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MACROCOSM

So Close to Recovery, So Close to Doom

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Donald Luskin with research input from **Lorcan Roche Kelly**

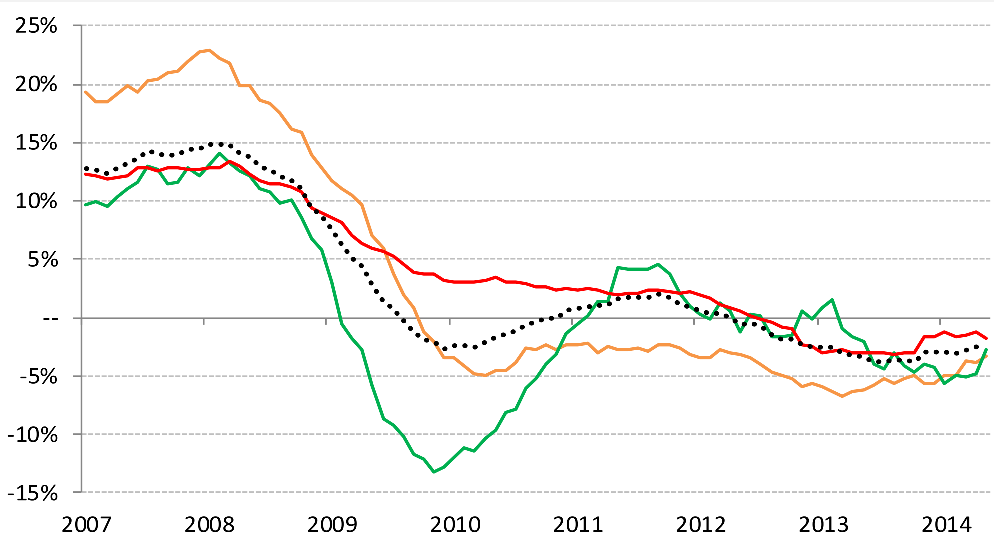
QE is coming to the euro area as bank lending recovers, and trade was with Russia looms.

The European Central Bank announced no new policy measures arising from today's Governing Council meeting. But in the post-meeting press conference President Mario Draghi said the ECB had "intensified preparatory work related to outright purchases in the asset-backed securities market" -- that is, QE, euro area style.

- The ECB is challenged by continuing too-low inflation -- embarrassed, actually, as price stability is this central bank's sole mandate -- and try as it might it can't deliver on it.
- And there are yet-unknown costs and risks arising from broader sanctions against Russia, and Russia's retaliatory trade restrictions.
- Yet for all that, the ECB must take some satisfaction in the first evidence of recovery in that most critical of economic indicators for the euro area -- bank lending. It's still early days -- but while loans to non-financial enterprises are still shrinking, the rate of shrinkage has slowed to a crawl (please see the chart below).

Euro area loans to non-financial enterprises, YOY

— 1 year — 1-5 yr — >5 yr ··· Total



Source: ECB, TrendMacro calculations

Update to strategic view

ECB, EUROPE MACRO, EUROPE STOCKS, EUROPE FINANCIAL STOCKS: Nothing new from the ECB this morning, except very explicit hints that purchases of asset-back securities are coming in the future. In the meantime, euro area banks are coming back to life -- lower credit standards, and both seeing and expecting increased lending demand. The durability of the euro area's retreat from its prior "doom loop" has been the inconsequential collapse of Espírito Santo, which would have been a global crisis if it had happened three years ago. Now the only threat is a full-on trade war with Russia, with MR17 having pushed Europe across the Rubicon of serious sanctions. Assuming away the worst-case outcomes there, the present correction in euro area markets is a buying opportunity.

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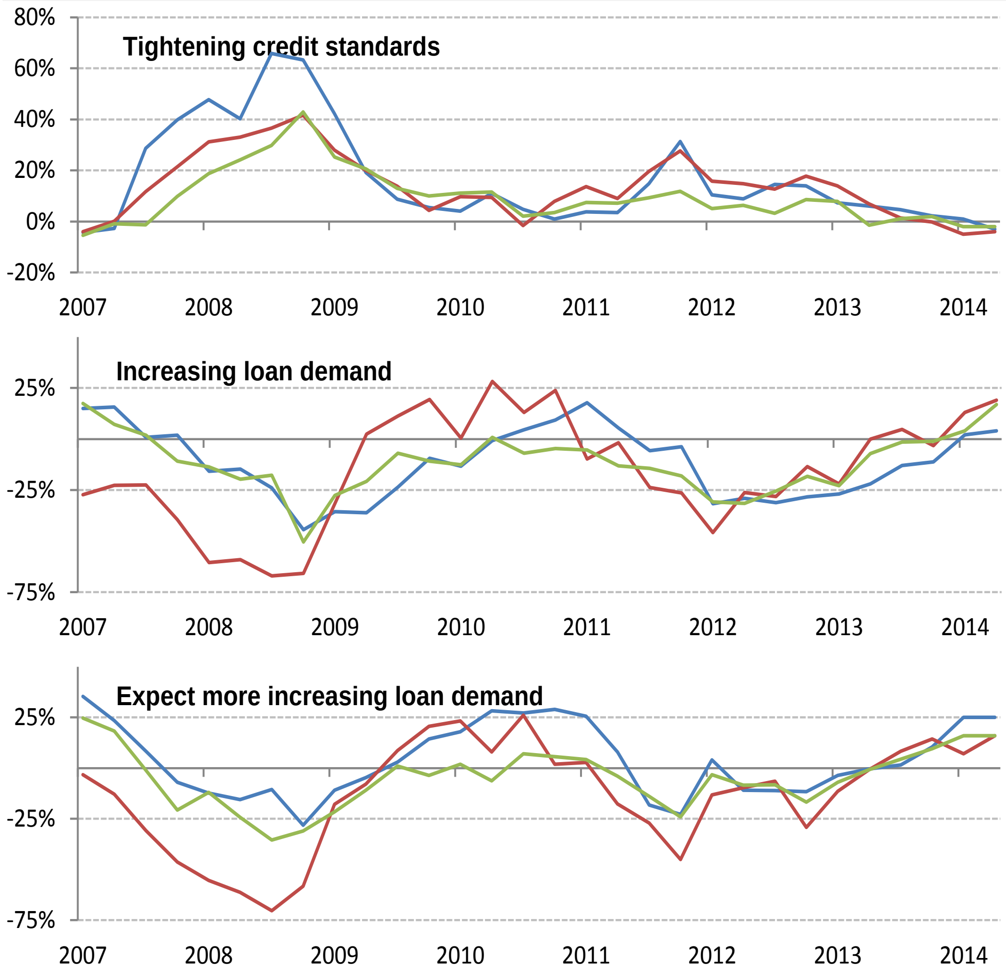
- And the most recent ECB Euro Area Bank Lending Survey shows easing credit standards, rising loan demand, and expected further demand across all lending categories (please see the chart below).

Euro area banks, percent responding — Enterprises — House — Consumer



Source: ECB, TrendMacro calculations

- At the same time, the Survey showed that lending margins to enterprises had narrowed. Margins for riskier loans narrowed, too, and for the first time in the history of the Survey.
- And "access to retail and wholesale funding improved further for all main market instruments."

Small change, perhaps, but it was only two years ago that the euro area was facing virtual non-existence, under the triple threat of cascading sovereign debt, bank and currency crises (see "Whatever It Takes Turns Two" July 25, 2014). The lifting of that triple-threat will do more for the euro area economy, and its banks, than any fine-tuning policy that Draghi might announce.

- Some evidence that the triple-threat has lifted is how little systemic impact resulted from the collapse of the corrupt

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Recommended Reading

How Does Tax Progressivity and Household Heterogeneity Affect Laffer Curves?
Hans A. Holter, Dirk Krueger, Serhiy Stepanchuk
Penn Institute for Economic Research
Working Paper 14-015
March 2014

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Portuguese bank Espírito Santo. If this had happened two or three years ago, we have no doubt that real or imagined contagion would have shaken world markets. As it turned out, even after assurances as to the bank's soundness made mere weeks ago proved to be false, in the end it was neatly resolved into a standard good bank/bad bank model, funded with a portion of leftover rescue funds remaining from Portugal's bail-out.

- Most telling, throughout the episode Portugal's sovereign yields barely budged (they peeked above 4% briefly when the crisis first emerged -- but they were above 18% a mere two and a half years ago). What was once known in the conventional wisdom as Europe's "doom loop" has, more definitely, been broken.

World markets are in a correction, for a variety of reasons (see "On the July Jobs Report" August 1, 2014), and Europe's are no exception. For the euro area reality of reciprocal trade sanctions with Russia -- and the remote threat of military involvement in Ukraine -- are the spear-point of the correction's narrative.

- While the trade sanctions against Russia now in place are still relatively minor, they are broader than we had ever expected Europe would adopt. The downing of Malaysian Airlines Flight 17 exerted a public demand effect that overcame the stiff resistance to sanctions by Europe's international business community and the politicians that serve it (see "On MH17" July 18, 2014).
- Sadly, the tougher sanctions were put in place too late. Right after the downing of MH17, Russian President Vladimir Putin was quite disoriented, put back on his heels by the humiliation of having caused an international humanitarian disaster by accident. A critical week went by while Europe dithered on sanctions before finally announcing them, during which time Putin recovered his equilibrium, and has come back more aggressively than ever.
- Be that as it may, Europe has crossed a Rubicon. So if under some pretext Russian troops invade eastern Ukraine, Europe would no doubt find it easier to move to even more self-damaging sanctions.
- We have never thought the real risk here was military. It is economic -- the possibility that Europe and Russia would engage in a mutually suicidal full-on sanctions war.
- For Russia, which derives 12.1% of GDP from exports to Europe, it would truly be suicide. For Europe, which derives 1.4% of GDP from exports to Russia, it would be damaging, but not necessarily fatal. What we don't know is whether, with the euro area's recovery so new and so fragile, whether that 1.4% would be a tipping point even that could restart the "doom loop."
- We don't expect such outcomes by any means. But they are a risk, and a greater one than ever. Until that risk passes, euro area markets will remain in correction.
- Assuming that the worst outcomes won't materialize, we are treating this correction as a buying opportunity.
- By the way, we are far less concerned about Russia's new restrictions on imports of US poultry. Not a *good* thing, to be sure.

But even if Russia banned *all* US imports, it would make little difference in the US economy -- exports to Russia amount to only 10 basis points of US GDP. For the US, the worst consequences would be second-order effects arising from damage to Europe, a large US trading partner.

Bottom line

Nothing new from the ECB this morning, except very explicit hints that purchases of asset-back securities are coming in the future. In the meantime, euro area banks are coming back to life -- lower credit standards, and both seeing and expecting increased lending demand. The durability of the euro area's retreat from its prior "doom loop" has been the inconsequential collapse of Espírito Santo, which would have been a global crisis if it had happened three years ago. Now the only threat is a full-on trade war with Russia, with MR17 having pushed Europe across the Rubicon of serious sanctions. Assuming away the worst-case outcomes there, the present correction in euro area markets is a buying opportunity.