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Economy

Outlook for credit in Europe remains positive

Wednesday 29 March 2017

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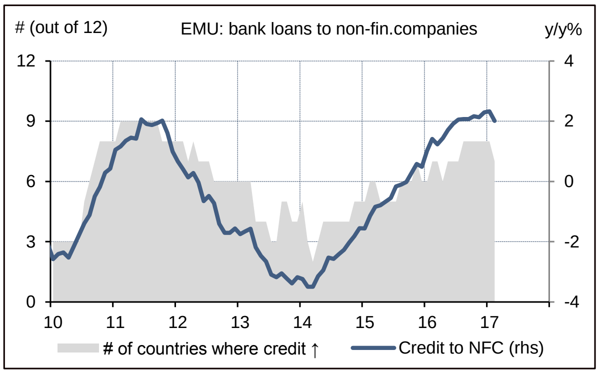
Over the past few months, growth in loans to businesses has plateaued at around 2% year-on-year in the Eurozone. At first glance, this might appear to signal that the credit cycle is moving past its peak, and, if that were the case, this would deprive the recovery of a necessary source of fuel. This fear fades when loans are broken down by major sectors. There is a stagnation of industrial loans, a belated reflection of the crisis in the oil sector. The sharp rebound in business sentiment shows that this problem is over. At the same time, the property market is picking up. As the obstacles on the credit supply side have been largely overcome, we may assume that the financing of the recovery is not at risk in the Eurozone.

Bank credit strengthens the recovery

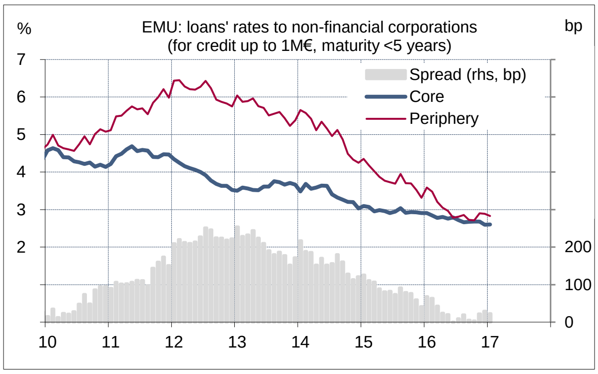
In an economy like the Eurozone, where two-thirds of the economy's financing comes from banks, the credit trend is crucial for economic activity. 2013 and 2014 were marked by a credit-less recovery. The situation really began to improve in 2015, and the uptrend has been continuous since then[1]. However, in recent months, we note the growth in the loans to businesses segment has stagnated. Bank credit to companies has plateaued at 2% year-on-year (chart lhs). Most of the Eurozone's peripheral economies are not contributing to this growth. The rise in corporate loans is less rapid that that of the value-added of non-financial companies (around 3.5% lately) whilst the two curves had traced a fairly similar trajectory during the pre-crisis period. **Has credit momentum peaked in the Eurozone?**

Before making a closer examination of the different types of loans, we are tempted to answer this question in the negative by considering credit supply conditions. Granted, the negative interest-rate policy is a cost for banks as it weighs on their reserves at the ECB, but the other monetary easing measures are beneficial for the banking sector overall. As of 2011, faced with a growing risk of the disintegration of the Eurozone, banks reacted by tightening lending standards and demanding higher interest rates. This is no longer the case. On the one hand, the ECB's quarterly survey on credit conditions shows that the situation has normalised for loans to businesses (and is even appears to be easing for households). On the other, the financial fragmentation between firms depending on whether they are at the Eurozone's core or periphery is now only a bad memory (chart rhs). Here too, we have returned to a situation which, at the very least, does not portend a calling into question of the euro.

Eurozone: bank loans to non-financial corporations



Eurozone: bank lending rate to businesses



Sources : Thomson Reuters, Oddo Securities

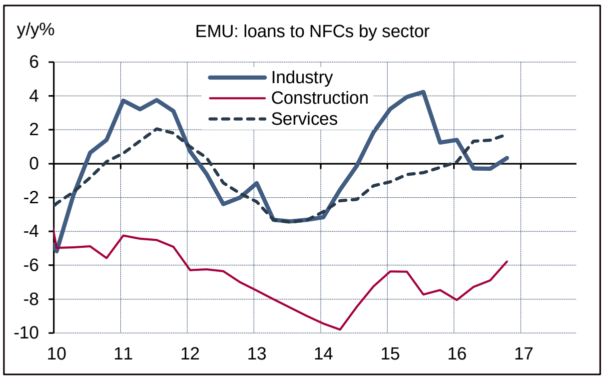
[1] *See earlier* Eco Notes*: "Green shoots in the Eurozone credit cycle" (26 March 2015); "Reflation via the credit channel, it works" (20 April 2016).*

Bank credit is not a leading indicator of the business cycle. It serves less as an estimator of GDP growth in the coming quarter than as a measure of the strength of the recovery. Without credit, recoveries are more fragile. Where do we detect signs of weakness at present or over the last few months? For sure, in industry. This is clearly revealed in a breakdown of the granting of loans by major economic sector (chart lhs).

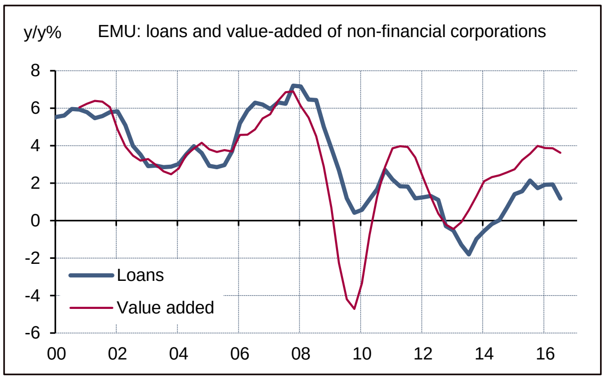
- **For the services sector (including transport and trade), the improvement in credit is gradual, and continued out to end-2016** (the latest figures available are for Q4).
- The **construction** sector remains in a cleaning-up phase: outstandings continue to fall due to the (massive) repayment of loans granted during the property boom. There are nonetheless signs of an upturn in new loan production.
- **In industry, where the upturn in credit had materialised the earliest, 2016 was marked by a significant stalling in the pace of growth**. This accounts for all of the stabilisation of the rate of growth in loans, all sectors included. This is linked to the soft patch experienced by manufacturing industry during the oil countershock from mid-2014 to mid-2016. The Eurozone does not have a major domestic oil sector, but this has not prevented manufacturing activity, the most exposed to oil investment, from slowing sharply. The value-added of this sector rose by 2.5% in 2016, vs 3.1% in 2015 and 3.5% in 2014[2]. The assumption according to which the oil countershock has acted as a significant drag on loans to industrial businesses is clearly borne out in the US case[3].

What about the outlook for the credit cycle? First, note that the industrial slump has given way to a strong wave of optimism in recent months[4]. This is what all the business sentiment indicators are implying. Indices such as PMI, Ifo, etc. are currently at peaks unrivalled in several years. It will probably take some time for this to feed through to activity figures – and therefore to loan figures which are roughly coincident – but the direction appears clear, it is upward. Moreover, there is a significant catch-up margin for credit in the construction sector. Of all of the sectors, this is the hungriest in terms of credit. According to the ECB data, credit volumes by unit of value-added are twice those of the rest of the economy (without that depending exclusively on the position in the business cycle). If construction continues to accelerate in the coming months, bank credit will likely support this trend[5]. **With growth in loans still below that of economic activity** (chart rhs), **the upturn in bank credit does not appear to be set to halt, quite the contrary**.

Eurozone: loans to businesses by sector



Eurozone: companies' loans and value added



Sources: Thomson Reuters, Oddo Securities

[2] *The calculation is based on the Eurozone's four major economies. Over the entire Eurozone, the deceleration is more marked but partly reflects a suspiciously high rate of growth in Ireland in 2015.*
[3] *See http://economistsview.typepad.com/timduy/2017/03/is-bank-lending-a-concern.html, blogpost of Tim Duy, 22 March 2017.*
[4] *See our* Eco Note *dated 24 March 2017: "*Escape velocity *for European growth")*
[5] *See our* Eco Note *dated 28 March 2017: "Broadening of the Eurozone's recovery"*

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