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ECB POLICY IS WORKING AS CREDIT CYCLE TURNS UP GRADUALLY

Berenberg Macro Flash

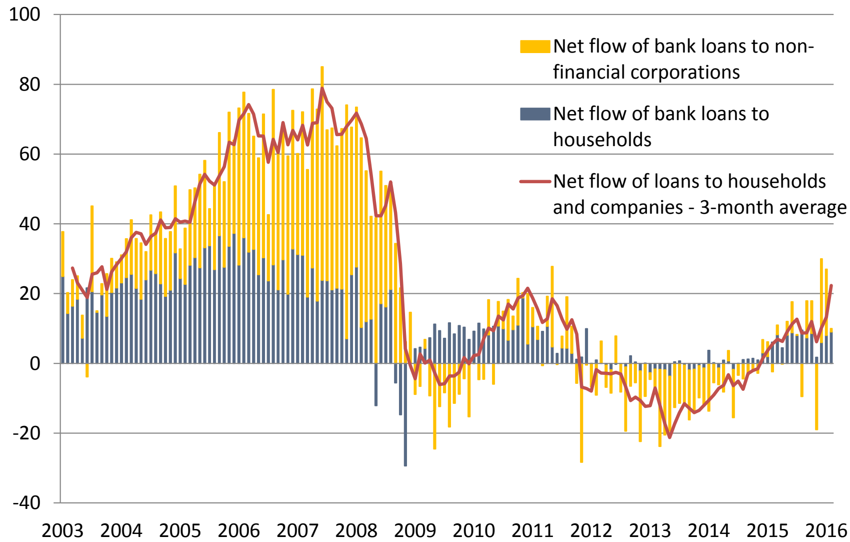
Monetary policy is working in the Eurozone. While less effective than in the past, the ECB's stimulus is yielding results. In March, credit growth in the Eurozone strengthened slightly further. As the data for March probably reflect decisions mostly taken before the ECB unveiled its surprisingly broad new package on 10 March, we look for further modest gains in credit growth later this year. Monetary policy has put the cyclical recovery on the right track. Unless major external shocks such as a Brexit were to intervene, Eurozone GDP growth should return to its 1.6% trend rate this summer. Of course, it would take pro-growth structural reforms rather than monetary policy to raise that trend rate of growth.

MONETARY POLICY IN TIMES OF FEAR

Across the Western world, monetary policy seems to be less effective in boosting domestic demand than in previous cycles. 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 than in previous cyclical upturns. As a result, credit demand is unusually weak while the propensity to save is strong. Amid widespread caution, supply of and demand for savings thus balance at unusually low interest rates. To stimulate demand for credit and keep domestic demand close to its trend rate nonetheless, monetary policy thus needs to be more aggressive than in previous cycles.

Since the ECB started to be suitably expansionary 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 Eurozone credit cycle has turned up (see chart 1). In March 2016, the growth rate of **loans to non-financial corporations** edged up to 1.1% yoy. While still paltry, it is much less subdued than the rates of 0.1% yoy in December 2015 and 1.0% in February 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 in March from 1.5% in February. Looking at monthly flows rather than the yoy rates, banks have extended more new loans to companies than to households in the last three months (see Chart 1). That is an encouraging signal. Businesses may finally be ready to invest a little more. (All data adjusted for sales and securitisations).

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



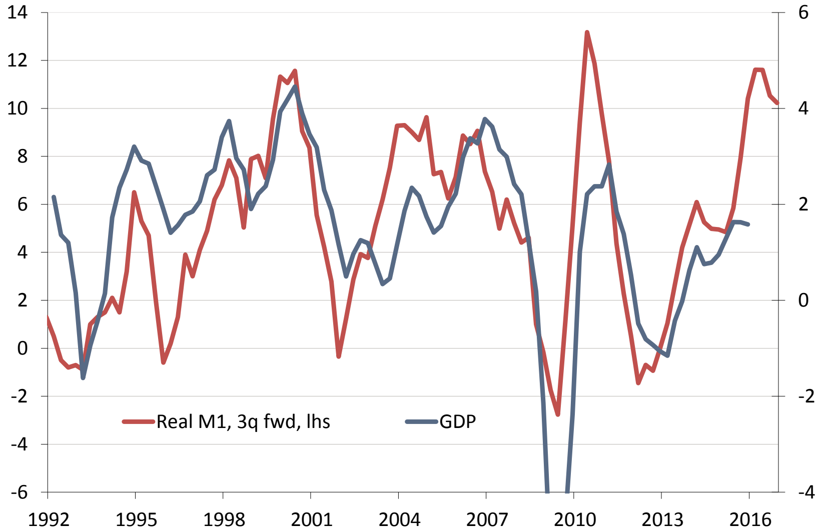
Monthly flow of bank loans to households and non-financial corporations in the Eurozone, in €bn, adjusted for sales and securitisations.
Source: ECB

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 March 2016 after 2.3% in February and 2.1% January, 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 March 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 measuring 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 domestic demand dynamics in late-2016. In March, nominal M1 growth eased to 10.1% yoy from 10.2% in February.

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 ECB's March policy package could boost liquidity further. Of course, to the extent that banks may pass on the more negative ECB deposit rate (now -0.4%) to their own big clients, future data could be distorted if some of these major clients move out of bank deposits included in M1 into other assets not including in the M1 definition.

Within M1, which consists of cash and overnight deposits, we find no sign yet of a major shift from overnight deposits (11.0% yoy growth in March after an average of 11.2% in the two months before) into cash (5.9% yoy growth in March, unchanged for the average of the prior two months). Of course, it is very early days. Future data will reveal more clearly whether or not bank customers may be withdrawing money from deposits to stash it aside as cash instead.

For the economic outlook, sentiment is key. We expect economic sentiment to recover over the spring and summer after the ECB's March stimulus package. If so, households and companies would probably spend more of the liquid balances which they 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 sub-trend rates of growth in the wake of the China/emerging market setback since last summer. We expect Eurozone GDP growth to re-accelerate to its trend rate of 1.6% in the second half of 2016 after rates around 1.2% in the first half.

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