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Is the EU growing or getting fat?

The economic **sentiment** index in the Eurozone is at a five-year high. The index (ESI) rose to 109.6 and has been growing for steadily. With estimates of consumption growth moving between 1.5 and 1.7%, and investment growth of 2.5%, data confirms that manufacturing indices also continue to expand.

To positive macro data, we can add **corporate results**. In the Eurostoxx 600 we have seen results from 186 companies with a decent sales increase, with a strong double-digit net income improvement. This growth also occurs at the same time as balance sheets have been strengthening.

Is it a direct consequence of the European Central Bank's policy? Not necessarily. **The ECB policy has negatively affected the financial sector earnings** and **corporate** margins remain poor in EU companies' domestic businesses while deleveraging was much more intense between 2011 and 2013.

There is no denying that **Mario Draghi** 's "stick and carrot" messages have been essential to preventing a new housing bubble fueled by cheap credit, but it is still relevant that almost 30% of the credit granted to the private sector goes to real estate, services and administration. The level of growth is not worrisome, but the increase of investment and credit growth is going to very low productivity sectors.

Investment growth is very poor because low rates and excess liquidity have been essential factors in perpetuating endemic overcapacity (25%) and zombifying sectors of low productivity. But, additionally, almost half of the gross capital formation in the EU's large economies comes from construction, as Claus Vistesen warns.

Credit growth of 2.4% in March shows that **the increase in money supply is still much higher than the growth in leading indicators**, and whether this improvement is generated in generate an important risk. That is why it is worth analyzing a ratio that analysts tend to be forgotten in Europe, inventory to sales. It has risen steadily in the past months.

The recent accumulation is not worrying in the Eurozone, but we cannot ignore the risk of extreme credit conditions pushing to perpetuate a model of poor added value. When more than 50% of the total credit granted – public and private – goes to current expenditure and areas of low productivity, the brief "placebo" effect of expansive policies may create a boomerang effect afterward.

According to Moody's the risk is huge when a very significant part of the companies and governments in the EU could not absorb a 1% interest rate increase.

That is why Draghi's message on the importance of structural reforms is so relevant, reminding that **monetary policy is not a free ride** to increase imbalances. Unfortunately, the perpetuation of those imbalances and the perverse incentive to increase the weight of low-productivity sectors is enormous. It is quite evident. Who are the sectors and companies whose investment decisions depend on low rates? Those with poor added value, low margin and weak productivity. With all the effort being made by the ECB to avoid perverse incentives, it is impossible to limit them because **the greatest perverse incentive is the so-called expansive policy itself.**

When that poor growth and productivity effect given by monetary policy ceases to have its placebo effect, it will be said that "it was not enough" and that it is necessary to repeat.

There are positive elements. Eurozone banks paid € 3.6 billion to the European Central Bank for excess liquidity in 2016 which, at the end of this article, remains at 1.27 trillion euros. That shows that they are not giving loans like crazy, and prefer to be penalized than to repeat the mistakes of 2007.

The reader may say that sectors with good margins and high productivity do not need credit, or at least in large amounts. But think of the reasoning. If it is so, then credit growth as a driver of improvement in the economy is a mistake, because it increases leverage to sectors that cannot face a change of cycle with strength.

In reality, the problem of the Eurozone has never been of liquidity – there was already an excess of it in 2013 – or access to credit, but of **excess debt, low value added and overcapacity**. The solution should not have come from a monetary policy that encourages indebtedness, no matter how much Draghi warns, but to **eliminate that excess of unproductive spending** and favor the change of growth pattern to technology and value-added sectors.

> ***By maintaining the imbalances of the***

We are far from a bubble situation, but **in Europe, we are perpetuating overcapacity and the weight of rent-seeking and low productivity sectors**, those that governments call "strategic", and increasing debt to sustain current expenditure. And all of this does not make the EU stronger, it makes it fatter.

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