

# Economist Insights

## *Kick the bucket*

Quantitative easing has been hugely useful for the Eurozone in keeping the EUR weaker. It has successfully boosted external competitiveness, but the next stage would be to kick-start domestic demand. Banks so far seem more willing to lend and at a cheaper cost, but nevertheless lending to the private sector has remained very weak. Does this mean that QE has not succeeded?



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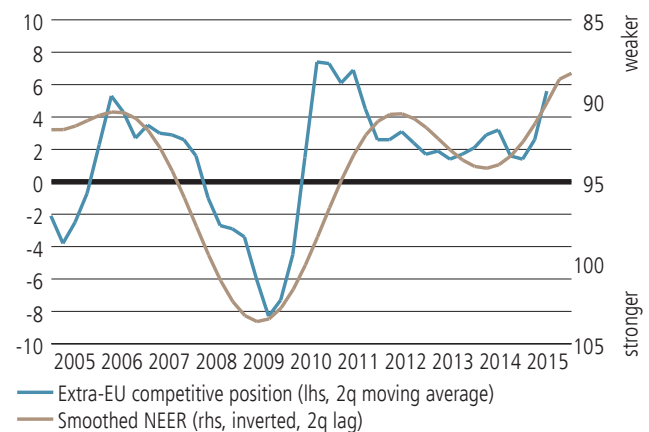
When an economy is in trouble, policy-makers usually reach for their toolkit of fiscal, monetary or exchange rate tools. In the Eurozone the fiscal policy tool has not been available; in fact, fiscal policy was going in the opposite direction as austerity became necessary. The monetary policy tool has been tried (despite a rather bizarre reversal in 2011), but with the banking sector busily reducing its balance sheet this is a bit like pouring water into a bucket with a hole in it. That leaves the exchange rate tool, but countries in the Eurozone have not directly controlled their currencies since the Euro-convergence days of the 1990s.

Policy-makers might no longer have direct control over the exchange rate, but they can have a big influence. Lower interest rates definitely helped keep the EUR weaker. But quantitative easing (QE) has been a hugely useful tool for weakening the EUR. A cynic could argue that the whole point of QE was to get the EUR weaker to boost external competitiveness. A more constructive view is that the ECB thought that QE would first boost competitiveness and hence external demand, and this would then kick-start domestic demand. Businesses that see good export prospects will invest more and hire more workers, which means more income and hence more spending domestically. Domestic-oriented businesses that are now less worried about imports (which the weaker EUR makes more expensive) may join in the increased spending and hiring.

So far, ECB QE has been successful at bringing the EUR down and boosting confidence amongst exporters across different industries. As the exchange rate against their trading partners weakened, survey measures of the perceived competitiveness of Eurozone exporters improved markedly (chart 1).

**Chart 1: Undercutting**

Eurozone firms extra-EU perceived competitiveness and smoothed nominal effective exchange rate (NEER)



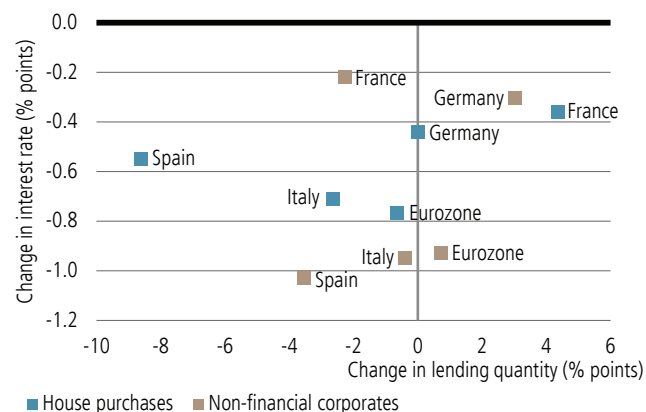
Source: ECB, European Commission, UBS Global Asset Management

What about the second part of the ECB effort, the hope to kick-start domestic demand? Unfortunately, here the leaky bucket that is the Eurozone banking sector gets in the way. Elevated rates of non-performing loans in some countries prevent banks taking more risk onto their balance sheets, and everywhere more stringent capital requirements discourage bank lending. Without bank lending, only those who have enough cash already can invest. Or those who can access other forms of credit, such as larger firms borrowing in credit markets.

But even if there was a good supply of credit, there still has to be demand for credit. With cuts to government benefits and high unemployment rates, households in many Eurozone countries are not interested in borrowing more even if the interest rate is low. Political uncertainty does not help, and in many countries households are trying to pay down debt. It is clear in the data: while the ECB has been successful in pushing down lending rates for both household mortgages and non-financial corporations, there has not been much of an increase in the amount of lending (chart 2).

**Chart 2: Supply fights demand**

Change in bank lending (%) and in interest rate on loans (% points) to households for home purchases and to non-financial corporations, March 2015 vs May 2014



Source: ECB, UBS Global Asset Management

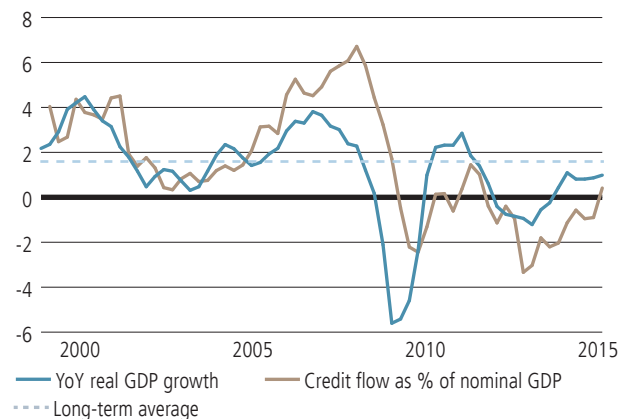
Lower prices (interest rates) and lower quantity of lending are good signs that there is a negative demand shock. But the surveys of bank lending practices indicate that banks are becoming more willing to switch some of their balance sheet out of government bonds into loans to the private sector. This sounds like a positive supply shock, especially with QE helping to bring down interest rates. A combination of a positive supply shock and a negative demand shock should mean lower interest rates but no change in quantity – and this indeed is pretty much what we have on the whole.

In the Periphery, however, the negative demand shock appears to outweigh the positive supply shock. Lending rates have fallen the most in Periphery countries like Italy and Spain, where unemployment is a problem, but nonetheless total lending in the Periphery continued to fall. Contrast this with Germany and France where interest rates fell by less (they did not have as far to fall) but lending did at least increase (or remain broadly flat), suggesting demand in those countries is a bit more supportive.

If the ECB has not yet been successful in kick-starting domestic demand, it may be hard pressed to get growth up. This does not mean that QE is a failure. After all, it is scary to think of how bad the credit situation would be if there had been no QE-driven positive supply shock to counteract the negative demand shock. And there are some first tentative signs that the credit flow is starting to turn supportive for the economy. Credit expansions tend to coincide with GDP growth in the Eurozone (chart 3). The causality of course can run both ways: more credit makes growth easier to achieve, and better growth prospects make people more willing to borrow.

**Chart 3: The chase**

Credit flow to non-financial corporations as % of nominal GDP and YoY real GDP growth (%)



Source: ECB, Eurostat, UBS Global Asset Management

For now it is still early days, and monetary policy can take a long time to feed through into the economy. Ultimately success will depend on whether the ECB is kick-starting a financial system that can start to lend, or just kicking the (leaky) bucket.

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