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MORNING BRIEFING

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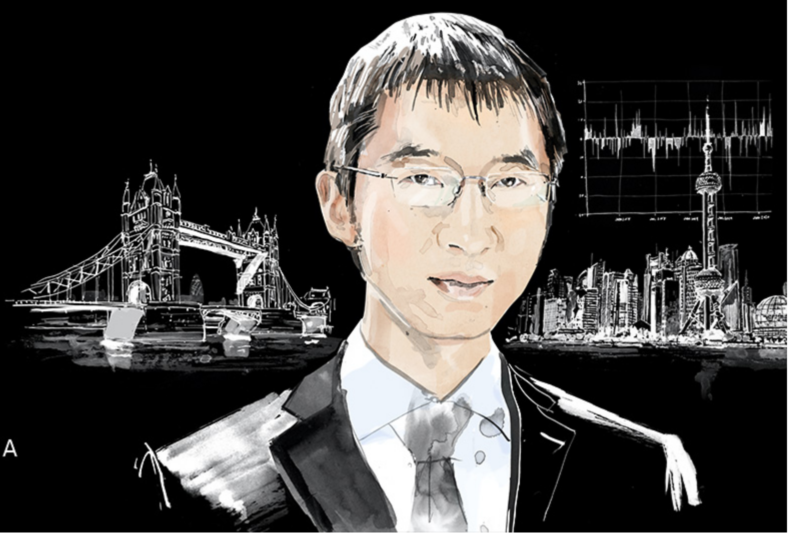


December 1, 2023

Credit Impulse Weakness To Pressure ECB

Material downside surprises in November CPIs for Germany and the Eurozone will likely be looked on by the European Central Bank as signs that its current policy stance is working. Like many peers globally, ECB officials in recent weeks have also warned that financial conditions are loosening disproportionately to inflation risk, so some offsetting communication or outright action is needed. This is perhaps justified from the Federal Reserve and Bank of England, but the inflation and price outlooks led by services economies are materially different from the Eurozone's manufacturing weakness. It was only going to be a matter of time before the highest value-added segment of the Eurozone economy suffered enough demand destruction such that services demand would also start to respond, leaving the labour market prone to adjust sharply lower as a result. Even public sector-based demand growth is now in question due to the budget ruling by the Constitutional Court.

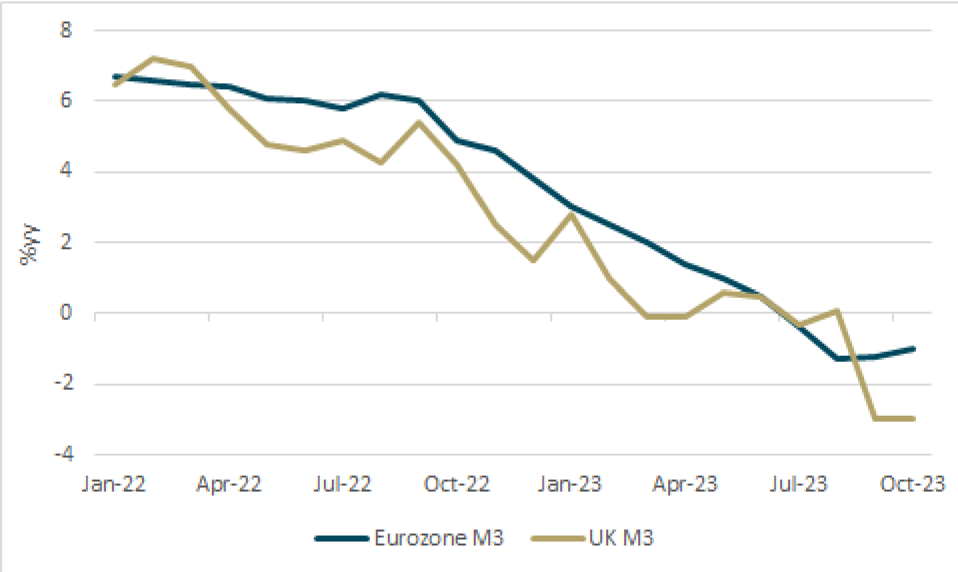
We believe the ECB will need to start executing a shift in its communication very soon. Mathematically, the December forecasts will likely show a clear path towards inflation moving back to target next year. Due to the lag in transmission – during both phases of a monetary policy cycle – early easing is needed, in our view.

The first phase of a change in communication would be to cease expressing concerns that financial conditions are still not tight enough. Leaving data aside, the ECB should acknowledge that the recent run-up in the euro alone represents an effective tightening in financial conditions. Considering that pass-through is much more relevant (even immediate) for Eurozone inflation compared to other aspects such as interest rates and credit spreads, we think the case for the ECB to remain 'synchronised' with other G10 central banks is weak. Furthermore, due to high export exposures in European corporates, a stronger euro also indirectly tightens financial conditions through the equity earnings channel.

If the ECB needed additional evidence that financial conditions could now be too tight, realised credit data may provide the strongest case. Based on Bloomberg calculations, the Eurozone credit impulse fell to below US levels in July and, despite recovering slightly in Q4, remains deeply negative. Looking at broad money indicators, M3 in both the Eurozone and UK is now materially negative and may need to remain so for an extended period for central banks to start thinking about changing bias. Even so, it is the distribution of credit relative to its importance in economic growth that will start to generate commensurate divergence.

As the UK is a services-based economy with high household debt levels due to mortgages, the drivers of credit dynamics will skew to the household. In the Eurozone the skew will be to corporates, especially manufacturers which deliver the highest value-added growth to the economy. However, inflation in both the UK and Eurozone is being driven by sticky services demand. In this respect, tightening in financial conditions is ‘healthier’ in the UK compared to the Eurozone because it is helping the central bank realise inflation objectives.

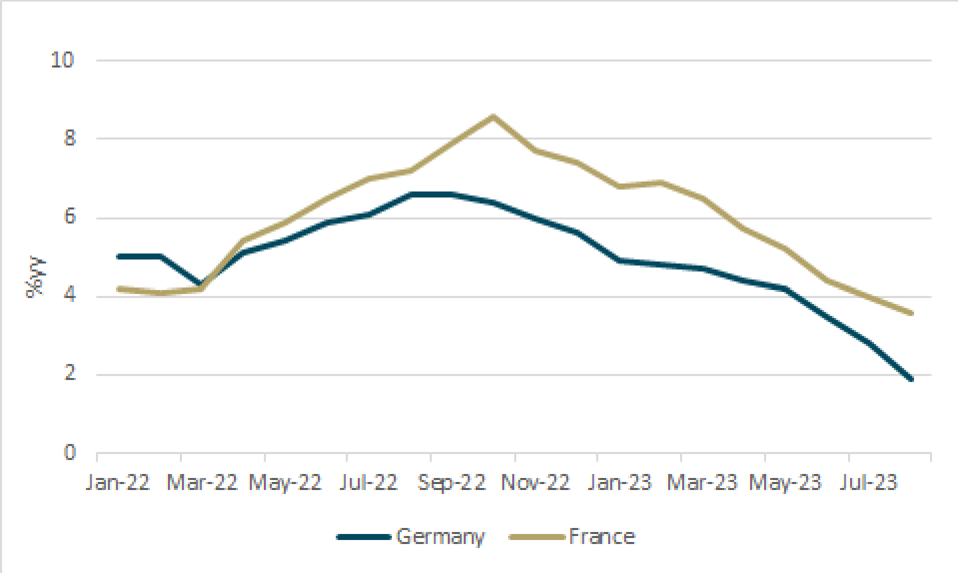
UK & Eurozone M3 Growth



Source: Bloomberg, BNY Mellon

Below we show that annualised loan growth to non-financial corporates in Germany and France has fallen sharply through this year. While still positive, these are the lowest levels since the recovery phase. The fact that the ECB is limiting declines in base money due to the reinvestment programme of public-sector securities means that the money multiplier is falling at pace for core economies in the region. Considering current policy guidance and communication, the level of loan growth – most likely negative in real terms – does not point to corporates responding to any easing in financial conditions at all. If this is the case for ‘core Eurozone’ economies, then for ‘non-core’ or the periphery which attracts a higher spread, accessing credit will be even more costly and money multipliers likely even lower.

Lending To Non-Financial Corporates

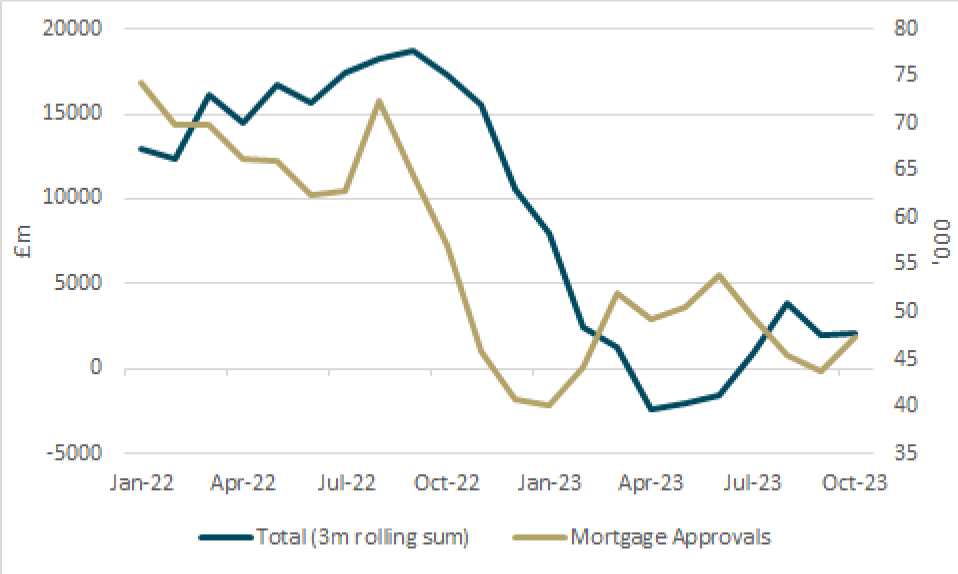


Source: Bloomberg, BNY Mellon

The ECB can plausibly make the case that it is targeting the household with its current policy stance, and that falling loan growth to corporates is either collateral damage or will lead to indirect transmission into weaker household cashflow through lower wage growth. Unlike the UK, there is generally lower susceptibility to mortgage debt and debt servicing ratios are lower in the Eurozone. On a relative basis, however, we believe that credit divergence between the Eurozone and the UK will only continue, and that this will be reflected in policy differentials between the BoE and ECB, and ultimately in EURGBP.

The latest mortgage approval figures in the UK finally point to some stabilisation in the housing market. As we can see below, net lending secured on dwellings has ceased to decline while mortgage approvals have stabilised in a new range. The divergence in trends between the two earlier this year suggested that prospective buyers offered lower loan-to-value ratios (LTVs) to limit interest costs. As mortgage costs have declined, the need to incrementally lower LTVs has also fallen, and this is despite the BoE maintaining a hawkish stance, which is likely to extend. While not directly applicable to the Eurozone, transmission mechanisms are never linear but credit impulse in core economic segments is the best signal for the trajectories of growth and prices.

UK Mortgage Lending And Approvals

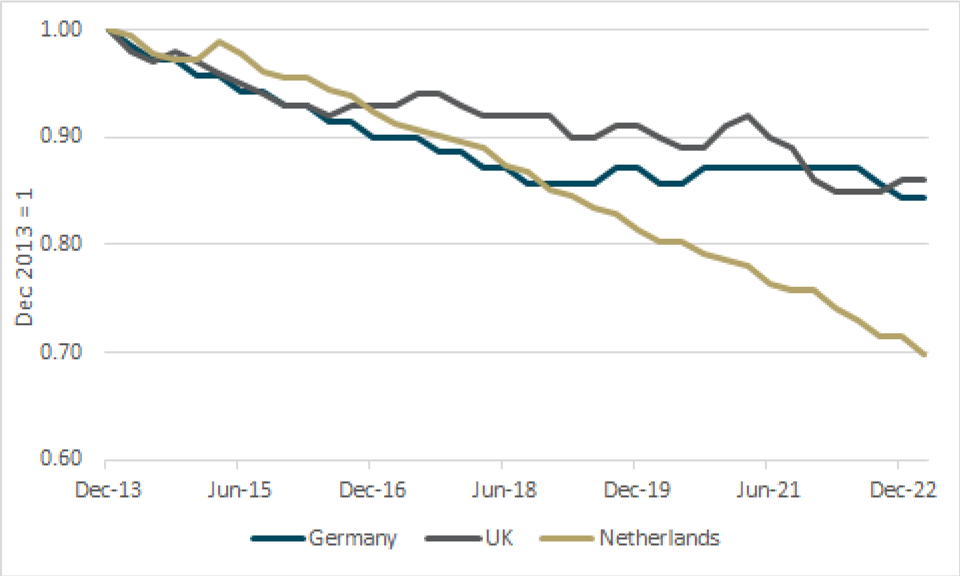


Source: Bloomberg, BNY Mellon

Regarding debt servicing, we note that starting points matter and the Eurozone is not homogenous in this respect. For example, while the UK is considered to have heavily indebted households, in the Netherlands a decade ago the debt-servicing ratio was 18.2% of gross household disposable income (GHDI) according to the OECD, almost twice as much as the UK equivalent. However, due to wage growth and the lack of new debt, the Dutch debt-servicing ratio has fallen to 12.7% of GHDI. That is still well above German and UK figures but only 70% of prior outlays and is continuing to fall. In contrast, the UK and German figures are now stagnant as tightening in financial conditions via debt servicing is just about being offset by higher wages.

For the ECB, this means that staying hawkish is not having an impact on Germany household cashflow, whereas Dutch household cashflow improvement appears impervious to ECB rates. If there is no demand impact on where it matters (the household) but too much impact on the key sectors for the economy (manufacturing), then policy itself is suboptimal. While it may be too early to reverse course, a new strategy to look at improving financial conditions for corporates may need to move up the agenda, lest credit impulse collapses further and there will be no expansion to speak of, even when external demand recovers.

Debt-Servicing Ratio, Cumulative Change



Source: Bloomberg, BNY Mellon

Please direct questions or comments to: iFlow@BNYMellon.com

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