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EUROZONE

Lending figures give green light for ECB exit

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Ultra-loose monetary policy is not only unwarranted given the healthy economy, today's bank lending survey results also argue in favor of a normalization of monetary policy. However, as the euro exchange rate and the eurozone bond market react sensitively to small tweaks to ECB communication, the Governing Council will continue to tread softly and there will be no major changes at this Thursday's meeting.

The results of the bank lending survey released today show a healthy backdrop for lending in every respect: in the second quarter banks eased their credit standards for enterprises further (they remain well below the historical average), with a further easing expected in the current quarter. Demand for loans to enterprises rose further and banks expect the increase to continue. Credit standards for households for house purchase were also eased further in Q2, with this trend expected to continue in Q3. Demand for housing loans has increased and banks expect it to grow further in the current quarter.

So on the lending side we are seeing positive signals for an imminent exit from expansionary monetary policy, already overdue in light of the healthy eurozone economy. However, since ECB president Draghi's statements in Sintra, the EUR/USD exchange rate and yields on 10yr German government bonds have risen substantially. According to our calculations, the bond purchasing program squeezes German long-term yields by around 80 basis points. For this reason alone, yields are set to move up further. But this will be cushioned firstly by the fact that the ECB is in no event going to reduce its presence on the market abruptly and, secondly, by the central bank's communication.

The ECB Council's balancing act lies on the one hand in not delaying decisions too long (in order not to get behind the curve), but on the other in guiding expectations (and not causing surprises) in such a way as to avoid financial market turbulence. This coming Thursday the ECB is likely to drop its QE easing bias (as was already considered at the last meeting according to the minutes). However, the main objective will be to steer expectations towards the September meeting. Together with the new staff projections, we then expect the ECB to announce a reduction in its monthly bond purchases to EUR 40bn or even 30bn from January. Regarding the tapering rhythm going forward, the ECB will be keen to maintain flexibility for as long as possible, but we expect tapering to have been concluded by the middle of next year.

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