Global macro matters

Europe's economy: A long haul

Vanguard research | Joseph Davis, Ph.D. | November 2014

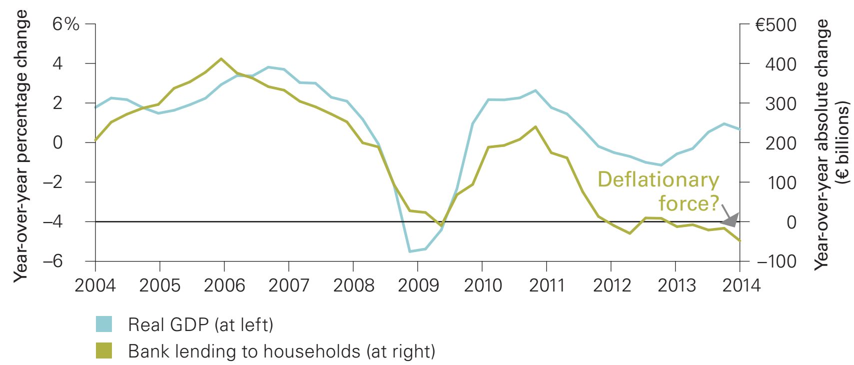
Europe's economy is risking a Japanese-style decade of near-zero growth and deflation

Since the onset of the sovereign debt crisis in 2009, we have maintained that the euro area would remain intact, but that the European economy would struggle to grow meaningfully, given banks' deleveraging and high debt levels in Europe's periphery countries.

Recent economic reports reinforce an outlook of meager growth into 2015, with real GDP expanding at best by about 0.5%–1%.

Whether this muted outlook is on or off the mark depends on the answer to at least three critical questions: Can fiscal policy become more stimulative? When will bank lending grow? and What more will the European Central Bank (ECB) do?

Real GDP growth is failing to recover, given contracting bank credit and rising risk of broader price deflation across Europe



Note: Household loans include loans to households and nonprofit organizations.

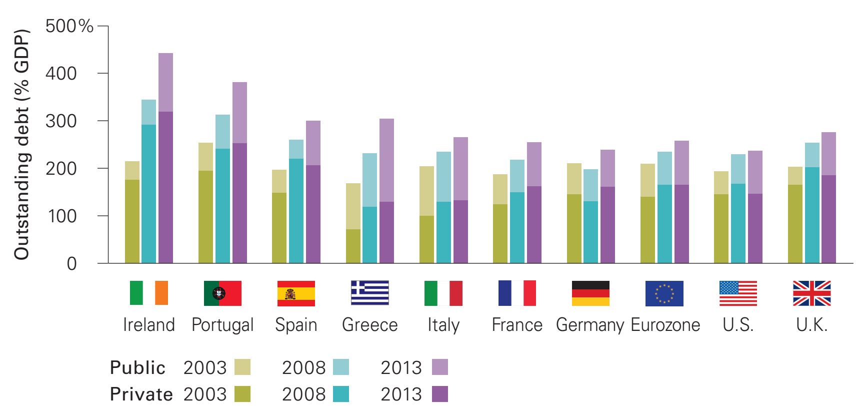
Sources: Vanguard and Eurostat calculations, based on ECB data.

Debt not especially high for aggregate euro area; but no appetite for more fiscal stimulus

Neither private- nor public-sector borrowing levels are particularly high in the aggregate euro area, compared with those of the United States or the United Kingdom. The bigger issue is the regional composition of debt.

In parts of periphery Europe, debt has risen sharply as bank losses, fed by impaired private debt, have prompted the need for publicly funded recapitalization. These public borrowing needs have been heightened by depressed economic activity. Partial debt default has ensued (in Greece), along with the need of some countries (Greece, Ireland, and Portugal) for external financing assistance. But calls for wider debt forgiveness or looser fiscal policy to provide stimulus to the region have been resisted in the creditor countries, especially Germany.

Evolution of private- and public-debt ratios (2003–2013): Selected periphery countries, France, Germany, euro area, United States, and United Kingdom



Note: Private debt comprises sum of borrowing by households and nonfinancial corporations.

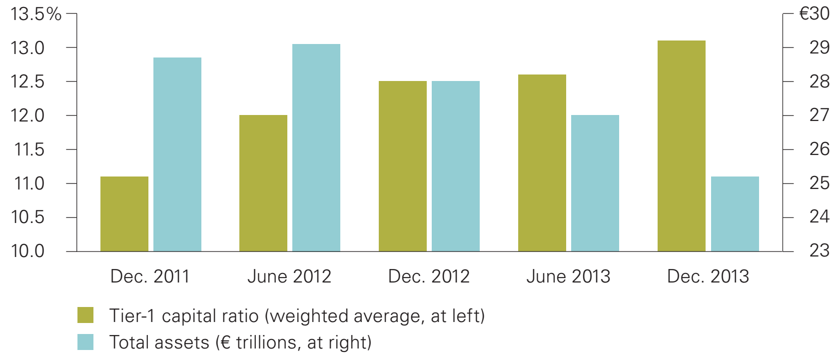
Sources: Vanguard, based on data from Thomson Reuters Datastream, Moody's Analytics Data Buffet, ECB, Banque de France, Eurostat, Federal Reserve, and U.S. Bureau of Economic Analysis.

Banks retrench, but are now better capitalized

An important consequence of the financial crisis is that it exposed the weakness of European banks' balance sheets. This weakness occurred both because of banks' earlier overexpansion and, more recently, because of lackluster economic activity, which has forced banks' losses to be written off. Tighter regulatory requirements aimed at preventing repetitive problems have required ongoing retrenchment by the banks. Injections of public and private capital have been needed as well as a radical scaling back of balance-sheet size (assets fell –12%, by €3.4 trillion, for the years 2011–13). And, significantly, new regulations have also involved aggressive deleveraging, with much tighter lending conditions.

As a result, we predict that bank lending in Europe will not begin to grow again until next year.

Improving capital ratios are partly achieved by shrinkage of European banks' balance sheets



Note: Capital ratios and balance-sheet size refer to aggregate of euro-area banks overseen by European Banking Authority (EBA).

Sources: Vanguard calculations, based on EBA Key Risk Indicator Database.

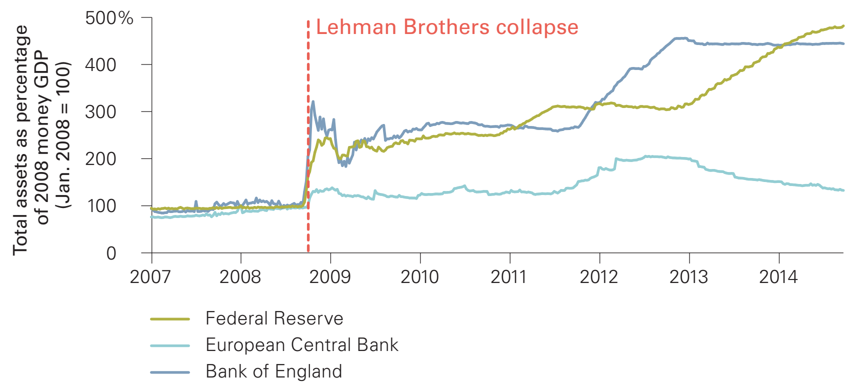
Europe needs bank lending to grow, a challenging task for the ECB

The necessity for bank deleveraging presents a paradox for European policymakers—about 80% of corporate funding in the euro area is intermediated through banks, compared with about 20% in the United States.

The ECB has recently announced stimulus plans, providing targeted liquidity to banks and buying securitized bundles of bank assets. The plans are designed primarily to encourage prudent bank lending, especially to smaller companies.

Although we believe these efforts will have a positive effect, experience in the United States and the United Kingdom suggests that if deflation is to be avoided, the ECB's balance sheet may need to expand even further, including outright quantitative easing via purchases of sovereign bonds. For now, political opposition, mainly from Germany, is preventing such decisive action. We believe chances are roughly even that this policy will be adopted, probably in early 2015.

Global central bank assets as percentage of a region's 2008 money GDP



Notes: Total assets for each central bank are shown as a percentage of that country's/region's 2008 GDP. Data as of September 7, 2014.

Sources: Vanguard calculations, based on data from Federal Reserve, Bank of England, ECB, Bank of Japan, and International Monetary Fund.

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