Efficiency of European financial sector in allocating finance

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ECONOMICS CONFERENCE 2016

Introduction / Key issues

- EU countries on a slow recovery path. Investment seems to underperform compared to other recoveries…
- Despite very accommodative monetary policies (NSM, still effective), fiscal policy mildly supportive and specific measure (EFSI at the EU level)
- Banks and NFCs stronger now
- But current configuration likely not sustainable for the financial system
- New or quicker policies needed, structural (CMU) and fiscal?

Outline

1. **The new shape of cross-border investment flows in Europe**
    1. The “Great Retrenchment” of gross international financial flows seems fairly persistent
    2. The retrenchment applies mainly to Europe and advanced economies

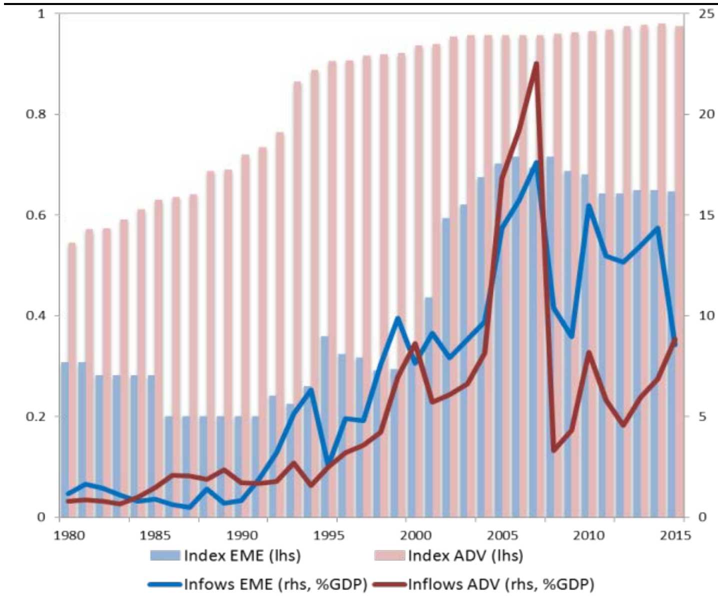
2. **Nfcs investment in the current macro-financial environment**
    1. Ongoing recovery but investment abnormally weak despite accommodative policies...
    2. …And loosened financing conditions compared to beginning of 2014

3. **Can the balance sheet adjustment of nfcs explain the weakness in investment**?
    1. Rebound in nfc earnings accompanied by cash accumulation
    2. Nfcs Financing liabilities dominated by debt
    3. Reduction in the debt burden and shift towards longer maturity
    4. Evidence of corporate bond issuance fueled by ECB policy

4. **Bank sector capacity to take risk and finance capex**
    1. EU banks have strengthened their balance sheet…
    2. And appear relatively resilient in the current environment…
    3. …in which the cost of bank borrowing has reached historically low level
    4. But the persistence of the current policy configuration may pose a risk to the capacity to provide credits

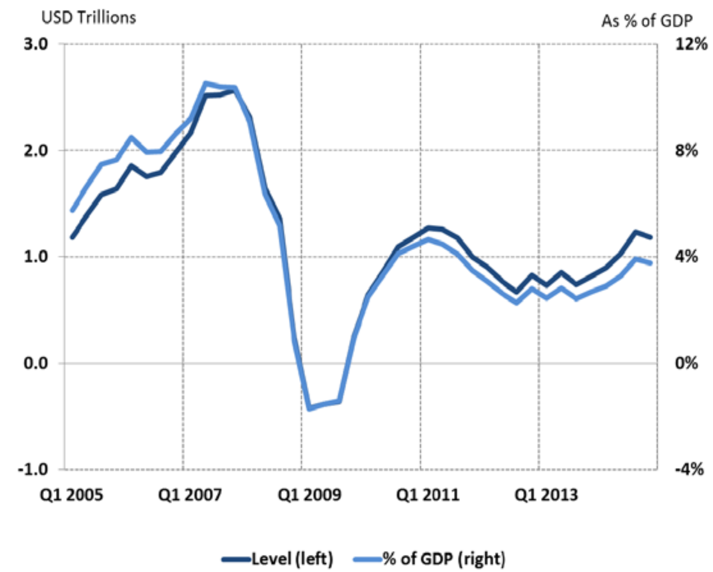
The "Great Retrenchment" of gross international financial flows seems fairly persistent

Chart 1 – Capital account openness and the pre-crisis boom of gross inflows. E (***as %GDP***)



Source: Chinn-Ito Index and ECON calculations based on IMF balance of payments statistics.
Notes: EME consists of Latin America, Central and Eastern Europe, Emerging Asia. ADV consists of North America, Western Europe, Asia (China is not included). 2015 data partially extrapolated.

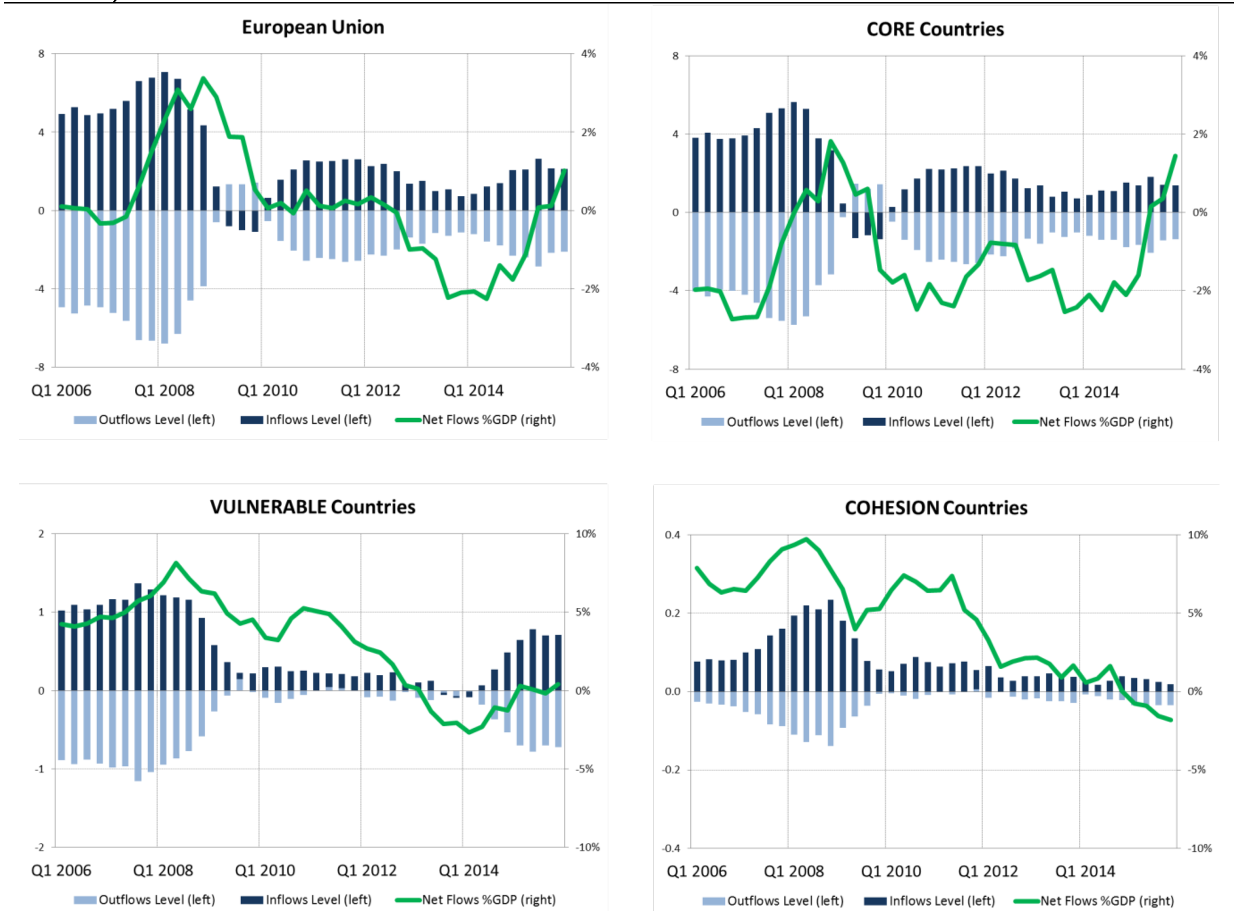
Chart 2 – Post crisis, global financial flows settled at a lower level (***4-qtr moving average***)



Source: ECON calculations based on IMF balance of payments statistics.
Notes: World Capital outflows. Last record 2015Q4. 2015 data partially extrapolated.

The retrenchment applies mainly to Europe and advanced economies

Chart 1 – Evolution of capital outflows and inflows in the EU (***level, USD trillions, lhs, and net flows in % GDP, rhs***)



Source: IMF Balance of Payments, International Financial Statistics and authors' calculations.

Note: CORE consists of DE, FR, UK, AT, BE, DK, FN, LX, NL, SD, VULNERABLE consists of IT, ES, GR, IR, PT, COHESION consists of CZ, PO, RM, HN and EU consists of EU countries except HR and BG. 2015 data estimated. Four-quarter moving average. Positive net flows reflect net outflows.

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Ongoing recovery but investment abnormally weak…
…Despite accommodative policies

Chart 1 – Money market rates in the US and selected EU economies ***(% p.a., 3-month maturity)***

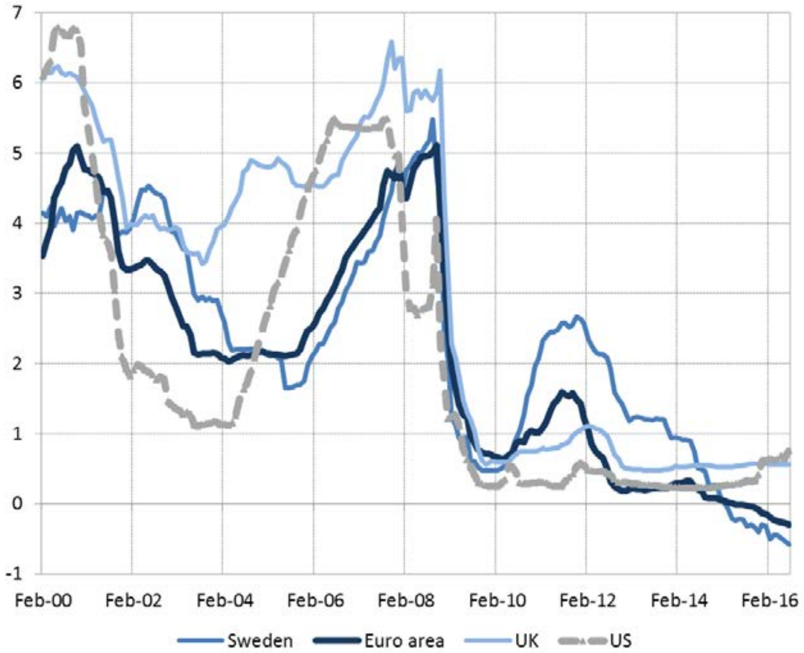
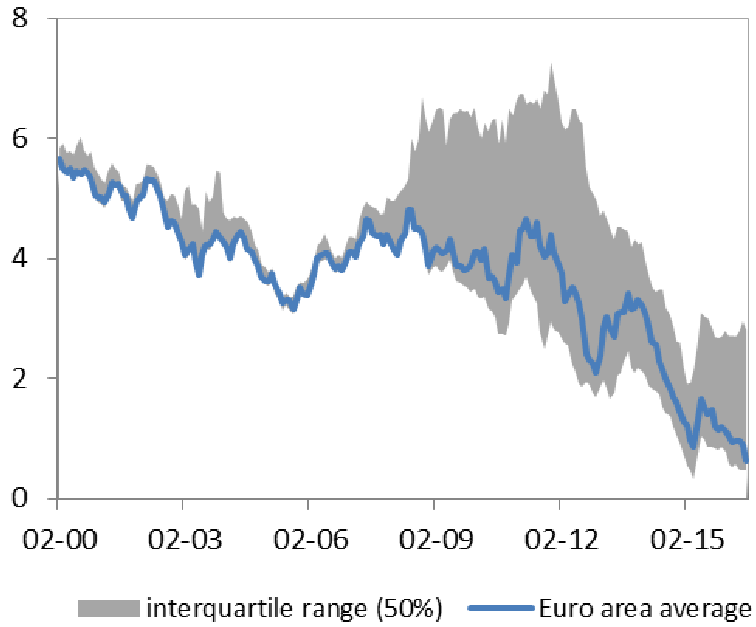


Chart 2 – 10-years nominal government bond yields in the EU ***(% p.a.)***



Sources: Thomson Reuters

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Rebound in nfc earnings accompanied by cash accumulation (1/2)

Chart 1 – Gross entrepreneurial income ***(annual growth rate, %)***

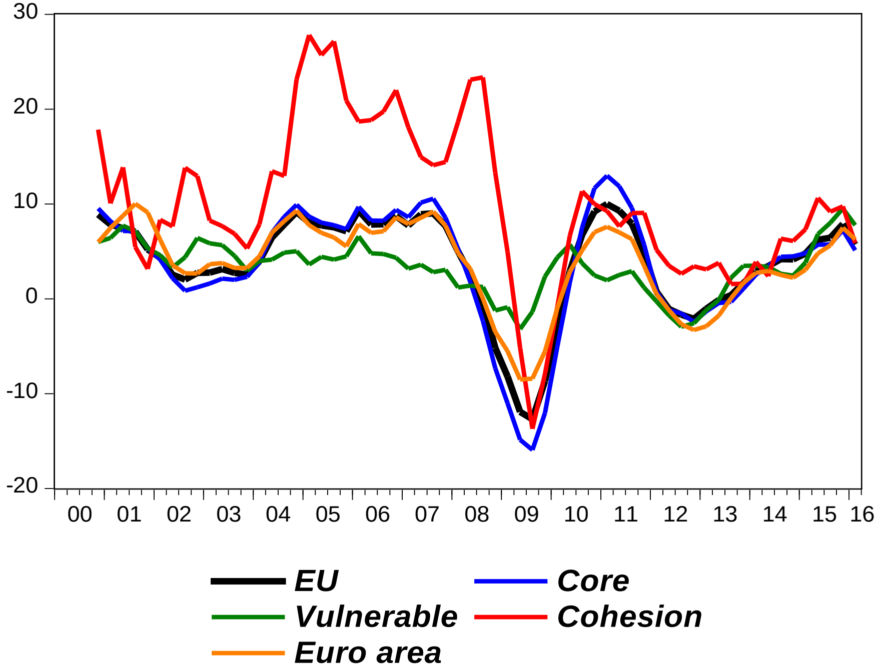
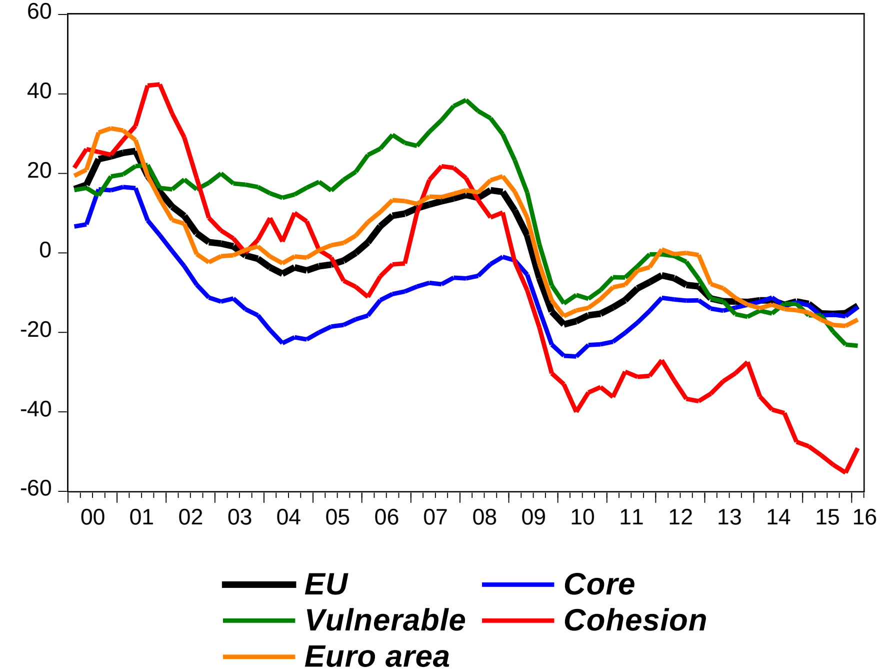


Chart 2 – Net borrowing over investment ***(%)***

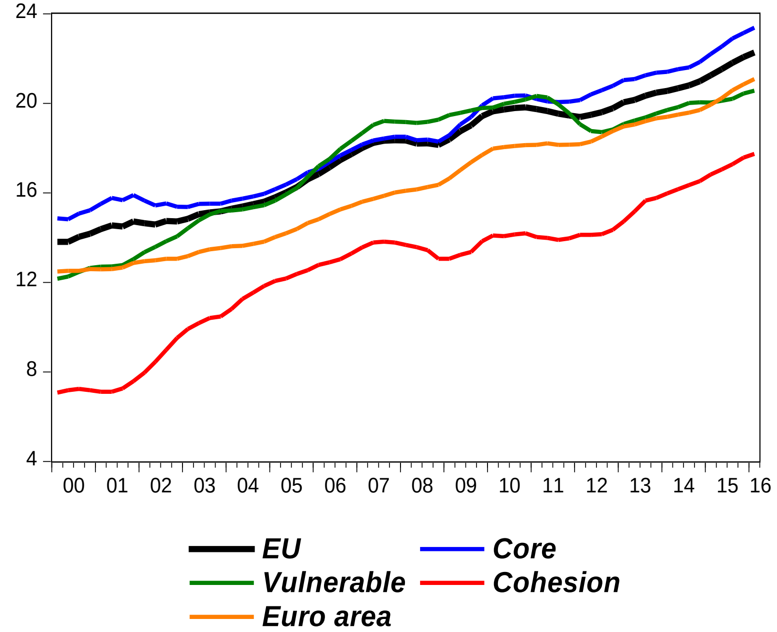


Source: ECON calculations based on EUROSTAT sectoral accounts.

Notes: 4-quarter moving average of the annual growth rate of non-seasonally adjusted data. See Footnote Error! Reference source not found. for the definition of the country groups.

Rebound in nfc earnings accompanied by cash accumulation (2/2)

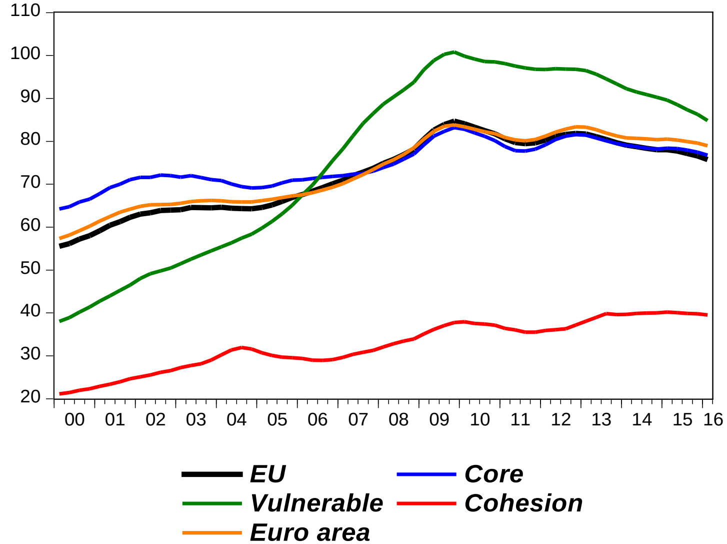
Chart 15 – Cash and deposit of NFCs to GDP (4-quarter moving average of the ratio)



Source: ECON calculations based on EUROSTAT sectoral accounts.
Notes: 4-quarter moving average of the annual growth rate of non-seasonally adjusted data. See Footnote Chart 6 for the definition of the country groups.

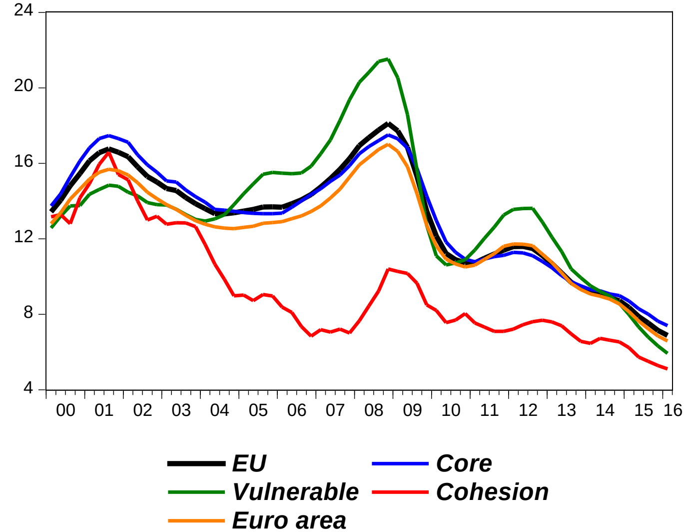
Debt dominates…but reduction of the debt burden and shift towards longer maturity

Chart 1 – Consolidated debt over GDP ***(%, 4-qtr moving average of the ratio)***



Sources: Based on EUROSTAT, Integrated accounts.

Chart 2 – NFCs gross interest payments ***(percent of nominal gross operating surplus)***



Source: ECB.
Notes: 4-quarter moving average. Latest observation: 2016Q1

Evidence of corporate bond issuance fuelled by ECB policy

Chart 1 – Geographical breakdown of the European corporate debt market ***(%)***

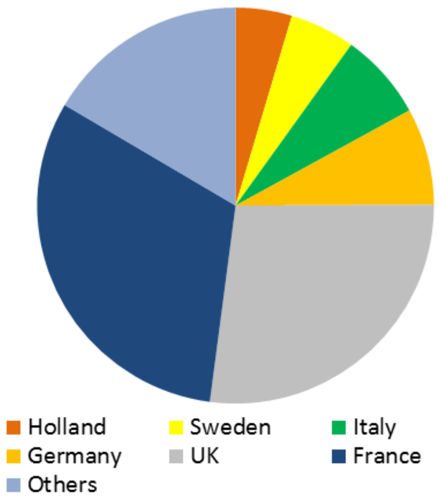
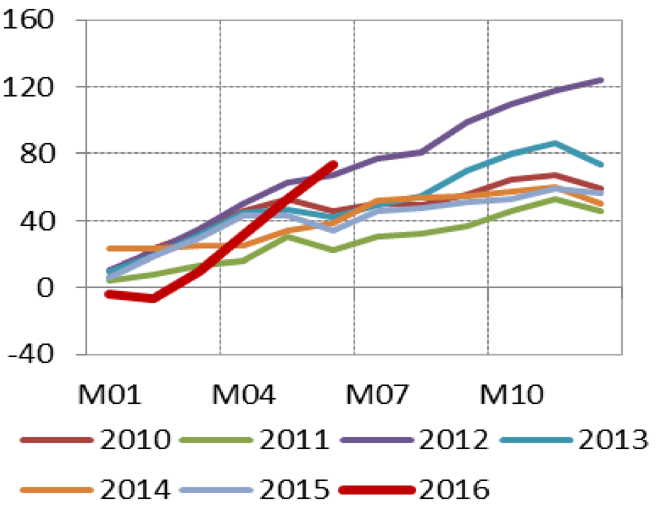


Chart 2 – Net issuance of securities in the euro area ***(sum since the start of the year, billions)***



Sources: Eurostat, ECB.
Notes: Last record is June 2016 (lhs, annual average from the middle of 2015 to the middle of 2016).

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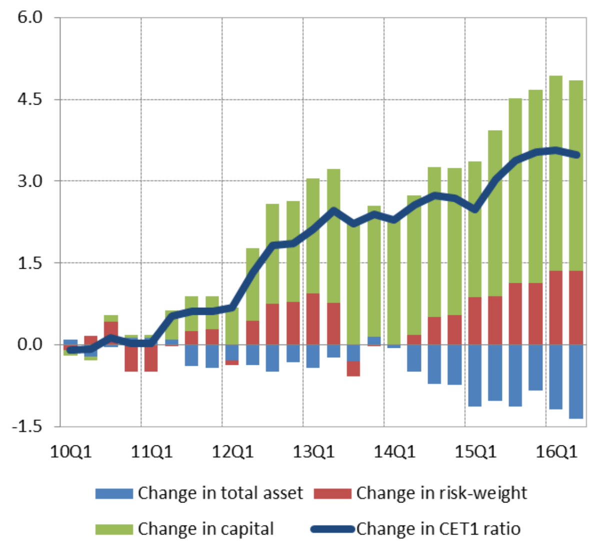
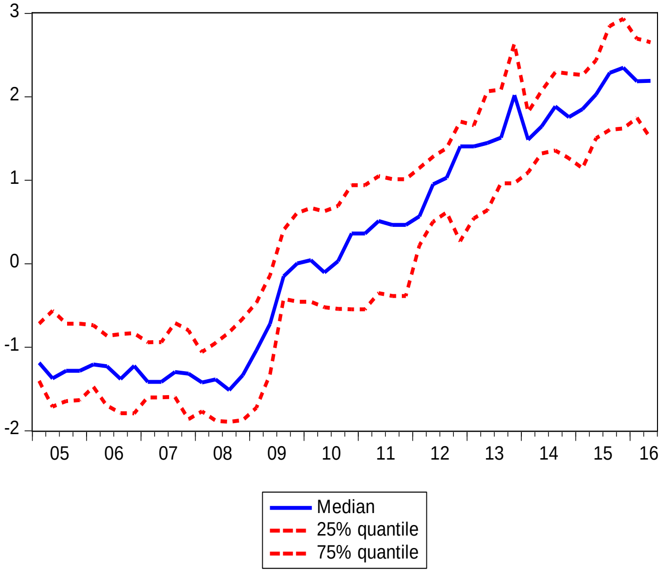
EU banks have strengthened their balance sheet…

Chart 1 – Accounting-based decomposition of the change in CET1 capital ratios of EU banks



Source: ECON calculations based on Eikon Datastream
Notes: Change since 2010 and contributions (pp). Based on the average of 33 listed banks. See footnote Chart 2.

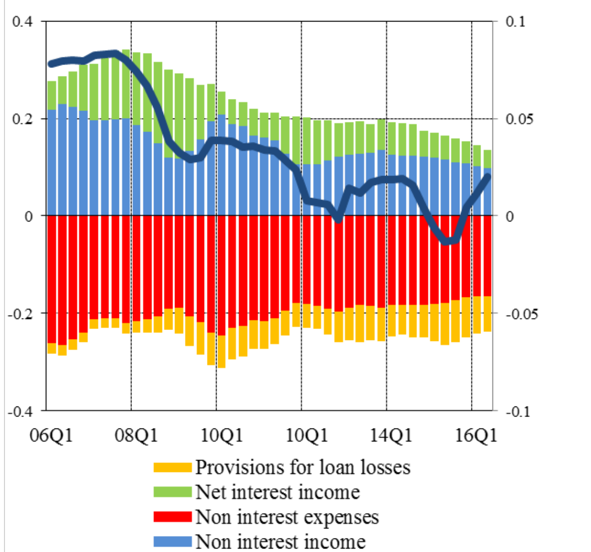
Chart 2 – Factor-based measure of capital and leverage ratio of EU banks



Sources: ECON computations based on Eikon Datastream.
Notes: see Galiay A. and L. Maurin (2015). 33 banks located in DE, FR, IT, ES, AU, UK, SW and DK. The blue line inside the red ones portrays the median of the indicator across the sample of banks while the two red dotted lines represent the 25% and 75% quartiles. (factor-based, de-meaned over 2003Q1-2015Q2)

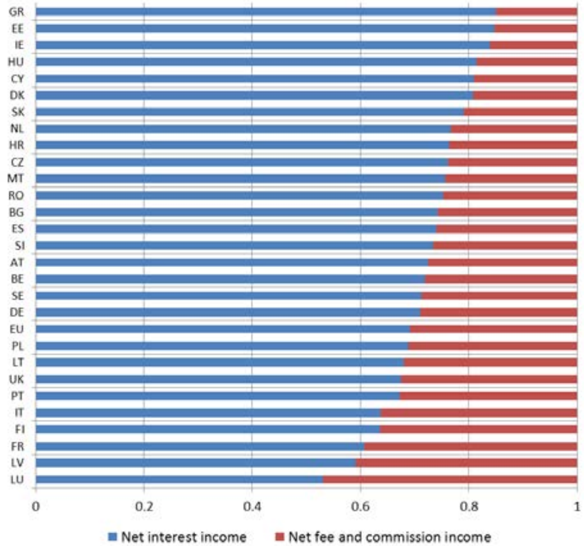
But the persistence of the current policy configuration may pose a risk to the capacity to provide credits (1/2)

Chart 1 – Bank profitability and contributing factors ***(percentages of asset, average)***



Source: ECON calculations based on Thomson Reuters.
Notes: Profit components are annualised median values displayed as shares of equity. Yearly figures are four-quarter averages. Based on a sample of 31 EU banks. Latest observation: 2016 Q2.

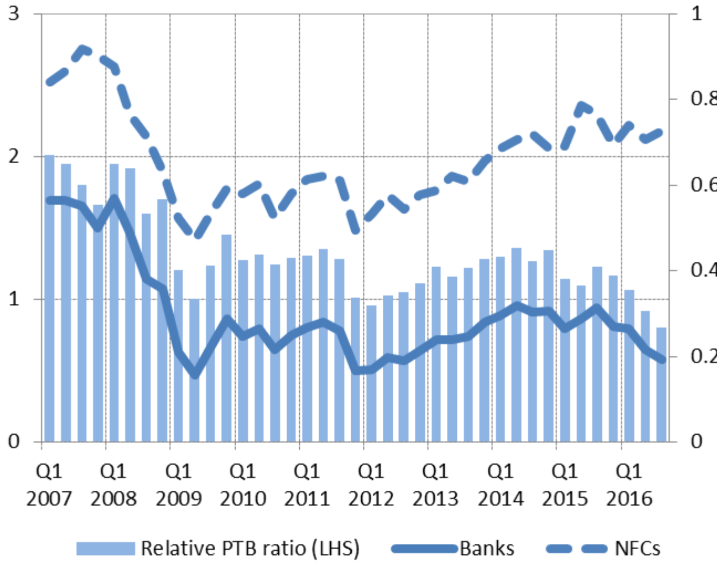
Chart 2 – Share of net interest income and net fee and commission income in the income of the EU banking sector ***(average %, over 2008-2013)***



Sources: ECON calculations based on ECB consolidated banking data.

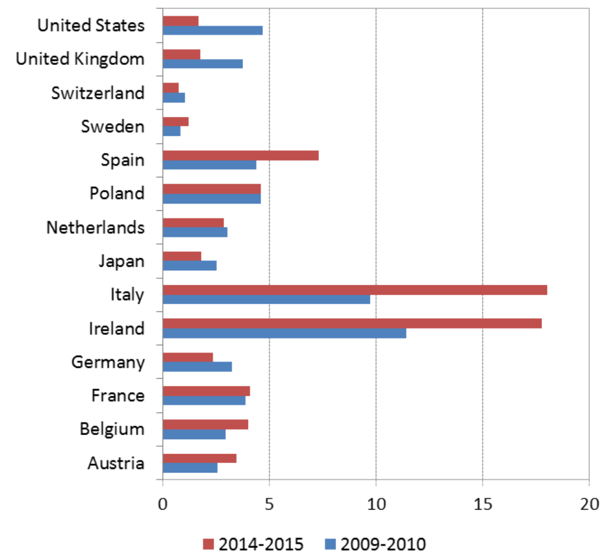
But the persistence of the current policy configuration may pose a risk to the capacity to provide credits (2/2)

Chart 1 – Price to book ratio of banks and NFCs ***(percentages of equity, median values)***



Source: ECON computations based on Eikon Datastream.
Notes: Latest observation: 2016 Q3, partly estimated.

Chart 2 – NPLs impairments (***%, as a ratio to the outstanding amount of loans***)



Source: IMF Financial stability indicators
Notes: for Germany, the data for the period 2014-2015 refers to 2014 only.

Issues for discussion

- ***Where do NFCs stand in the deleveraging cycle – is there a post-crisis "new" optimal financial structure?***

- ***What are the major impediments to CMU and how to alleviate them?***

- ***How to explain the negative reaction of bank equity to the stress test ? what are the prospects for the EU banking sector?***

- ***What are the implications of the low rate environment for individual banks and more widely the financial system?***

Thank you!