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Economics Group

Special Commentary

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Will QE Be a "Silver Bullet" for the Eurozone?

Executive Summary

The European Central Bank's (ECB) quantitative easing (QE) program is less than a month underway, but its effect on financial markets has already been impressive. Since the program was announced on January 22, the STOXX 50, the benchmark equity index in the Eurozone, has risen roughly 12 percent. The yield on the 10-year German government bond has fallen about 30 bps, and market-based inflation expectations have edged higher. Moreover, the value of the euro has fallen against most major currencies, and is down nearly 5 percent on a trade-weighted basis since the announcement of the program. While these financial market developments are undoubtedly positive, the longer-term effects of the program on the real economy are arguably more important to its success, however.

QE has already had a marked effect on financial markets.

To gauge the effects of QE on the real economy, we analyze the key sectors of the Eurozone economy that are likely to be directly affected by the QE program and what impact we are likely to see in these sectors. As a further means of judging the potential effects, we use the United States as a benchmark to compare the relative size and importance of each of these sectors to the Eurozone economy.

Europeans Hold Fewer Financial Assets than Americans

Since bottoming out in 2009, the S&P 500 index has more than trebled in value. While difficult to precisely quantify the effect of QE on stock prices, theory suggests that QE should reduce the discount rate on future cash flows, thus increasing the present value of these cash flows and, in turn, boosting stock prices. Partly as a result of the booming stock market, household net worth in the United States has risen by roughly 50 percent since 2009. If European equity markets experience a similar rally as American markets did over the past few years, will European households' net worth get a similar boost?

Generally speaking, residents in the euro area have less of their wealth tied up in financial assets than Americans. Figures 1 and 2 show that Eurozone households predominately hold nonfinancial assets, the vast majority of which represent equity in real estate. In contrast, two-thirds of U.S. households' assets are financial assets. Looking at the data in further detail, we see that equity shares account for twice as much of total household assets in the United States as in the Eurozone. Moreover, U.S. household assets are relatively more comprised of debt securities and mutual fund shares, both of which would arguably appreciate in value if interest rates were to trend lower via QE. Within financial assets, households in the Eurozone tend to hold relatively more currency and deposits than their counterparts in the United States.

Most of euro area households' wealth is tied up in nonfinancial assets or less risky financial assets.

Thus, it seems that households in the Eurozone are generally less well-positioned than their American counterparts to take advantage of appreciation in financial assets, should it occur. However, we note an important structural difference between the European equity markets and the American stock market: there are 19 countries in the Eurozone, and thus a number of different benchmark stock indices. Thus, while the German DAX stock index might see a rally in the coming years, this does not guarantee a rally in the French CAC index or any other euro area index. Unfortunately, there are no breakdowns that are readily available of stock holdings by country, so we cannot offer insight into where European households hold equity positions.

Figure 1

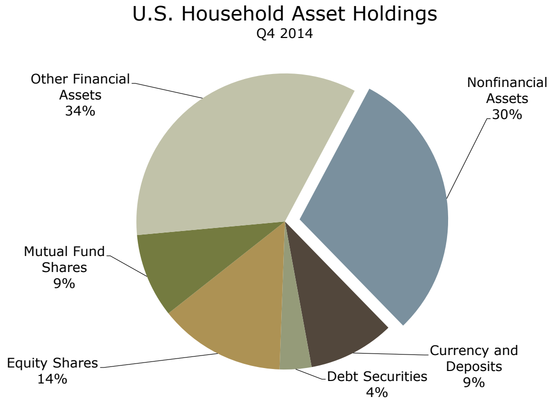
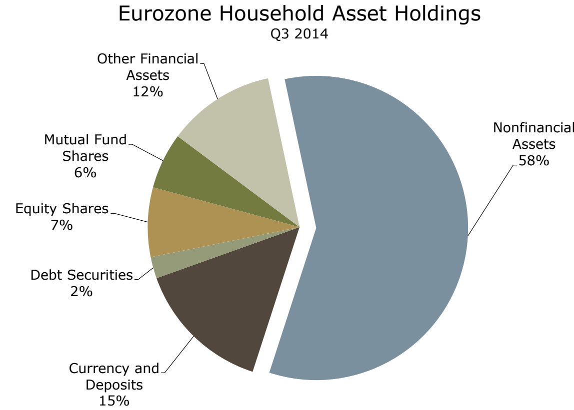


Figure 2



Source: Federal Reserve Board, European Central Bank and Wells Fargo Securities, LLC

Corporate Bonds Not as Important in Europe as in the United States

The U.S. corporate bond market dwarfs the European market.

One of the key trends that we have seen in U.S. credit markets during this recovery is the boom in corporate bond issuance over the past few years (Figure 3). While this undoubtedly is a typical cyclical trend, QE likely played a role in depressing long-term bond yields and thus lowering borrowing costs for U.S. corporations (Figure 4). The size of the market for U.S. corporate debt securities is roughly $4.5 trillion, which represents about 68 percent of the $7.6 trillion of total outstanding corporate credit in the United States.[1] How does Europe's corporate bond market compare?

Figure 3

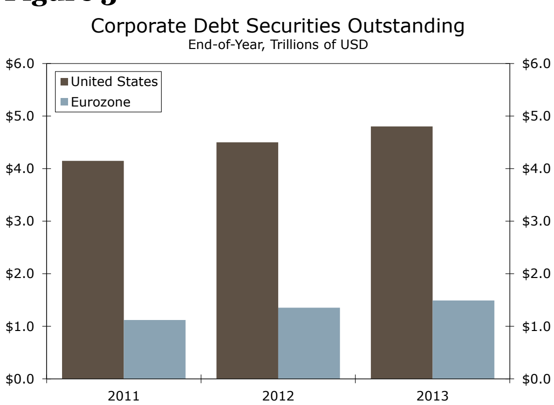
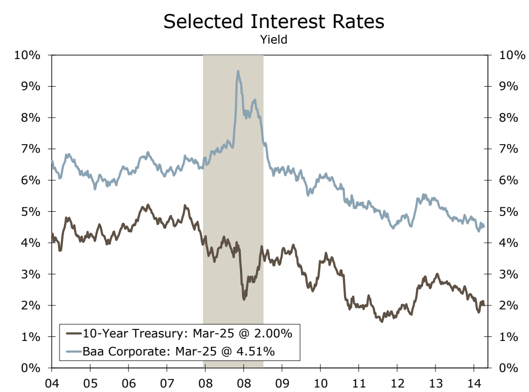


Figure 4



Source: Bloomberg LP, Moody's and Wells Fargo Securities, LLC

Of the €10.1 trillion total outstanding credit of European corporations, only about €1.2 trillion, or roughly 12 percent, is in the form of debt securities. In other words, corporate bonds are a far less prominent form of financing in the euro area than they are in the United States. However, beyond the relative size of the two country's corporate bond markets, there are some other important differences between the situations of the two regions.

First, the Eurozone is arguably at a different stage of the business cycle than the United States was when QE was first introduced. Nominal borrowing costs across Europe are generally far lower than borrowing costs in the United States when QE was first initiated. In November 2008, when the Fed unveiled its first round of QE, the 10-year Treasury was yielding roughly 3 percent. When

[1] For consistency with Euro area data, we include $518 billion of municipal (industrial revenue) bonds and $182 billion of commercial paper in our calculation of U.S. corporate debt securities, as a detailed breakdown beyond "debt securities" is not available for Euro area non-financial corporations.

the ECB announced its bond buying program on January 22, benchmark 10-year yields in Germany, Spain and Italy were 0.45 percent, 1.41 percent and 1.55 percent, respectively. Although sovereign bond markets in Europe have rallied, how much lower can yields realistically fall? And while the United States was in the middle of one of the worst downturns in its economic history when its first round of QE was introduced, the Eurozone has technically been out of recession for roughly a year and a half.

Furthermore, depending on where a corporation decides to issue debt in the euro area, it is likely to have a different benchmark for its borrowing costs. For example, the same company would likely have different borrowing costs in Greece than it would if it decided to borrow in Germany. As a result, the net effect of the program on benchmark borrowing costs will likely vary widely by country.

Structural differences make a U.S.-Eurozone comparison less clear.

Some Signs of Life in European Bank Markets

While bond issuance is not as popular among European corporations as it is among U.S. corporations, traditional lending is a far more prevalent form of financing for European companies. Specifically, loans account for €9.0 trillion, or 88 percent, of the €10.1 trillion outstanding stock of corporate credit in the euro area. By comparison, loans account for only $1.8 trillion, or roughly 32 percent, of all outstanding U.S. corporate credit. What does this mean in the context of the ECB's QE program?

Figure 5

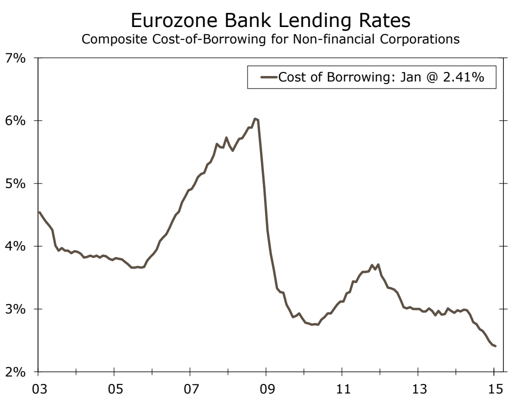
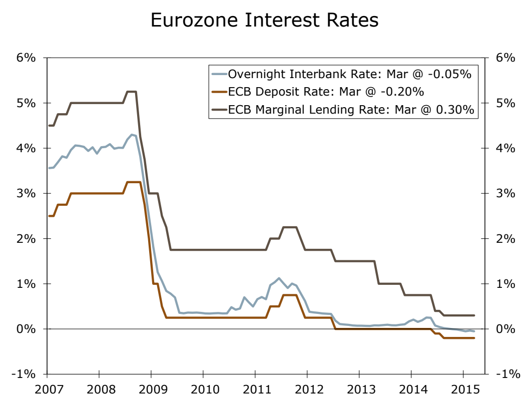


Figure 6



Source: European Central Bank, Bloomberg LP and Wells Fargo Securities, LLC

In implementing QE, the central bank finances its bond purchases from commercial banks via the creation of bank reserves, providing more fuel for banks to lend to consumers and businesses. QE should put downward pressure on loan rates, and we have already seen a sharp decline in bank lending rates in recent months (Figure 5). Further adding an incentive to lend is the ECB's negative deposit rate, which means that banks must pay to hold their excess reserves with the central bank (Figure 6).[2] These forces in tandem should, in theory, work to boost bank lending, all else equal.

Bank lending will be supported by a multitude of factors going forward.

However, there are far more variables that determine bank lending activity, both on the supply side (regulations and credit standards) and the demand side (businesses' willingness to make capital investments). That said, the ECB's bank lending survey shows promising data for loan supply and demand, as a net positive percentage of banks are reporting easing standards for loans to businesses and a solid net positive percentage of banks are reporting stronger demand for these loans (Figure 7). In another sign of positive progress, loan growth in the Eurozone has turned positive, albeit modestly, for the first time in nearly three years (Figure 8).

[2] The ECB also lowered the interest rate on its Targeted Long-Term Refinancing Operations (TLTRO) by 10 bps to 0.05 percent. Through its TLTRO program, the ECB provides subsidized long-term loans to European banks provided that those banks use the liquidity to make loans to the private sector.

Figure 7

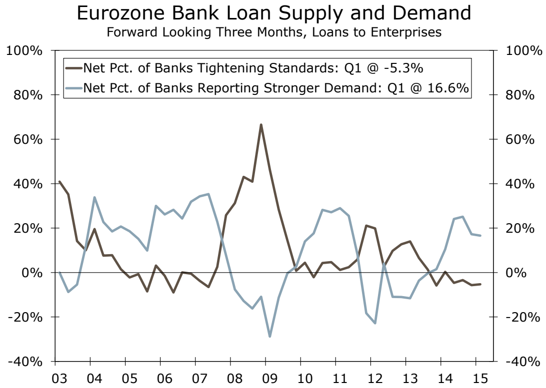
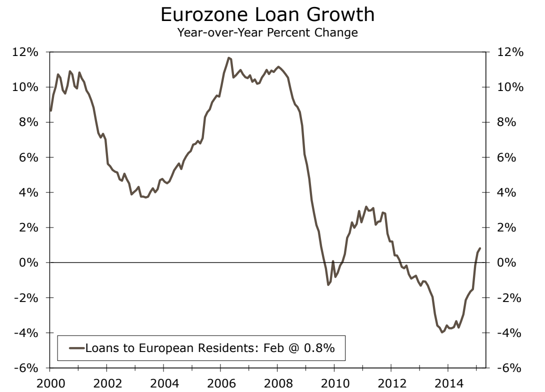


Figure 8



Source: European Central Bank, IHS Global Insight and Wells Fargo Securities, LLC

The Euro and the Export Channel

The euro has already depreciated against most major currencies.

The rout of the euro in recent months, particularly relative to the U.S. dollar, has been noteworthy. Since May 2014, the euro has fallen more than 20 percent against the greenback and nearly 15 percent against the British pound. The nominal effective exchange rate, a trade-weighted measure, has fallen nearly 15 percent over the same period and is now at its lowest level in more than ten years (Figure 9). While there are a number of key implications of a weaker currency for the European economy, one of the most significant is the effect on net exports. All else equal, if a country's currency depreciates against the currencies of its trading partners, that country will enjoy an increase in the price competitiveness of its exports.

Figure 9

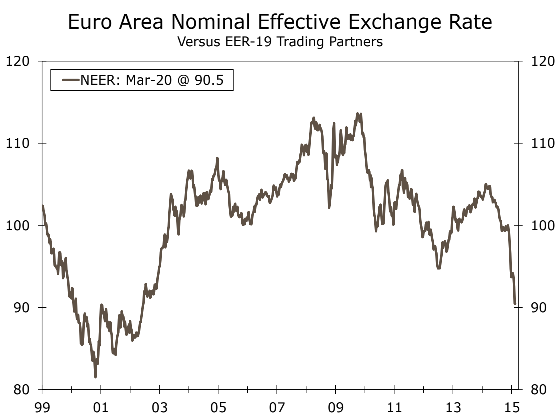
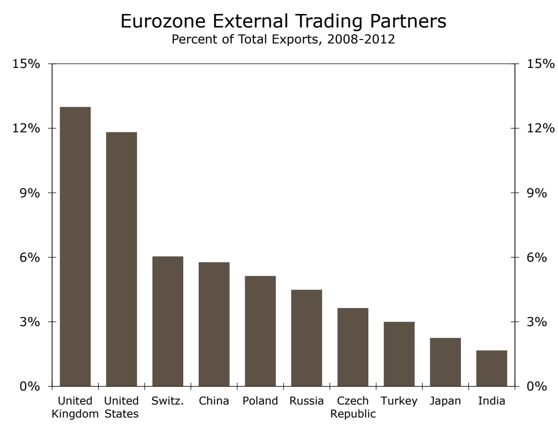


Figure 10



Source: European Central Bank and Wells Fargo Securities, LLC

While the ECB's QE program has arguably been priced in to financial markets to some degree, we suspect that a sustained bond purchase program will cause the euro to depreciate further. In fact, our currency strategists currently expect the euro to continue to decline and trend lower against the U.S. dollar in coming months. Assuming we do see further euro weakness following the implementation of QE, how significant will a boost to net exports be for the Eurozone economy?

Most trade in the Eurozone is between member countries.

At first blush, the Eurozone seems like a remarkably open economy. For example, exports are equivalent to about 45 percent of GDP in Germany and represent more than 50 percent of GDP in Austria. However, most of this trade is not affected by fluctuations in the value of the euro, as it occurs within the borders of the currency union. To gauge the effect of the falling euro on trade, we must look at exports from the Eurozone to non-Eurozone countries. Based on 2013 data, Eurozone exports to non-Eurozone countries account for roughly 12 percent of Eurozone GDP. In contrast, U.S. exports represented about 9 percent of GDP in 2013. Figure 10 provides a breakdown of the Eurozone's most significant external export markets, which gives a sense of which euro exchange rates would be the most important drivers of aggregate export growth in the coming years.

While this difference is not monumental, it demonstrates that exports are a more significant portion of GDP in the Eurozone than the United States. However, statistical analyses we have done in previous publications show, at least in the U.S. case, global growth is a more important determinant of export activity than the value of a nation's currency.[3] Thus, while exports are a more significant component of Eurozone GDP, currency depreciation via QE will not necessarily provide a sizable boost to GDP growth in the region in the coming quarters.

Bottom Line: Boost for Some, Nudge for Others

The ECB's QE program has been fully operational for less than a month, but we have already seen the power of expectations take hold in financial markets. While financial developments have been generally positive for the Eurozone, the true litmus test of the program will be its longer-term effects on the real economy. Based on our analysis, we conclude that corporate capital expenditures, via lower interest rates, and net exports, via a weaker euro, are set to benefit the most from the program. Household wealth, on the other hand, is likely to get less of a boost, particularly in the context of the U.S. case. On net, QE is unlikely to be a "silver bullet" for the Eurozone economy, but it should help on the margin.

The true litmus test of QE will be its longer term effects on the real economy.

[3] See *"Will Dollar Strength Scuttle U.S. Exports?" (March 13, 2015). This report is available upon request.*

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