Box 1

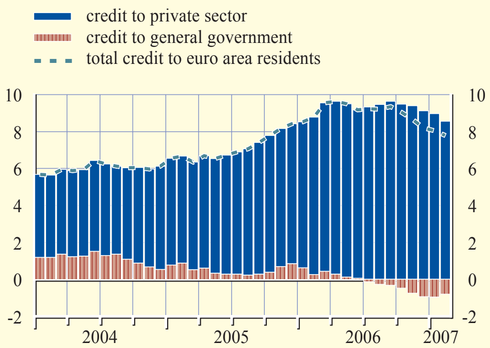
RECENT CHANGES IN THE COMPOSITION OF GROWTH IN CREDIT TO EURO AREA RESIDENTS

Credit granted to euro area residents by monetary financial institutions is the largest counterpart of the broad monetary aggregate M3. The recipients of such credit include both general government and the private sector. MFIs provide this credit both by granting loans to other entities and by purchasing securities issued by these other entities, either in the form of debt securities (i.e. securities other than shares) or in the form of shares and other equities. The relative importance of these different categories of MFI credit can vary over time in response to demand and supply factors, and also to conjunctural and structural influences. This box looks at recent changes in the composition of growth in total MFI credit and assesses them in the light of longer-term developments.

The bulk of the growth observed in total credit to euro area residents is explained by the expansion of credit to the private sector (see Chart A) and, more specifically, by the growth of loans to the private sector (see Chart B). However, focusing entirely on the growth of loans can conceal economically interesting developments in the other, smaller categories of MFI credit. For instance, Chart A shows that since end-2005 the contribution that credit to general government has made to the annual growth rate of credit to euro area residents has declined steadily, even turning negative in the second half of 2006. By contrast, overall credit growth remained broadly stable up to the autumn of 2006. In September 2006 the contribution of credit to the private sector also started to decline.

Chart A Breakdown of growth in MFI credit to euro area residents

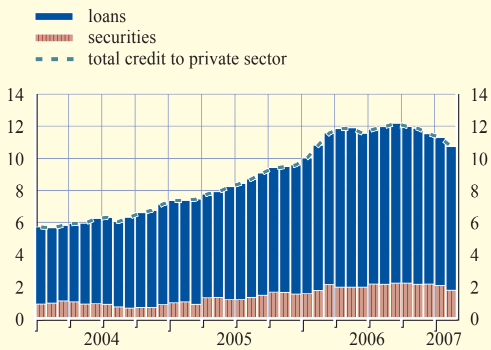
(annual percentage changes; contributions in percentage points)



Source: ECB.

Chart B Breakdown of growth in MFI credit to the private sector by instrument

(annual percentage changes; contributions in percentage points)



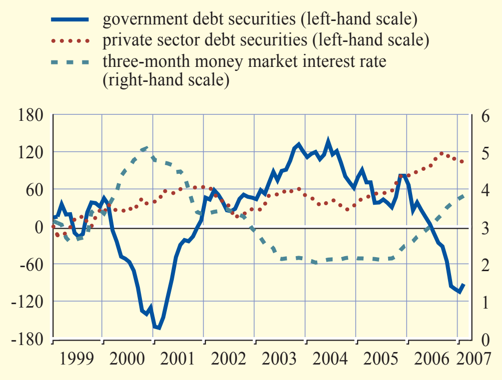
Source: ECB.
Note: Securities comprise both "securities other than shares" and "shares and other equities".

Chart B shows that this decline largely reflects a moderation in the annual growth rate of loans, while MFIs' purchases of private sector securities have remained broadly stable since the spring of 2006. Over this period MFIs' purchases of private sector securities have accounted, on average, for around 2 percentage points of the 12% annual growth rate of credit to the private sector, with around 1 percentage point coming from debt securities and another percentage point coming from shares and other equities.

One factor that is likely to have influenced the relative dynamics of the different categories of credit in recent quarters is the increase in key ECB interest rates since end-2005. On the liability side of the MFI balance sheet, the gradual removal of policy accommodation has led to a shift from overnight deposits to more highly remunerated short-term time deposits. On the asset side, the private sector has shown greater demand for loans with longer initial periods of rate fixation, as the rates on these loans have increased less strongly than those on loans with shorter initial rate fixation periods. Together, such rebalancing operations are likely to have had a dampening impact on the margins that MFIs earn in channelling deposits into credit, and this may have led MFIs to rebalance their credit portfolios, shifting assets from the government to the private sector and, within the private sector, from loans to securities. Overall, this leads to a larger share of assets which promise higher yields but also imply exposure to different types of risk.

Chart C MFIs' purchases of debt securities and the short-term market interest rate

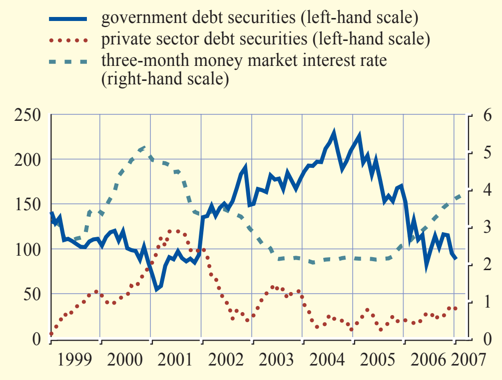
(annual flows in EUR billions; percentages per annum)



Source: ECB.

Chart D Net issuance of debt securities and the short-term market interest rate

(annual flows in EUR billions; percentages per annum)



Source: ECB.

Looking more specifically at the relative dynamics of MFIs' purchases of government and private sector securities, Chart C illustrates the contrasting developments observed since short-term market interest rates began to rise. At the end of 2005 the annual flows of these two credit categories were of broadly the same magnitude. Subsequently, MFIs have purchased increasing volumes of private sector securities, well above the levels observed in previous years, while sharply reducing their holdings of government securities. In February 2007 the annual flow of MFIs' net purchases of private sector securities stood at around €100 billion, while net sales and redemptions of government securities had the same value. Chart C also suggests that a similar rebalancing of portfolios may have taken place earlier, when monetary policy tightening in 1999-2000 resulted in the annual flows of MFIs' purchases of government and private sector securities moving in opposite directions.

Comparing the two periods of increasing interest rates, the pick-up in MFIs' purchases of private sector securities has been stronger in the period since end-2005 than it was in the period 1999-2000. This is possibly related to the substantial lending activity that MFIs undertook in the earlier period vis-à-vis the private sector, which may have exhausted the risk exposure to this sector that MFIs were willing or able to incur. In this respect, it is interesting to note that in the more recent period there has been both robust loan growth and a strong accumulation of private sector debt securities by MFIs. From a cyclical perspective, the rebalancing from loans to security holdings observed over recent months on the asset side of the MFI balance sheet may be part of the pass-through process whereby MFIs provide bridging loans to cover the period until non-financial corporations issue debt securities. However, from a more structural perspective, MFIs' ability to sustain strong lending growth may reflect a lower exposure to risk in current loan portfolios if MFIs have shifted part of their credit risk to other sectors through synthetic securitisation.[1]

Increased net purchases of private sector securities by MFIs and increased shedding of government securities in the period since end-2005 might obviously also reflect the relative availability of these securities. Chart D shows that the annual flow in the net issuance of government debt securities has decreased in the past two years, reflecting, inter alia, the upturn in the economic cycle and the associated improvement in public finances. It has, nonetheless, remained positive. If MFIs had wished to maintain a certain percentage of government debt securities in their credit portfolios, this would not have been hindered by a restrictive issuance policy. Conversely, MFIs' strong purchases of private sector securities since end-2005 have taken place in an environment where the issuance of private sector debt securities has remained relatively subdued. Issuance statistics do not, therefore, suggest that MFIs' shedding of government debt securities and increased purchases of private sector debt securities are a reflection mainly of conditions in the supply of securities.

To sum up, it appears that the recent changes in the composition of MFI credit to euro area residents over the period since end-2005 may have been driven by MFIs' reaction to changes in the interest rate environment and by their willingness to rebalance their credit portfolios in favour of assets with higher yields, but also different types of risk.

1 See Box 1, entitled "The impact of MFI loan securitisation on monetary analysis in the euro area", in the September 2005 issue of the Monthly Bulletin for details of these two types of securitisation.