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GLOBAL ECONOMIC RESEARCH

EUROPEAN ECONOMIC PERSPECTIVES

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European Economic Perspectives

Why Is Rising Euro-Area Bank Lending Not Igniting Demand?

Euro-area bank lending is growing at its fastest pace in four years. Combined with a pick-up in inflation to 2.5% and better leading indicators, this is likely to encourage the European Central Bank (ECB) to take a more hawkish stance after next week's Governing Council meeting. Yet the ECB is unlikely to raise interest rates in the near future. In part, this is because rising credit growth is still showing few signs of igniting a recovery in domestic demand.

Euro-area bank lending growth rose to a year-over-year rate of 8.4% in August, its highest since July 2001 (**Display 1**). In the US or UK, buoyant lending growth typically boosts the economy, as individuals take on more consumer credit, homeowners borrow against their properties and companies invest in productive capacity. However, this is clearly not yet happening in the euro area. The question is why?

The fastest-growing component of bank lending in the euro area is mortgage borrowing, which rose by 10.7% year over year in August. This strong growth is driving house prices higher in most euro-area countries (Germany is the most obvious exception). However, unlike in the US or UK, this is not feeding through into higher consumption. This is because it is difficult and costly for residents in most euro-area countries to extract equity from their properties. As a result, strong mortgage borrowing and rising house prices are providing only modest support for euro-area growth.

The other key component of household borrowing is consumer credit, which rose by 7.0% year over year in August, its highest since the fourth quarter of 2000. However, the impact of consumer credit on euro-area consumption should not be overstated. Consumer credit accounts for just 7% of bank lending and the total increase over the last year has been just €35 billion, equal to 0.6% of household consumption. By way of comparison, consumer credit in the UK has risen by £19 billion over the last year, equal to 2.7% of household consumption.

The biggest component of bank lending in the euro area is lending to non-financial companies (**Display 2**). ECB data show that company lending eased slightly in August. Still, at 6.7% year over year, it remains much higher than the low of 3.2% registered in early 2004. Clearly, the bulk of these funds is not being used to finance fixed investment, which rose by just 1.0% year over year in the second quarter.

The European Central Bank's (ECB) quarterly bank-lending survey provides some useful insights into company borrowing. The latest survey shows that the most important reasons for increased corporate borrowing are balance-sheet restructuring and merger activity (**Display 3**). The latter is consistent with a sharp pick-up in European merger activity this year. In contrast, the survey shows that fixed investment is not acting as a major driver of bank-lending growth and that, if anything, it has become even less important in recent months.

Conclusions

The ECB continues to regard high money supply and credit growth as a significant threat to medium-term inflation prospects. The recent rise in credit growth supports the ECB's contention that the level of interest rates is not a barrier to growth in the euro area and that rates will eventually have to move higher. That said, it is also clear that the rise in credit growth is proving extremely slow to feed through into faster domestic-demand growth. So long as this remains the case, the ECB will continue to warn about upside risks to price stability but is unlikely to actually raise interest rates. We continue to expect a rate hike in the second quarter of next year.

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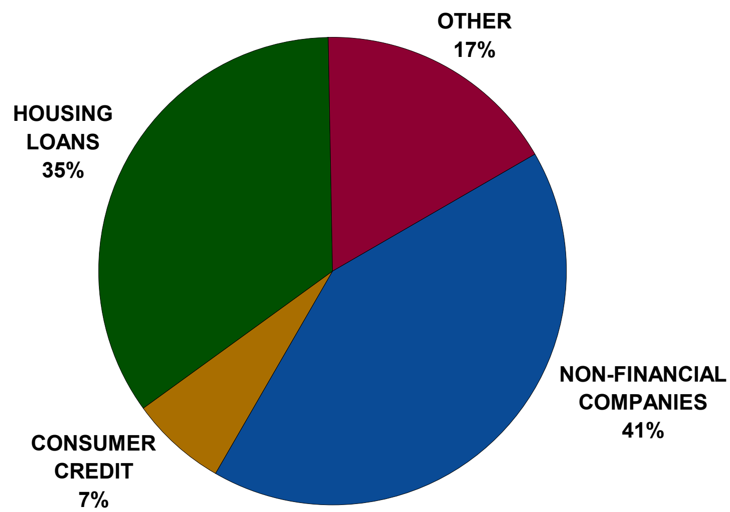
Display 1: Bank Lending Growth Continues to Accelerate
Euro-Area Bank Lending Growth

Source: European Central Bank and Alliance Capital Fixed Income; September 30, 2005

Bank-lending growth has accelerated steadily since reaching a trough. This supports the ECB's contention that euro-area interest rates are not hindering the recovery. Nonetheless, domestic demand growth is proving very slow to respond to faster credit growth.

Display 2: Mortgages and Company Loans Are the Main Components of Bank Lending

Breakdown of Euro Area Bank Lending, July 2005

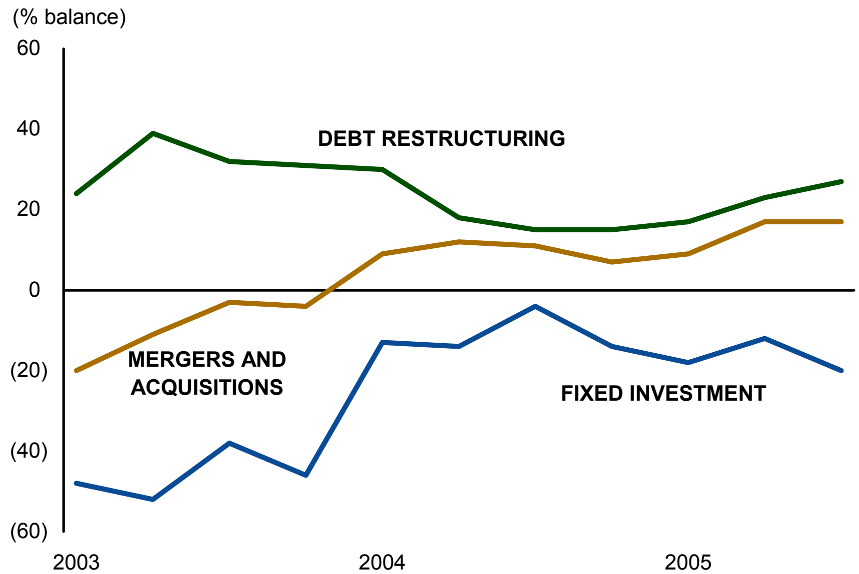


Source: European Central Bank and Alliance Capital Fixed Income; September 30, 2005

The biggest components of bank lending are lending to non-financial companies and housing loans. Consumer credit is very small. The bulk of the "other" component is lending to other financial intermediaries.

Display 3: Debt-Restructuring and Merger Activity Are Driving Corporate Borrowing

Balance of Respondents Citing This Factor as a Reason for Borrowing



Source: European Central Bank and Alliance Capital Fixed Income; September 30, 2005

The ECB's bank-lending survey shows that the main reasons for increased company borrowing is debt restructuring and merger activity.