Europe

Catching a cold

Chilly financial winds have been blowing across the Eurozone over recent weeks. **European bank equities have fallen by a quarter since the turn of the year, according to the Euro Stoxx index,** with the cost of insurance for some bank debt (CDS) jumping to levels not seen since the sovereign debt crisis. There are a number of reasons why banks have had such a tough time of it. Risk appetite in general remains weak, with broader Eurozone equites down close to 15% thus far over 2016 and cyclical sectors like banks faring even worse. Meanwhile, regulation remains a headwind for the sector, despite progress already made. Finally, there is growing concern over some of the side effects that central bank medicine has on the banks. The combination of negative interest rates and asset purchases has put pressure on bank margins (see Chart 6). This pressure could increase if market expectations for a further 20 basis points of ECB deposit rate cuts are delivered.

The banking sector is important in the Eurozone, with credit markets less developed than in the US or even UK. We have seen a sustained easing in credit conditions over recent years, helped by a looser monetary policy and healthier banking sector. This has supported a gradual uptick in net lending across the household and corporate sector, although this has clearly been dampened by simultaneous deleveraging of previous excesses. **In the real economy, this has translated into an increase in investment of 4% since the recovery started in 2013, with machinery and equipment posting the largest increase (see Chart 7).** This represents a slow upturn, especially considering the fact that investment is still 15% lower than its peak. On a positive note, before the latest market turmoil, most signs were pointing to an acceleration in business investment on account of improving sentiment, supportive monetary/fiscal policy settings and rising profits. Indeed, survey data from the end of last year showed that demand for loans from both firms and households was the strongest since the crisis. However, any acceleration in investment is threatened by turbulence across markets and particularly the financial sector. The longer this stress persists, the greater the likelihood that credit standards will tighten as banks become more cautious. Stress is also likely to dampen firms' enthusiasm to invest given rising uncertainty. The chilly winds from the financial sector could easily flow through to the real economy.

The ECB will be nervous that the transmission of its policy stimulus could, again, be threatened by stress in the banking sector. Barring a rapid improvement, it should act forcefully. Further rate cuts and an increase to the asset purchase plan (potentially through the pace of purchases) look likely. We may also see bank-specific policies, including further long-term liquidity operations and even more incentivised liquidity for lending to the real economy. The ECB could also switch to a tiered deposit rate structure to try and limit the effect of negative rates on banks. Governments can help too. If the private sector is not in a position to invest, then the public sector can fill some of this shortfall through infrastructure investment. **With government bond yields extremely low, there looks to be a strong case for action to boost both short- and long-term growth prospects.**

Chart 6: Squeezed margins

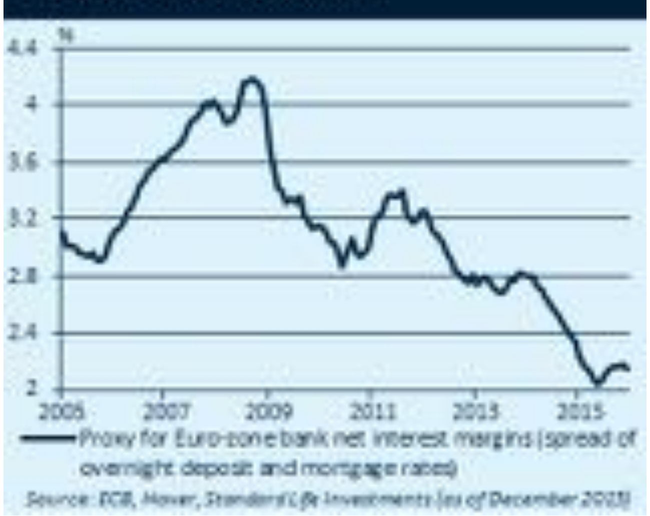

Chart 7: Getting going