No credit crunch (yet) – but here is why we should be worried

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The European Central Bank has just published its Bank Lending Survey for the second quarter of 2020. This survey provides a window in bank lending in the euroarea and, in particular, the supply of loans by banks to the non-financial sector. Taken at face value, the numbers are not that bad. We observe only a small tightening of lending standards across the euroarea, large firms do not experience any tightening while small and medium enterprises (SMEs) face somewhat stricter supply conditions.

But here are **three reasons** why we should be worried:

1. **SMEs might have limited access to credit and higher funding costs**. Large firms do not have any problems in obtaining credit. They have stronger relationships with large lenders and usually unused credit lines they can draw from to increase cash reserves. Importantly, they have considerably increased access to new credit commitments since April 2020. Banks, as provider of these commitments, have thus committed a substantial percentage of their equity capital to fund these commitments, particularly in an aggregate shock in the same way as we have recently witnessed. SMEs usually lack these relationships and commitments and might face tighter constraints if the economic situation does not improve over the medium term.
2. **Zombie lending and congestion in weaker countries**. Germany is one of the few cases that experiences a tightening in lending standards, while e.g. France, Italy and Spain report a net loosening of lending standards. However, this appears to be entirely driven by loans under a government guarantee program, which are fully or at least partly guaranteed. Moreover, bank risk tolerance has substantially increased among Italian banks. In all three countries, we find arguably both weaker banks and a more leveraged corporate sector. Particularly weak banks have more incentives to pay down own exposures to risky borrowers and / or roll-over existing loans and less incentives that firms enter an (efficient) liquidation procedure. This has likely negative effects on competition of firms in those sectors these firms operate in, followed by a decrease in innovation and low growth. Economic development between eurozone countries might further diverge.
3. **Credit crunch when government support programs stop**. Almost all lending in France, Italy and Spain is based on government support. That is, once government support programs stop, we will likely see a credit crunch in countries hit particularly hard by the COVID-19 induced stress. This will put further pressure on economy recovery.

What do we need to do?

1. European leaders need to agree on European solution and funds for the corporate sector.
2. This won't likely prevent corporate stress translating into a banking crisis. A key issue is the capitalization of the banking sector. Banks should raise capital now but European leaders need to prepare to recapitalize the banking sector quickly and decisively.