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Still in the shadows

Euro area's two-speed credit recovery

by Marcello Minenna in Rome

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The euro area banking system remains under pressure, despite the reassuring results of the latest stress tests on European banks. The problem of non-performing loans in peripheral countries is increasing the sector's capital needs. Italy's Monte dei Paschi is a case in point, but certainly not the only one.

Since early 2016, European Union 'bail-in regulations' have sent shockwaves through the market, with a further collapse following the UK vote to leave the EU. European bank stocks have declined by 30% on average, compared with 10% for the market as a whole.

A negative confluence of regulatory uncertainty, more than two years of ultra-low interest rates and high non-performing loans has produced a credit crunch hampering the manufacturing sector's ability to recover – often in an environment in which bank lending has been the sole source of funding for small and medium-sized enterprises. Disbursed loans have fallen sharply and borrowing costs have spiked, badly damaging the SME manufacturing base in peripheral countries.

Nevertheless, positive trends have started to emerge. An initially weak recovery of loans to the non-financial sector is gathering pace, while interest rates on new loans are falling steadily, especially in southern Europe. The data from the last five years confirm a narrative of decline and recovery, though one that has been confined mostly to peripheral countries. For example, loan growth in the first half of 2011 was stronger in Italy than Germany, only for the tide to turn quickly as confidence surrounding the sustainability of Italian debt collapsed in mid-2011.

Loans continued to contract in subsequent years as austerity policies weighed on aggregate demand. The decline in lending to the non-financial sector reached a record low of 7% year-on-year in December 2013. Meanwhile, lending volumes in Germany continued to rise until the end of 2012, when the 2013-14 European recession hit. Even then, however, German total loans only fell by 2% year-on-year, a considerably milder decline than in Europe's periphery.

Following a period of sustained inertia, the ECB in mid-2014 launched its targeted long-term financing operations programme, guaranteeing European banks a broad base of cheap liquidity to be mandatorily lent to the non-financial sector. Despite this support and further unconventional monetary expansion programmes, there was no immediate credit recovery. In Germany, financing to businesses declined until May 2015, with contraction persisting in Italy until November 2015. And, while the credit recovery has strengthened further in Germany this year (annual growth was 2.9% in July), there has been no equivalent pick-up in Italy.

The divergent nature of the credit recovery has been mirrored in interest rates. Following years of moving in step, the sovereign debt crisis led to a rapid rise in the cost of bank loans in peripheral countries in June 2011. In Italy, rates on new loans rose by around 1 percentage point in just over six months. The spread on corporate loans widened further as German interest rates began a long descent. Rates on both government and corporate debt eventually turned negative, benefiting German industry. In Italy, the volume of loans continued to fall until mid-2014, and rates were 1.6 percentage points higher than German rates on average over the period, a financial penalty for Italian companies.

The ECB's policy shift in June 2014 was a game-changer, starting a trend towards converging interest rates on new loans to the non-financial sector. For the euro area as a whole, convergence with German rates is almost complete. However, a significant spread of more than 0.3 percentage points persists in Italy, while not all the new data look rosy. According to the Centre for Economic Policy Research, around a fifth of new loans to the Italian non-financial sector is to 'zombie' enterprises with little prospect of turning a profit, following political interests. These loans carry a high risk of non-repayment, reinforcing a vicious cycle that drags the economy down. The conclusion must be that, while euro area peripheral countries appear to be exiting a four-year credit crunch, shadows loom over the recovery.

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