SPECIAL REPORT

TD Economics

May 8, 2015

EZ CREDIT

ECB POLICIES LEADING TO RISE IN CREDIT AND ECONOMIC GROWTH

Highlights

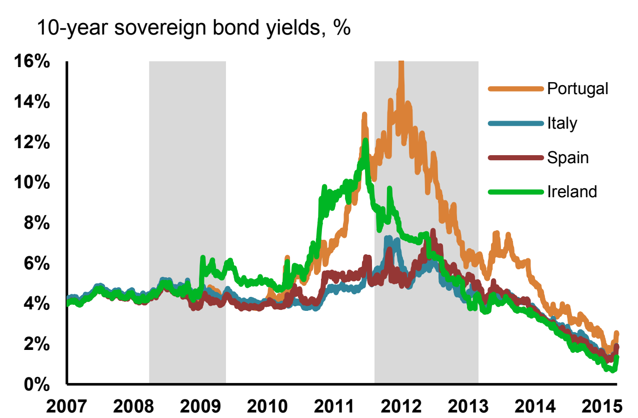
- Next week, Q1 GDP data will be released for the euro area and a number of individual countries. The experience will likely run counter to the US, which produced a disappointing flat performance. The euro area looks set to post Q1 growth of roughly 2% (annualized), which would mark the fastest pace since Q1 2011.
- This economic momentum has the foundation to be sustained in the next two quarters, creating upside risk to our March Quarterly Economic forecast. At its root is a stronger-than-expected impulse to growth stemming from credit expansion.
- The ECB is finding success in the transmission of monetary policy across the euro area, thereby reducing financial fragmentation. No longer are firms within the core countries the main beneficiaries of lower business lending rates. Credit standards are easing in a number of periphery countries and bank lending is rising more broadly.
- Notwithstanding ongoing uncertainty related to Greece, market optimism has crept back into Europe's broader growth prospects, reflecting improved confidence in the banking system alongside evidence that a slew of ECB monetary policy measures are filtering through to the real economy. The recent rise in European yields partially reflects this and the trough should remain behind us.

In mid-2012, Mario Draghi famously declared "...the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."[1] At that time, investor concern over a sovereign debt financial crisis within the peripheral countries had created an acute case of financial fragmentation. Peripheral or "distressed" countries were not fully capturing the benefits of the European Central Bank's (ECB) accommodative policy stance, via a pass-through to bank lending rates and, thus, the real economy.

After throwing down the gauntlet, the ECB has made steady progress towards strengthening the monetary union and reducing the financial fragmentation that had stymied a broad economic recovery. Even with the recent rise in European bond yields, they remain low by historical standards, particularly for the peripheral countries (chart 1). Likewise, interest rates on bank loans to nonfinancial corporations have followed suit, and credit standards have eased more broadly across the euro area. Most importantly, bank lending is now rising (chart 2).

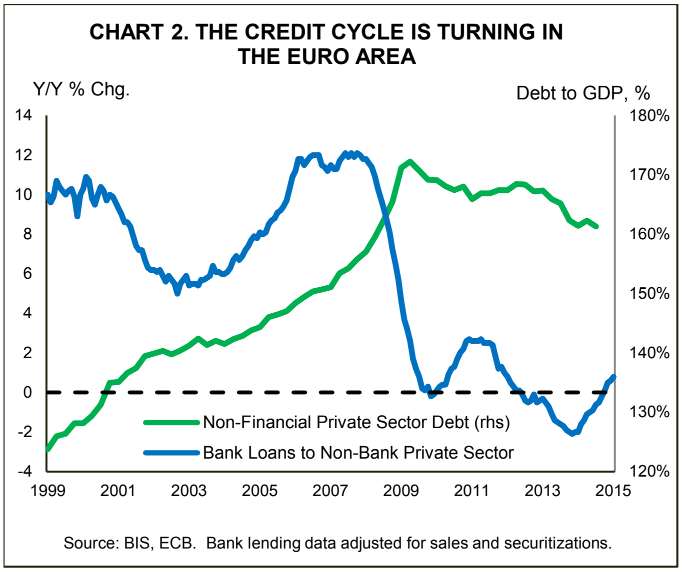
Notwithstanding ongoing uncertainty specifically related to Greece, a dose of market optimism has now crept back into Europe's broader economic growth prospects. Still, it's far too

CHART 1. SOVEREIGN BOND YIELDS STILL AT VERY LOW HISTORICAL LEVELS



Source: Bloomberg, TD Economics. Grey area indicates euro area recession.

Beata Caranci, VP & Deputy Chief Economist, 416-982-8067
Andrew Labelle, Economist, 416-982-2556



early to declare the European Central Bank measures successful in sustaining economic growth. Greece continues to weigh on the confidence of investors and may potentially test the soundness of the broader banking system. But, thus far, the ECB has succeeded in improving the transmission of monetary policy to the broader euro area.

Based on the pickup in lending, euro area economic growth could average in the 2.0-2.5% range over the first three quarters of 2015, which suggests upside risk to our March Quarterly Economic Forecast (1.7% growth in 2015 vs 1.4% in March QEF). However, our outlook beyond that remains very much similar, with growth of roughly 1.8% for 2016.

Monetary policy measures and impact on financial markets

Weak economic growth alongside tumbling inflation prompted the European Central Bank to follow-through on a series of increasingly aggressive policy initiatives. Among the laundry list of measures was the long-awaited Single Supervisory Mechanism that gave the ECB oversight over roughly 130 of Europe's largest banks. Market confidence in the banking system was boosted with the completion of the comprehensive assessment of Europe's banks in October 2014. An asset quality review found relatively limited capital shortfalls. However, long before these results were announced, the ECB was cutting a new path. From June 2014 onwards, the ECB aggressively lowered interest rates, broke a lower bound barrier with a deposit rate of -20 basis points, pursued a targeted longer term refinancing operation (TLTROs) program to help stoke loan growth to the non-financial private sector, and embarked on "QE-lite" with purchases of covered bonds and asset backed securities. By January 2015, the big guns came out on QE with the announcement of a €60bn per month asset purchase program that included government security purchases.

The financial market response has been clearly visible. The broad trade-weighted euro has depreciated 10% since late May 2014 and short-term bond yields have turned negative in a number of countries. With the exception of Greece, longer term bond yields have fallen dramatically across the Eurozone, with the benchmark 10-year German Bund getting as low as 0.05% in mid-April, before recently backing up to roughly 0.6%. However, even with this recent move, Bund yields remain more than 70 basis points below the start of June in 2014.

The key test of success of the ECB measures is whether the transmission of monetary policy is occurring *broadly* within the euro area, thereby alleviating what's known as financial fragmentation. Simply put, are the peripheral countries in the Eurozone benefiting from the transmission of monetary policy in terms of increased credit flow, market access and low borrowing rates? Or, are these benefits accruing disproportionately to the core countries[2]? If it's the latter, then the scope for a sustained and robust economic recovery will be stunted.

ECB policies lessen financial fragmentation

To gauge financial integration, the ECB devised two measures known as FINTEC (FINancial INTEgration Composites) that capture pricing and quantity information from four market segments (money, bond, equity and bank-

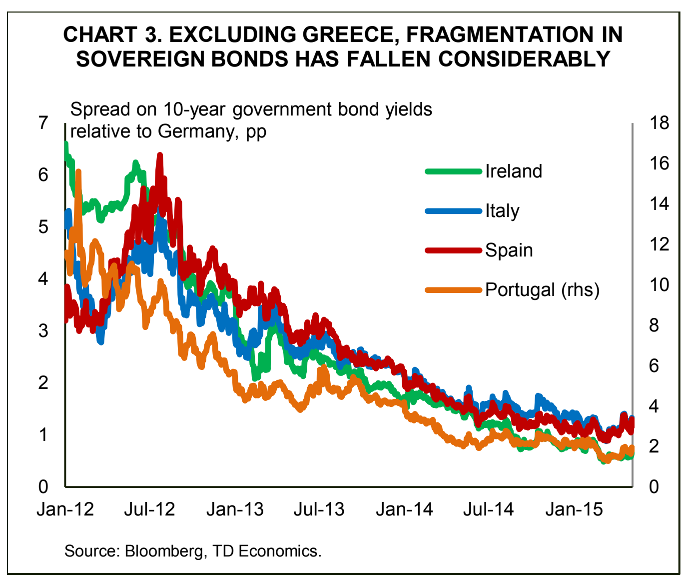
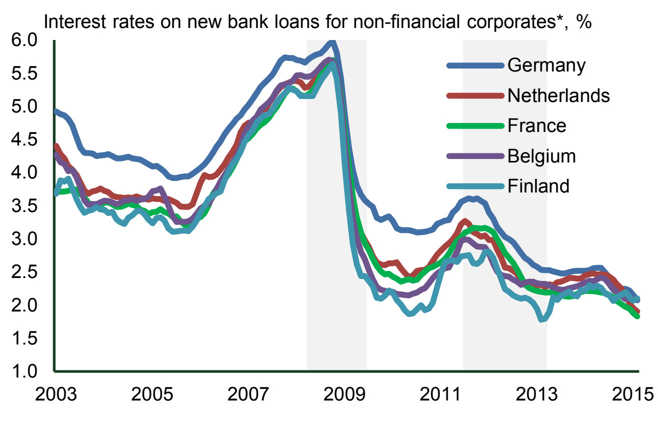


CHART 4. BUSINESS BORROWING COSTS HAVE COME DOWN SIGNIFICANTLY IN THE CORE



Source: ECB. *Includes both revolving and non-revolving loans.

ing). The indexes are released annually, with the latest data being for 2014 (i.e. prior to the ECB's commitment to full QE initiatives). Nonetheless, the FINTEC measures showed broad improvement in both the level and the dispersion of credit interest rates in 2014 relative to the prior two years. Naturally, some indicators showed more improvement than others.

One such indicator was government bond yields. The ECB FINTEC data was focused on 2014, but Chart 3 shows that the compression of Eurozone sovereign spreads relative to the benchmark 10-year German Bunds became even more pronounced in 2015 once QE was unleashed, with the exception of troubled Greece of course. For instance, in May 2012, the dispersion of Portuguese-German 10 year spreads went from 1083 basis points to 226 basis points in late May 2014, and moved further to 182 basis points in early May of this year. With the recent sudden back-up in European yields, there has not been a material deterioration in German to peripheral spreads, reinforcing that financial fragmentation has lessened.

However, we're ultimately interested in the transmission of lower bond yields to the end users that drive real economic growth: businesses and households. And here too, there is evidence of success.

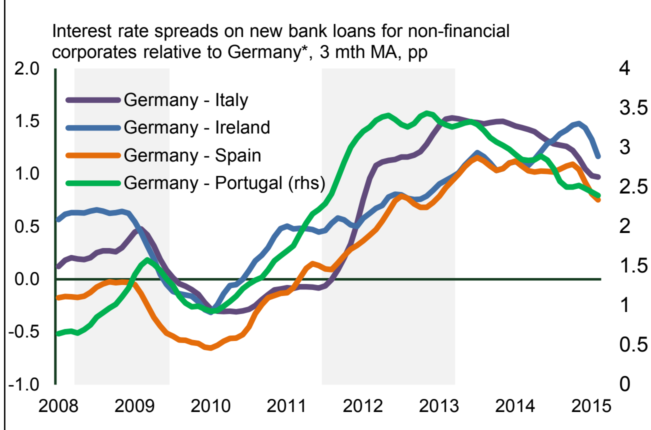
Feedthrough to business credit

First, lower bond yields have manifested into lower corporate debt yields, but these are limited to non-financial companies (NFCs) large enough to tap debt markets. A sustainable economic recovery requires a transmission of low bond yields to bank lending rates and this, in turn, needs to be observed widely within countries. In Europe, 80% of financial intermediation occurs through the banking system[3].

Across the core economies, interest rates on new business loans fell significantly following the end of the acute period of the sovereign debt crisis in 2012 (see chart 4). This is not surprising given their more sound management of their economies and government coffers, which automatically provides a stronger foundation for financial transmission and business operations. Business lending rates within the periphery economies, however, did not follow their core peers until the ECB embarked on more aggressive policy measures. Chart 5 shows a persistent wedge in credit spreads for Ireland, Italy, Spain and Portugal until 2014. Since then, interest rates on new bank loans have trended down more forcefully, narrowing the spread to their German counterparts[4]. That said, the level of lending rates to non-financial corporations within the peripheral economies has not returned to the low point realized in late 2009/early 2010, prior to the sovereign debt crisis. However, progress has been made in lowering borrowing costs across countries and in reducing financial fragmentation. This bodes well for a more inclusive and robust economic recovery.

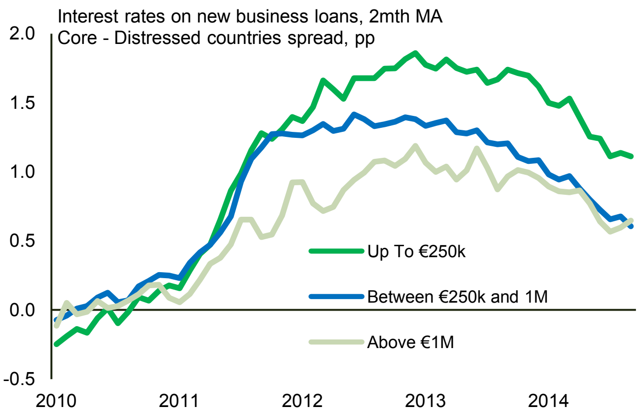
To really put this thesis to the test, it's important to consider lending behavior to small and medium sized enterprises (SMEs). This is because these companies employ around three-quarters of the euro area's workforce[5]. Returning to the ECB's financial integration report, NFC lending rates are grouped by the size of the loan to gauge the borrowing costs of SMEs. In the absence of financial fragmentation, an apples-to-apples comparison of investment opportunities between countries would allow the supply of credit to flow

CHART 5. SPREADS ON NEW BUSINESS LENDING RATES HAVE BEGUN TO NARROW MORE SUBSTANTIALLY



Source: ECB. *Includes both revolving and non-revolving loans.

CHART 6. SMALL BUSINESSES HAVE HAD TO PAY A MUCH LARGER PREMIUM SINCE SOVEREIGN DEBT CRISIS



Source: ECB. TD Economics calculations. Aggregates weighted by share of GDP. Core: AT, DE, FI, FR, NL. Distressed: ES, IE, IT, PT.

freely, until the cost of funding the marginal investment is equalized in every country. However, the ECB report found a persistent wedge in SME lending rates between NFCs in peripheral vs core countries – suggesting fragmentation.

In Chart 6, we break the business loans into three categories, small (up to €250K), medium (€250K to €1M) and large (above €1M). We then aggregate the data by core and peripheral countries, excluding Greece, and look at the spread in interest rates. It's plain to see that NFCs in the peripheral economies have been persistently paying a premium since the sovereign debt crisis, particularly within the small business grouping. ECB policies have helped to narrow the spreads, but certainly not to pre-crisis levels. Nor have they fully leveled out the playing field between regions. But, this partial success must be placed alongside the fact that by providing unprecedented funding to the banking system, the ECB did succeed in lowering SME borrowing costs within each country, returning levels among many peripheral countries below the pre-crisis period. This combination is stoking credit demand in the euro area, and, by extension, economic growth.

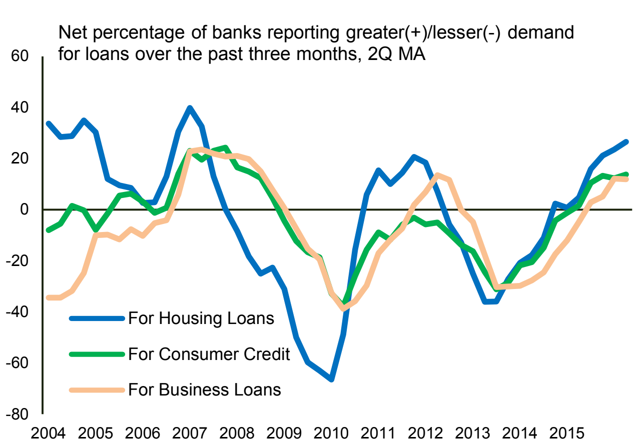
Supply + Demand of loans = Economic growth

For the first time since the financial crisis, more banks, on net, are reporting a rise in loan demand across the three key categories: housing, consumer and business loans (see chart 7). The rise in demand for housing loans began in 2013. However, it was only in 2014 that growth in consumer and business loans came into the fray. With all three engines engaged, it now offers a more realistic prospect for a sustained economic recovery. Further credence is offered by the steady rise across categories in the net percentage of banks reporting greater loan demand over the past year.

With the pieces of the puzzle coming together, bank loans to the private sector, adjusted for sales and securitizations have risen for five consecutive months and have grown on a year-over-year basis since December (blue line in chart 2). The last time this occurred was in 2012.

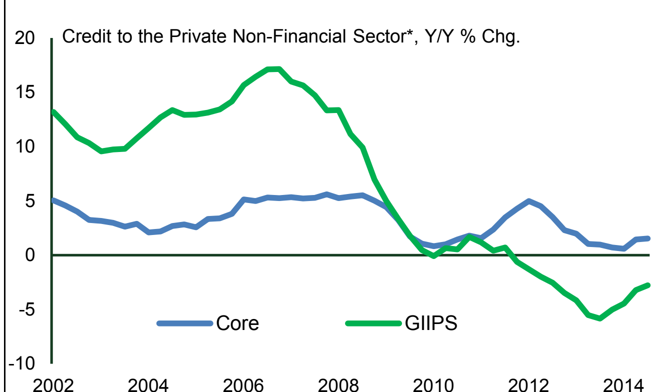
Just as important as overall credit growth is the fact that deleveraging in the euro area appears to have come to an end or lessened to a great degree (green line in chart 2). To see this, we look at BIS data on total credit, including bank loans and debt issuance, which shows that deleveraging in the euro area non-financial private sector – households and non-financial corporations – appeared to be nearing an end as of the second and third quarters of 2014. Within

CHART 7. MORE BANKS REPORTING PICKUP IN LOAN DEMAND



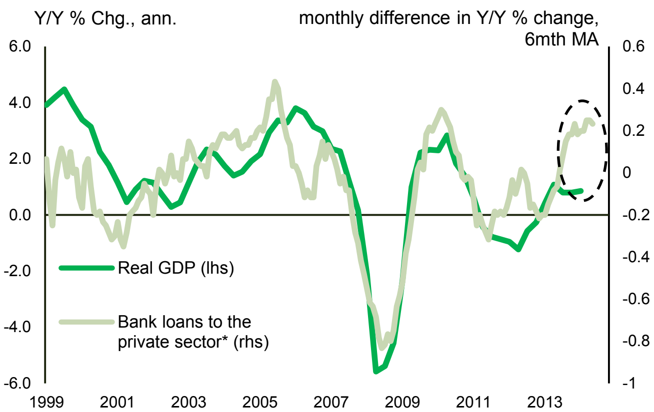
Source: ECB.

CHART 8. PRIVATE SECTOR CREDIT GROWING IN CORE , PACE OF DECLINE DECELERATING IN THE PERIPHERY



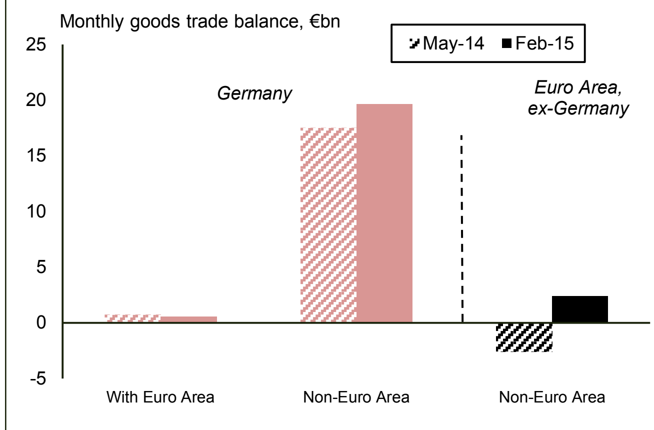
Source: BIS. *Non-financial corporations and households. Core: AT, BE, DE, FI, FR, NL. GIIPS: ES, GR, IE, IT, PT. Data goes until Q3 2014.

CHART 9. UPWARD SHIFT IN CREDIT CYCLE IS POSITIVE FOR ECONOMIC GROWTH



Source: ECB. *adjusted for sales and securitizations.

CHART 10. EURO AREA EX-GERMANY NOW ALSO HAS A GOODS TRADE SURPLUS WITH REST OF THE WORLD



Source: Eurostat.

core countries, credit is expanding, while the retrenchment among peripheral countries has significantly lessened (chart 8). This trend leads more private agents to spend on goods and services, rather than redirect funds to paying down debt.

While BIS data are comprehensive, they are only available with a lag, which make is less useful in gauging current economic momentum. Using bank lending data from the ECB, a fairly tight contemporaneous relationship between the change in the pace of loan growth and real GDP growth can be observed (chart 9). Although the relationship has not been as tight in recent months, it does suggest that economic activity in the euro area could surprise to the upside in 2015.

Euro region economy reflects a trifecta of growth impulses

As we learned from the U.S. economy in the aftermath of the 2008 financial crisis, an absence of credit growth and a well-functioning banking system results in an absence of a sustainable economic recovery. These elements are key to the structure of an economy and this is why we are encouraged by recent developments in credit markets in the euro region. However, the area has two more cards in its pockets – a sharp improvement in competitiveness and a boost to income/profits from low oil prices. In terms of the former, the broad trade-weighted euro has fallen 10% since late May 2014. Since currency movements are relative, the euro's decline has largely come at the expense of a sharp appreciation in the greenback. Net trade has severely weighed on U.S. real GDP growth over the past two quarters, with the euro area on the receiving end of some of this redistribution. And, export growth is not just a German story, as 10 of the 18 countries[6] are sharing in the benefits of rising exports, with notable gains among the peripheral countries of Portugal, Ireland, and Spain (chart 10).

Combine low corporate and household borrowing costs broadly filtering through the real economy with a boost to competitiveness from the euro and some lift to incomes from a decline in oil prices and you have a region primed for a break-out period in economic growth.

Modelling real GDP growth in the euro area with reasonable assumptions for continued credit growth and assuming that no large external shocks weigh on consumer confidence or create severe financial market stresses, suggests that quarterly economic growth could average between 2.0-2.5% over the first three quarters of 2015[7]. If realized, this would be the strongest consecutive pace of quarterly economic gains since the post-financial crisis rebound in 2010-early 2011. It also suggests moderate upside risk to our current forecast for 1.4% growth in the euro area in 2015, with the annual average growth rate coming in closer to 1.6-1.7%. Based on credit data by country, some of the bigger upside surprises to economic growth could be in the Netherlands, Spain, Germany, Malta and Luxembourg. Beyond the near-term quarters, economic growth in the euro area is expected to remain elevated at 1.8% 2016, which is above its long-term potential growth rate of 1.3%.

Bottom Line

The ECB's measures have led to lower lending rates and increased confidence in the banking system, which now appear to be bearing fruit. The ECB may not have yet fully succeeded in remedying financial fragmentation through extraordinary measures in monetary policy, but certainly one can conclude that distressed economies are benefiting from lower borrowing costs and greater access to credit.

The recent pickup in bank lending should be viewed as a positive underpinning to the recovery in the euro area. While the pace of credit growth may be relatively subdued as debt levels remain elevated, the end of the deleveraging cycle alone should lead to stronger near-term economic activity. What's more, credit growth should be stimulative for domestic demand, which is positive from a global economic perspective, and suggests that the gains in Europe will not come solely from net trade, as a result of a lower euro.

The recent improvement in European data has already had an impact on financial markets, evidenced by the retracement of the Euro-USD cross to roughly 1.12 after falling as low as 1.05 in mid-March. Robust activity in the euro area and only slowly improving U.S. data suggests that euro strength may persist in the near term. However, in time, the reality of a Fed moving closer to rate hikes against an ECB still engaged in QE could cause downward pressure on the euro to resume. For fixed income markets, stronger economic growth alongside rising consumer price data and inflation expectations has partially contributed to the recent repricing in European sovereign bonds, suggesting that the trough in yields will likely remain behind us.

The euro area still faces a number of challenges, including the unresolved situation with Greece, unfinished reforms and integration at the national and supranational level. Ensuring the flow of credit solves at least one critical issue facing the euro area. But, as Mario Draghi stated in late November: "credit is the necessary, but not sufficient condition to have growth"[8].

Beata Caranci
VP & Deputy Chief Economist

Andrew Labelle
Economist

End Notes

1. Source: Mario Draghi. https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html
2. In this report, core refers to Germany, France, Netherlands, Austria, Finland, and Belgium. Periphery refers to the countries hit worst during the euro crisis, which are Italy, Spain, Portugal and Ireland. Greece was excluded as it is currently dealing with idiosyncratic factors unrelated to the others.
3. Source: Mario Draghi. https://www.ecb.europa.eu/press/key/date/2014/html/sp141009.en.html
4. Portuguese-German spreads on lending interest rates to businesses have been declining for longer - since early 2013. In this case, lending rates had reached much higher levels during the sovereign crisis, reflecting increased investor risk aversion to Portugal at the time.
5. Source: Mario Draghi. https://www.ecb.europa.eu/press/key/date/2014/html/sp140911_1.en.html3.
6. We omitted Lithuania as it only joined the euro monetary union in January 2015. Exports in nominal terms from May 2014 to February 2015.
7. Consumer confidence assumption is based on current consumer confidence expectations. Real GDP is modelled using lags of GDP, consumer confidence, VIX, change in credit growth, and a moving average of the change in the quarterly change in credit growth.
8. Source: Mario Draghi. http://www.ecb.europa.eu/press/inter/date/2014/html/sp140924.en.html