

Europe: How big will the interest rate shock be in 2023?

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EXECUTIVE SUMMARY



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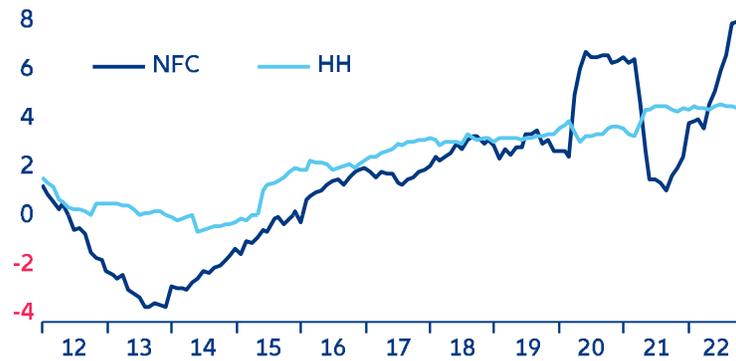
- Against the background of rising interest rates and a worsening economic outlook, still favorable credit dynamics in the Eurozone are unlikely to last for much longer. After a year of stabilizing lending standards, banks have become significantly more risk averse. Credit standards are likely to tighten further as banks' declining risk tolerance, the higher cost of funds and balance-sheet constraints will affect credit supply over the next few months. The extent of net tightening is similar to levels recorded during the early stages of the Covid-19 crisis in 2020.
- For companies, we expect an average increase in interest rates by +200bps in the first half of 2023. Looking ahead, the rise in non-financial corporates' financial debt to new records in absolute terms, combined with the global tightening of financial conditions, are set to intensify interest expenses and to add to companies' costs. We forecast that further increases in the policy rate would raise average interest rates for corporates by an additional 200bps by mid-2023, which in turn will cut firms' margins by more than -3pps. Italy, Spain and France are most at risk. However, note that more than 50% of corporate loans increased their maturity to above five years, with less than 20% below one year.
- For households, the interest rate pass-through is likely to reach 210bps on average. This shock could be partially compensated by excess savings related to Covid-19 and precaution. Looking at the share of loans at variable rates (i.e. less than 10% of total loans against close to 40% before 2012), we estimate that the loss in terms of Eurozone household purchasing power will stand at -1pp on average, equivalent to close to EUR500 per household. Interest expenditures in 2023 would represent around 20% to 30% of total post-Covid savings in Germany and France, 45% in Italy and more than 50% in Spain. Overall, despite a high inflation rate, the velocity of broad money remains well below its pre-Covid level, which means that the bulk of the increase in money supply has been absorbed by a higher demand for precautionary balances (i.e. money that does not change hands, as opposed to transactions balances).

Eurozone credit demand has remained strong, but banks are getting worried.

Despite rising interest rates and a deteriorating economic outlook, credit dynamics have remained favorable in the Eurozone - but not for good reasons (Figures 1-5). Overall annual credit growth to the private sector averaged at +5.7% in September. Lending remained particularly strong for firms (at +8.9% y/y in September), especially for shorter maturities as surging energy and raw material prices increased companies' working capital requirements. Conversely, loan demand by firms over the longer term has markedly slowed as uncertainty about the energy crisis and the potential for renewed supply-chain disruptions have dented

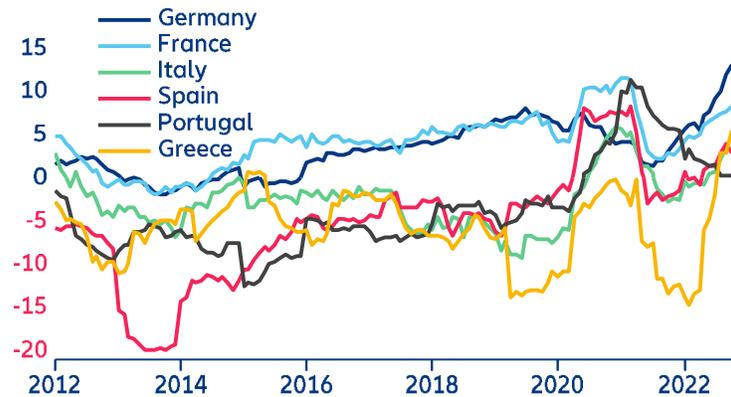
business prospects. Declining business confidence has also dampened firms' net demand for loans to finance investments. At the same time, declining consumer confidence and a softening housing market have weighed on household borrowing during the last quarter.

Figure 1: Eurozone – credit growth to private sector (y/y %)



Sources: Refinitiv, Allianz Research

Figure 2: Eurozone – credit growth to non-financial corporations (y/y %, by country)



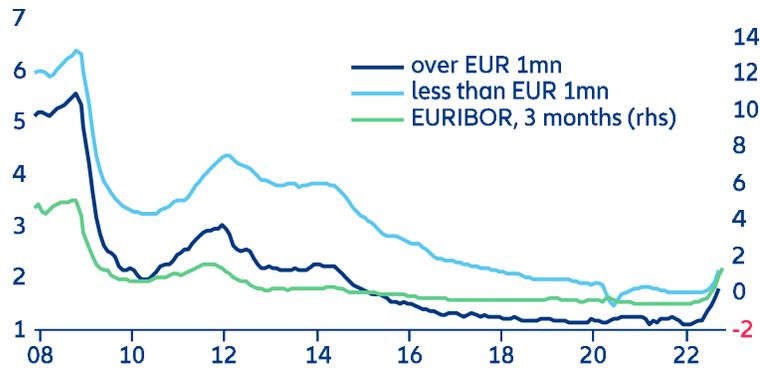
Sources: Refinitiv, Allianz Research

Figure 3: Eurozone – credit growth to non-financial corporates (y/y %, by maturity)



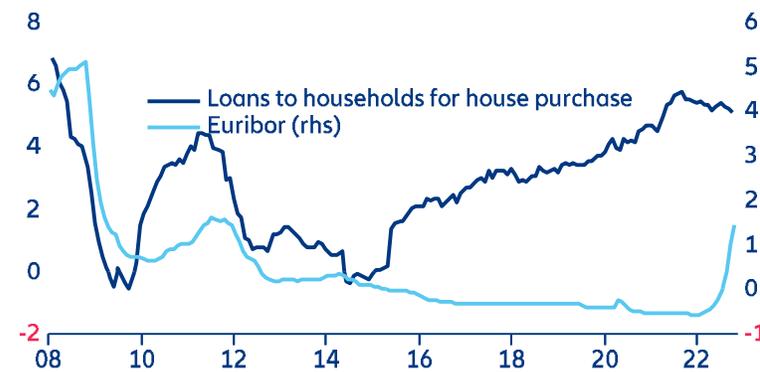
Sources: Refinitiv, Allianz Research

Figure 4: Eurozone – lending rates for new loans to non-financial corporates (y/y %, by size)



Sources: Refinitiv, Allianz Research

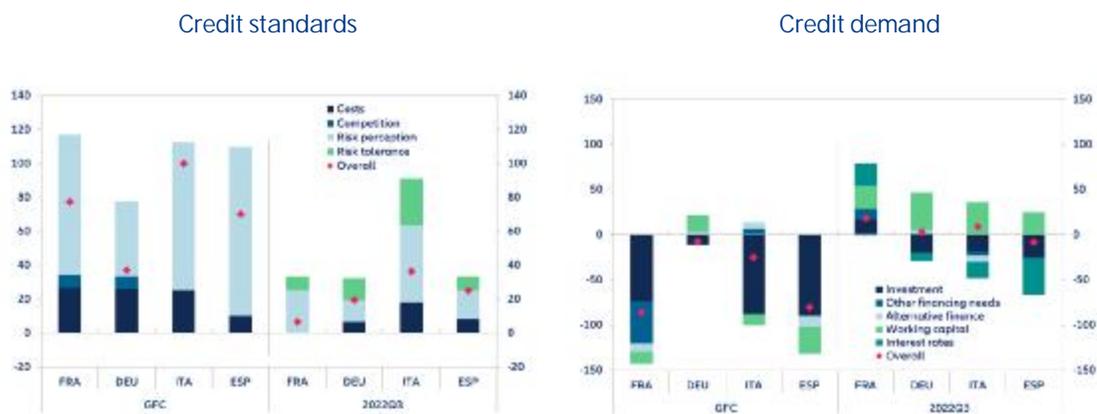
Figure 5: Eurozone – credit growth to households for house purchases (y/y %) vs. money market rate



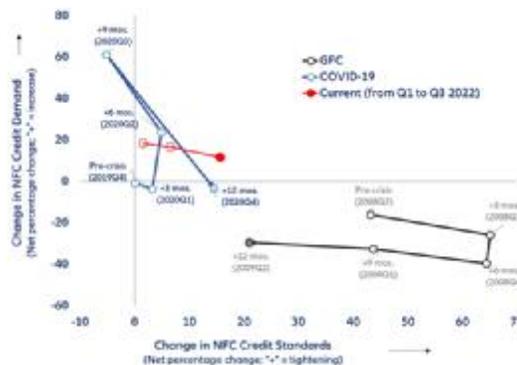
Sources: Refinitiv, Allianz Research

According to the ECB's latest Bank Lending Survey, after a year of stabilizing lending standards, banks have become significantly more risk averse. Higher interest rates have increased the cost of funds and balance sheet constraints, leading banks to considerably tighten credit standards (i.e. internal guidelines or loan approval criteria) in Q3 2022. Looking ahead, credit standards are likely to tighten even further this quarter, and banks' declining risk tolerance, the higher cost of funds and balance-sheet constraints will affect credit supply to firms and households alike over the next months. The extent of net tightening is similar to levels recorded during the early stages of the Covid-19 crisis in 2020. However, compared to the aftermath of the global financial crisis (GFC), there is still no credit crunch (Figure 6).

Figure 6: Eurozone – change in credit standards and demand (ECB Bank Lending Survey)



Credit standards vs. credit demand

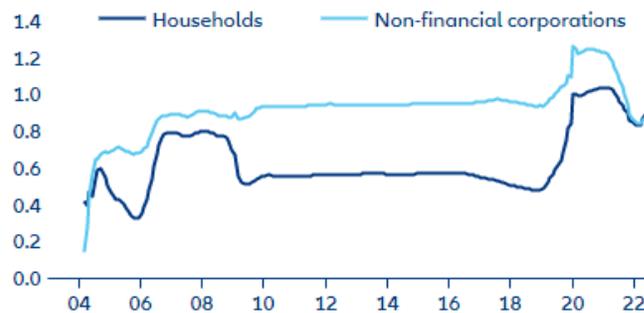


Sources: ECB, Refinitiv, Allianz Research. Note: GFC=global financial crisis (2009 Q1). Changes in credit standards (+ = tightening) during the respective quarter based on net percentages calculated as the difference between banks seeing tightening versus easing credit standards. Contributing factors do not add up to the overall assessment of credit standards. In each country, the GFC episode refers to the quarter in which credit standards peaked. Changes in credit demand (+ = increase) during the respective quarter based on net percentages calculated as the difference between banks seeing increasing versus decreasing demand. Contributing factors do not add up to the overall assessment of demand conditions. In each country, the GFC episode refers to the quarter in which credit demand troughed.

The interest rate shock is still ahead of us in Europe: an average increase of 200bps for corporates and households in H1 2023

For corporates, the pass-through between market and bank interest rates has historically been stronger than that for households (Figure 8).¹ In most countries, the pass-through is also greater for smaller loans (up to EUR1mn). Our analysis shows that the sensitivity of business loans to rises in the policy rate was equal to one after the GFC, while for household loans the sensitivity was around 0.5-0.6.

Figure 7: Eurozone—sensitivity of lending rates for non-financial corporations (NFC) and households (HH) to changes in the policy rate (10y rolling estimate)



Sources: Refinitiv, Allianz Research

Asset quality concerns may resurface soon. Significant fiscal support amid the energy crisis continues to significantly suppress defaults. Nonetheless, corporate insolvencies are already rising² and crisis-related scarring effects are challenging firms in heavily affected sectors. Larger firms with market access have mostly covered their refinancing needs until next year, which makes them less sensitive to tightening financing conditions. Sizable cash buffers (+32% above end-2019 levels as of September) will also help prevent immediate liquidity stress—but only if the recession proves moderate and short-lived, and if energy prices do not rise much further. As a result, we expect insolvencies to rise during the next few months and surpass pre-pandemic levels in early 2023, after which they will accelerate (+19% at the global level, +5pps compared to Q2). We estimate that current state support measures are reducing the rise in insolvencies by -12pps (or saving 2,600 firms) over 2022 and 2023.

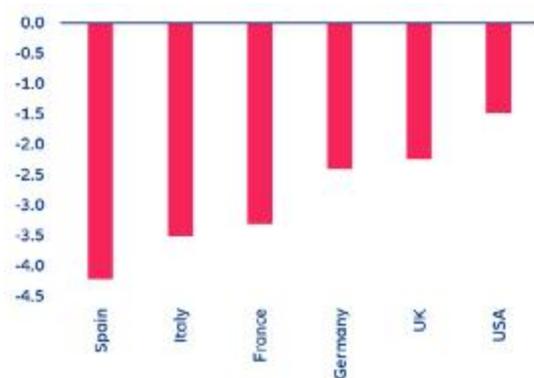
In 2023, further rate increases will raise financing costs for corporates: We expect an increase of bank loan rates of 200bps that could dent margins by -3pps in the Eurozone, with Italy, Spain and France most affected (Figure 8). Looking ahead, the rise in NFC financial debt to new records in absolute terms, combined with the global tightening of financial conditions, are set to intensify interest expenses and to add to companies' costs. This poses a risk to lower-rated and highly leveraged firms. The interest-expenses coverage has already dropped noticeably in the Eurozone over the last quarters, down from 5.6 in Q3 2021 to 3.2 in Q2 2022. We forecast that further increases in the policy rate would raise average interest rates for corporates by an additional 200bps by mid-2023, which in turn will cut firms' margins by more than -3pps. Italy,

¹ corporate rates tend to be higher on average, given the lower recovery rate and shorter duration compared to residential mortgages.

² See our report ["Energy crisis, interest rates shock and untampered recession could trigger a wave of bankruptcies"](#)

Spain and France are most at risk. However, note that more than 50% of corporate loans increased their maturity to above five years, with less than 20% below one year.

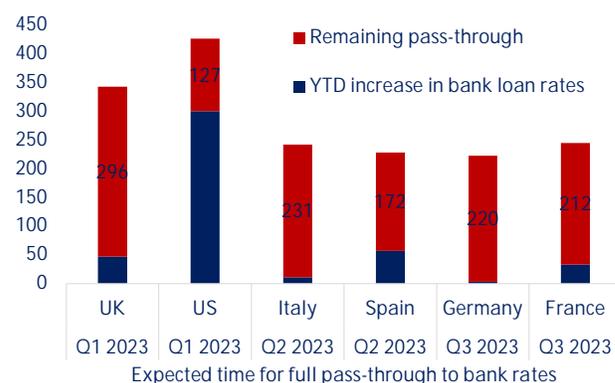
Figure 8: Loss in margin considering the pass-through of rising interest rates (+200bp), in pp of value-added



Sources: Eurostat, ONS, Refinitiv, Allianz Research

For households, the remaining interest rate pass-through averages about 2pps. In our previous report³, we showed that fiscal support measures are softening the blow of high energy prices on households' purchasing power, saving domestic demand equivalent to 1.7% of GDP on average (more than EUR1,300 per household). But the interest rate shock is looming, likely to materialize in 2023 as the average pass-through from the policy rate to bank rates ranges between four months in Italy and Spain and up to six months in Germany and France, and we expect a peak in key interest rates in Q1 2023. Looking at the share of loans at variable rates (i.e. less than 10% of total loans, against close to 40% pre-2012), we estimate that the loss in terms of households' purchasing power will average -1pp (Figures 9-12).

Figure 9: Pass-through from rising key interest rates to household bank loan rates (in bp) and timing



Sources: Eurostat, ONS, Refinitiv, Allianz Research

Households' savings post Covid-19 can still compensate for part of the interest rate shock, but this seems less likely in Spain. We examine Eurozone household savings accumulated

³ See our report: ['Whatever it takes' reloaded? Europe's fiscal response to the energy crisis](#)

since 2020 to understand the size of the remaining buffers. In the first half of 2022, excess savings dropped by around -7% on average, compared to end-2021, but remain at EUR448bn. For our panel, interest expenditures in 2023 would represent around 20% to 30% of total excess savings in Germany and France, 45% in Italy and more than 50% in Spain (Figure 12).

Figure 10: Expected average bank loan interest rates for households in 2023

	2008	Actual	Taking into account remaining pass-through
Germany	4.3%	2.1%	4.3%
France	4.7%	1.7%	3.9%
Italy	4.7%	2.7%	5.0%
Spain	4.5%	2.5%	4.2%
UK	6.5%	2.6%	5.6%
US	4.4%	2.6%	3.9%

Sources: ECB, BoE, ONS, Fred St Louis, Refinitiv, Allianz Research

Figure 11: Expected increase in interest expenditures based on expectations for bank loan interest rates for households in 2023

	Interest expenditures if share of loans at variable rates remains stable			Interest expenditures if the share of loans at variable rates goes back to pre zeronomics		
	pp of disposable income		LCU/household	pp of disposable income		LCU/household
	Actual	Taking into account remaining pass-through on rates		Taking into account remaining pass-through on rates		
Germany	0.6	1.0	584	1.3	746	
France	0.7	0.8	415	1.1	580	
Italy	0.1	0.7	325	2.6	1249	
Spain	0.4	1.4	580	3.5	1489	
UK	3.4	3.8	2014	6.6	3472	
US	3.9	4.5	6268	5.7	7886	

Sources: ECB, BoE, ONS, Fred St Louis, Refinitiv, Allianz Research

Figure 12: Households' remaining savings post Covid-19 vs interest expenditures

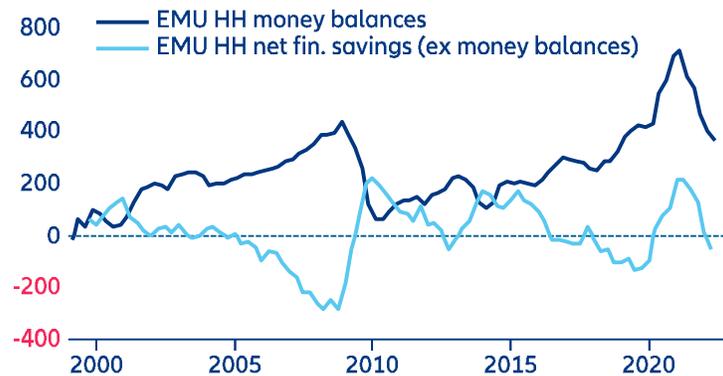
	Interest expenditures in 2023 (LCUbn)	Remaining households' savings post Covid (LCUbn*)	Share of total excess savings
Germany	30	110	27%
France	17	70	25%
Italy	31	68	45%
Spain	30	58	51%
UK	93	144	65%
US	1084	4704	23%

Sources: Eurostat, ONS, BLS, national sources, Refinitiv, Allianz Research

However, most excess savings are due to hoarding and are not a sign of resilience. Overall, despite the high inflation rate, the velocity of broad money remains well below its pre-Covid-19 level, which means that the bulk of the increase in the money supply has been absorbed by an increased demand for precautionary balances (i.e. money that does not change hands, as

opposed to transactions balances). The question is whether this increase in hoarding is temporary or permanent. Uncertainty linked to the pandemic and the war in Ukraine may have a stronger impact on money velocity than inflation and inflation expectations. Both in the US and in the Eurozone, households' net financial saving (which considers hoarding by netting out money balances minus debt) is now negative, though not as much as before the GFC. This could be considered a sign of households' vulnerability - households seem to prefer accumulating money balances as a precaution rather than investing (Figure 13).

Figure 13: Eurozone-household money balances and net financial savings. EUR bn, 4Q cum. flows.



Sources: Refinitiv, Allianz Research

Declining money growth sets the stage for abating inflation pressures and slower rate hikes.

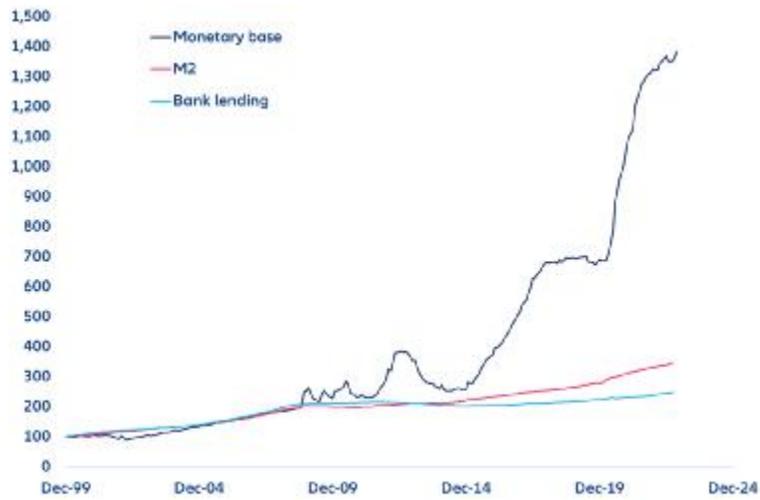
With Eurozone headline inflation reaching record levels in October (10.6% y/y), the ECB should justifiably focus on keeping inflation expectations from becoming de-anchored. However, as banks' rising risk aversion causes credit conditions to tighten further, lower money demand should be disinflationary, with the Eurozone registering a declining contribution to global money growth (Figures 14 and 15). During the last two quarters, velocity has remained almost unchanged. In fact, much like in other large economies, base money is growing faster than broad money, which in turn grows much faster than bank lending to the private sector. In this context, one can say that central banks have been and still are pushing on a string. Thus, the Governing Council might consider slowing the pace and reduce the scale of interest rate hikes. However, we still expect an increase of the ECB policy rates by at least 50bps at the next meeting in December, with a downside risk of 75bps if the November inflation print indicates that inflationary pressures have yet to peak.

Figure 14: Contribution to global money growth (by country)



Sources: Refinitiv, Allianz Research

Figure 15: Eurozone—monetary base, M2 money aggregate, and bank lending



Sources: Refinitiv, Allianz Research

These assessments are, as always, subject to the disclaimer provided below.

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