

Creditless growth?

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Economics - Eurozone

Why the eurozone is not feeling the tightening yet

- ◆ Tightening credit conditions and the credit impulse turning negative show that monetary policy is starting to bite...
- ◆ ...but post-pandemic reopening effects, high inflation and fiscal support are dampening the impact on the economy
- ◆ This should still come further out and weigh on growth – but the longer it takes, the greater the ECB's dilemma

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The first leg of the tightening is working – At its May meeting, the European Central Bank (ECB) said that “the past rate increases are being transmitted *forcefully* to euro area financing and monetary conditions” [our emphasis]. Indeed, the ECB Q1 Bank Lending Survey showed a further tightening of credit conditions in Q1 2022. Higher borrowing costs are leading to an intensifying fall in credit demand from households and firms – including for investment purposes. Credit growth is also easing fast and the credit impulse has turned negative – which in the past has been associated with recessions given how credit-intensive eurozone growth is.

...but little signs of an impact on activity yet – The ECB also noted, though, that “the lags and strength of transmission to the real economy remain uncertain”. Indeed, even though growth has slowed since H1 2022, that's largely due to surging inflation eating into real household incomes – the tightening hasn't had much of an impact on growth yet, which has strengthened of late.

To us, rapidly falling energy inflation, the post-pandemic bounce-back and ongoing fiscal support explain much of the growth resilience. But, at least for the housing sector, it is difficult to be optimistic about prospects going forward. Falling house prices and high mortgage rates should lead to a further drop in housing investment. For firms, it is more of a mixed bag. Bank lending standards might ease a little ahead if the uncertainty surrounding the banking sector fades, and with firms feeling optimistic about the possibility of passing on their higher costs to consumers, lending demand might improve. Meanwhile, strong public sector support via state aid and generous tax credits might reduce the need to tap external funding sources – meaning the eurozone could sustain higher growth rates with less credit than in the past.

More impact likely, but the ECB could face a dilemma – Eventually, though, monetary policy should have its (desired) cooling effects. As demand fades, firms might feel less confident about borrowing at increasingly higher rates. Government fiscal space might be limited by higher borrowing costs and EU fiscal rules coming back. So we still see growth easing in H2 2023 and below-potential in 2024, helping contain inflationary pressures. But there are risks, particularly of more fiscal support tied to the energy transition challenge. And with stubbornly high inflation, the more delayed the impact of the tightening is on activity, the bigger the dilemma the ECB faces – should it keep hiking until it has cracked inflation, or pause and wait until the tightening eventually works its way through the economy?

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The first leg is working

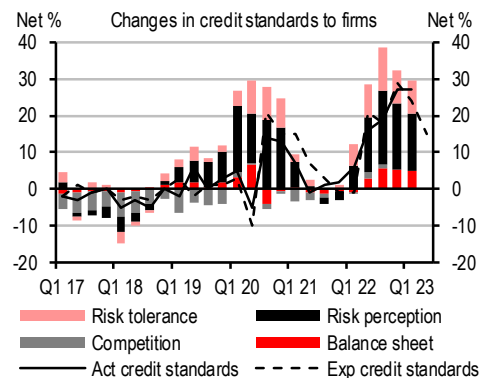
‘Forceful’ transmission

At the 4 May meeting, the ECB said that “the past rate increases are being transmitted *forcefully* to euro area financing and monetary conditions” [our emphasis]. This is a marked step change relative to previous communication on the transmission of the monetary tightening – at least for the first leg, as the statement goes on to say that “the lags and strength of transmission to the real economy remain uncertain”. So, what prompted the ECB to make that change?

The Q1 Bank Lending Survey (BLS) showed a sharp further tightening of credit conditions in Q1, broadly in line with Q4 2022 and greater than banks had anticipated (Chart 1), while higher interest rates are leading to an intensifying fall in loan demand for households and firms – including for investment purposes (Charts 2-4). The drop in firms’ loan demand was the sharpest since the Global Financial Crisis (GFC), while mortgage demand has fallen at an all-time record pace for two quarters in a row.

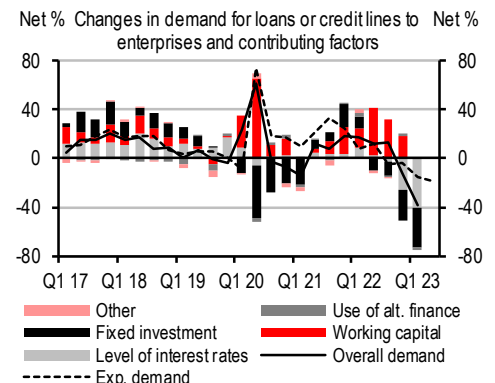
The Q1 Bank Lending Survey showed a further tightening of credit conditions and a sharp drop in loan demand

1. Credit conditions tightened further in Q1, and banks expect further tightening ahead



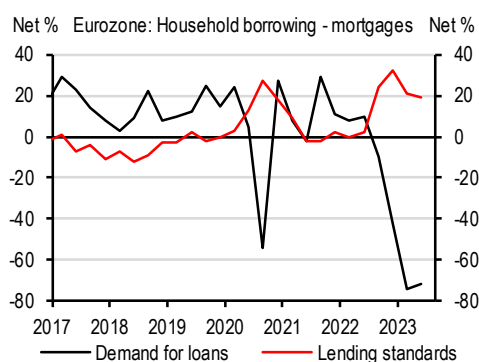
Source: ECB BLS, HSBC.

2. Loan demand by firms fell at the fastest pace since the Global Financial Crisis



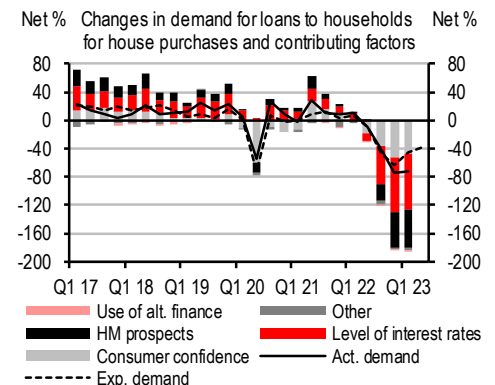
Source: ECB BLS, HSBC.

3. Mortgages demand also continued to fall at a near record-high pace...



Source: ECB BLS, HSBC.

4. ...as households face higher interest rates and fear worse housing market prospects



Source: ECB BLS, HSBC.

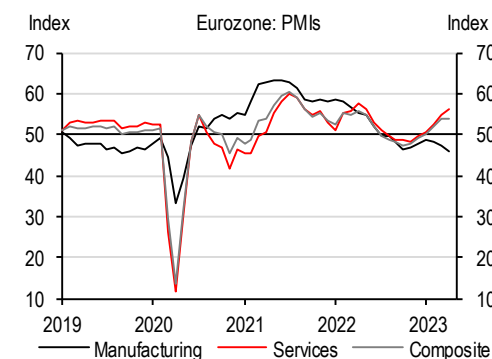
The overall outlook improved in Q1

The context in which the further tightening of credit conditions and falling loan demand took place is also important. In Q4 last year, eurozone inflation had surged, hitting an all-time high of 10.6% y-o-y in October and energy prices were on the rise again at the start of the winter. However, Q1 saw a huge drop in energy prices and rapidly falling inflation – at least headline – which has contributed to an improving economic outlook, as evidenced by PMIs (Chart 5). Firms’ investment intentions also improved relative to last autumn based on the European Commission (EC) survey (Chart 6), which should have been supportive of more loan demand for investment

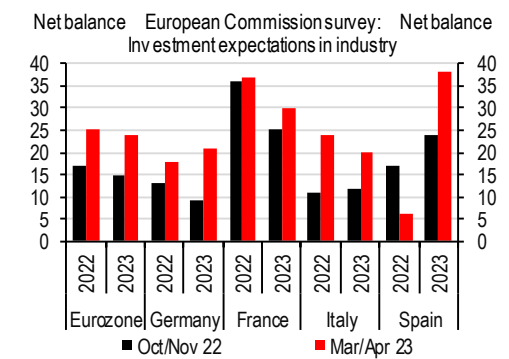
With the outlook improving in Q1, the deterioration in credit conditions shows the impact of monetary policy tightening

So, in light of the improved outlook in Q1 relative to Q4, the further deterioration in credit conditions could be seen as a more direct effect of monetary policy – which might explain the use of the word ‘forcefully’ by the ECB. Having said that, it is also possible that, given the time in which the responses for the Q1 survey were collected, the increased uncertainty following the collapse of Silicon Valley Bank (SVB) and emergency takeover of Credit Suisse by UBS could have played a role.

5. Services PMIs have improved markedly since the end of last year...



6. ...and firms are more sanguine about their investment prospects

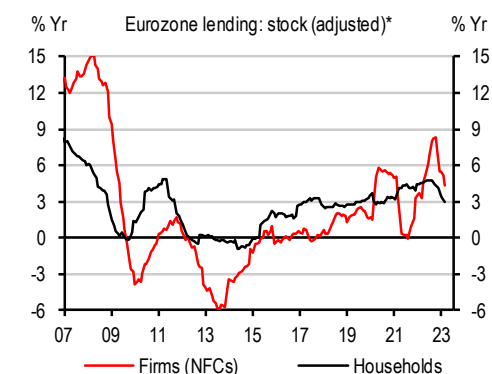


The medicine is working

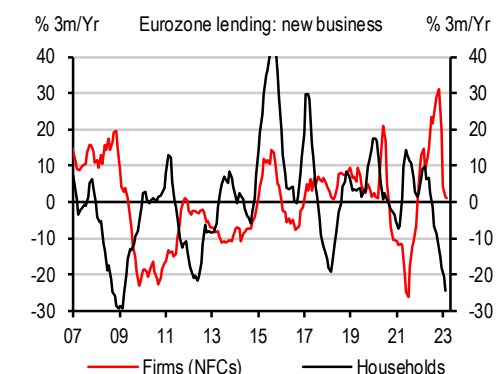
The hard data are also pointing to tighter conditions having an impact on credit. Growth in loans to the private sector (adjusted for loan sales, securitisation and notional cash pooling) eased to 3.8% y-o-y in March from 4.3% in February. Within this, the annual growth rate of loans to households decreased to 2.9%, its slowest since June 2018 (Chart 7). Looking at new business (new loans) rather than stock data, the drop is even more dramatic (Chart 8).

Credit growth is easing fast for both households and firms

7. Lending growth to households and firms has started to ease significantly...



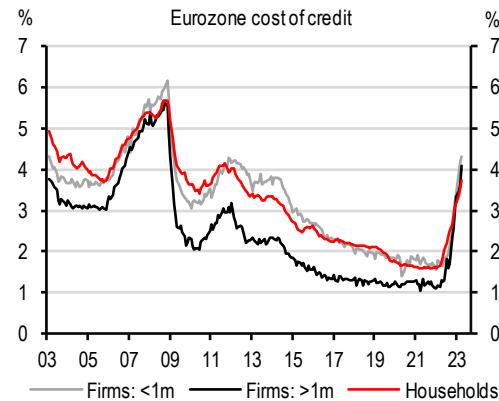
8. ...even more so when considering new loans



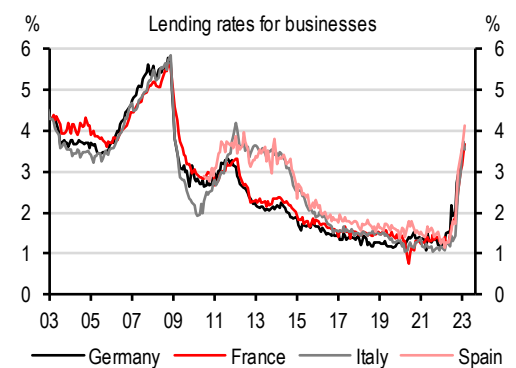
The sharp rise in borrowing costs is likely to have been a factor in dampening demand

The subdued economic outlook, particularly for manufacturing firms, is likely to have been a factor in lowering loan demand. But the sharp rise in borrowing costs also likely played a role. Lending rates for firms are now higher than during the eurozone sovereign debt crisis, at least in nominal terms, even if they remain lower than those prevailing in the period preceding the GFC (Chart 9). Relative to the sovereign debt crisis, we are seeing any hardly divergence across the Big 4 (Chart 10) – a sign that so far fragmentation risk has remained relatively contained.

9. Borrowing costs have risen sharply for eurozone households and firms...



10. ...but with limited signs of renewed fragmentation risk across the eurozone

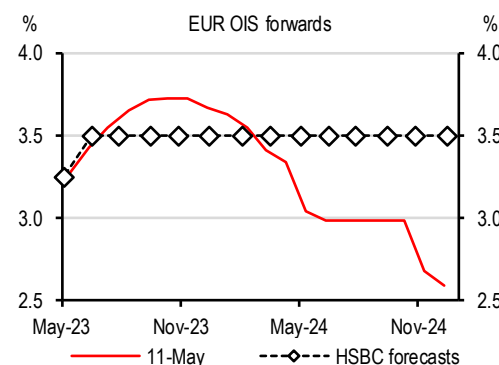


With the ECB signalling further hikes, conditions should tighten more ahead

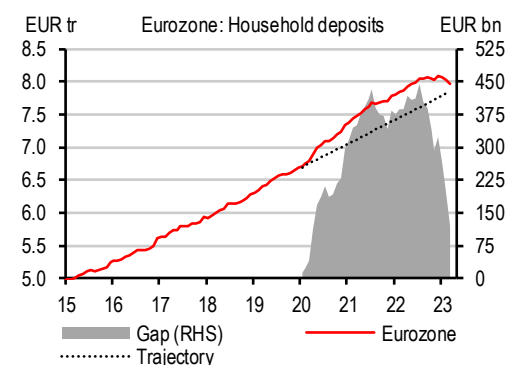
Further deterioration ahead?

In May, even though it slowed the pace of rate rises from 50bp to 25bp, the ECB signalled that there will be more hikes to come; we forecast one more 25bp hike in June (Chart 11), with rising risk the ECB might keep hiking through the summer. We also see rates staying at the peak for much longer than the market currently anticipates. Against that backdrop, lending rates should continue to rise in the coming months. This might be even more the case considering the latest fall in bank deposits (Chart 12), which could increase funding pressures on banks – particularly the weaker ones – coming on top of EUR1trn of TLTROs expiring between June 2023 and December 2024 (with nearly EUR500bn this June).

11. We expect one more 25bp hike from the ECB, but there could be more



12. Bank deposits have been falling over the last couple of months across the eurozone



Rising bankruptcies could lower banks' risk appetite

Rising corporate bankruptcies could lower the banks' risk appetite further. The Bank of Spain estimate that a 400bp rise in rates could lead to a 10% rise in the share of corporate debt in the economy held by firms under 'high' financial pressure. So far, though, rising bankruptcies have been largely tied to the withdrawal of pandemic-era support measures, which artificially kept non-viable firms alive – with limited impact on banks' NPLs.

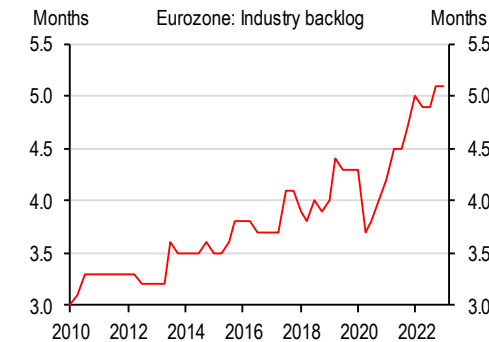
A further tightening of credit conditions is not a given

Having said that, looking at the history of the ECB BLS survey, banks have tended to front-load credit tightening at the start of a tightening period to lose them slightly afterwards. This was not the case in Q1, but the uncertainty surrounding the banking sector might have played a role. So, if the situation remains relatively calm between now and June, we could see a slight correction in lending standards in the Q2 ECB BLS survey (to be published on 13 June).

Higher inflation expectations
reduce the rise in real rates

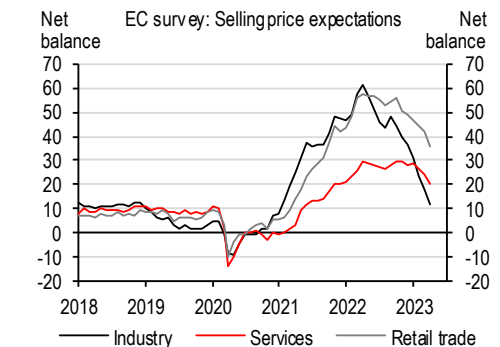
Some of the recent weakness in loan demand might also be overcome if firms remain confident about demand (particularly given high work backlogs, Chart 13) and the possibility of passing on higher costs to consumers (even though most recently inflation expectations have started to decline, particularly in the manufacturing and retail sector, although overall they remain high – Chart 14). Higher inflation expectations by firms means rising rates are increasing less than nominal.

13. Eurozone firms are sitting on high backlogs of work



Source: European Commission, HSBC.

14. Firms' selling price expectations have eased off since last year but remain high

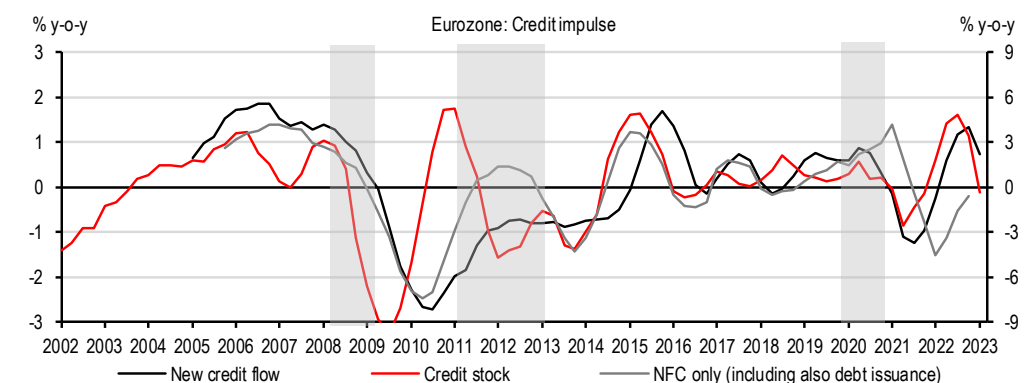


Source: European Commission, HSBC.

The second leg – when and how much?

As discussed in our latest Eurozone Economics Quarterly, credit is a key driver of growth in the eurozone. Almost of 90% of firms' debt is bank loans, with only around 10% of debt coming from capital markets. This is pretty much the opposite of what happens in the US – making the pass-through of changes in market rates to firms faster.¹

15. A negative credit impulse tends to be associated with recessions in the eurozone



Source: ECB, HSBC. Notes: Shaded areas indicate recessions.

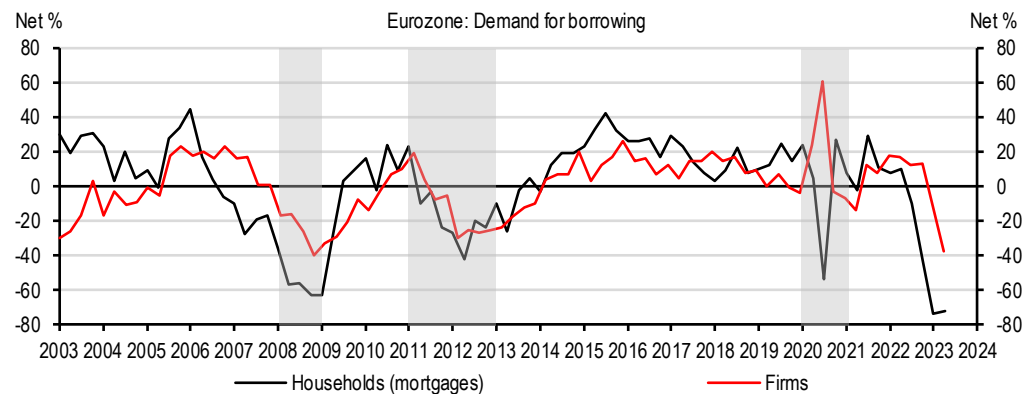
Credit impulse has turned negative

This has also tended to make the credit impulse a good predictor of GDP growth, and this has now turned negative (Chart 15). Periods of negative credit growth have previously been associated with GDP contractions, such as during the eurozone sovereign debt crisis. Similarly, the scale of the drop we have seen in demand for loans by eurozone households and firms based on the ECB BLS survey is also consistent with recessionary episodes (Chart 16).

Periods of negative credit
growth in the eurozone have
previously been associated
with GDP contractions

¹ ECB research shows that it takes three months for a full pass-through with bank lending, while it takes a full year for debt securities (and the pass-through is only about half after three months). See *The transmission of monetary policy*, Speech by Philip Lane, ECB Chief Economist at the "EU and US Perspectives: New Directions for Economic Policy" conference on 11 October 2022.

16. The fall in loan demand by households and firms has been rapid in recent quarters



Source: ECB BLS, HSBC. Notes: Shaded areas indicate recessions.

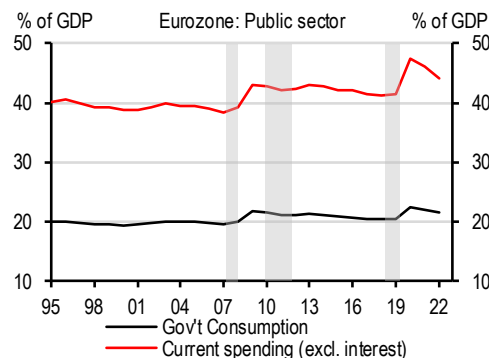
We don't see a combination of public and private sector deleveraging at the moment

From private to public capital?

One factor that might soften the relationship between credit and GDP growth relative to the past is public sector support. Government spending surged during the pandemic and, even though it has been shrinking since then as a share of GDP – thank to high inflation boosting nominal GDP – it remains elevated by historical standards (Chart 17). Also, investment spending remains on an upward trajectory – a stark contrast to the austerity years following the GFC when it was cut sharply (Chart 18). The combination of public and private sector deleveraging is likely to have been a key driver of the 2011-13 recession – and we don't see this at play today.

To some extent, this is the result of the conscious investment effort by governments in the energy and digital transition – for instance, spending under the Next Generation EU (NGEU) plans has been gathering speed this year in some countries after a slow start.

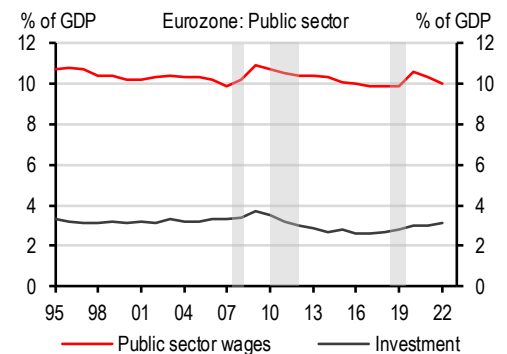
17. Public sector spending remains at historically elevated levels



Source: European Commission, HSBC. Notes: Shaded areas indicate recessions.

Ongoing state aid support and generous tax credits reduce the need for firms to tap external funding

18. Public investment in particular continues to increase, unlike after the GFC



Source: European Commission, HSBC. Notes: Shaded areas indicate recessions.

But governments have also been intervening to support investment by households and firms. For instance, the suspension of EU state aid rules to enable government to support firms during the energy transition process has been one of the cornerstones of the European response to the US Inflation Reduction Act. And we are now seeing tax credits widely implemented across eurozone countries:

- ◆ In Italy, the government provides a generous tax credit to firms, covering part of their energy bills (previously up to 45%, reduced to 10-20% by March). There is also a 140% tax credit for firms' investments, and until recently Italy also had tax credit covering 110% of housing renovation costs to improve the efficiency of the housing stock (the 'Super-bonus').

- ◆ France has cut production taxes (by EUR10bn) in 2021, and plans another EUR7bn cut over 2023-24 in its recovery plan. The government introduced a tax credit for thermal renovation targeted at SMEs (30% of total spending, with a ceiling at EUR25k), as well as one for thermal renovation of homes for households, costing EUR2.5bn (extended to 2023).
- ◆ In Germany, the government provides a tax-free subsidy of 25% of salaries and wages for certain R&D purposes, for up to EUR1m per year.
- ◆ Spain has recently announced it intends to also tap EUR84bn of NGEU loans, a significant chunk of which will be devoted to support private, rather than public, investment (Greece has also been using its NGEU loans successfully to support private sector investment).

We could see higher growth rates relative to what we have experienced in the past given the credit outlook

So, to some extent, all these interventions should reduce the need for firms to tap external funding sources and enable greater use of their retained profits for investment – so it's a form of substitution between private and public credit for eurozone households and firms. This means we could see higher growth rates relative to what we have experienced in the past given the credit outlook. Having said that, clearly at some point, higher borrowing costs for governments are also likely to reduce the available fiscal space for governments to support the economy – considering also the re-introduction of EU fiscal rules from next year. France's downgrade one notch to AA- by rating agency Fitch on 28 April is a reminder of the risks to public finances.

Tightening should bite – but maybe a little later (and less)

So, overall, the post-pandemic reopening effect (and accumulated excess savings) combined with ongoing fiscal support may have delayed – and also cushioned – the impact of tighter credit conditions and lower borrowing by households and firms on the economy. But it seems unlikely that there will be no impact, particularly as credit conditions keep tightening.

One place where the impact of monetary tightening is increasingly evident is the housing market

For instance, one area where the impact of monetary tightening is increasingly evident is the housing market. Sweden has been leading the way, but house price inflation has slowed sharply in France and German property investment has tanked. ECB estimates based on historical data suggest that a 1ppt rise in mortgage rates leads to a 5ppt drop in house prices after two years, and an 8ppt drop in housing investment. With housing investment accounting for about 25-30% of total gross capital formation in the eurozone, the impact of the recent tightening could be meaningful, leading to a drop in total investment of around 6-8ppt over the next two years. In turn, that could knock around 1.5ppt off of GDP growth.

We still see a slowdown in growth in H2 2022 – but the longer it takes, the bigger might be the ECB's dilemma

So overall, this chimes with our view of growth easing in H2 2023 and, as we head into next year, consistent with monetary tightening having the biggest impact on the economy with about 4-6 quarters of lag. This should also help inflationary pressure ease a little – including in the services sector where it is still building up – allowing the ECB to pause its hiking cycle. But, clearly, the possibility that government policy remains expansionary – particularly while EU fiscal rules remain de facto suspended (no country will be put in the Excessive Deficit Procedure until next spring at the earliest), while the environmental transition challenge requires more fiscal support – is a clear upside risk to growth and, in turn, inflation. And this could also cause a dilemma for the ECB.

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