Allianz Research

Eurozone: watch credit conditions!

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Andreas (Andy) Jobst
Head of Macroeconomic and Capital Markets Research
andreas.jobst@allianz.com

Maddalena Martini
Economist
maddalena.martini@allianz.com

Eric Barthalon
Head of Capital Markets Research
eric.barthalon@allianz.com

EXECUTIVE SUMMARY

- After the ECB hiked interest rates for the first time in over 11 years today with a surprise 50bps-hike, could sharply tightening financing conditions spark a credit crunch? While banks are in a better condition compared to the sovereign debt crisis more than a decade ago, they have already become more risk-averse. The exit from crisis support measures will further constrain their ability to lend. Most debt moratoria and public debt guarantees have been phased-out and the third installment of the ECB's TLTROs expired at the end of June, ending more than eight years of cheap access to central bank money. In this context, the private sector could face a considerable rise in funding costs, which could amplify the negative effects of inflation on consumption and investment.

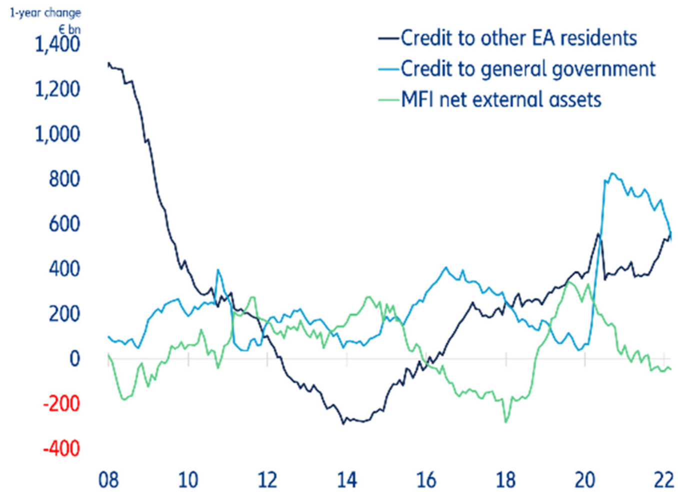
- With headline inflation reaching record levels, the ECB is understandably focused on keeping inflation expectations from de-anchoring. However, as banks' rising risk aversion cause credit growth to slow, lower money demand should be disinflationary. Thus, sharply tightening credit conditions may sway the Governing Council to soon adopt a more gradual pace of policy normalization amid rising recession risks.

Would tightening financing conditions due to rising rates cause a credit crunch?

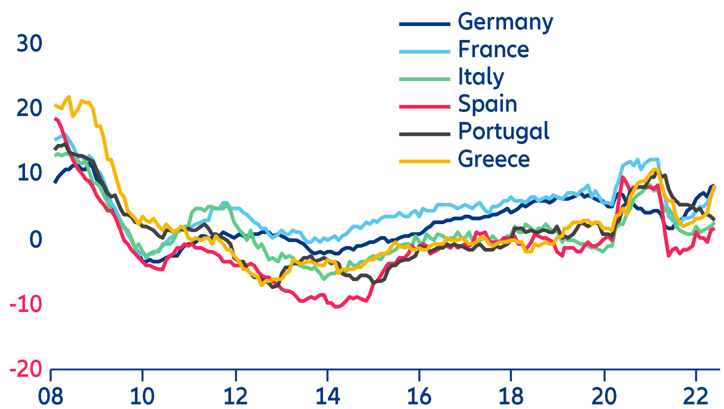
The ECB's Governing Council front-loaded its exit from negative rates and hiked its policy rates by 50bps at its meeting today. Yet, credit conditions are already starting to show the first cracks amid the deteriorating economic outlook. While the overall credit impulse has remained positive as private sector lending remains buoyant (overall credit growth reached 5.7% y/y last month, mostly driven by commercial lending), current credit dynamics seem to be explained by a rotation away from (contracting) public sector lending (Figure 1). In addition, the lending rate for new loans to SMEs (proxied by loans with a nominal amount of up to EUR1mn) relative to larger firms has declined significantly across Eurozone member countries. Lending rates have been between 1.4% and 3.8% during the first five months of 2022 (compared to between 2.7% and 7.2% during the first half of 2012 at the height of the European sovereign debt crisis).

Figure 1: Eurozone – credit growth and net external assets of monetary financial institutions (MFIs)

Change in Outstanding Credit



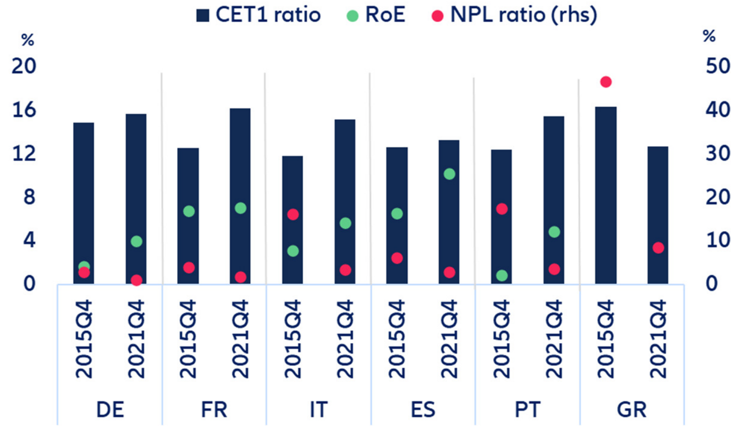
Credit Growth (y/y %)



Sources: Refinitiv, Allianz Research

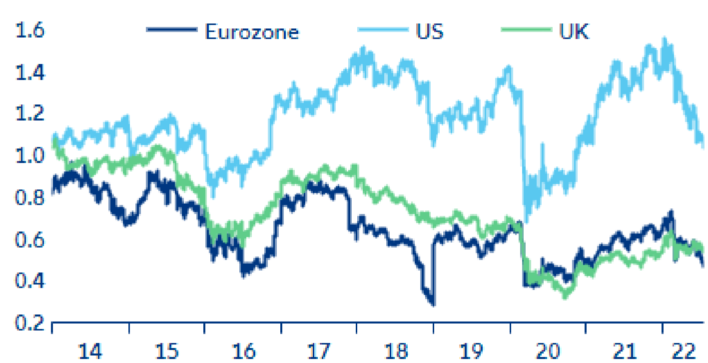
A healthier banking sector could provide the credit outlook with a safety cushion. Although profitability remains a major challenge for Eurozone banks, capital and asset quality have improved in recent years (Figure 2), thanks to harmonized and enhanced regulation and cost-efficiency efforts. The former helped banks to build up solid capital positions, with the CET1 ratio decreasing only slightly to 15.2% in Q1 2022 from 15.8% at the end of last year. Efforts to reduce the stock of non-performing loans (NPLs), especially in the Southern European countries, have proved effective, and pandemic-related relief measures prevented a significant deterioration in asset quality. In addition, an active secondary market for NPLs in Italy, Greece, and Spain allowed banks to offload impaired assets (with Greece reaching single digit ratio from the peak at 47% in 2016). Consequently, the NPLs ratio decreased from 3.2% at the end of 2019 to 1.9% in Q1 2022. Meanwhile, risky loans (classified as Stage 2) have remained broadly stable over the period (at 9.3% in Q1, with a coverage ratio of 4%). Despite significant improvements, the price-to-book ratio of Eurozone banks indicates that the challenging environment continues to weigh on valuations, which limits banks' capacity to lend due to a high cost of capital and shore up capital buffers to enhance their resilience over time (Figure 3).

Figure 2: Eurozone – bank profitability, capitalization, and asset quality (2015 vs. 2021)



Sources: Refinitiv, Allianz Research.
Note: CET1=common equity Tier 1 capital ratio. Greek banks' return on equity (RoE) was negative and has been omitted (reported at -24% in Q4 2015 and at -20% in Q4 2021).

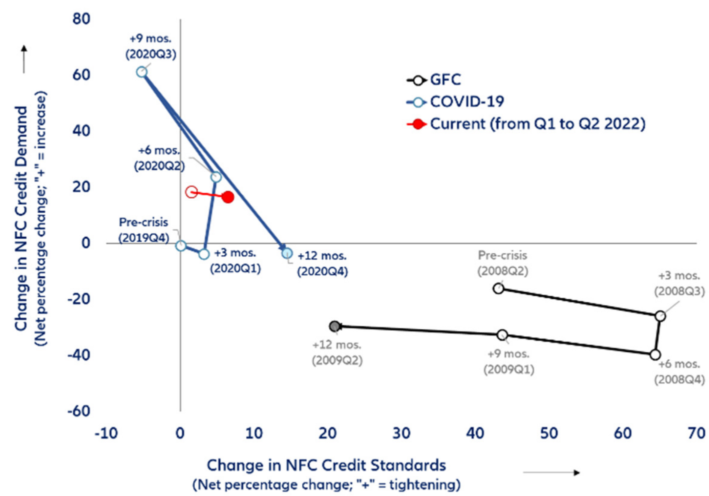
Figure 3: Comparison of price-to-book ratios of banks in the Eurozone, UK and US



Sources: Refinitiv, Allianz Research

However, according to the ECB's latest Bank Lending Survey, after a year of stabilizing lending standards, banks have become significantly more risk averse. Reporting that the normalization of monetary policy has increased the cost of funds and balance sheet constraints, they have also considerably tightened their credit standards (i.e. internal guidelines or loan approval criteria) in Q2 2022. 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 has been no credit crunch (Figure 4).

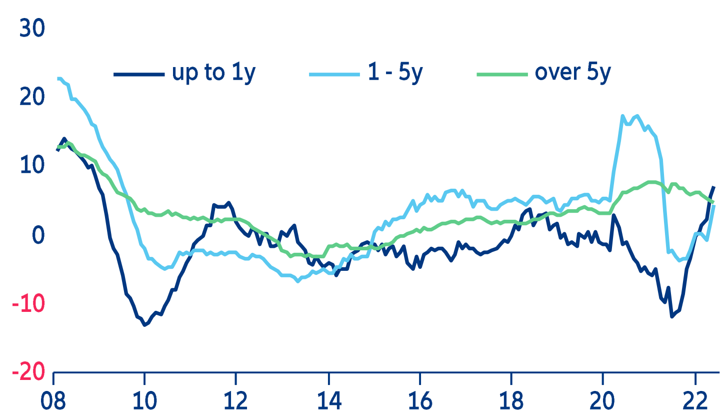
Figure 4: Eurozone – credit conditions for non-financial corporates (ECB Bank Lending Survey)



Sources: Refinitiv, Allianz Research

At the same time, net credit demand due to working capital requirements has remained strong. Firms' financing needs are likely related to surging energy and raw material prices and continuing supply-chain disruptions, which have resulted in higher borrowing at shorter maturities (Figure 5). However, declining business confidence dampened firms' net demand for loans to finance investments (Figure 6).

Figure 5: Eurozone – change of NFC credit (by maturity, percent)

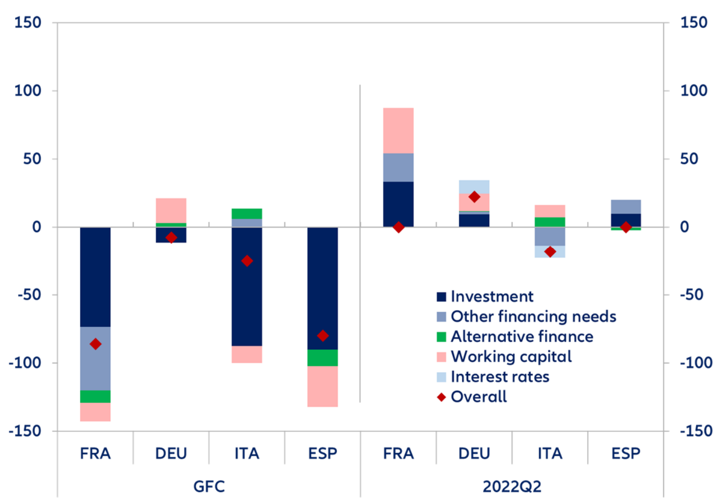


Sources: Refinitiv, Allianz Research

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

Credit Standards

Credit Demand

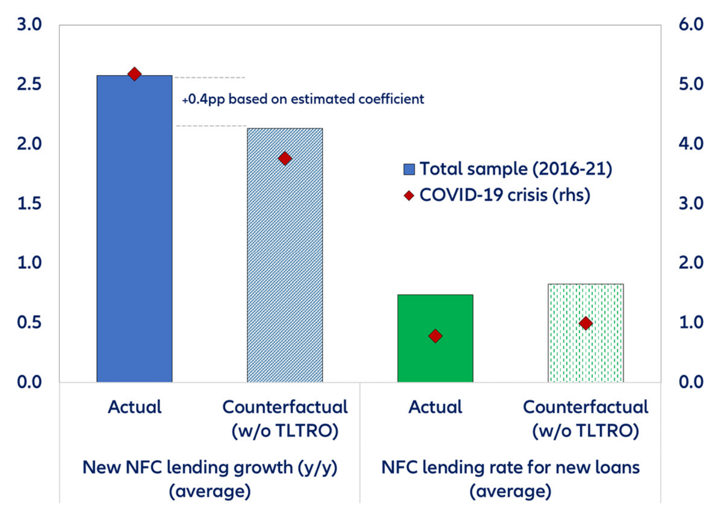


Sources: ECB, Refinitiv, Allianz Research.

Note: GFC=2009Q1. 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 exit from crisis support measures will further constrain banks' capacity to lend. While some Eurozone countries have prolonged or reinstated public guarantee schemes for corporates and support for trade credit insurance, most debt moratoria have now expired and, thus, will raise the cost of risk for banks. In addition, the third instalment of the ECB's targeted longer-term refinancing operations (TLTRO) expired at the end of June, which ends more than eight years of cheap access to central bank money for banks. TLTROs were the ECB's main tool to ensure that the lending channel operated efficiently and have undergone important changes in implementation since inception, especially during the Covid-19 crisis. In a recent IMF study, Jobst and Nguyen (forthcoming)[1] find that the take-up of TLTRO funding resulted in higher net lending to firms, especially on large loans, while the impact on lending rates was muted (and statistically insignificant) (Figure 7). However, banks' benefit from TLTRO funding is still significant, especially in countries with large borrowing amounts, such as France, Italy and Spain, but will diminish over time as repayments of the various tranches come due until end-2024.[2]

Figure 7: Eurozone – average impact of TLTRO take-up on NFC lending (percent)



Sources: ECB, Jobst and Nguyen (forthcoming), Allianz Research

What will tightening financial conditions mean for households and corporates?

For corporates, the pass-through between market and bank interest rates has historically been stronger than for households (whose rates tend to be higher on average, given the lower recovery rate of consumer loans and the longer duration of mortgages compared to shorter corporate credit lines) (Figure 8). 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 policy rate was equal to one after the GFC, while for household loans the sensitivity was around 0.5-0.6. However, since the onset of the pandemic, household lending rates have become more sensitive to changes in the policy rate; this suggests an increased sensitivity of the long end of the yield curve (which affects households) to changes in central bank rates (mostly affecting NFCs).

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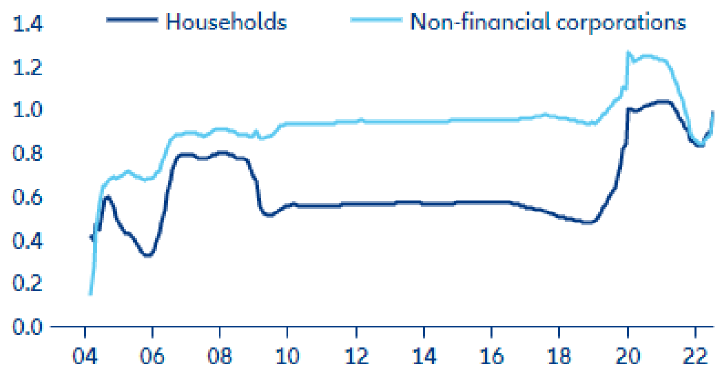
[1] See Andreas A. Jobst and Vina Nguyen, forthcoming, "The Impact of ECB's TLTROs on Bank Lending," IMF Working Paper (Washington, D.C.). They also found that impact of TLTRO take-up also depends on banking sector characteristics (capital buffer and NPL levels) and the design of TLTRO programs (favorable rates, eligible borrowing amount).
[2] The latest round of TLTRO funding carries an implicit subsidy of at least 50bps relative to the effective policy rate if banks' record positive net loan growth.

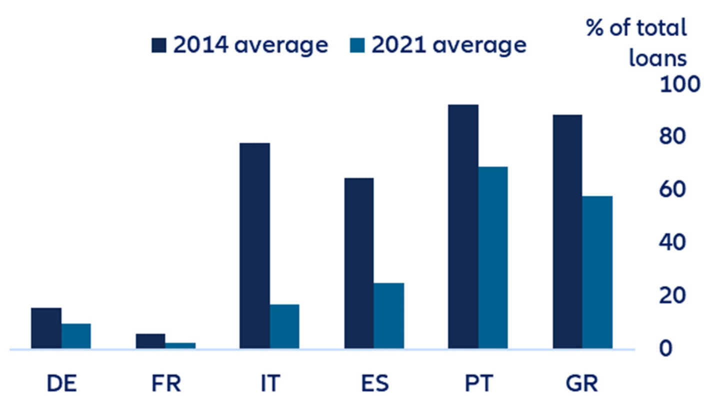
Figure 8: Eurozone—sensitivity of lending rates for non-financial corporations (NFC) and households (HH) to changes in the policy rate (10y rolling estimate)



Sources: Refinitiv, Allianz Research

As a result, credit conditions and demand for house purchases will also be affected. In particular, countries with a high share of loans at variable rates will be more impacted by rate increases (Figure 9). Despite a significant switch of mortgage borrowers to fixed rate loans, 60-70% of new loans for house purchases in Greece and Portugal are still at variable rates. To cover increased financing costs, households will likely spend some of the excess savings accumulated during the pandemic, which have started to be released in recent quarters. Indeed, the saving rate in the Eurozone decreased further to 15.7% in Q1 2022, from the peak of 20.6% reached a year before.

Figure 9: Eurozone—share of newly originated loans at variable rates



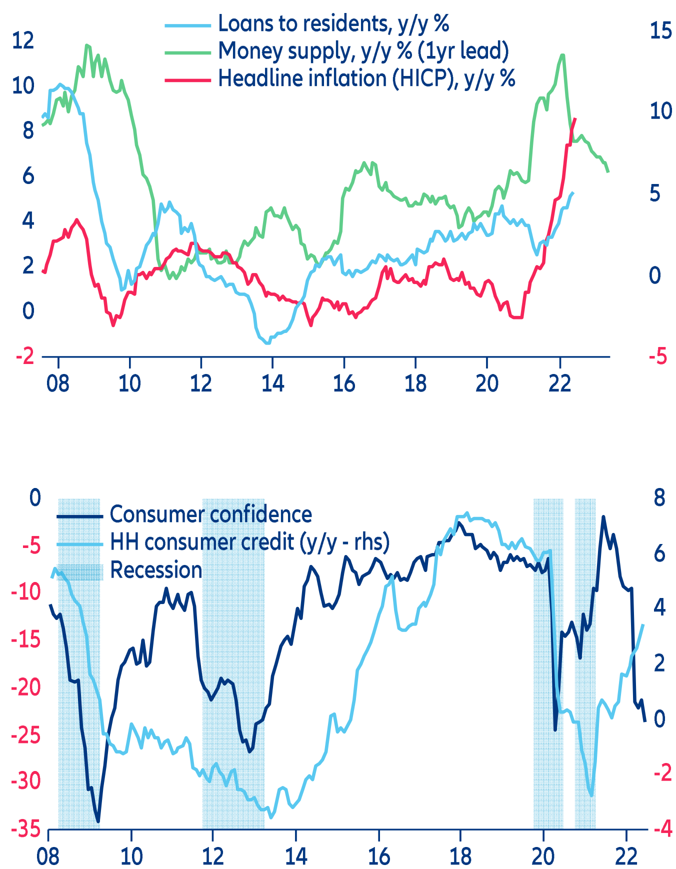
Sources: ECB, Allianz Research

When it comes to corporates, asset quality concerns may resurface soon. Corporate insolvencies are already rising as bankruptcy moratoria and public debt guarantees expire and crisis-related scarring effects challenge firms in heavily affected sectors. Larger firms with market access have mostly covered their refinancing needs over the near term already, which makes them less sensitive to tightening financing conditions. Also sizable cash buffers (up +13% in 2021 compared to 2020) can help firms absorb current price pressures—but only if growth does not slow further and energy prices do not rise much further. Thus, we expect insolvency cases to surpass pre-pandemic levels[3] this year only Spain and Greece, while in the other bloc's economies, bankruptcies are likely to be manageable.

In this context, could rising downside risks force the ECB into a policy U-turn?

With Eurozone headline inflation reaching record levels in June (8.6% y/y), the ECB should justifiably focus on keeping inflation expectations from becoming de-anchored. We expect inflation to peak this quarter (unless Russia shuts down all gas exports). At the same time, strong credit demand suggests that firms and households have started leveraging up again to cope with current price pressures (Figure 10). Yet, rising downside risks to the growth outlook might soon warrant slower monetary tightening, especially if credit growth eventually slows. As banks' rising risk aversion causes credit conditions to tighten further, lower money demand and a declining income velocity of money should be disinflationary (Figure 11). Thus, the Governing Council might soon be swayed towards adopting a more gradual pace of policy normalization amid mounting growth concerns.

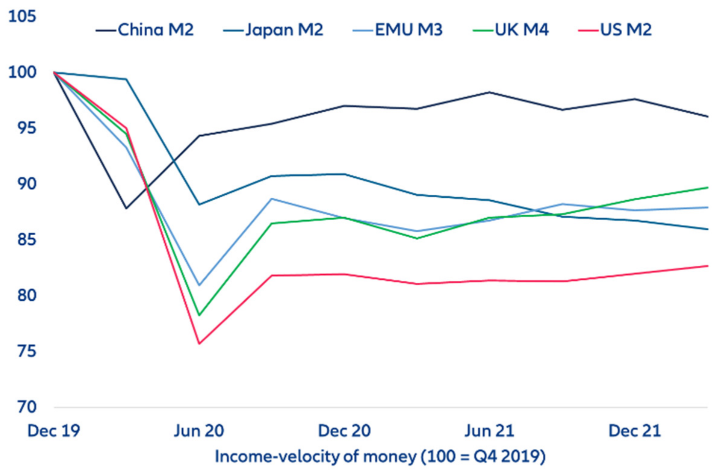
Figure 10: Eurozone – credit, consumer confidence and inflation (percent)



Sources: Refinitiv, Allianz Research

[3] Global Insolvency Report: growing risks and uneven state support

Figure 11: Income velocity of money (indexed)



Sources: Refinitiv, Allianz Research

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