MACRO NEWS 22/03/16

Holger Schmieding, Chief Economist | Holger.schmieding@berenberg.com | +44 20 3207 7889

ECB: MONETARY POLICY IS STILL WORKING

Berenberg Macro Flash

"Monetary policy is no longer working. Instead, ECB attempts to support demand and nudge inflation gradually back to the desired rate of close to 2% are merely creating dangerous distortions." These assertions have turned into the standard refrain of many observers, sung most loudly in the German debate. The facts including today's money and credit data show that the refrain is wrong. ECB policies are still working.

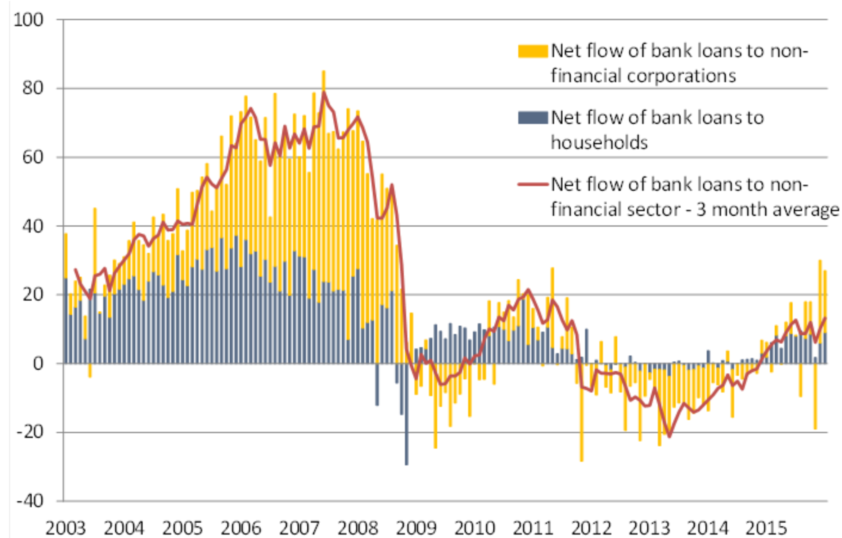
Remember the good old days when the German Bundesbank still believed in monetarism, usually setting annual targets for **M3 growth** around 4.5-5.0%? If only the Bundesbank hadn't abandoned that approach. For the Eurozone, old-fashioned monetary analysis still carries a clear message today: the ECB is finally pursuing the right policy. At 5.0%, annual growth in M3 broad money supply held steady in February 2016. From mid-2009 to February 2015, M3 growth had averaged just 1.8%, far below what the Bundesbank (and the Issing-ECB) had long regarded as the appropriate norm. No wonder that domestic demand in the Eurozone had been extremely for years, held back by a monetary policy that had been less aggressive than that of the US Fed and more timid than would have been required to keep core inflation closer to 2%. Helped by ECB asset purchases, M3 growth finally returned to where it belongs last spring.

A MATTER OF CREDIT

In the wake of the post-Lehman mega-recession and the subsequent euro confidence crisis, fear continues to reign supreme. Households are more reluctant to borrow, companies are less willing to invest. As a result, credit demand is unusually weak while the propensity to save is strong. Amid widespread caution, supply and demand for savings balance at unusually low interest rates. To keep domestic demand close to its trend rate nonetheless, monetary policy thus needs to be more aggressive than in previous cycles. But saying that monetary policy needs to do more to achieve results is very different from saying that monetary policy is no longer working.

As usual, the proof is in the data. Since the ECB started to be suitably aggressive in June 2014, edging towards a traditional open market policy of buying assets to inject liquidity into the system ("quantitative easing" in modern parlance), the credit cycle has turned up (see chart 1). In February 2016, the growth rate of **loans to non-financial corporates** edged up to 0.9% yoy. While still paltry, it is much less subdued than the rates of 0.1% yoy in December 2015 and 0.6% in January 2016. Until late 2015, credit to companies had still contracted in the Eurozone. The growth rate of **loans to households** also rose slightly further to 1.6% yoy from 1.4% in the two months before. Looking at monthly flows rather than the yoy rates, banks have extended more new loans to companies than to households in the last two months. That is an encouraging signal. Businesses may finally be ready to invest a little more.

Chart 1: ECB POLICY AT WORK - CREDIT CYCLE TURNING UP



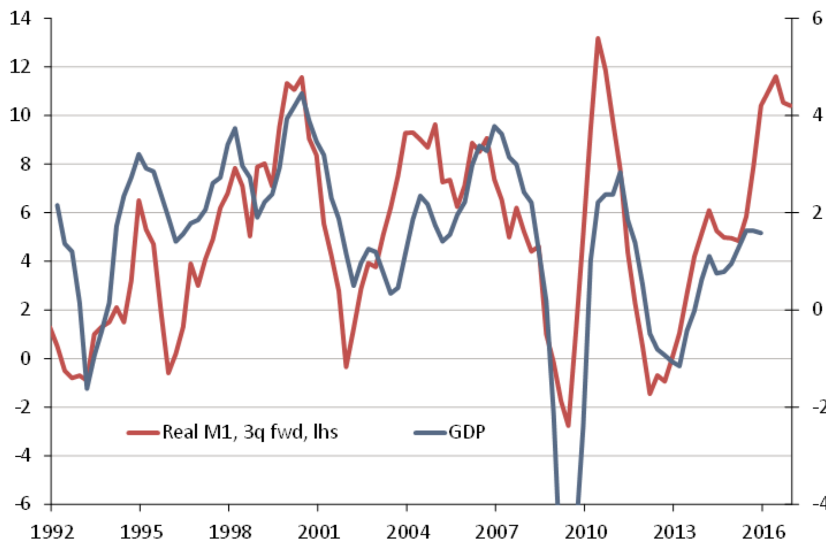
Monthly flow of loans to households and non-financial corporations, in €bn, adjusted for sales and securitisations. Source: ECB

Some observers worry about a risk that the ECB may be blowing up a bubble, for instance in real estate. The data do not support that assertion at all. Yes, **bank lending for house purchases** is less subdued than overall bank lending. But with growth in mortgage loans running at just 2.3% yoy in February 2016 after 2.1% in the two months before, the rate is still roughly half of what would have been considered normal in previous cycles. The ECB is far from blowing up a credit-fuelled bubble anywhere. Instead, the data for loan growth justify the ECB's recent decision to react to a major downward revision in its own projections for GDP growth and inflation with a further significant monetary stimulus.

M1: THE POWER OF MONEY

Real M1 money supply, that is the most liquid balances held by households and companies, is our favourite lead indicator for major turns in the Eurozone business cycle some three quarters in advance. The logic is simple: if households and companies have a lot of liquidity, they will eventually spend part of it unless some shock makes them want to hold on to it instead. Real M1 growth remains exceptionally strong (see chart 2). However, it has softened slightly in the last two quarters. Taken at face value, this could point to a modest weakening of growth in domestic demand in mid-2016.

Chart 2: REAL M1 - STILL STRONG BUT EASING SLIGHTLY



Yoy growth in real GDP and real M1 money supply; real M1 on left-hand scale advanced by 3 quarters, real GDP on right-hand scale.
Source: ECB, Eurostat, Berenberg calculations

However, chart 2 shows that M1 growth remains ample enough to finance more growth. Also, the new ECB stance could give a further boost to M1 growth in coming quarters. As often, sentiment is key. If – in the wake of the ECB decision to ease policy further – economic sentiment recovers over the spring and summer, households and companies would probably spend more of the liquid balances which already have – and take up an occasional extra credit on top of that. Monetary policy has prepared the ground for a somewhat firmer economic recovery after the sud-trend rates of growth in the wake of the China/emerging market setback since last summer.

This message has been produced for information purposes for institutional investors or market professionals, it is not a financial analysis within the meaning of § 34b or § 31 of the German Securities Trading Act (Wertpapierhandelsgesetz), no investment advice or recommendation to buy financial instruments. The message does not claim completeness regarding the information on the developments referred to in it. On no account should it be regarded as a substitute for the recipient's procuring information for himself or exercising his own judgements. The message may include certain descriptions, statements, estimates, and conclusions underlining potential development based on assumptions, which may turn out to be incorrect. Berenberg and/or its employees accept no liability whatsoever for any direct or consequential loss or damages of any kind arising out of the use of this message or any part of its content. -- For full economics reports please visit our website or contact capitalmarkets@berenberg.de.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7889
www.berenberg.com
holger.schmieding@berenberg.com