Benoît Coeuré: Credit and investment in the European recovery

Speech by Mr Benoît Coeuré, Member of the Executive Board of the European Central Bank, at the IMF/Bank of Slovenia high-level seminar on "Reinvigorating Credit Growth in Central, Eastern and Southern European Economies", Portoroz, 26 September 2014.

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Summary

To revive the euro area economy recapitalisation not only in the banking sector but also a repairing of private sector balance sheets is needed. The banking sector is undergoing a necessary process of structural reforms. With concluding the Comprehensive assessment there is potential to ensure that credit supply constraints diminish and the cycle turns.

For a stronger rebound in investment the private non-financial sector needs to raise equity. One instrument especially for smaller and medium size enterprises is to allow EU investment funds to be distributed in the form of equity and not only in the form of debt, as the European Bank for Reconstruction and development (EBRD) and the International Finance Corporation (IFC) already do in many countries. Also the fragmentation in venture capital markets should be reduced.

For smaller firms with the need of deleveraging debt-for-equity-swaps, possibly fostered by tax incentives, could facilitate private debt workouts.

What is also needed is to raise productivity. An "upward shock" to total factor productivity is needed but only possible in highly competitive markets.

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Introduction

Across Europe credit growth is weak. In most central and eastern European countries credit is either stagnant or growing at low rates. In many countries of the euro area[1] credit to the private sector is even in negative territory. The reasons for this are several, but at the heart is a vicious circle of low growth, low investment and low credit. And the challenge facing policymakers today is how to break it.

The current policy debate is largely focused on the credit dimension. And indeed, there is evidence that creditless recoveries, while not as rare as sometimes contemplated, are much less common in high income, financially developed economies than in low income countries.[2] As European economies heavily depend on bank loans, it stands to reason that the recent weak credit performance of Europe is contributing low economic growth rates.

It is nevertheless important that reinvigorating credit growth is not seen as an end in itself. Research based on international evidence suggests that a fast-growing banking sector can be detrimental to aggregate productivity growth.[3] And we have seen in the euro area that

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1 In Q2 2014, the annual growth rates of MFI loans to the private sector were negative in Cyprus, Greece, Ireland, Latvia, Malta, Netherlands, Portugal, Slovenia, and Spain.

2 See for example Darvas, Zsolt, (2013), "Can Europe recover without credit?" Using Data from 135 countries, covering five decades, the study suggests that creditless recoveries, in which the stock of real credit does not return to the pre-crisis level for three years after the GDP trough, are not rare and can be characterised by remarkable real GDP growth rates. However, the study finds that the implications of these historical episodes for the current European situation are limited, as creditless recoveries are much less common in high-income countries, and such recoveries were associated with significant real exchange rate depreciation.

3 Cecchetti, Stephan G and Enisse Kharroubi (2012), "Reassessing the impact of finance on growth", BIS Working Papers No 381.

credit growth that leads to the wrong type of investment creates financial imbalances eventually leading to crises, while doing little to support long-term economic performance.

Indeed, the 1999–2007 period saw a positive correlation between the initial level of GDP per capita and average total factor productivity (TFP) growth rates: the highest TFP growth rates were found in Germany, Austria, Netherlands and Finland, while in the "catching-up" economies (Spain, Greece, Portugal, Ireland) TFP actually declined. An important explanation for this is that capital in the latter economies flowed disproportionately into the non-tradable/services sector, which in general has lower productivity growth. Investment was highest in the construction and real estate sectors, closely followed by retail, transport and leisure.[4]

This experience shows us that the *quality* of credit matters as much as the quantity, and it implies that policymakers should focus on a broader question than just reviving credit – namely, "how can we channel savings towards productive investment?". This focus on investment is warranted because, in the short run, it is key to boosting demand and creating a self-sustaining recovery. And over the longer run, ensuring that investment is efficiently allocated helps create a virtuous circle between productivity and credit, thus avoiding mistakes of the past.

Achieving this requires a policy agenda that encompasses both credit supply and demand factors. It requires that we unclog and diversify the channels of financial intermediation in the euro area; that we recapitalise the economy through both reducing debt and raising equity; and that we have a policy mix that makes borrowing to invest worthwhile.

In other words, it requires a comprehensive approach. And what I would like to do this afternoon is sketch out for you what such a comprehensive approach could look like, drawing on the lessons learnt from the crisis and the post-crisis adjustment.

Fixing the credit channel

The starting point is logically the financial sector, and here we are confronting a changing landscape: the European banking sector is undergoing a necessary and largely unavoidable process of structural change. Banks are adopting less risky business models, moving to more deposit-based funding strategies and strengthening their equity capital. As a result, there is a clear trend towards an overall smaller and less leveraged banking industry.

While there are several benefits to this process[5], it also presents an important question, which is how we can have more credit for productive firms, but less leveraged banks.

The medium-term solution is for both banks and capital markets to adapt to the new environment. For banks this means refocusing their business models and taking advantage information technology developments to improve risk management and lower operating costs. We will always need strong banks in the euro area, as they play an essential role in situations where information cannot be standardised or where state verification is costly, for example lending to small- and medium-sized enterprises (SMEs).[6]

The main challenge in capital markets is to expand market access for firms across the euro area. This is to some extent already happening organically, as firms that can issue diversify their funding sources, but it is uneven: bond issuance is strongly concentrated in countries

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4 European Commission, 2013, "Catching-up processes in the euro area", in Quarterly Report on the Euro Area, Vol. 12, Issue 1, March 2013.

5 See speech by Benoît Cœuré, "On the optimal size of the financial sector", Frankfurt, 2 September 2014.

6 See for a discussion Levine, Ross (1997). "Financial development and economic growth: views and agenda". Journal of Economic Literature 35, 688–726 or more recently Jayaraman, Sudarshan. and Anjan V. Thakor, 2014, "Who Monitors the Monitor? Bank Capital Structure and Borrower Monitoring", mimeo.

and among firms where bank lending constraints are lowest. As the ECB has argued on several occasions[7], this is one reason why we need to urgently focus on creating the legal and regulatory framework for a genuine single market in capital in Europe.

Essentially, what we are aiming for is a more balanced financing mix where firms have a greater ability to substitute bank and market finance, and hence intermediation becomes more contestable and resilient. I would however emphasise that balance is key; we should not view market finance as a cure-all. Indeed, there is some research to suggest that too much substitution towards market finance may lead to less total borrowing, as firms that replace bank loans with bond issuance internalise the fact that this type of borrowing will be harder to restructure in bad times.[8] Besides, Europe does not have a set of institutions consistent with a fully market-based allocation of savings, such as funded pension schemes.

In any event, a more diversified financing mix is realistically a project for tomorrow. We are now seeing signs that credit demand is picking up, making it imperative that nascent demand is not choked off by credit supply constraints. Our focus today therefore has to be on bank finance, namely ensuring that it can continue to fund the real economy even as banks downsize and restructure. And this is where two current policy initiatives come in.

The first is the comprehensive assessment of bank balance sheets, which has the potential to ensure that supply constraints diminish as the cycle turns this year. One purpose of the assessment is to steer the deleveraging process towards a "good" form – i.e. banks quickly carving out non-performing assets and raising equity – which international experience suggests leads to a faster rebound in credit to viable firms. Indeed, empirical research suggests that the oft-heard view that higher bank capital leads to lower loan supply is not accurate. Long-run evidence for Germany, for example, finds that higher bank capital tends to be associated with higher business loan volume, with no evidence of a negative effect.[9]

While the exercise will only conclude next month, we can already see signs that it has affected both the speed and quality of deleveraging. Whereas from 2011 to 2012 asset deleveraging accounted for only 0.1 percentage point of 1.3 percent increase in banks' Core Tier 1 ratios, from 2012 to 2013 (i.e. after the assessment was launched) it accounted for 1.0 percentage point of the overall increase of 1.2 percent. Capital increases accounted for about half the increase over the 2 years.[10] This acceleration of the process suggests that, once the final results are known and residual uncertainty is removed, banks will be in a stronger position to resume new lending.

The second on-going initiative is the full rollout of the ECB's credit easing package, which aims to encourage banks to use their new balance sheet space for lending to the real economy.

The Targeted Long-Term Refinancing Operations (TLTRO) have a built-in incentive mechanism to encourage loans to firms and households, and we expect a stronger take up from banks in the December operation and in the six subsequent instalments until June 2016. And our programmes to purchase outright high quality asset-backed securities (ABS) and covered bonds complement this by providing market incentives for banks to originate more saleable securities, and thus more loans to collateralise them.

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7 See speech by Benoît Cœuré, "Completing the single market in capital", ICMA Capital Market Lecture Series 2014, Paris, 19 May 2014.

8 Crouzet, Nicolas (2013), "Corporate debt structure and the macroeconomy", mimeo.

9 Buch, Claudia and Esteben Prieto (2014), "Do better capitalized banks lend less? Long-run panel evidence from Germany", International Finance 17:1.

10 See ECB Financial Stability Review, May 2014.

In short, the combination of these two initiatives results in a confluence of factors – improved incentives and higher capital – that should allow loan supply to expand elastically to meet loan demand. And to the extent that credit supply and demand are endogenous, for instance through the effect of supply constraints on macroeconomic risk, we could see the beginnings of a self-sustaining credit recovery.

I would nonetheless question whether a credit recovery is enough to achieve an investment recovery, and hence a sustained recovery for the economy. If we look at the breakdown of credit demand components in the survey data, fixed investment is only having a mildly positive effect on demand after 11 quarters of negative effects.[11] And this demand may well be "backward-looking" – that is, delayed projects coming back online. From a "forward-looking" perspective, there are reasons to cautious about the degree of pent-up investment demand.

Principal among these is that, while banks might have deleveraged, not all of their customers have. In several euro area countries firms still face a debt overhang that affects the economics of taking on new credit.

Real interest rates in the euro area are expected to decrease, as nominal interest rates will remain low for a long period while inflation is expected to gradually rise back towards 2%. But the issue for over-indebted firms is that long-term real interest rates probably cannot go low enough to make new investment attractive: any profits generated will be absorbed by servicing existing debt. Indeed, we see a clear negative correlation – with a coefficient of –0.48 – between corporate debt-to-GDP levels in different countries at the beginning of the crisis and the evolution of non-residential investment since.

Repairing private sector balance sheets

If we want to see a stronger rebound in investment across the euro area, the next step therefore has to be repairing non-financial private sector balance sheets. And as this process will take place against the backdrop of low inflation and, in the most affected countries, limited fiscal space, it will have to involve reductions in nominal debt.

The rebooting of the financial sector that has already taken place puts us in a better position to achieve this. When the comprehensive assessment concludes, banks will acknowledge losses and raise provisions and capital – after the disclosure of the results, capital shortfalls are expected to be covered within six months for the Asset Quality Review or the baseline stress test scenario, and within nine months for the adverse stress test scenario. Thus, from the bank side, restructuring loans to distressed borrowers should become more feasible.

What we need going forward is more efficient debt restructuring and insolvency regimes for firms, which at present vary widely between euro area countries. The effectiveness of the restructuring regimes is often hampered by sluggish creditor coordination, a lack of new financing for viable companies undergoing restructuring and an overburdened judicial system. For example, according to the World Bank, to resolve insolvency in Italy takes 1.8 years, compared with just 0.4 years in Ireland.

A number of stressed countries have already begun to take initiatives to improve restructuring and insolvency proceedings. In Greece, for example, facilitating debt workouts for viable companies is being made simpler by two new out-of-court debt restructuring tools: one for larger enterprises that includes a multi-creditor coordination mechanism inspired by international standards; and one for SMEs that employs standardised templates.

In Spain, the substantial amendment to the Insolvency Law earlier this year, among other things, makes facilitating out-of-court settlements easier while also making in-court

[11] See ECB Bank Lending Survey, July 2014.

settlements more effective. Court approved refinancing agreements now have lower majority requirements and permit the extension of maturities on bank loans, negotiating haircuts and arranging debt-for-equity swaps. Ireland and Portugal have also introduced various measures targeted at enterprises, SMEs and households.

In most cases, however, restructuring and insolvency regimes could be made more efficient still by adopting best practice more broadly. This would include, inter alia, strengthening measures to facilitate out-of-court settlements for viable firms; introducing centralised guidelines for voluntary debt workouts coupled with independent intermediation for larger companies; and establishing standardised voluntary workouts for SMEs.

The deleveraging of European firms is however not only about reducing debt; it is first and foremost about raising equity. We have in fact already seen a significant decline in debt-to-equity ratios for larger euro area corporates since end-2009 due to valuation gains in equity markets, supported by low interest rates.[12] To the extent that our new monetary policy measures affect the relative supply of financial assets and initiate further portfolio rebalancing, we may see further spillovers to equity markets that continue this trend.

For smaller firms, however, these channels are less powerful as equity markets are largely underdeveloped. Raising equity therefore has to be more proactive process.

One way to achieve this is to use debt-for-equity swaps (fostered possibly through tax incentives) to facilitate private debt workouts. Another is for EU investment funds to be distributed in the form of equity as well as debt, as the European Bank for Reconstruction and development (EBRD) and International Finance Corporation (IFC) already do in many countries, and as I called for in a recent article.[13] A third, more medium-term aim is reduce fragmentation in European venture capital markets to increase the depth of private equity markets.

This last point is another example of where advancing towards a single market in capital would be beneficial for the euro area – it would not only help strengthen capital markets relative to banks, but also help strengthen equity funding relative to debt. This would also have positive structural effects for the euro area: cross-country integration through equity improves risk-sharing and, as it is harder for investors to “cut and run”, would most likely provide more resilience in a crisis than integration through interbank lending and fixed income investment. New research shows that the vulnerability of the euro area to a “sudden stop” worsened the crisis by further constraining the fiscal reaction of governments during the downturn.[14]

While such options to increase equity funding are being developed, a strategy that can improve debt dynamics for all firms’ is to raise “implied equity” – the outlook for future income. If firms expect higher income, it improves their debt-to-income ratios and debt service capacity, which in turn creates space for new investment.[15] In this sense, raising both the level and trend of potential growth is an integral part of recapitalising European firms, and indeed of the economy as whole.

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[12] For more information see article on “Deleveraging patterns in the euro area corporate sector”, ECB Monthly Bulletin, February 2014.

[13] See opinion piece by Benoît Cœuré and Jörg Asmussen, “A three-pillar-strategy for the euro”, published in Berliner Zeitung and Les Echos, 19 September 2014.

[14] Martin, Philippe and Thomas Philippon (2014), “Inspecting the Mechanism: Leverage and the Great Recession in the Eurozone”, forthcoming.

[15] The concept of “implied equity” echoes in an investment context what Holmstrom and Tirole have called “inside liquidity”, i.e. future income streams that the private sector can pledge to react to a liquidity shock. Raising implied equity has therefore the additional benefit of making the economic system more resilient to shocks, i.e. it has stabilising as well as allocative properties. See Holmström, Bengt and Jean Tirole (2010), Inside and Outside Liquidity, MIT Press.

We face however a circular problem in the euro area: we need higher potential growth to work through the debt overhang so that firms can being investing again; but that investment is itself necessary to raise potential growth. And this circle is potentially vicious: if low potential growth leads to lower investment, then it further lowers potential growth.

A policy mix to lift investment demand

This is where the next part of a comprehensive approach comes in: getting the policy mix right on the supply side of the economy to lift investment demand.

In a basic Solow growth model, investment grows at the growth rate of productivity plus the growth rate of hours worked along the steady state path of the economy. As we can only expect limited labour participation gains in an ageing society, to raise investment demand we therefore have to raise productivity. Indeed, achieving an upward shock to TFP seems to me essential to trigger, in a sustainable way, a positive accelerator effect between productivity, investment and credit.

But it requires an environment characterised by two things: *competition* and *certainty*.

Competitive markets are necessary to ensure that investment and productivity are indeed mutually enhancing, which as I said earlier is not a given: high investment in several euro area countries in the pre-crisis period did not lead to a convergence in TFP. Certainly, an important reason for this was that too much capital flowed into real estate. But misallocation also resulted from low levels of competition in the non-tradable/services sector more generally which distorted price signals. As some firms could capture excess rents, a falling marginal product of capital was counterbalanced by rising profit margins, meaning that total compensation from investing in these sectors remained high.[16]

So: the flipside of productive investment is more competitive markets that produce more accurate price signals, thus drawing resources to where they are most efficiently employed. Achieving this requires not only product and labour market reforms that accelerate the "churn" process within and across sectors[17], but also reducing unnecessary regulations that hinder the allocation and reallocation of resources.

The World Bank's "Doing Business" report gives examples such obstacles. If an entrepreneur wants to start a new business in Spain, she has to go through 10 separate procedures, while doing so in Slovenia requires only two. If a firm wants to launch a green field investment, it would have to wait 200 calendar days in Ireland before a new warehouse gets electricity; in Germany it would have to wait only 17 days.[18]

There are reasons to be optimistic about the effects of a reform process in the euro area. Recent micro-level research from the Eurosystem's Competitiveness Network, for instance, shows that there is a large and skewed distribution between the most and least productive firms in individual euro area countries. Far from being normally distributed, there are a few highly productive firms and many which have low productivity.[19] This implies that a faster and more efficient reallocation across firms and sectors could be quite powerful.

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16 European Commission (2013).

17 For more on the effects of "churning" on productivity see Foster, Lucia, John Haltiwanger, and Chad Syverson (2008), "Reallocation, Firm Turnover, and Efficiency: Selection on Productivity or Profitability?", American Economic Review, 98(1).

18 World Bank (2013), Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises.

19 CompNet Task Force (2014), "Micro-based Evidence of EU Competitiveness: The CompNet Database", ECB Working Paper Series No. 1634.

Where *certainty* complements this process is by fixing expectations: the more firms trust that structural reforms will be followed through vigorously, the more they will be inclined to invest on that basis. Put differently, certainty allows the positive medium-term effects of structural reforms to be brought forward into the present. The fact that euro area corporates are currently holding record amounts of cash, rather than investing, suggests that plans for structural reforms are not yet credible enough to reap this “certainty dividend”.

Certainty also extends to tax policy. Remember that what matters for firms when deciding whether to invest is the *after-tax* return on investment. Thus, if firms expect the burden of future taxation to rise, the internal rate of return on a given project is lowered, effectively cancelling out the stimulative effect of lower interest rates on investment. And by contrast, a lower expected tax burden increases the effectiveness of any monetary policy measures.

But certainty means also that we stick to our commitments. Indeed, sticking to our own commitments has to become the hallmark of the euro area. The ECB will continue to provide a nominal anchor to the euro area recovery by delivering its primary mandate to bring inflation back to a growth rate of below but close to 2%. It is essential that in parallel all countries follow the rules outlined in the Stability and Growth Pact (SGP) and in the Macroeconomic Imbalances Procedure (MIP) and that these rules are not stretched to the point where they would lose credibility.

Conclusion

My main message today is simple: we need to focus on the quality of credit, not only the quantity.

To create an environment where credit flows to productive investment requires a coherent and comprehensive approach. It requires managing the bank deleveraging process while the euro area transitions to a more balanced financing mix. It requires finding workable solutions to reduce the debt overhang involving both reducing debt and raising equity. And it requires acting on the basic determinants of investment demand, namely productivity.

Fortunately, all the pieces of the jigsaw are now in place to achieve such an approach. Banks are approaching the end of their deleveraging. This is creating a better capitalised sector that can facilitate restructuring. And we have an emerging consensus on the importance of supply sides policies to boost growth potential. We now simply need to put those pieces together.