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Asset management

Giving credit

Economist Insights

The latest round of monetary stimulus policies announced by the ECB should, in theory, be pumping ample liquidity into the system, stimulating recovery. But do increased liquidity and looser financial conditions necessarily equate to increased borrowing? The evidence suggests not. Is it that firms have more attractive alternatives open to them, or might they simply be sceptical about the economic and political outlook? And what are the wider implications of their reluctance to borrow?

Joshua McCallum
Head of Fixed Income Economics
UBS Asset Management
joshua.mccallum@ubs.com

Gianluca Moretti
Fixed Income Economist
UBS Asset Management
gianluca.moretti@ubs.com

There is an old saying that you can lead a horse to water but you can't make it drink. The European Central Bank (ECB) is now finding that you can lead a firm (or household) to liquidity but you can't make it borrow.

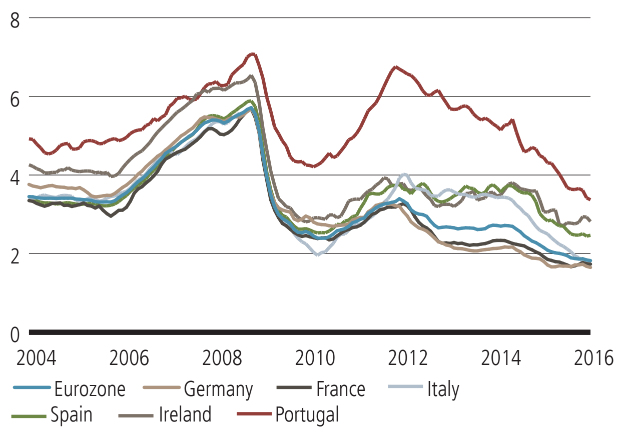
The ECB has to be given credit for having delivered a quite comprehensive package of measures to stimulate the recovery in the Eurozone and to boost domestic inflationary pressures. In particular, the ECB itself is supplying credit, in the form of a new version of the Targeted Long-Term Refinancing Operations (new TLTRO). This has the potential to significantly expand the ECB balance sheet (see *Hot potato*, 14 March 2016) and in theory should inject plenty of liquidity into the system.

That's the theory. In reality, not only will the ECB find it difficult to get firms to borrow, it may well find it difficult to get banks to actually provide the extra liquidity. Thus far, banks have been willing to lend to households for house purchases in particular. However, what matters for the ECB at this point in the recovery is providing loans to financial corporations which are designed more to facilitate investment spending. On the one hand, the ECB does not want to fuel a housing bubble by boosting mortgages, while on the other hand business investment provides a greater boost to potential growth than housing construction. For these reasons, lending for house purchases has not been deemed eligible for the new TLTRO.

On the surface, it appears that banks have become more willing to lend to non-financial corporations. Or, at least, it has become cheaper for such firms to borrow. The various measures introduced since the height of the sovereign crisis have managed to bring down borrowing costs in the Eurozone quite remarkably (chart 1). In many countries, it has never been cheaper for firms to borrow since the EURO was introduced.

Chart 1: Rate discount

Lending rates for new loans to the non-financial corporations (%, 3 month moving average)

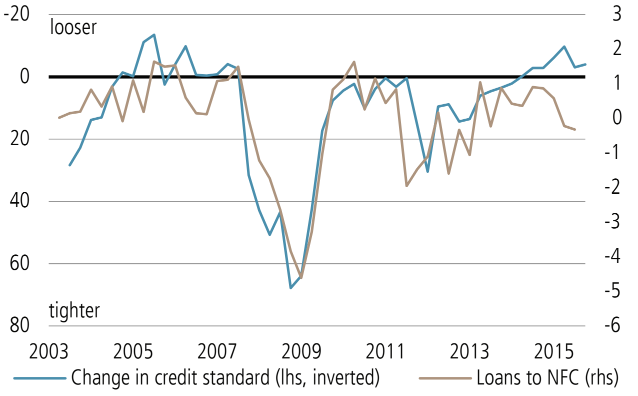


Source: European Central Bank

Yet a drop in borrowing costs does not necessarily imply stronger credit creation. Even if the ECB has been successful in increasing the supply of credit, demand for the loans could be lower. That would force banks to keep interest on loans low as they compete to supply credit to a limited number of firms. Unfortunately, this appears to be a pretty accurate description of the Eurozone situation. The ECB's Bank Lending Survey (BLS) shows that banks have become less strict with their credit standards since the events of 2012, and initially this helped to support a stabilisation of loan growth (chart 2). But the recent outright loosening of financial conditions has in fact been met with slowing loan growth.

Chart 2: Missing credit

ECB Bank Lending Survey change in credit standard to firms (net percentage, 2 quarter lead) and change in loans to non-financial corporations (EUR billions, 3 quarters moving average)



Source: ECB, UBS Asset Management

So the recent increase in supply (easier conditions) was not met by stronger demand from non-financial corporates. The hard numbers actually contradict the BLS results, where banks say that demand for their loans has picked up, and should pick up even more in the future. It would appear that banks are better at judging their own credit conditions than they are at judging demand amongst their customers: the demand survey has historically been a poor predictor of loan growth. Banks are routinely too optimistic about loan growth.

So the ECB and the banks have provided the liquidity; why don't firms want to borrow? There are a few reasons why firms may not have taken advantage of the improved financial conditions. The first could be that larger firms prefer to finance themselves in capital markets, rather than through banks. The cost and terms of corporate bond issuance may well be more attractive than bank lending. Most of the growth in corporate debt is located in the core countries, where ultra-low or even negative government bond yields have pushed some corporate bond yields below bank interest rates. Since this is also where most of the extra liquidity in the Eurozone has ended up, corporate bonds then become a much more attractive investment opportunity.

The second reason why firms may not want to borrow is more straightforward: pessimism about the current economic and political environment. Although consumer spending has benefited from lower oil prices, the recovery in the Eurozone has remained fragile. Weakness in emerging markets means that external demand is not going to encourage firms to invest. On top of this economic uncertainty, the political situation is characterised by weak political leadership and fragmented parliaments. No surprise then that firms are reluctant to borrow more.

Nonetheless, you could still see a relatively large bank participation in the new TLTRO without an accompanying acceleration in lending. The conditions set by the ECB to access the zero or negative interest rates are relatively easy. So it should not be surprising if banks decide to refinance some of their current loan books using the TLTRO in place of market funding.

The ECB seems to be aware of the potentially limited impact on growth from the new TLTRO. This was reflected in its latest ECB forecasts. Despite the potential impact that the TLTRO could have on the its balance sheet, the ECB has nevertheless revised down its outlook for business investment in its last macroeconomic projections. So the forecasters at the ECB at least understand that increasing liquidity is not the same thing as increasing borrowing.

This acceptance of the policy limitations is reflected in the design of the new TLTRO. While it tries to incentivise banks to lend more, it does not penalise them if firms do not want to borrow. If there is a credit demand problem in the Eurozone, then making the holding of reserves punitively expensive in order to force banks to lend is not the right solution. It would be like throwing your horse into the water because it does not want to drink. You might make it drink, but you also might make it drown.