EUROPEAN ECONOMICS UPDATE

26th Mar. 2009

CAPITAL ECONOMICS

Euro-zone Monetary Indicators Monitor (Mar.)

ECB's liquidity provisions yet to boost lending

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- **The latest euro-zone money supply figures further support the view that the ECB's injections of short-term liquidity into the banking sector will not be sufficient on their own to encourage banks to increase their lending into the wider economy.**
- Admittedly, M1, a narrower measure of the money supply picked up in February, but this appears to reflect investors moving their money from time deposits accounts (which are not included in M1) to overnight deposit accounts due to the sharp fall in time deposit interest rates. (See Chart 1.) By contrast, the stock of M3 has recently started to plateau and the annual growth rate has slumped to its lowest rate in more than four years. (See Chart 2.)
- This, coupled with the increases in the monetary base (notes and coins in circulation plus banks' current account balances at the ECB), has led the ratio of broad money to narrow money (or the "money multiplier") to fall sharply. (See Charts 3 & 4.) **In other words, it seems that the ECB will need to expand its balance sheet more aggressively than in the past if it wishes to boost bank lending.**
- **Meanwhile, it seems that the economic downturn is prompting euro-zone households to save more and borrow less, suggesting that household spending continued to contract at the start of the year.** Households' bank deposits expanded at a healthy annual rate of 9.4% in February, while annual lending growth fell to a record low of 0.7%. (See Charts 5 & 6.)
- **By contrast, non-financial firms' bank deposits have recently fallen sharply, suggesting that the recession is reducing firms' profits.** Admittedly, lending to non-financial firms still expanded by 7.6% on an annual basis. (See Chart 7.) But this is the slowest growth rate since 2005. What's more, the overall stock of lending has recently flattened off and other forms of financing continue to expand only modestly (See Charts 8 & 9.) Given that investment fell in the latter part of 2008, despite double digit annual lending growth, the latest lending figures do nothing to change our view that investment continued to contract at the start of 2009.
- In all, then, there are growing signs that the credit crunch is forcing banks to rein in their lending. **Against this background, pressure on the ECB to adopt further unconventional policy measures in order to encourage banks to lend more is likely to continue to grow.**

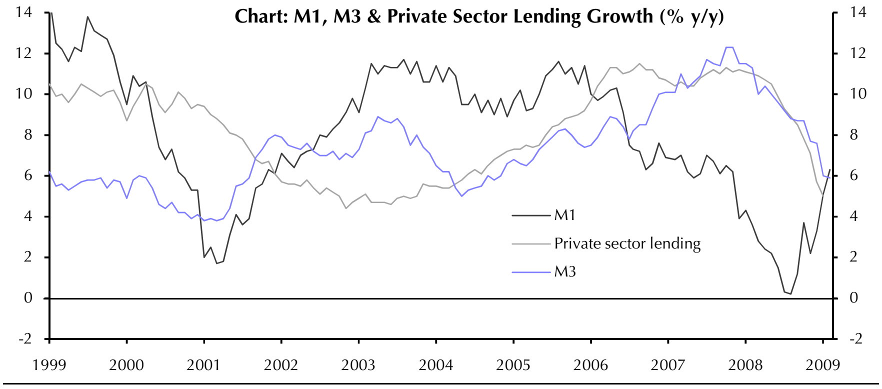


Chart 2: Stock of M1 & M3 (€bn)

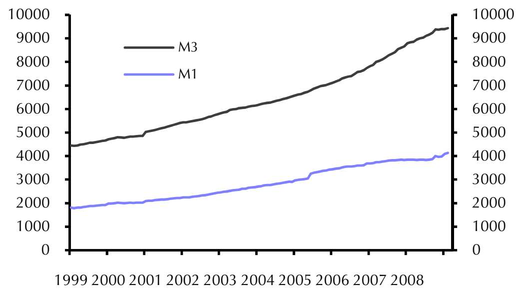


Chart 3: ECB Assets & the Monetary Base

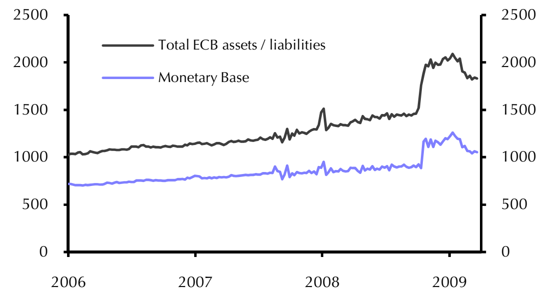


Chart 4: Money multiplier

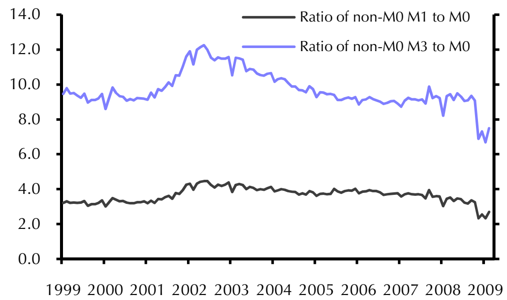


Chart 5: M3, Households' and Firms' Deposits

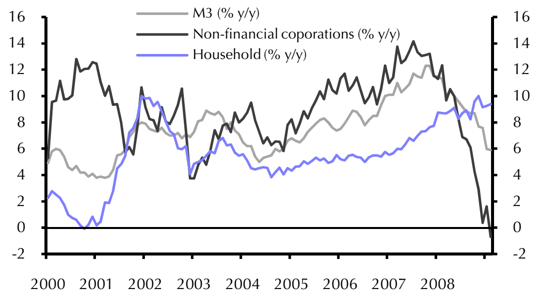


Chart 6: MFI Lending to households

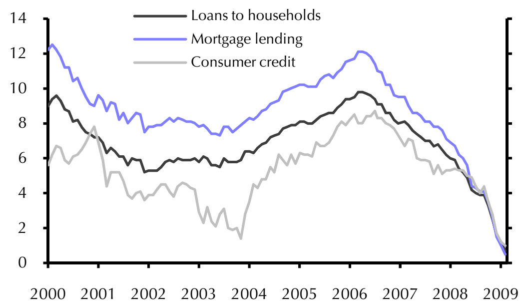


Chart 7: MFI Lending

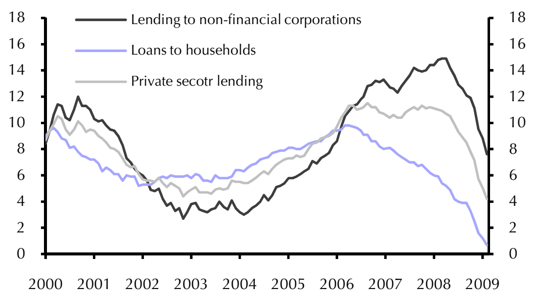


Chart 8: Stock of lending by MFIs (€bn)

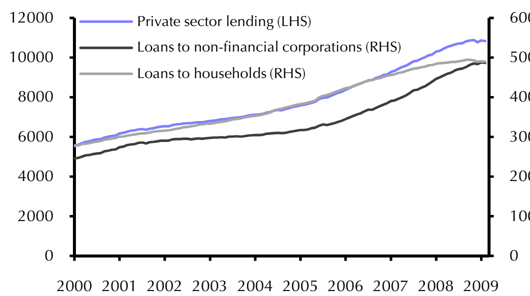
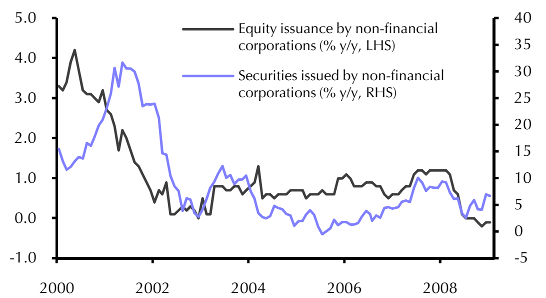


Chart 9: Equity and Security Issuance by Non-financial Firms



EURO-ZONE M3 MONEY SUPPLY (% Y/Y)

	2008											2009	
	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	**Feb**
M1	3.6	2.8	2.4	2.2	1.5	0.3	0.2	1.7	3.7	2.2	3.3	5.1	**6.3**
M3	11.3	10.0	10.4	10.0	9.6	9.2	8.8	8.7	8.7	7.7	7.6	6.0	**5.9**
Lending to firms	14.8	14.9	14.9	14.2	13.6	12.9	12.6	12.1	11.9	11.1	9.5	8.8	**7.6**
Lending to households	5.9	5.4	5.2	4.9	4.2	4.0	3.9	3.9	3.3	2.5	1.6	1.2	**0.7**