Why the ECB should cut borrowing costs in periphery

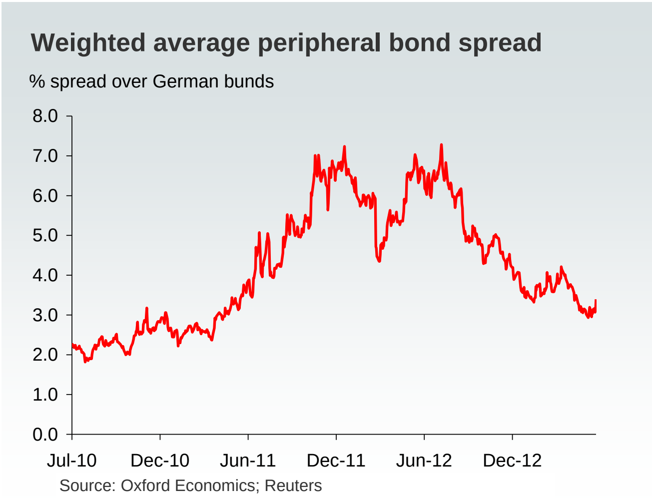
The European Central Bank has postponed any plans to introduce targeted measures to reduce the cost of borrowing for small and medium-sized businesses in the credit-starved peripheral Eurozone economies. Given the widening gap between the lower costs of borrowing for companies in Germany and France and the higher costs in the periphery, we think that there is a strong case for the ECB to take action.

Simulations using our Global Macroeconomic Model show that if half the tightening in credit conditions seen since 2008 were to be reversed within two years, Eurozone GDP would be 0.7% higher by the end of 2017 than under our baseline forecast. There would be over 400,000 fewer people unemployed. This would be particularly beneficial for peripheral Eurozone risk assets.

No new measures were announced at the European Central Bank (ECB)'s press conference, this month to reduce the cost of borrowing for small and medium-sized businesses (SMEs). Mario Draghi, the ECB's President, said that measures other than outright monetary transactions, or OMT, remain "on the shelf" for now. This is probably because the ECB's governing council neither agrees on the need for more action nor can agree on what the most appropriate action would be. The ECB does not seem to be planning any radical action to help SMEs in stressed countries like Spain and Italy gain access to cheaper borrowing.

We believe measures to reduce corporate borrowing rates in the periphery should be introduced to help ensure economic recovery

Given that corporate borrowing rates remain high in the periphery, we believe the ECB should take further steps to reduce borrowing costs for SMEs in these countries. Any measures need to be aimed at addressing the broken monetary policy transmission mechanism in the periphery, which has its origins in the fragmentation of the European banking system and financial markets. At present, low interest rates are not being passed through to the real economies in the periphery, where stimulus is most needed. Over the past year, the ECB has been successful at reducing intra-Eurozone government bond spreads, but it has been far less successful at cutting the cross-country divergence in banks' lending rates to companies, which have remained stubbornly high, despite the stabilisation of government bond markets.



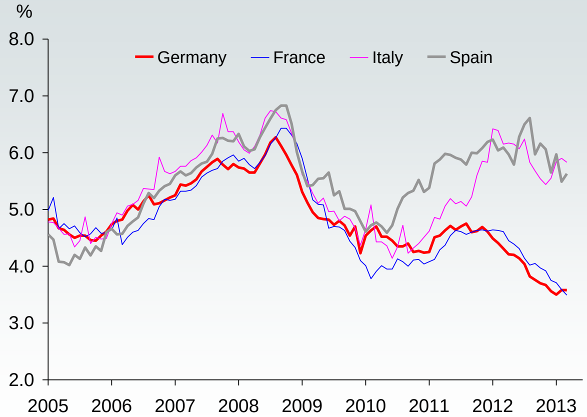
There was a clear break in 2011, when interest rates charged to businesses in peripheral countries started to diverge from rates in the core countries. Before then, companies in the periphery and the core paid similar rates of interest on bank loans. Now, Spanish and Italian companies pay over 5.5% to borrow money, but their German and French counterparts pay only around 3.5%. This fragmentation of the banking system should be the ECB's next focus.

Measures need to be targeted directly at reducing corporate borrowing rates

This problem will not be fixed by cutting interest rates again. Indeed, additional cuts in interest rates would probably mean that the deposit rate (the interest rate paid to banks for deposits with the ECB) would turn negative. This would hit banks' profits and therefore be counterproductive.

A more effective way for the ECB to ease monetary conditions would be to create new incentives for banks to lend to businesses, particularly SMEs. For example, this could be done by easing collateral rules in its liquidity operations, which would enable banks to fund their lending to SMEs more cheaply. Discussions are under way between the ECB and the European Investment Bank to help fund a European asset-backed securities market for loans to SMEs. Unfortunately, at this month's press conference, Mr Draghi told us that this is a "medium to long-term proposition".

Typical interest rates on loans to businesses



Source: Haver Analytics

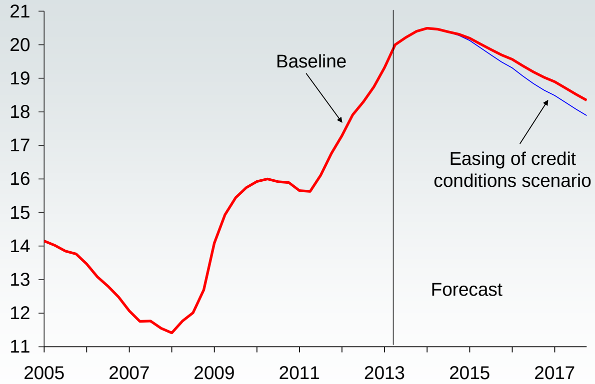
Easing credit constrains would provide a meaningful boost to the economy…

Although early moves on this front appear unlikely, we think that easier and broader-based access to finance for SMEs could be a significant factor in securing the recovery of the Eurozone economy. At present, many small companies have to rely on retained profits or borrowing from banks if they wish to expand by investing in new machinery or hiring additional workers. Small companies tend not to have direct access to financial markets. Consequently, weakness in bank lending hits them much harder than it does large enterprises. Therefore, any measure that is successful in bringing down lending rates to SMEs should boost business investment, the labour market and hence the broader economy.

Impact of Halving Credit Constraints in the Eurozone
(Percenatge chnages from baseline forecast, unless otherwise specified)

	Private Consump.	Fixed Invest.	GDP	Industrial Output	Unemp. (thous.)	Employm.	Average Earnings	Consumer Prices	3-month Rates (ppts)	Exchange Rate ($/Euro)	Current Account (% GDP)	Govt. Balance (% GDP)
2013	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2014	0.1	0.0	0.0	0.0	-10.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2015	0.6	0.5	0.3	0.3	-138.6	0.1	0.1	0.0	0.3	0.4	-0.1	0.1
2016	1.3	1.1	0.6	0.6	-323.4	0.2	0.5	0.2	0.8	1.1	-0.3	0.3
2017	1.6	1.3	0.7	0.5	-432.7	0.3	0.9	0.6	1.2	1.3	-0.4	0.4

For example, if half the tightening in credit conditions that has occurred since 2008 were to be reversed within two years, investment would be 1.3% higher by 2017 than under our baseline forecast. In addition, reflecting over 400,000 fewer unemployed by the end of 2017 and 0.9% higher average earnings, consumer spending would be 1.6% higher as well. The overall impact on the economy would be sufficient to raise Eurozone GDP by 0.7% (around €65bn) by 2017. The "cost" of this increase in GDP is a 0.6% rise in the level of prices by 2017; but given that Eurozone inflation is just 1.4% at present, that does not seem a concern.



Source: Oxford Economics

…and be beneficial for peripheral Eurozone risk assets

By boosting the economy, and eventually profits, an easing of credit conditions would be a positive for the Eurozone equity market, particularly the peripheral markets where it would have the most impact on the economic outlook. In addition by providing stimulus to the peripheral Eurozone economies it would help their public finances and reduce the yields on their government bonds relative to our baseline forecast. This would narrow spreads over German bunds, and the gap would be reduced further by rising German bond yields as investors became more confident and markets priced in a faster pace of policy tightening by the ECB. Under this scenario, three-month interest rates would be 2% by the end of 2017, 120 bps higher than under our baseline scenario.

Watch out for:

Indications that credit conditions are easing may come from:

- suggestions in ECB announcements that a policy aimed at easing credit conditions in the periphery is in the pipeline
- surprises on the upside or downside to subsequent employment data
- signs of an actual easing of credit conditions should show up in the spread between the borrowing rates paid by households and companies in the periphery and those in the core and in the ECB lending surveys.

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