraint. First, the emergence of a global capital market has increased the demand for U.S. sovereign debt as a benchmark asset for both public and private portfolios. Second, increased capital requirements and central bank policy have increased the demand for sovereign debt, especially U.S. debt, such that the increased supply of debt has been easily absorbed by increased demand, a reason that U.S. sovereign yields actually declined in the face of rapidly rising supply.

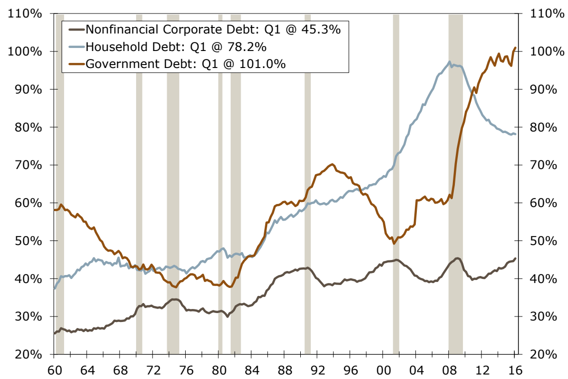
Squeeze the Balloon Here, Get Expansion Over There

Since the early 1980s, the share of credit supplied in the markets has evidenced a steady rise in the share of non-bank credit relative to bank credit (middle graph). This development signals the continued rise of non-bank credit allocation for nonfinancial corporations. Yet regulation has focused on banking as a terminal rather than a way station, a conduit of credit allocation. As a result, credit is still allocated but through a different set of pipes than traditional bank loans. Even post Dodd-Frank legislation, the squeeze on banks has and will likely continue to promote greater expansion in the non-bank sector.

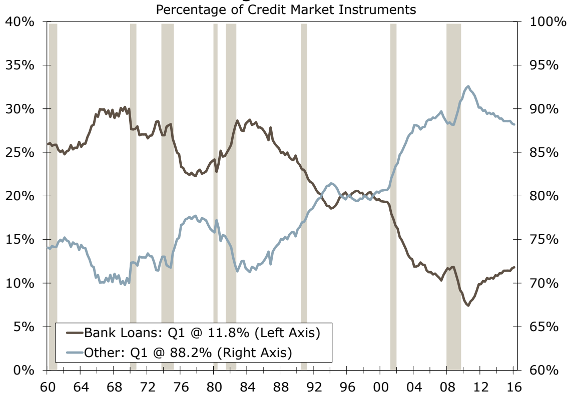
Non-Financial Finance: Increasing Diversification

Another development that is often overlooked is the diversification of finance. Since the early 1980s, bank loans as a share of debt financing have declined while the corporate bond market has increased its share. The globalization of capital markets over this time period has helped make capital markets deeper and more liquid. This in turn has likely been one reason, among others, that alternative means of debt financing, such as corporate bonds, have grown in popularity. In addition, since 2008 there has been a distinct slowdown in non-financial corporate finance via mortgages and commercial paper sources.

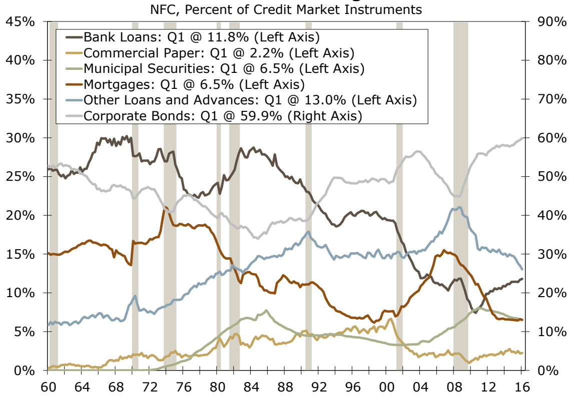
Credit Market Debt as a Share of GDP
Total Sector Debt



Debt Financing - Bank Loans to NFC
Percentage of Credit Market Instruments



Debt Financing
NFC, Percent of Credit Market Instruments



Source: Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Securities

Wells Fargo U.S. Interest Rate Forecast

	Actual						Forecast					
	2015				2016				2017			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25
3 Month LIBOR	0.27	0.28	0.33	0.61	0.63	0.65	0.70	0.95	0.95	1.20	1.20	1.45
Prime Rate	3.25	3.25	3.25	3.50	3.50	3.50	3.50	3.75	3.75	4.00	4.00	4.25
Conventional Mortgage Rate	3.77	3.98	3.89	3.96	3.69	3.57	3.46	3.53	3.57	3.60	3.64	3.67
3 Month Bill	0.03	0.01	0.00	0.16	0.21	0.26	0.28	0.47	0.55	0.77	0.82	1.01
6 Month Bill	0.14	0.11	0.08	0.49	0.39	0.36	0.39	0.58	0.65	0.87	0.92	1.11
1 Year Bill	0.26	0.28	0.33	0.65	0.59	0.45	0.48	0.67	0.73	0.94	0.99	1.20
2 Year Note	0.56	0.64	0.64	1.06	0.73	0.58	0.66	0.83	0.92	1.13	1.22	1.35
5 Year Note	1.37	1.63	1.37	1.76	1.21	1.01	1.02	1.15	1.19	1.33	1.39	1.48
10 Year Note	1.94	2.35	2.06	2.27	1.78	1.49	1.41	1.50	1.55	1.60	1.66	1.71
30 Year Bond	2.54	3.11	2.87	3.01	2.61	2.30	2.09	2.13	2.17	2.24	2.28	2.31

Forecast as of: July 13, 2016

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2016	2017
Change in Real Gross Domestic Product		
Wells Fargo	1.8	2.0
FOMC	1.9 to 2.0	1.9 to 2.2
Unemployment Rate		
Wells Fargo	4.7	4.5
FOMC	4.6 to 4.8	4.5 to 4.7
PCE Inflation		
Wells Fargo	1.5	2.1
FOMC	1.3 to 1.7	1.7 to 2.0
"Core" PCE Deflator		
Wells Fargo	1.7	1.7
FOMC	1.6 to 1.8	1.7 to 2.0

Forecast as of: July 13, 2016

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: June 15, 2016

Source: IHS Global Insight, Bloomberg LP, Federal Reserve Board and Wells Fargo Securities

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