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ECB POLICY: LESS EFFECTIVE BUT STILL WORKING

Berenberg Macro Flash

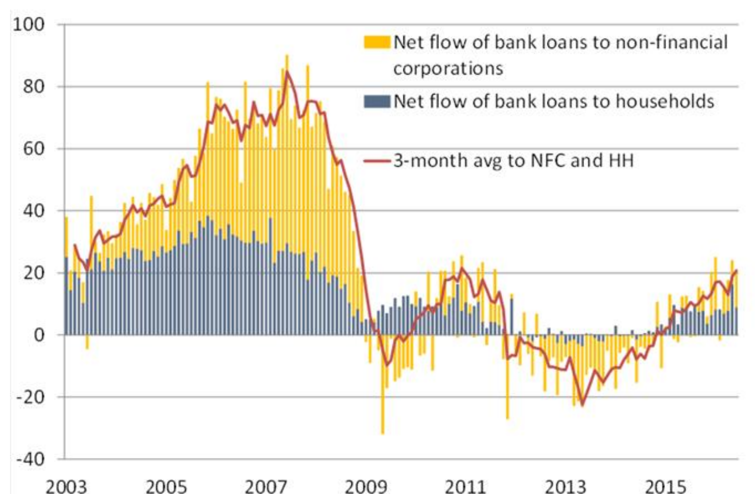
Monetary policy is still working in the Eurozone. While less effective than in previous cycles, the ECB's stimulus is yielding some results. In July, credit growth in the Eurozone strengthened slightly further. The monetary and credit dynamics are compatible with trend growth in GDP, which we put at roughly 1.6%. Although the impact of Brexit, political uncertainty and possibly renewed concerns about China will likely push actual Eurozone growth slightly below its trend rate in Q3 and Q4, we expect the region to return to trend growth in early 2017.

MONETARY POLICY IN TIMES OF FEAR

Across the Western world, monetary policy seems to be less effective in boosting domestic demand than before. In the wake of the post-Lehman mega-recession and the subsequent euro confidence crisis, fear still reigns supreme. Households are more reluctant to borrow and companies are less willing to invest than in previous cyclical upturns. As a result, credit demand is weaker while the propensity to save is stronger than usual. Amid widespread caution, supply of and demand for savings thus balance at unusually low real interest rates. To stimulate demand for credit and keep domestic demand close to its trend rate of growth 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 July 2016, the growth rate of **loans to non-financial corporations** edged up from 1.8% to 1.9% yoy, the strongest rate since the euro crisis escalated in the autumn of 2011. With core inflation at a mere 0.9%, the expansion of credit to companies has now reached a satisfactory pace in real terms. Until late 2015, credit to companies had still contracted in the Eurozone. The growth rate of **loans to households** remained at 1.8% yoy in July, also a satisfactory pace. Looking at monthly flows rather than the yoy rates, the supply of new loans to the private economy is oscillating around €20bn per month, equivalent to a 2.3% annualised rate.

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

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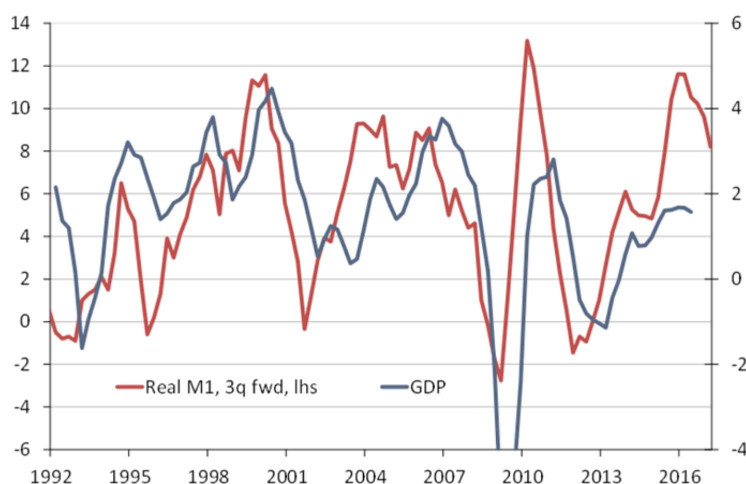
Some observers worry about a risk that the ECB may be blowing up a bubble, for instance in real estate. The data do not support that assertion. Yes, **bank lending for house purchases** is less subdued than overall bank lending. But with growth in mortgage loans running at just 2.3% yoy in July, up from 2.1% in June and unchanged on the 2.3% for May, 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. Whereas 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, they do not suggest a need for any further monetary stimulus now.

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 fairly strong (see chart 2). However, it has softened significantly over the last three quarters. Taken at face value, this could point to a weakening of domestic demand dynamics in late 2016 and early 2017. In July, nominal M1 growth eased further to 8.4% yoy from 8.7% in February.

However, we need to interpret the weaker dynamics in real M1 with some caution. First, the actual growth rate of real M1 remains ample enough to finance a significant increases in household and company spending. Second, we now live in a world in which the ECB imposes a significant penalty on banks depositing excess funds at the central bank. To the extent that banks may pass on the more negative ECB deposit rate (-0.4%) to their own big clients, the data could be distorted if some of these major clients move out of bank deposits included in M1 into other assets not included in the M1 definition. Put differently: with negative deposit rates, we will only learn over time whether the old relationship between major turning points in real M1 and real GDP is still as reliable as it was in the past. Nonetheless, we need to watch this relationship carefully. Whereas credit growth – a coincident indicator for economic trends – looks healthy, the forward-looking indicator of real M1 is now sending mixed signals.

Chart 2: REAL M1 - STILL STRONG BUT EASING NOTICEABLY



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

For the economic outlook, sentiment is key. We expect economic sentiment to decline modestly in the next few months in the wake of the Brexit uncertainty and some other political concerns. But unless political risks in Italy or the US were to materialise in a major way, sentiment should rebound by the end of the year, paving the way for a return to trend growth in early 2017. The ECB has laid the monetary basis for that. The uptrend in construction and employment and a modest fiscal stimulus of perhaps 0.2% of GDP in 2017 for the Eurozone support that outlook.

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