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Insights

Europe: A Lost Decade Ahead?

JANUARY 2014

The credit crunch under way now for five years in Europe may have already created permanent and irreversible damage to those economies. We ask the question: Is Europe on its way to a lost decade?

European Macroeconomic Environment

- Economic activity in Europe is overwhelmingly driven by small- and medium-sized enterprises (SMEs) to a much greater extent than in the US and most other developed countries. These companies do not have access to capital market financing due to size and ownership structure, and therefore are highly dependent on bank financing of capital expenditure and R&D.
- The financial crisis and subsequent European banking and sovereign debt crises have constrained bank credit growth thereby placing pressure on SMEs and helping to entrench recession-like conditions in Europe. As capital expenditure is postponed or canceled, long-term productivity and employment growth prospects are diminished, ultimately leading to lower GDP growth relative to history.
- Germany's insistence on austerity, and its resistance to debt mutualization and monetary accommodation all indirectly serve to maintain the competitiveness of its export sector. This austerity, however, has had the effect of prolonging the crisis and the recession. A fickle and feeble recovery will prolong the weak earnings pattern of the past few years for European corporations, except perhaps for export-oriented firms.

Investment Implications: The Banking Sector

- Given that banks are the heart of the European economic model, the potential for a Lehman-like default is substantially less in Europe than in the US. The authorities would intervene much more aggressively as the threat of a systemic bank issue in Europe is far more frightening than in the US.
- As a result, Banks, while recognizing the need to shrink their balance sheets, will do so only at a very gradual and measured pace. Wholesale selling of large blocks of bank loans is unlikely to occur at "fire-sale" prices. Instead, banks have curtailed the issuance of new loans and gradually marked down assets as earnings allow.
- Potential opportunities exist for investors to serve as alternative financial intermediaries for SMEs in these capital-constrained conditions – many of these SMEs are leaders in their niche markets.

Investment Implications: Capital Markets

- The flip side of high unemployment and wage deflation is that cost pressures will remain subdued for many European companies. Therefore, European corporations with substantial sales outside Europe and those with access to capital market financing are attractive on a relative basis, especially with valuations more attractive in Europe versus the US.
- Poor household income growth, diminished living standards, and lack of credit lead to drastically reduced import demand into Europe. On a relative basis, exports have held up well. Combined, these factors have led to a substantial and growing current account surplus for Europe. Unsurprisingly, households' misery implies more international competitiveness. This provides a tailwind for appreciation of the Euro, though of course political events remain the chief concern.
- Much as southern US states are re-industrializing, peripheral Europe stands to reindustrialize as well – driven by labor market reforms enacted in desperation by the likes of Spain and Portugal.

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Europe: A Lost Decade Ahead?

The tendency of people to extrapolate their personal experiences to seemingly similar situations abroad is a natural one, yet it is often filled with pitfalls for investors, especially so when considering the vast structural differences between the economies of Europe and much of the rest of the world. The European banking system plays a much more central role in the fundamental health of the European economies when compared to the US banking system and that of the other Anglo Saxon countries. At a high and perhaps oversimplified level, Europe can be thought of as a bank-intermediated system, whereas the US can be thought of as a market-intermediated system. It is only with this context in mind that the intractability of the ongoing European Sovereign and Bank Debt Crisis and the severity of the resulting impact on future growth can be fully appreciated. For investors, correctly understanding the situation reveals both risks and potential opportunities.

In this paper we will provide historical and cultural context as to why and how European economies evolved to be driven by very small companies that by their very scale and design are not able to access equity or bond-based capital and are therefore constrained to bank financing. We then examine the current situation in Europe and observe that the credit situation has not improved since the financial crisis – in fact it seems to be worsening. Based on the current economic situation and current bank behavior we see little potential for improvement in credit flows. If that is the case, critical R&D and capital expenditures will not be made and therefore future growth in Europe will be compromised. This implies that potential growth in Europe will likely fall from its already low levels – often quoted at 1-1.5% / year. Said differently, the credit crunch currently under way in Europe may have already created permanent and irreversible damage to those economies. Finally, the constrained spending in current periods due to low credit availability will also serve to dampen the weak recovery currently under way.

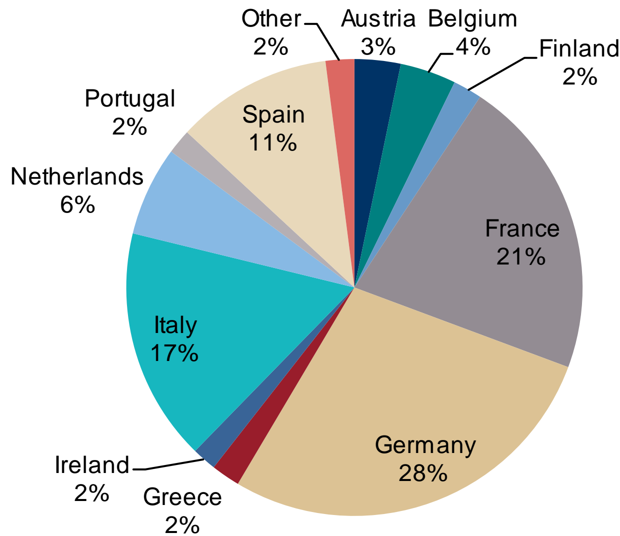
It is based on these findings that we ask ourselves the question: Is Europe on its way to a lost decade?

Historical and Economic Background

Providing some historical context into how the European banking system has evolved is necessary to understanding its importance. As is so often the case for Europe, much of the banking system's current structure has its roots in post-World War I & II reconstruction. Not surprisingly, the two Eurozone countries that were arguably the most devastated in the wars, Germany and Italy, bear the marks of heavy state involvement in the banking system to provide financing for business. Between Germany and Italy, approximately 45% of Eurozone GDP is represented, as per Figure 1 below. Add in Spain and 56% of Eurozone GDP is represented. Perhaps more importantly, Figure 2 shows that the two leading net exporters of the Eurozone are Germany and Italy, and Germany most specifically focuses on manufactured goods, which are inherently capital intensive. If one is worried about the survival of the Euro and the importance of the banking sector in maintaining Eurozone growth, it makes sense to focus on these two countries. Of note, much of what will be said about Germany will also be directly applicable to Austria, since the two economies underwent similar historic processes and today exhibit striking similarity in terms of the structure and financing of their economies.

2012 EU-17 GDP Shares

100% = €9.5T



Source: IMF World Economic Outlook October 2013, Makena Analysis

Figure 1: 2012 Eurozone GDP Shares (100%=€9.5T)

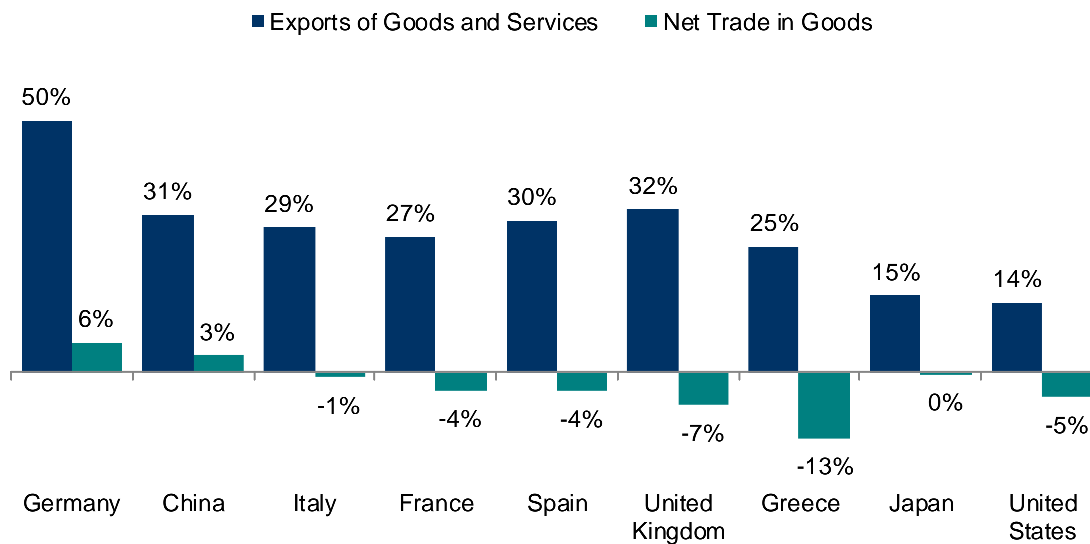


Figure 2: Exports of Goods & Services and Net Exports Of Goods

The Mittlestand Backbone of Germany & Austria: Captive to Bank Financing

After World-War II, under the US Marshall Plan, Germany created the *Kreditanstalt für Wiederaufbau* (KfW), or Reconstruction Credit Institute, to fund reconstruction of German industry. In Italy, a similar entity funneled US reconstruction aid into the economy, the *Istituto Mobiliare Italiano*, or Institute for Italian Industrial Finance, known by its initials, IMI. In both cases, though particularly in Germany, the focus of the funding was on small and medium businesses ("SME"), ostensibly to avoid having large and powerful corporations returning and posing a military threat. Indeed, in Germany, all the while funding German businesses via the various US schemes, the Allies were also busily dismantling German heavy industry, destroying some 1,500 plants (chiefly steel and coal-related operations) by the late 1940s.

The US-led financing, coupled with a traditional reliance on owner-entrepreneur small businesses, caused the small business sector to flourish in Germany. One cannot understate the historic and cultural importance of owner-entrepreneur small business in Germany, which is highlighted by the German term *Mittelstand*, for which there is no direct translation. The *Mittelstand* has often been described as the backbone of the German economy, employing some 70% of non-government workers, accounting for 44% of value added in the economy, 50% of gross investment, 50% of R&D expenditure, and 80% of apprentice-based training[1]. A recent book on the German Economy defines *Mittlestand* as follows:

[1] *SMEs in Germany - Facts and Figures 2004*, Institut für Mittelstandsforschung, Bonn

> Small and medium-sized firms make up the Mittelstand. In a narrow interpretation, the Mittelstand may be defined as all those firms with an annual revenue of €50 million or less, or with fewer than 500 employees. [...]. In these firms private ownership of the entrepreneur plays an important role, and the owner-entrepreneur is the driving force of the enterprise [...]. As a rule, the more important firms of the Mittelstand are technological specialists in their field; they are built around a technological idea, often stemming from the owner-entrepreneur or developed further by him[2].

Over time, a symbiotic-type relationship has evolved between German banks and industry. Both KfW and the eight federally and state-owned regional banks (the *Landesbanken*) finance themselves in the public markets, but have explicit government debt guarantees, allowing them to raise capital at low rates (the *Landesbanken* recently lost their guarantees). That capital is then funneled into loans for German corporations, including specific programs aimed at keeping the *Mittlestand* well-financed. In return, the *Mittlestand* essentially have become beholden to their local bankers, entrenching a system where relationships dominate the close ties between industry and banks. While this symbiosis allowed German corporations to benefit from low costs of capital, and German banks to worry relatively little about credit monitoring, it stifled the development of public capital markets. Figure 3 below highlights this fact by showing that the bond markets in Germany are less than one-tenth the size of the loan market, whereas in the US, the bond and loan markets are approximately the same size.

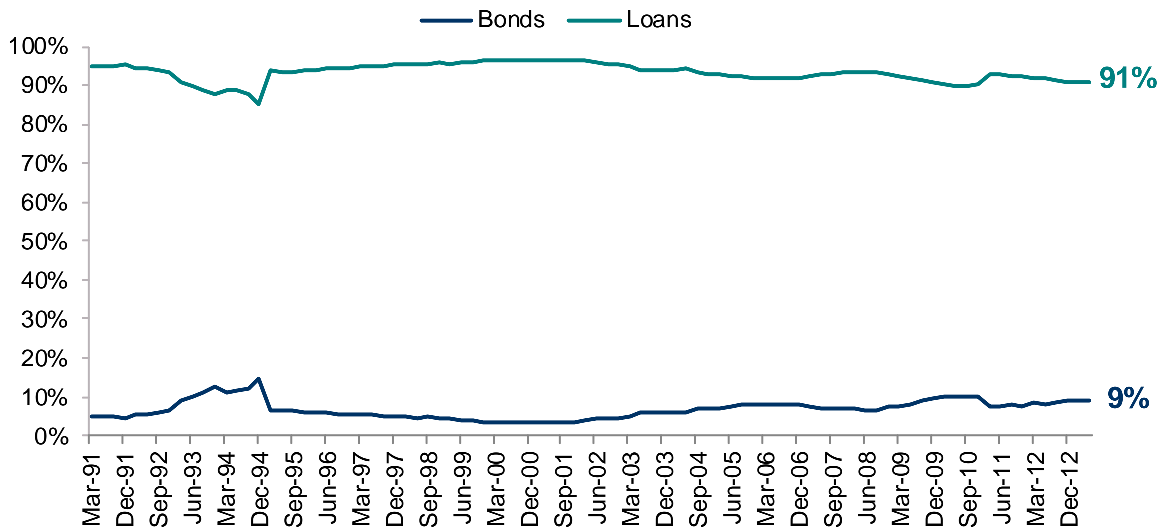


Figure 3: Credit Extended to German Non-financial Corporations

[2] *The German Economy: Beyond the Social Market*, Horst Siebert

Most of the *Mittlestand* firms are privately held, and for the reasons just mentioned cannot easily access public capital markets. Also, because they are typically active in capital-intensive industries, it is difficult for them to rely purely on equity financing from the owner-founders. Hence, to finance their exports, equipment purchases, and R&D, *Mittlestand* companies rely heavily on bank loans. The typical *Mittlestand* company capital structure only has ~14% of equity, and ~41% of bank debt, as per Figure 4 below.

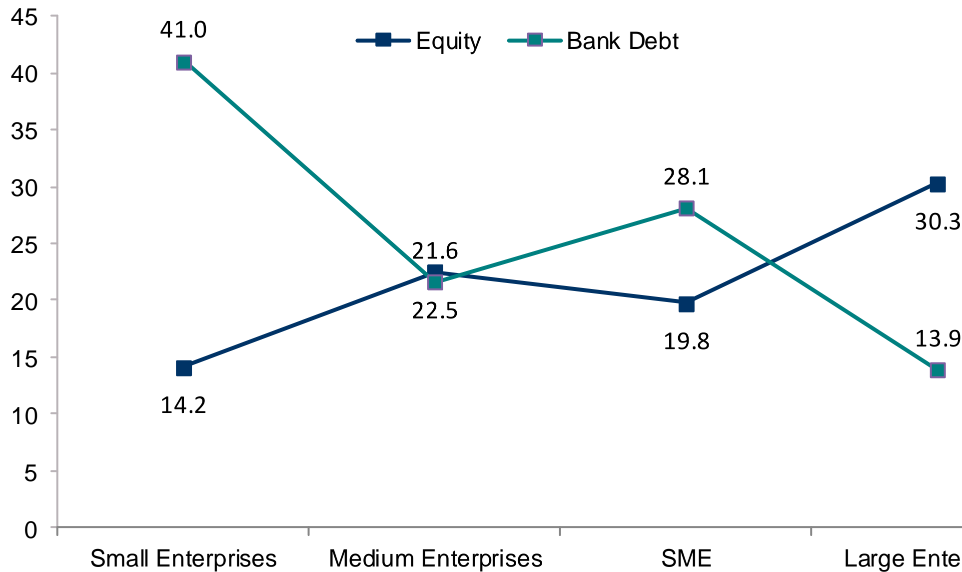
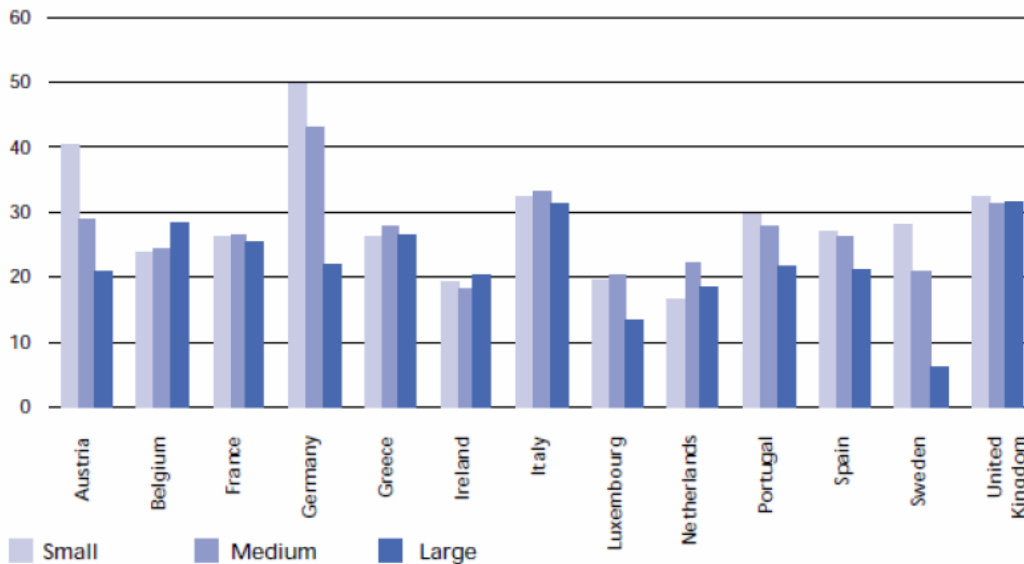


Figure 4: Median Capital Structure of German Mittelstand firms, as % of Balance Sheet Total

Figure 5 below highlights the fact that German small enterprises are highly levered relative to other countries, reflecting the heavily bank-financed nature of German companies. Further, note that Austria and Italy are the other two outliers in the Eurozone in Figure 5.



Source: Bannier and Grote (2009), "The Capital Structure of Germany's Mittelstand"

Figure 5: Financial Debt of Enterprises in EU Countries (Percent of Total Liabilities)

At this point, it should be unequivocally clear that a smoothly functioning banking sector is critical to the functioning of the German economy as a whole, much more so than perhaps anywhere in the world. Without access to bank loans, the *Mittlestand* backbone of the economy would quickly suffocate.

Italy: Even More Beholden To Small Enterprise and Bank Intermediation

Let us now move to the Italian situation. Italy also has a strong tradition of owner-entrepreneurs, focused in the north of the country, but it manifests itself differently, mostly because industry evolved around regionally and industrially-specialized clusters (e.g. leather goods, foods, manufacturing equipment). The underlying situation is, however, surprisingly similar to Germany. The data in Figure 6 below highlights the importance of the SMEs in the Italian economy. In 2003, SMEs accounted for a huge 81% of non-government employment, and 43% of the economy's value-added[3]. Note that Spain is not far behind Italy with 75% of non-government employment in SMEs.

[3] *Public Credit Guarantees and SME Finance*, Istituto Di Studi E Analisi Economica, Working paper #73, October 2006

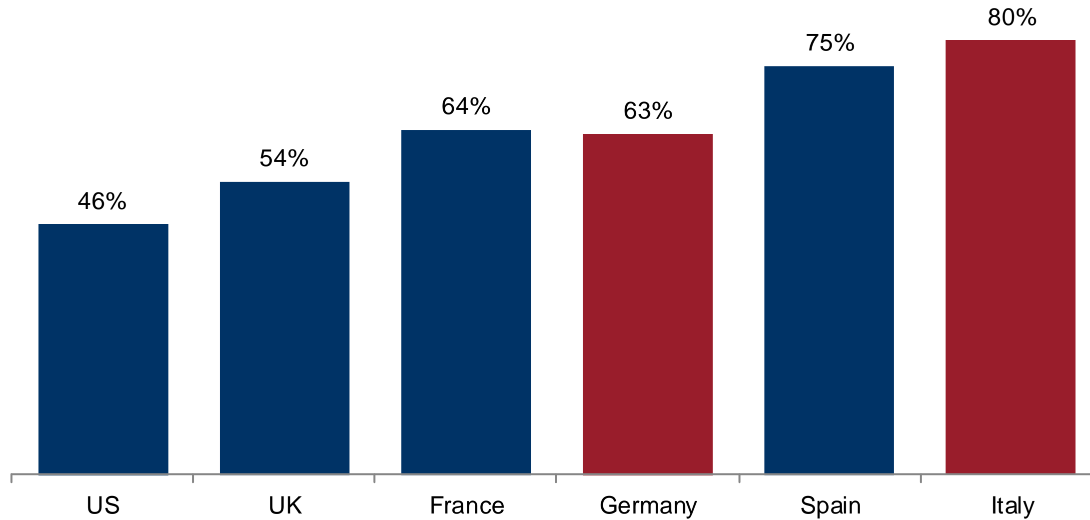
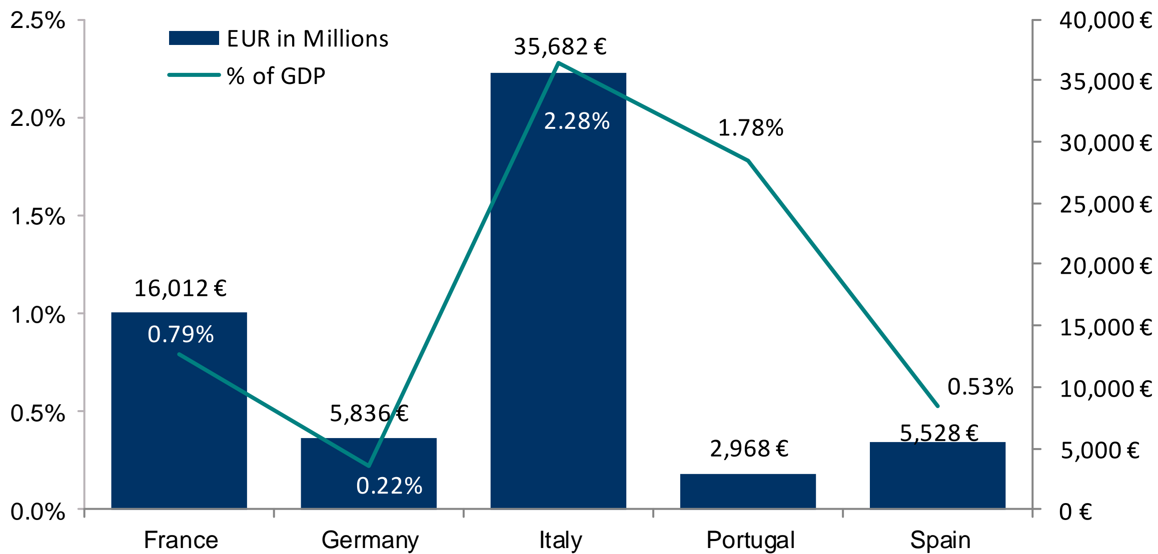


Figure 6: Persons Employed by SMEs as % of Total Private Employment

Again, like in Germany, Italian SMEs rely on debt financing, but rather than having individual relationships with banks, companies in specific clusters form mutual guarantee institutions (MGIs), where the SMEs in the cluster mutually share their default risk, to access financing at more reasonable terms. The MGIs typically deposit some cash collateral at banks, and often also benefit from government guarantees. The size of the MGIs in Italy dwarfs similar schemes elsewhere in Europe, as this is the primary scheme for Italian SMEs to raise capital. Figure 7 below highlights the relative size of the MGIs across the major Eurozone countries:



Source: AECM Statistics 2012, Makena Analysis

Figure 7: Total Loan Guarantee Portfolio Size by MGIs, 2012

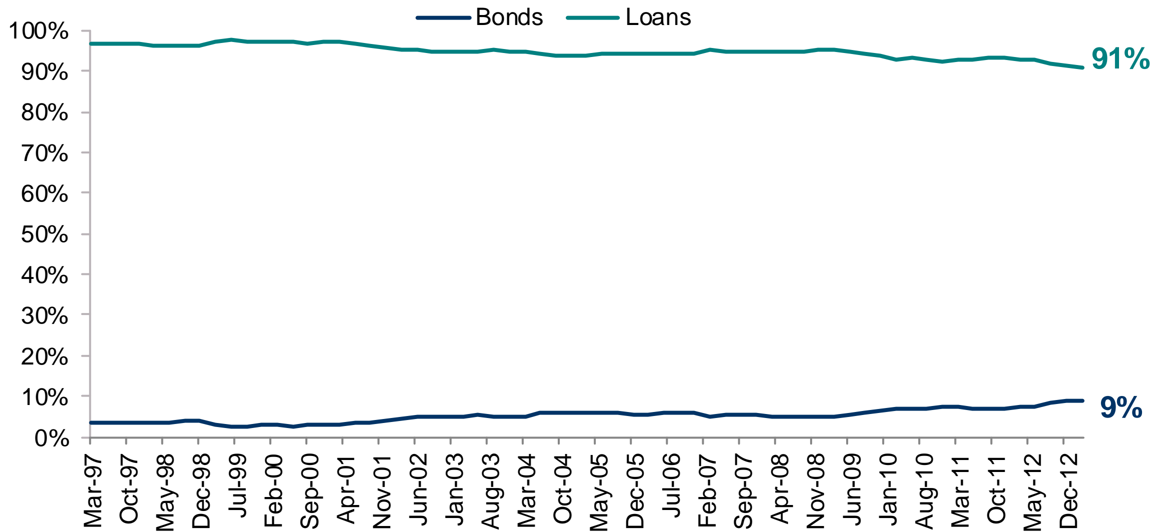
Since the SMEs are not directly borrowing from banks but rather do so via the MGIs, macro statistics understate the importance of bank financing for Italian industry. Furthermore, as is the case in Germany, the setup of the financing system has stifled the development of the Italian capital markets, and few SMEs are even equipped to access either the bond or equity markets, even if such markets were readily available (see Figure 8 below).

Finally, since government guarantees typically help corporations by giving them access to cheaper financing, there is a direct link between the central government's cost of borrowing and private business' cost of capital – as CDS on sovereign debt have increased in most Eurozone countries. The implication is that local businesses are almost immediately affected in their costs of capital, rendering them less competitive on a global basis (see Figures 9 and 10 below). Here, German fiscal rectitude gives German industry a leg up on other Eurozone countries, as KfW for instance was recently rated the safest bank in the world[4].

[4] *The World's Safest 50 banks, 2009* Global Finance, http://www.gfmag.com/

Credit Extended to Non-financial Corporations: Italy

Percent of Total (%)

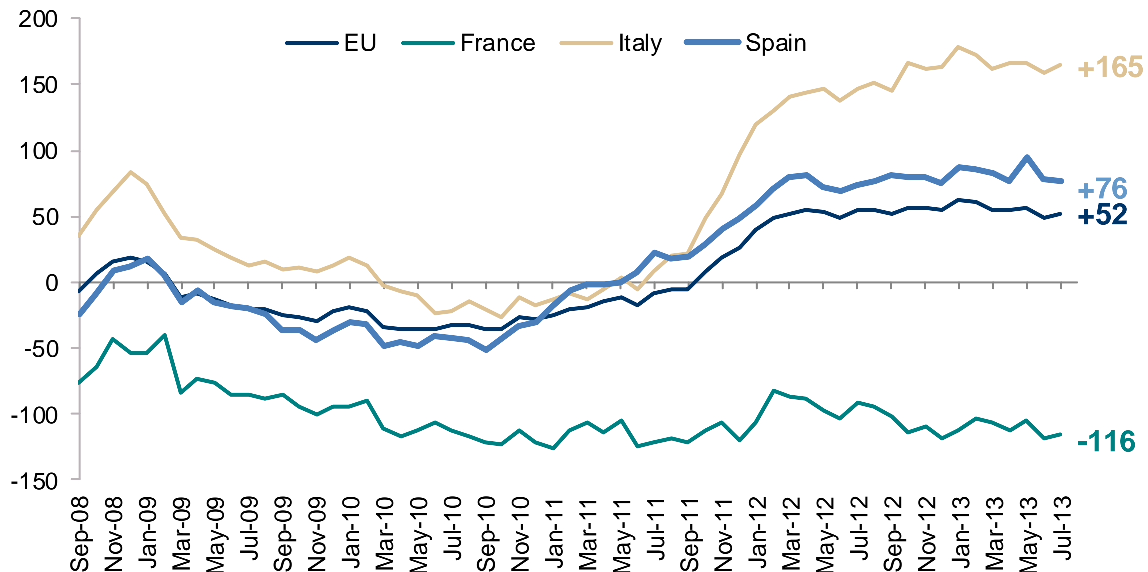


Source: Banca di Italia, Makena Analysis

Figure 8: Credit Extended to Italian Non-financial Corporations

Corporate Lending Rate (<1 Year)

Spread to Germany (BPS)



Source: CEIC, IMF, Makena Analysis

Figure 9: Corporate Lending Rates (<1 Year) of Select Eurozone Countries

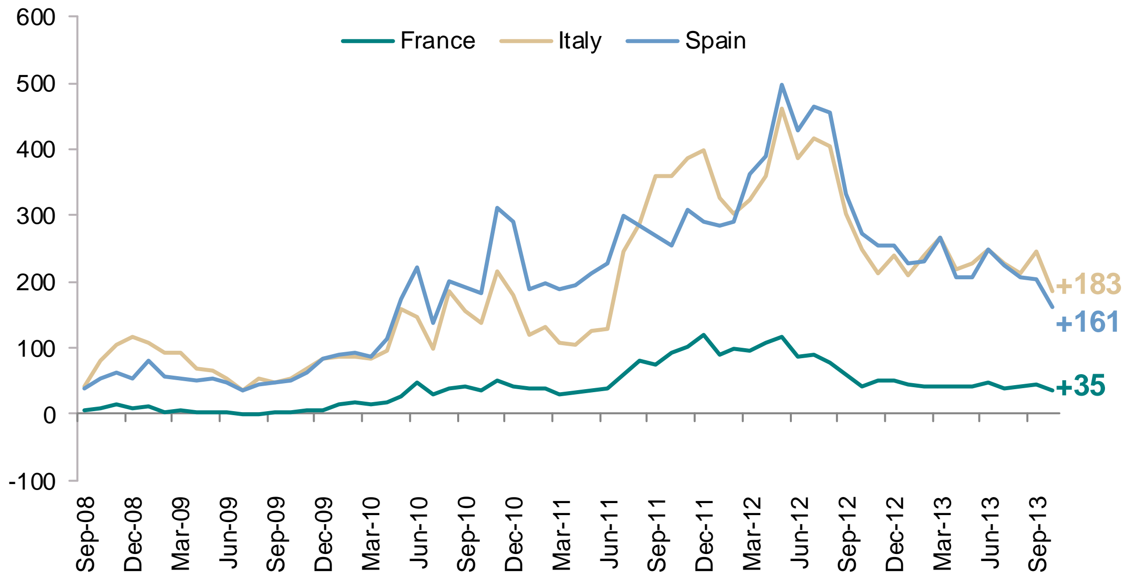


Figure 10: 5-Year CDS of Select Eurozone Sovereigns

One might reasonably wonder whether private equity markets are potentially at work helping finance the SMEs in Germany or Italy, given that SMEs are so beholden to their banking-type relationships. To date, however, private equity seems to have barely scratched the surface of Eurozone SMEs. Figure 11 below highlights this fact.

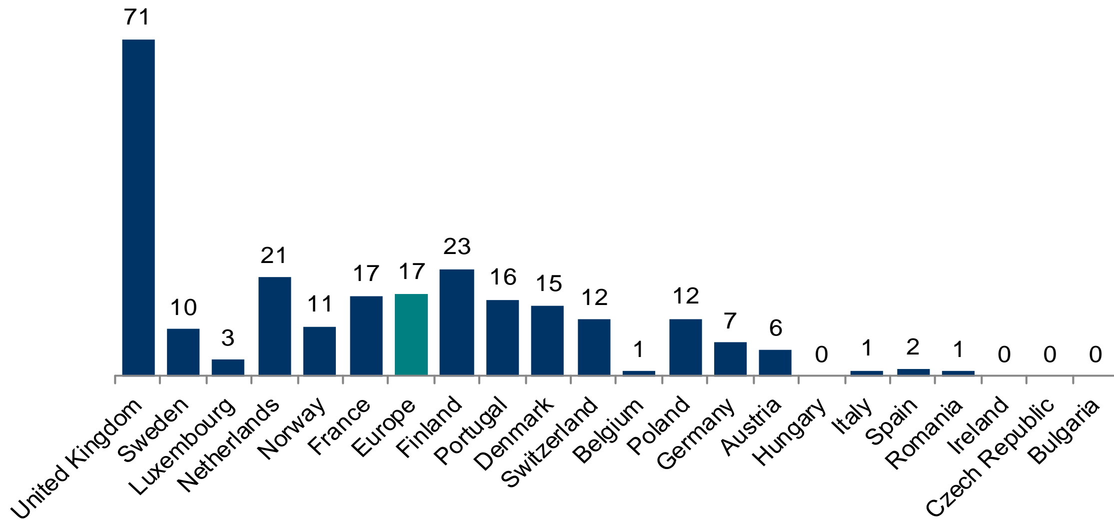


Figure 11: Private Equity Investments Per Country, % of GDP, Trailing 3-yr Average

European Banking Sector: Constrained Credit

Now that we have established how central to the operation of the economy the banking system is in the Eurozone, especially for Germany and Italy who champion the SMEs and represent nearly half of Eurozone GDP, let us now turn our attention to some recent macro observations on the banking sectors in the Eurozone.

In the Eurozone, total bank lending in Figure 12 shows a dramatic fall from not only the "bubble" period of 2006-2008, but also below levels in the early 2000s. The macro data commingle loans to corporations, households, and foreigners; however, the squeeze must be felt across all categories, including the all-important SMEs.

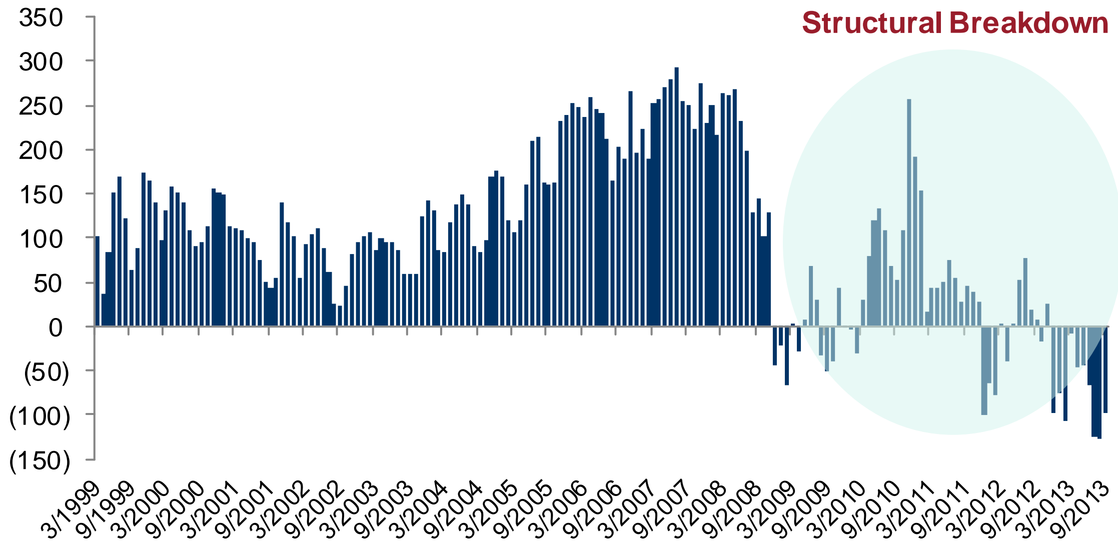


Figure 12: Total Eurozone Bank Lending

A look at non-financial company lending seems to confirm this hypothesis, in Figure 13.

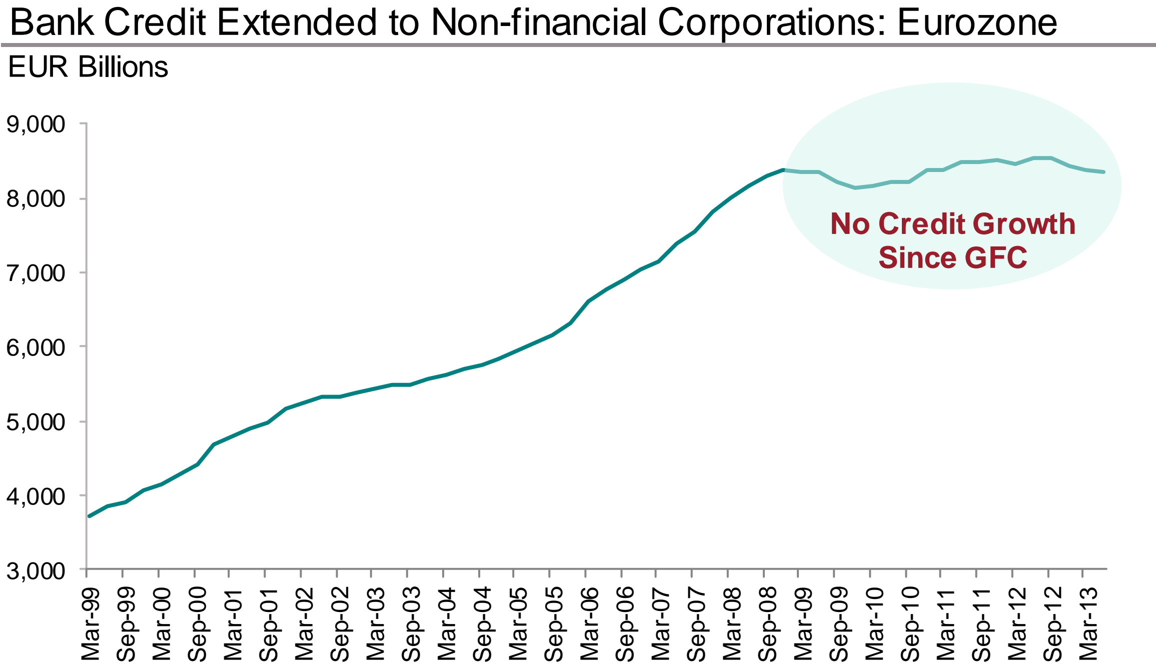


Figure 13: Eurozone Bank Lending to Non-Financial Corporations

Meanwhile, Figure 14 shows German exports rebounding strongly, implying a need for trade financing and working capital for Germany's companies.

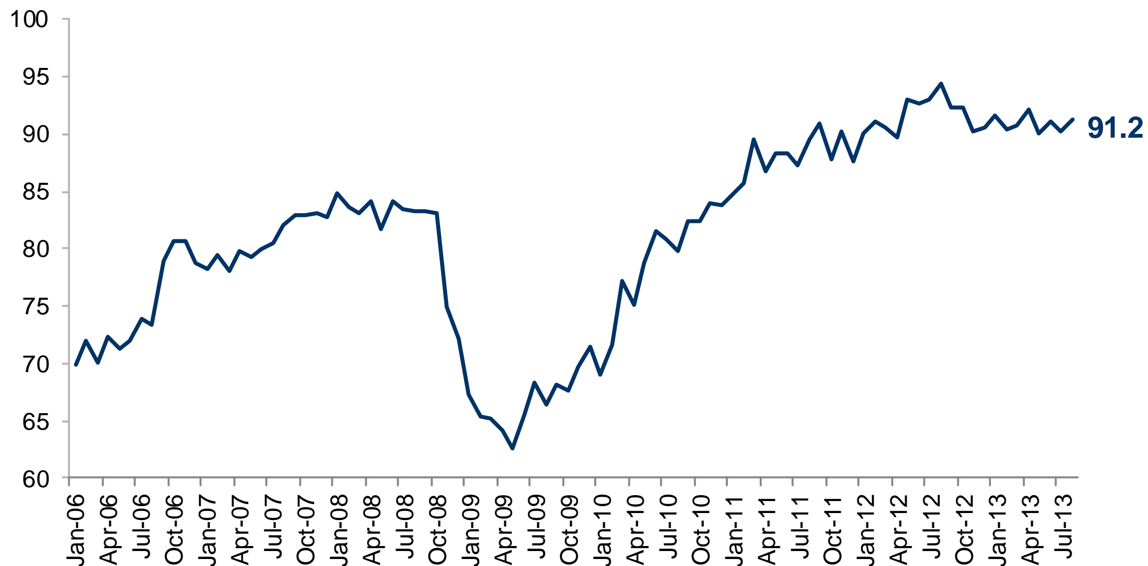


Figure 14: German Exports, Billion Euros

The upshot is that Germany simply cannot afford a pan-Eurozone banking crisis. The devastation to the underlying economy would be much larger than an equivalent banking crisis elsewhere, with the *Mittlestand* and its exports most likely getting crushed in the process.

At first glance, one might therefore find it odd that German politicians are clamoring for fiscal rectitude. However, once it is clear how important to Germany a well-functioning bank credit mechanism is, fiscal rectitude makes more sense.

First, by keeping German government borrowing costs low through a commitment to fiscal rectitude, Germany helps its *Mittlestand* backbone enjoy a competitive advantage via a lower cost of debt financing, and given the German debt-based culture, this effect is a lot larger than in other economies where firms also finance themselves via equity markets. For Italy, the commitment to the Euro can be useful in that respect, since under normal circumstances this commitment would allow the enormous SME sector to enjoy relatively lower costs of capital in its also credit-heavy economy.

Second, given German households' well-documented high savings rates and concomitant low propensity to consume (again similar in Italy), fiscal rectitude probably has less of a negative impact on European households' consumption - they have already cut to the bone. Figure 15 below shows the net household savings level as a percentage of disposable household income for several countries. Note how Germany and Italy both stand out as thrifty households.

Third, Germany's economy is geared to being an export-led economy – the productive capacity of the economy is optimized to a trade surplus of ~7-8% if one looks at historic trends in capacity utilization. In other words, German industry never expects to be self-reliant on domestic consumption. To avoid capacity underutilization and the inevitable increase in unemployment it would bring about, it is absolutely crucial that Germany maintain its exports. German workers have clearly understood the issue, since wages have grown much more slowly over the last decade as compared to other Eurozone countries, as per Figure 16 below. In short, goosing domestic consumption via stimulus packages is not a very effective tool for the German economy, between the thriftiness of German households and the need to maintain export competitiveness.

Overall, one can therefore credibly expect Germany to both fight any kind of banking sector worries and force austerity measures which might lower domestic consumption and savings, but will not affect the competitiveness of its export economy. Part of that fight will surely require preserving the Euro – with the havoc that a Euro collapse would wreak on German (and Italian) banks' balance sheets, the export engine of Europe would be doomed. The picture does not look too promising for peripheral Eurozone countries who might be hoping to grow their way out of their debt problems – they face a fierce competitor with an export-oriented economy backed by thrifty consumers. Perhaps an even more daunting challenge to growth and financial normalization in the periphery (and even the "softer" core Eurozone countries) is Germany's imposition of austerity on the economic zone and resistance to any kind of debt mutualization or monetary loosening (the German-mandated bail-in structure of the Cyprus "rescue" is tantamount to tightening). Through these policies, Germany will maintain its low financing rates for the *Mittlestand* and thus its export competitiveness without inflicting so much pain and financial balkanization that the Eurozone dissolves. But as befits a true dilemma, these very policies all but ensure a prolonged and difficult economic situation in Germany's primary trading partners.

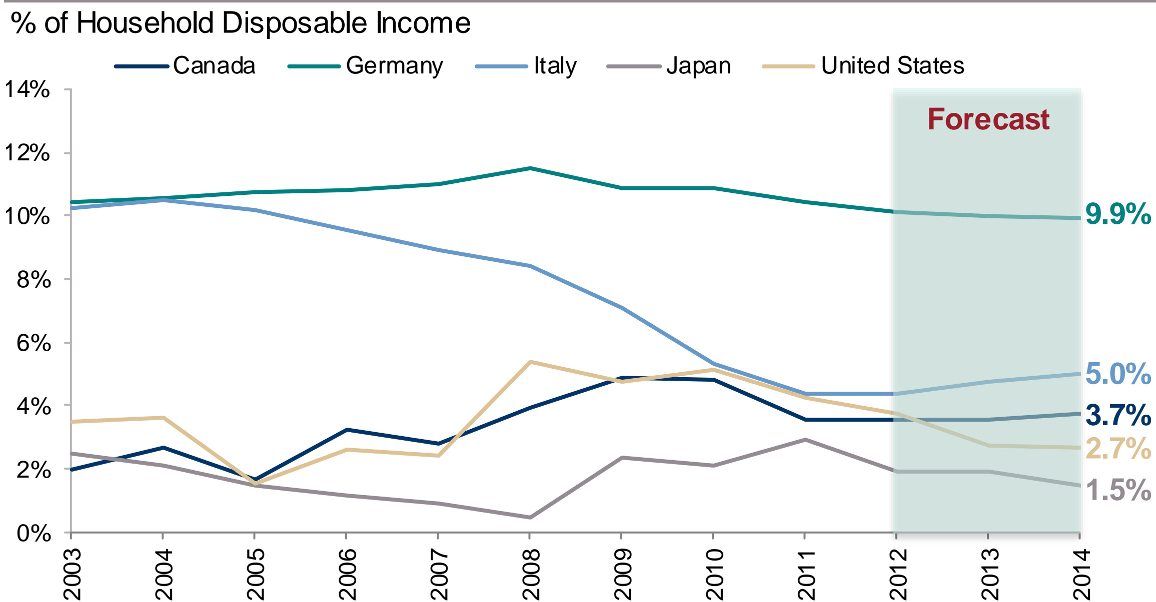


Figure 15: Household Net Savings Rate, % of Household Disposable Income

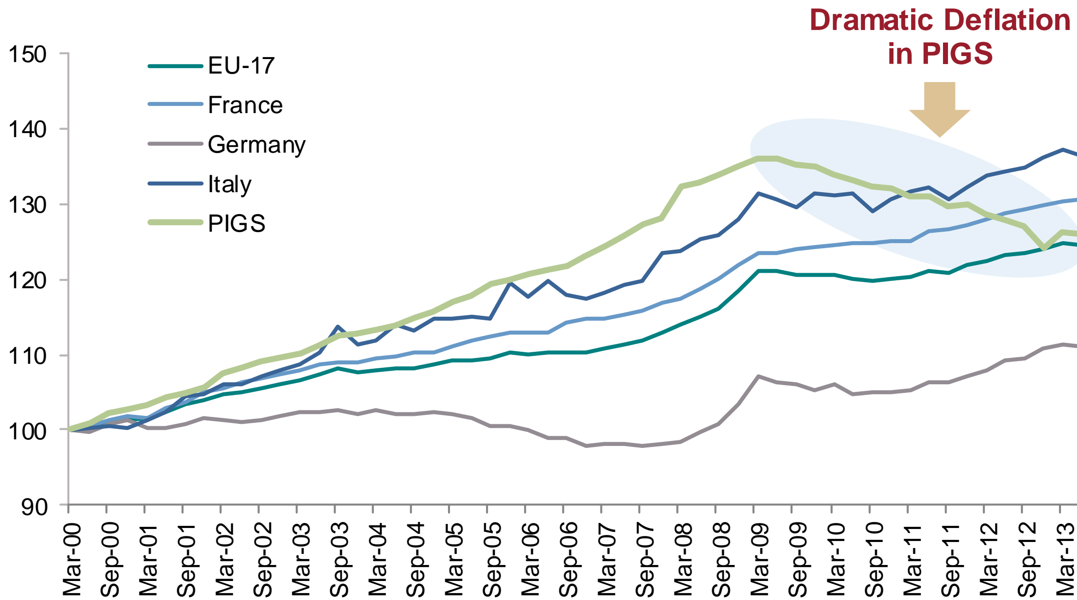


Figure 16: Unit Labor Costs of Select Euro Area Countries

International Competitiveness

Finally, we turn to international competitiveness of the Eurozone relative to the rest of the world. Unsurprisingly, households' misery in the form of high unemployment and low wage growth implies more competitiveness on an international basis.

A fickle and feeble recovery with low GDP growth rates and high unemployment implies that labor cost pressures will remain subdued for many European companies. Therefore, European corporations with substantial sales outside Europe and those with access to capital market financing will remain attractive on a relative basis.

Furthermore, poor household income growth, diminished living standards, and lack of credit availability lead to drastically reduced import demand into Europe. On a relative basis, exports have held up well. Figure 17 below highlights this fact for Italy and Spain, where exports have surpassed pre-crisis levels, yet imports remain nearly 20% below their pre-crisis levels. The combination of a collapse in imports and growth in exports have led to a substantial and growing current account surplus for Europe, as illustrated in Figure 18 below. This provides a tailwind for appreciation of the Euro, though of course political events remain the chief concern.

Import/Export Performance: Spain and Italy

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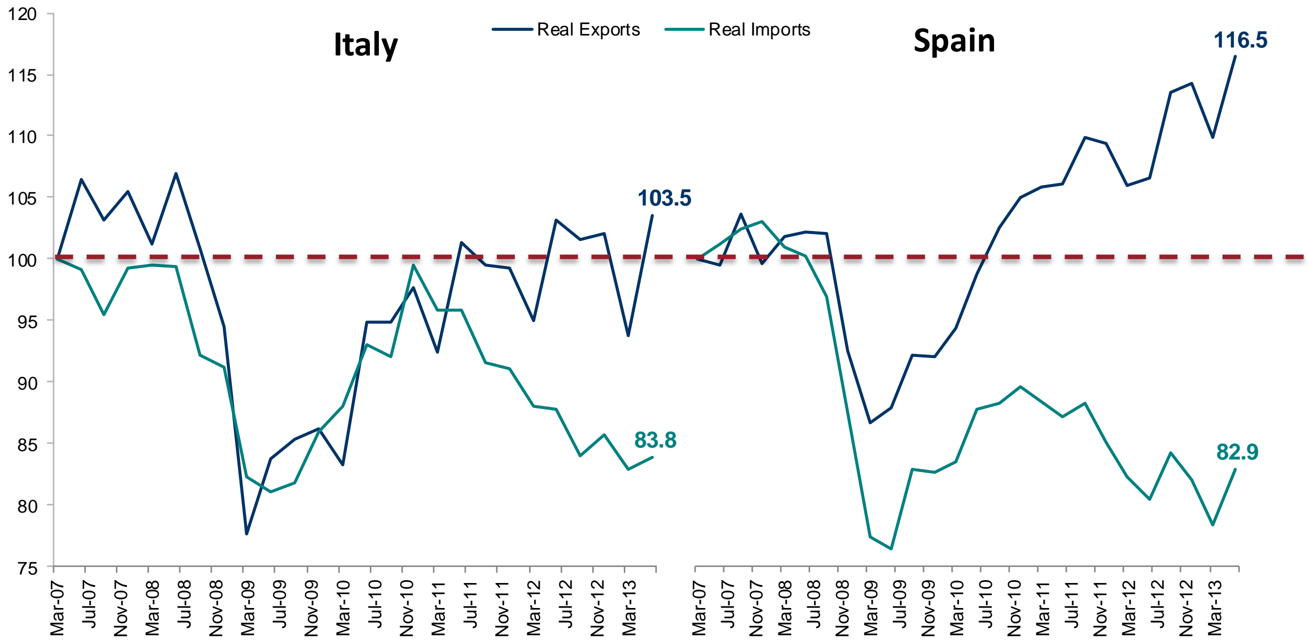
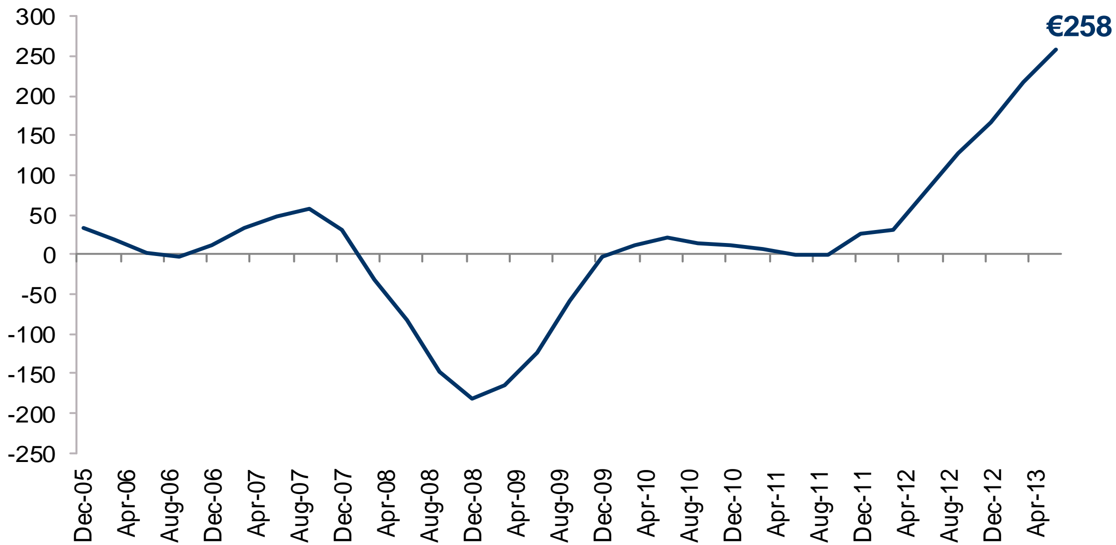


Figure 17: Import / Export Performance of Italy and Spain since the GFC

EU Current Account

Rolling 4 Quarter in EUR billions



Source: IMF, Makena Analysis

Figure 18: The Eurozone Shows A Large And Growing Current Account Surplus

Conclusion

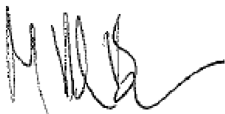
In conclusion, we believe that the European situation will characterize itself in the following ways over the next few years:

The Eurozone will continue to face a demand deficit. Under the aegis of the Germans, internal devaluation will proceed apace in periphery and perhaps even in the weaker core countries (Italy, France). To some extent, improved competitiveness will enable the Eurozone to capture demand from non-Eurozone countries resulting in further growth of the current account surplus. Import demand and domestic demand generally will remain weak and the export demand so acquired will prove inadequate to generate either strong growth or a meaningful reduction in unemployment.

What could break this cycle of stagnation would be the emergence of an expansionary credit cycle, which is tantamount to bank balance sheet expansion. There are two barriers to this occurring. The first is the current poor state of the economy which raises credit risk. The second is the continued need to mark down various assets. The planned structural reforms—the move to a single supervisor, the AQR and EBA stress tests—are intended to accelerate this process. Ceteris paribus, we expect these processes to improve the functioning of the banking system albeit with the possibility of near-term volatility due to uncertainty and the possibility of larger impairments than is currently expected. However, it is difficult if not impossible to predict whether these improvements will be sufficient to break the cycle of poor economic fundamentals deterring banks from lending.

The preceding analysis assumes that Germany remain in effective control of monetary (and to a lesser extent fiscal) policy. This in turn presupposes that the Germans never let the noose of internal devaluation tighten to the point that a country or countries decide to leave the Euro or else form a "club med" coalition to overrule the German insistence on austerity and tight monetary policy. We would expect the latter to occur should the situation in Italy deteriorate substantially or even more so should the situation in France become politically untenable.

The central truth of the European crisis is that it is deeply unnecessary and therein lies the tragedy.



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