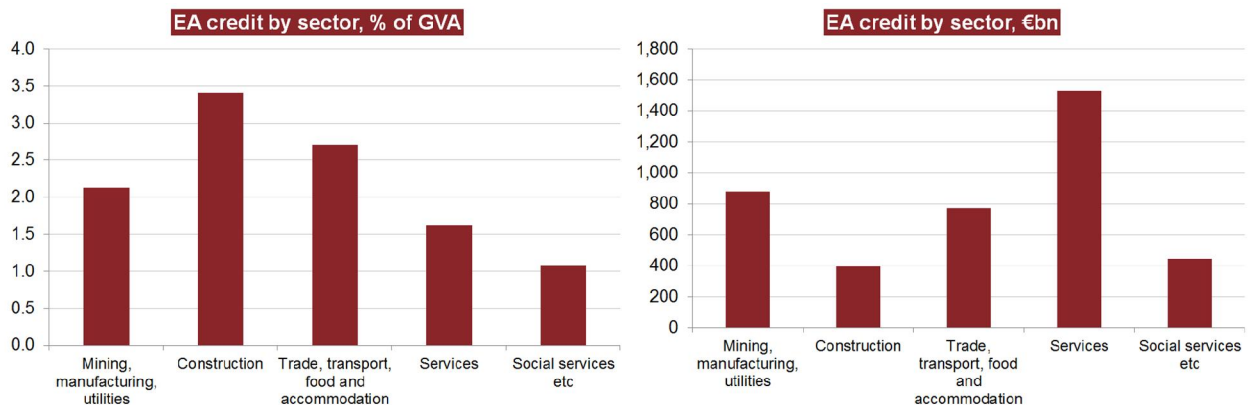


EA credit flows

- **Low interest rates do not mean a loose monetary policy**
- **SME-intensive sectors are also those most starved of credit in the euro area**
- **The deflation risk remains, implying further weak demand for credit**

As expected, the ECB kept its interest rates unchanged at 0.25% in December, a record low level. However, it is a common misconception that a low policy interest rate automatically means a loose monetary policy. In truth, whether monetary policy is loose or not is really determined by the results. On this basis, euro area monetary policy is far from loose. Broad money growth fell to 1.4% in the year to October, the slowest rate since July 2011. Credit to the non-bank private sector fell by 1.4% over the same period; but this continues to be boosted by the fact that housing loans to households are still rising (albeit barely). Lending to the non-financial corporate sector fell by 5.6% in the year to October, by far the sharpest contraction on record. However, within this group, there are some substantial differences, highlighting where the credit squeeze has struck the hardest. One way of doing this is to compare development in credit to various sectors with changes in economic activity by sector.

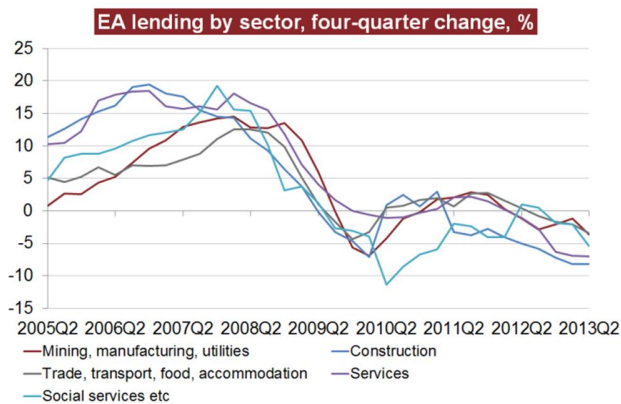
Ignoring agriculture, the two most credit-intensive sectors – where the stock of bank credit is equal to more than 3% of gross value added – are construction; and trade, transport, food & accommodation. In absolute terms, the sector with the largest amount of credit liabilities is the services sector, with just over €1.5tn in the first half of 2013.



The construction and services sectors are also the most credit-starved since the beginning of the Great Recession. For instance, the stock of credit to the construction sector has fallen by 17% since peaking in 2009 Q1. This is perhaps not surprising; these were the sectors where credit had risen the fastest in the early 2000s and the end to the construction boom (notably but not exclusively in Spain and Ireland) was bound to lead to a sharp slowdown in lending to construction.

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Both construction and services are characterised by a larger-than-average share of small companies. We already know that this category has had more problems accessing finance than larger companies as shown in the ECB's survey of SMEs and their financing. This is the more worrying as SMEs tend to be the most dynamic sector in terms of employment. Although the ECB's latest bank lending survey shows respondents expecting both slightly looser lending standards and slightly higher demand for loans in Q4, this has not yet appeared in the data.

Equally troubling is that credit to the manufacturing sector, which is crucial for the euro area's mainly export-led recovery, also continues to shrink.

There are a number of different reasons why euro area credit growth is weak. One is of course that deleveraging, rather than taking on new loans, remains the order of the day for most companies. Another is that weak household sector demand is unlikely to spur a bout of corporate investment (which in turn would spur credit growth).

A third cause is likely to be the recently arisen worries about the euro area potentially heading into deflation. As covered in previous Comments, one of the main impacts on deflation is that it raises the burden of debt. It stands to reason that companies, if faced with the risk of deflation will exercise caution before taking on new debt.

During the summer, the ECB had hinted at possible measures aimed at easing credit conditions for SMEs. These now seem to have been abandoned. As the risk of deflation and the implications it would have for the public and private debt burdens dominate the outlook for 2014, these measures should be back on the agenda. Meanwhile, the euro area risks remain firmly on the downside.

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