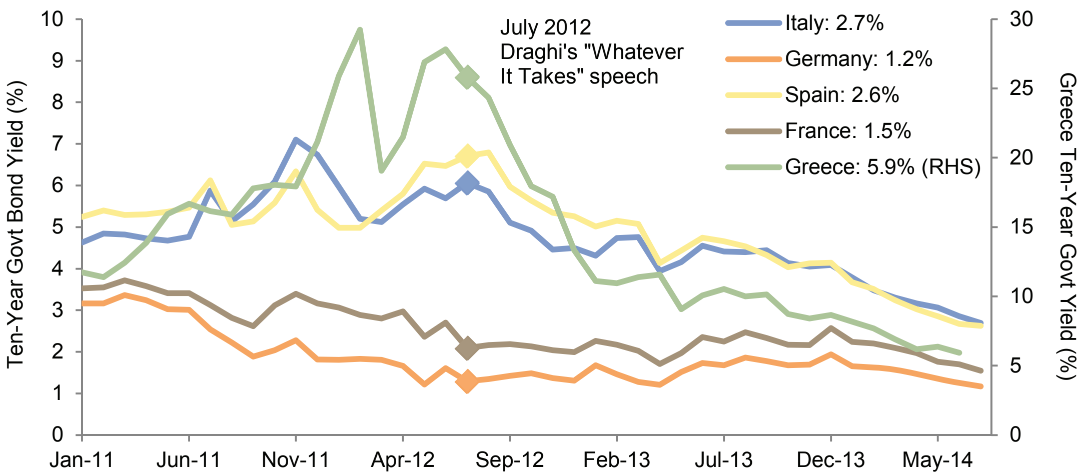
Eurozone Lending: No Recovery in Sight

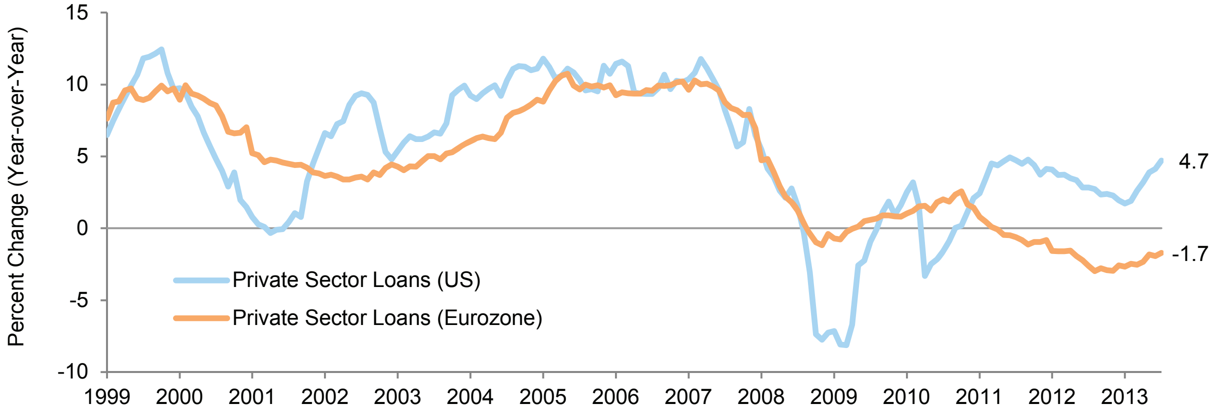
Given that credit creation is the *raison d'être* of modern central bankers, the fact that European bank lending remains anemic despite a plethora of new measures from the European Central Bank (ECB) seems to us substantial cause for concern. The ECB's pronouncements and alphabet soup of new programs have been remarkably effective at bringing down sovereign bond yields, but have had far less success convincing loan officers to extend credit. This is not particularly surprising, as a few extra basis points of spread have little effect on a bank's willingness to make loans, particularly when loan demand itself is weak; however, cheap money and a virtual guarantee that interest rates will be suppressed for the foreseeable future are powerful incentives to buy sovereign bonds, particularly those with higher coupons.

Ten-Year European Government Bond Yields
January 31, 2011 – July 31, 2014 • Euro



Private Sector Loan Creation

December 31, 1999 – June 30, 2014 • Local Currency



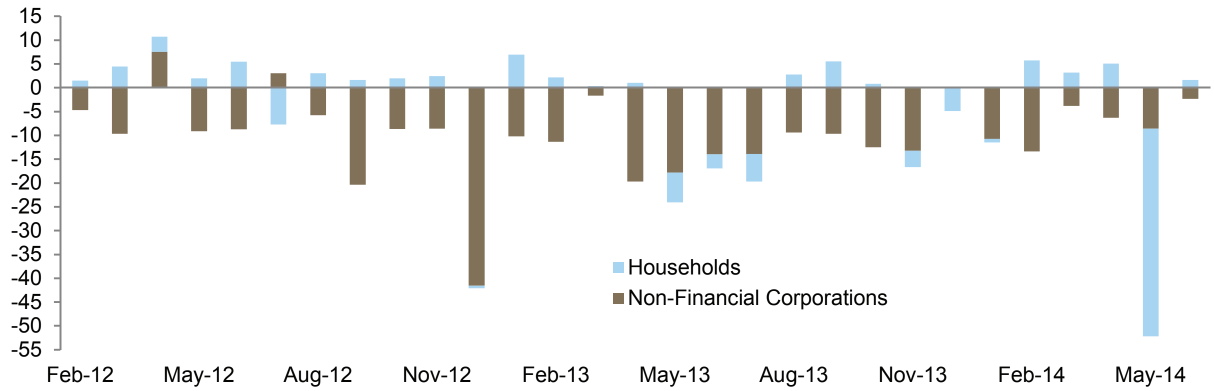
Many analysts are pinning their hopes on the recently announced targeted long-term refinancing operations (TLTRO) to boost bank lending. However, this program is little different than the ECB's prior macro schemes, and is unlikely to affect decisions that are by necessity made at the micro level. Even ECB President Mario Draghi acknowledged the limits of monetary policy during a recent Q&A, bluntly stating that "the lack of structural reforms" in many Eurozone countries is to blame for weak credit creation.

Pushing on a String?

One of the problems with financial analysis is the ease with which cause and effect can become muddled. As always, correlation does not equal causation. For example, many countries have long employed policies that encourage homeownership, based largely on studies that show homeowners tend to be more stable, higher earning, and more involved in their communities than renters. However, such studies failed to discern whether owning a home made people better citizens, or if people with such traits tended to be homeowners. Similarly with current central bank policies that seek to encourage bank lending through lower interest rates and offers of additional capital, the question must be asked: are banks failing to lend due to internal constraints (e.g., lack of capital), or a lack of creditworthy borrowers? The ECB's actions since the 2007–08 crisis suggest it believes the former, so why have its policies not worked?

In our view the problem is not with the banks, but rather with the lack of credit demand, something far more difficult for a central bank to fix. (To be clear—European banks may well have problems, but these do not appear to be what's holding them back from making loans.) According to surveys, *zero* European banks say liquidity constraints are causing them to tighten lending standards, and the ECB reported that in the second quarter, Eurozone Lending to Households and Non-Financial Corporations: Monthly Flows

February 28, 2012 – June 30, 2014 • Euro (billions)



Eurozone banks eased credit standards to enterprises for the first time since 2007. Ernst & Young, meanwhile, recently reported the average return on equity (ROE) for European banks has plunged from nearly 16% pre-2008 crisis to a meager 4% since.[1]

In other words, European banks have capacity to take on new loans, profits are way down, and authorities are exhorting them to lend. And yet loans to both households and non-financial corporations have continued to fall.

Meet the New Boss …

Thus the ECB has introduced the aforementioned TLTRO, which provides a "borrowing allowance" to banks based first on current loans outstanding to the Eurozone's private sector (as of April 30, excluding loans for house purchases), and subsequently on loans made in subsequent periods *in excess of* the pace of loans made over the 12 months ended in April. The first round of funding—banks are eligible to borrow up to 7% of their current stock of non-financial private sector loans—could total close to €400 billion, with the second round, where banks are eligible for three times their lending above the trend-line benchmark, summing to nearly €500 billion if banks stabilize lending at current levels (a big "if").

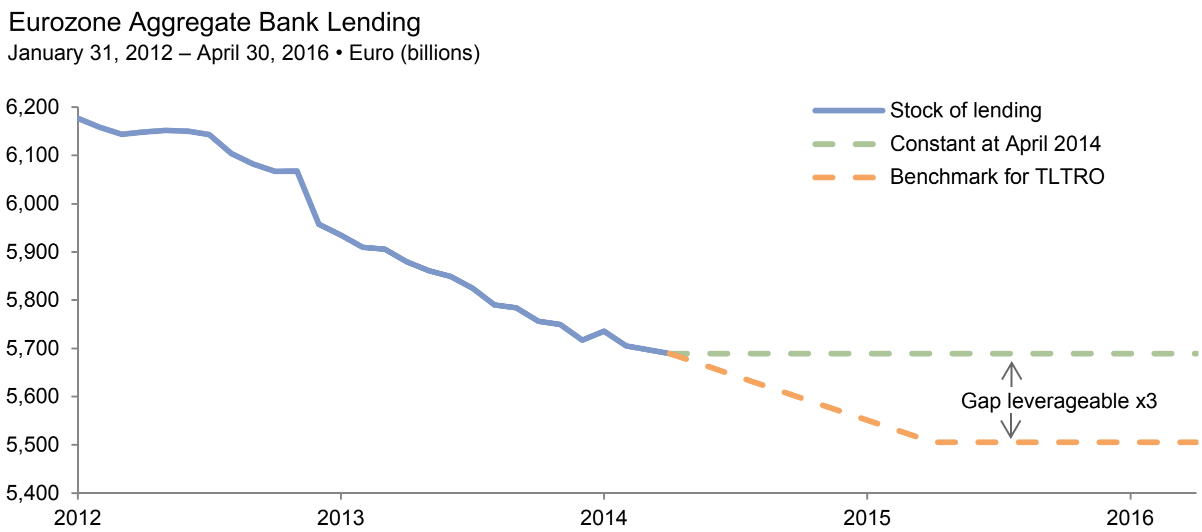
Potential 2014 TLTRO

As of June 30, 2014 • Euro (billions)

	2014 TLTRO Estimates*	Current LTRO
Eurozone	**381**	**469**
Core	**226**	**94**
Germany	95	16
France	77	52
Netherlands	29	7
Austria	15	5
Belgium	10	14
Periphery	**155**	**374**
Spain	54	150
Italy	75	171
Greece	10	1
Portugal	8	35
Ireland	8	17

* Estimates for 2014 TLTRO are as of April 2014.

[1] US banks had a similar pre-crisis ROE and troughed at 8%, but have since rebounded to 11%.

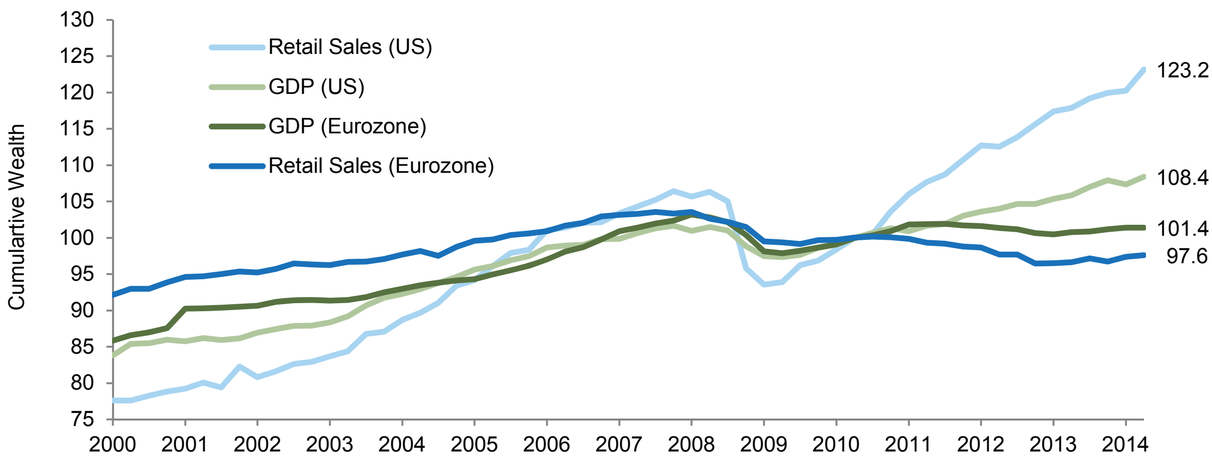


In plain English, the ECB has crafted a *very* targeted program—banks are entitled to additional cheap money, but only to the extent they extend credit to households and non-financial businesses. And this, of course, is the rub. While one can pick apart the US economic recovery for being largely based on fickle credit-dependent industries such as autos and housing, it has been inarguably stronger than the anemic situation in Europe. It seems a stretch to argue TLTRO will magically unlock some vast reservoir of pent-up credit demand that has so far failed to materialize among European consumers and businesses. Indeed, given that household debt ratios in most countries have barely budged off pre-crisis levels—with Ireland and Spain the notable exceptions—it is perhaps unsurprising that total Eurozone investment in the first quarter was a mere 80% of its 2007 peak, compared to 90% in the United States.

Recent poor economic data also make it hard to believe the TLTRO can have the desired effect. Consider:

- Italy has fallen back into recession.
- Eurozone retail sales growth remains barely above zero.
- German factory orders fell in June at the fastest rate since 2011 (-3.2%), with orders from *within* the Eurozone plunging more than 10%. In other words, this is not simply a Russia/Ukraine story.
- German business sentiment dropped in July for the third straight month, to its lowest level since October.
- Eurozone unemployment is 11.7%, just off its 2013 high of 12.3%, with youth unemployment in many countries more than double this rate.

Eurozone vs US Economic Activity
January 31, 2000 – June 30, 2014 • Rebased to 100 at December 31, 2010 • Local Currency



Short of some sort of wholesale debt forgiveness/default—which, while perhaps generating fresh borrowing demand, would also bring its own set of issues—it is difficult to see how the latest measure to loosen bank lending standards will succeed where its very similar predecessors have failed.

The Draghi Dilemma

Interestingly, the ECB has shown signs of being aware of these issues, most notably at Mario Draghi's August 7 press conference, which is worth quoting at length:

> *The levels* (sic) *of private investment for the euro area as a whole is low and certainly much lower than it is in other parts of the world, like in the United States.*
>
> *Then we asked ourselves why this is so. Now, certainly it's not the cost of capital, because interest rates, nominally and real interest rates have been low and, in some parts of the euro area are negative, have been negative for quite a long time.*
>
> *So the answers are one has to do with expected demand, but the second answer has to do with reforms, uncertainty. The general uncertainty that the lack of structural reforms produces is a very powerful factor that discourages investments.*
>
> *There are stories of investors who would like to create to build plants and equipment and create jobs, but it takes them months to get an authorization to do so. There are stories of young people who try to open their business, and it takes eight, nine months before they can do so.* ***That has nothing to do with monetary policy*** (emphasis added).

While the concept of eurosclerosis is nothing new, the fact that Draghi sees fit to invoke it indicates the ECB is *very* worried about the ineffectiveness of its policies to boost demand. The prospect of France and Italy, for example, acting quickly to reform labor markets seems to us on par with expecting Russia to suddenly declare "mission accomplished" and withdraw its troops from Ukraine.

Where Could We Be Wrong?

European credit demand could certainly surprise on the upside. A sustained fall in the euro would *ceteris paribus* be a boon to Eurozone exporters, and a strong recovery in the United States and/or China could pull Europe up as well. Some observers, meanwhile, expect new Italian Prime Minister Matteo Renzi will finally be the man to, as one columnist recently put it, "hack a path through the jungle of Italian red tape."[2] Finally, unexpected good news from the Russia/Ukraine conflict would at the very least remove some of the uncertainty that has hung over the Continent in recent months.

The Bottom Line

The stubborn resistance of European credit growth to increasingly aggressive actions by policymakers speaks to a fundamental disconnect between actions—which seek to make it easier and more profitable for banks to lend—and the underlying problem of a lack of creditworthy borrowers. Thus, we expect the TLTRO—to say nothing of any future attempt at QE—to have a similar effect to prior programs, namely to further depress bond yields but do little to boost bank lending. ■

[2] "Matteo Renzi's Red-Tape Problem," Beppe Severgnini, *The New York Times*, August 12, 2014.


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Exhibit Notes

Ten-Year European Government Bond Yields
Source: Thomson Reuters Datastream.
Note: Latest available data for Greece are as of June 2014.

Private Sector Loan Creation
Source: Thomson Reuters Datastream.

Eurozone Lending to Households and Non-Financial Corporations: Monthly Flows
Sources: European Central Bank and Thomson Reuters Datastream.
Notes: Lending data are seasonally adjusted, but not adjusted for sales and securitizations. Lending to households data include loans for house purchases.

Potential 2014 TLTRO
Sources: Bloomberg, L.P., European Central Bank, and Morgan Stanley Research.

Eurozone Aggregate Bank Lending
Sources: Bloomberg, L.P. and Thomson Reuters Datastream
Note: Benchmark for TLTRO data is based first on current loans outstanding (as of April 2014, excluding loans for house purchases), and subsequently on loans made in subsequent periods in excess of the pace of loans made over the 12 months ended in April 2014.

Eurozone vs US Economic Activity
Source: Thomson Reuters Datastream.
Notes: Data are quarterly and seasonally adjusted. Latest available Eurozone GDP data are as of first quarter 2014.