(Early) Promising signs from Eurozone credit mechanism

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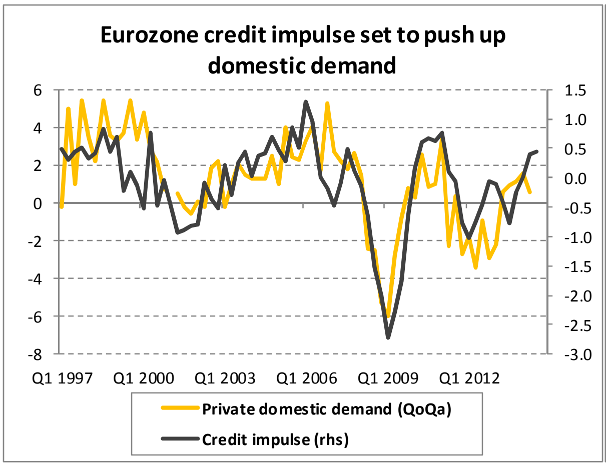
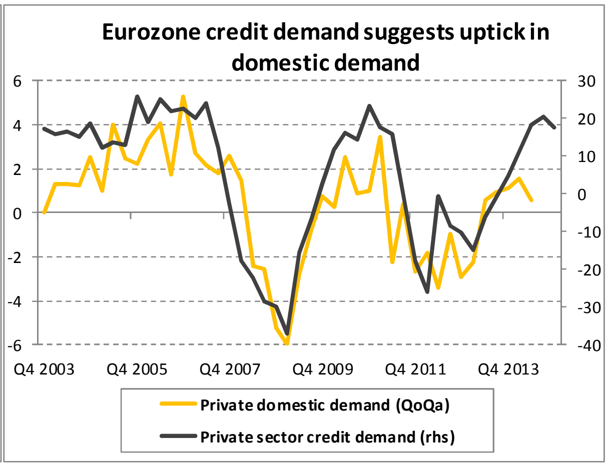
One of the many things holding back the Eurozone economy these past few years has been the dysfunctional credit mechanism. The amount of outstanding credit to the private sector is currently 4.2% lower than at the end of 2011. Because of health issues in the banking sector and the clouded economic outlook, banks have been reluctant to extend credit to companies and households, especially in the periphery. This has kept investment spending low. On top of that, in situations were banks were willing to extend credit, demand has often been lacking as companies see no opportunities to invest with the uncertain outlook and still ample unused capacity throughout the Eurozone. As such, efforts by the ECB to improve financial conditions have not really had much of an effect on the real economy.

Recent weeks have brought some signs that the Eurozone credit mechanism could gradually get back to life again. The bank lending survey by the ECB showed that banks are easing credit standards, i.e. the criteria to accord credit, again. Granted this is the first easing following several years of tightening of credit standards, but nevertheless this should improve the supply of credit. Last weekend's Asset Quality Review/stress test of the main Eurozone banks by the ECB should add to that. Uncertainty about the quality of bank balance sheets was impacting the funding conditions of banks. The analysis by the ECB of bank balance sheets and the efforts of a number of fragile banks to strengthen their balance sheets is clearly not a miracle solution that erases all the problems in the Eurozone banking sector. Nevertheless, these efforts should help to rebuild confidence in the sector to some extent. As such, this should improve the funding conditions of the healthy banks, which should add to the improvement in the supply of credit.

Improving credit supply is not sufficient to get the credit mechanism working again as long as the demand for credit is lacking. The meagre outlook for the Eurozone implies that there is not much need for new investment. However, the ECB survey also highlights that demand for credit is picking up. Especially households are looking for credit again, mainly for mortgages. This is probably a combination of a stabilisation in housing markets that crashed during the crisis, and of households trying to benefit from ultra-low interest rates. On top of that, credit demand from both small and large firms is also increasing. Given the amount of slack in the economy, it is highly unlikely that companies are looking to expand capacity. However, after several years of under-investment the need for replacement investment is probably increasing. This is likely to be the main driver behind corporate investment in the Eurozone in coming years.

Against this backdrop, the change in credit growth has been improving in recent months (even if overall outstanding credit is still decreasing). This positive trend is likely to continue in coming months, and should translate into increasing economic activity. To be clear, these early signs of improvement in the credit mechanism will not push the Eurozone economy into overdrive. However, they should provide a buffer against recent exaggerated pessimism about the economic outlook for the region.





Credit impulse: change in credit growth