Box 1

RECENT DEVELOPMENTS IN MFIS' PURCHASES OF DEBT SECURITIES ISSUED BY THE EURO AREA GENERAL GOVERNMENT SECTOR

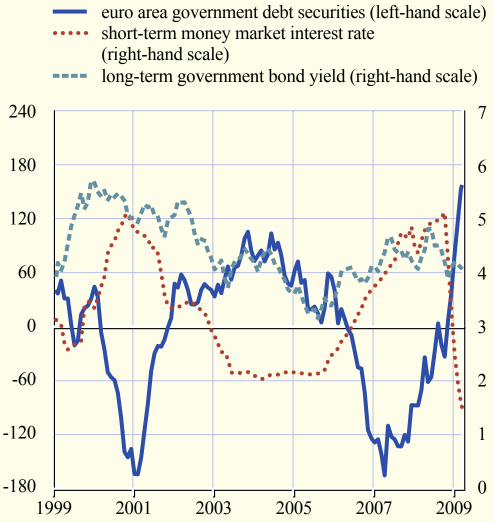
Purchases of government debt securities are part of the overall flow of MFI credit granted to euro area residents. MFIs hold these securities – which are nearly all denominated in euro – for both investment and liquidity purposes, given that they can easily be traded in the market and can be used in secured refinancing operations. Purchases of these securities typically display a cyclical pattern which runs counter to that of short-term market interest rates and often implies some rebalancing of MFIs' total assets, with shifts from private to public sector credit.[1] This box examines recent developments in the purchases of government debt securities against the background of the specific turmoil-related interest rate developments of the past few months.

MFIs' purchases of government bonds and the level of interest rates

Between October 2008 and April 2009 MFIs' net purchases of debt securities issued by the euro area general government sector totalled €217 billion in the context of rapidly declining short-term interest rates. This entirely reversed the net sales of €191 billion observed between December 2005 and September 2008 in the context of rising short-term interest rates. As Chart A shows, situations in which purchases of government debt securities and short-term interest rates

Chart A MFIs' purchases of government debt securities and the level of interest rates

(annual flows in EUR billions; adjusted for seasonal and calendar effects; percentages per annum)

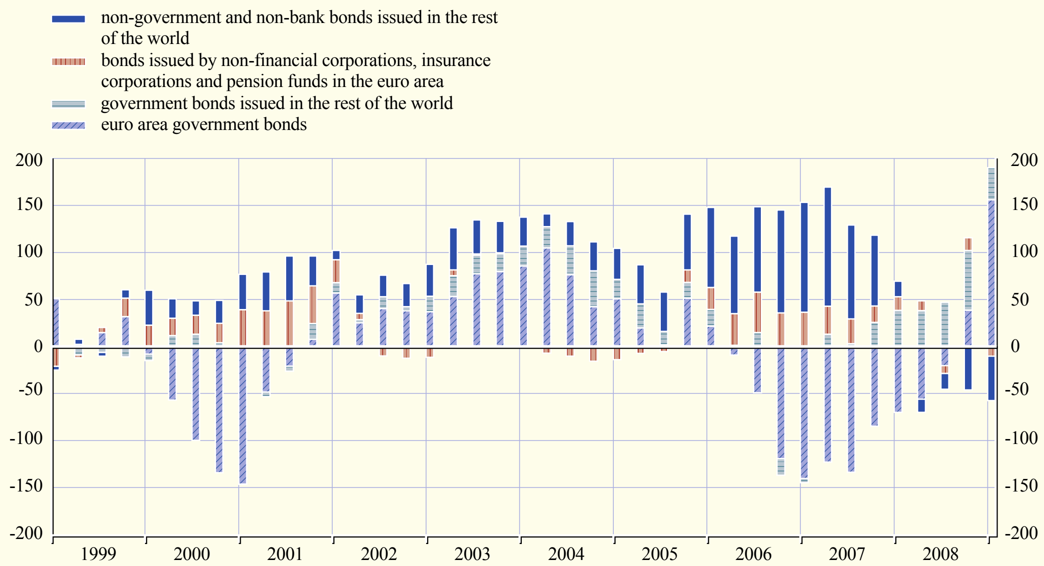


Source: ECB.
Note: MFI sector excluding the Eurosystem.

1 For previous analysis of developments in credit to euro area residents, see the box entitled "Recent changes in the composition of growth in credit to euro area residents" in the April 2007 issue of the Monthly Bulletin.

Chart B Purchases of debt securities by euro area MFIs

(annual flows; EUR billions; not adjusted for seasonal or calendar effects)



Source: ECB.
Notes: MFI sector excluding the Eurosystem. Securities purchased from domestic OFIs have been omitted, as the strong retained securitisation activity observed during the financial turmoil has heavily distorted the series.

move in opposite directions are a regular feature of the interest rate cycle and essentially reflect the impact that changes in short-term interest rates have on the slope of the yield curve, as measured by the spread between the yield on long-term government bonds and short-term money market interest rates.[2] A steepening of the yield curve – when the funding costs implied by short-term rates are low relative to the yield that can be achieved on government bonds – allows MFIs to achieve a stable return, without much impact in terms of capital charges and without having to take on credit risk in the presence of weak economic activity. Chart B shows that government bonds – mainly euro area bonds, but also bonds issued in the rest of the world – see their share in MFIs' total purchases of debt securities increase rapidly in such periods. This does not necessarily imply the crowding out of private sector securities and may, instead, simply reflect the fact that, in a period where lending to the private sector is weak owing to the adverse economic environment, the funding accumulated by banks warrants channelling into other profitable assets.

Additional factors related to the interest rate structure in recent quarters

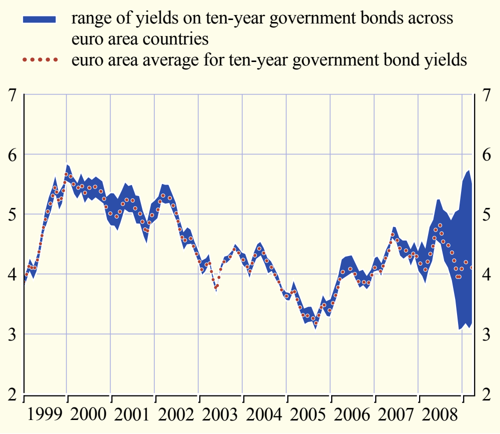
The relatively regular patterns described above for purchases of government bonds over the interest rate cycle may have been affected by specific factors related to the intensification of the financial tensions in September 2008.

First, the spread between government bonds of euro area countries with the lowest and highest yields has widened, after remaining at very low levels for several years (see Chart C). This reflects, among other things, a deterioration in the fiscal outlook for some euro area countries and increased risk aversion on the part of investors. On the one hand, government bonds with higher yields are particularly attractive if their current yield is considered to reflect excessive financial market risk aversion that is expected to diminish over time. On the other hand, the AAA-rated bonds with lower yields may be attractive because they have experienced short-term capital gains, which arise on account of higher valuations as interest rates decline. Both considerations would tend to increase the general attractiveness of the government bonds issued by various euro area countries.

Second, in normal circumstances banks that wish to earn interest at the long-term rate often engineer such payment flows through swap arrangements, rather than holding long-term debt instruments on their balance sheets, owing to swap arrangements' greater liquidity. Furthermore, the spread between receiving the ten-year fixed swap rate and paying the standard six-month EURIBOR rate normally exceeds the spread between receiving government bond yields and paying the six-month EURIBOR rate, reflecting the slightly higher level of counterparty risk embedded in the swap

Chart C Yields on ten-year government bonds in the euro area

(percentages per annum)



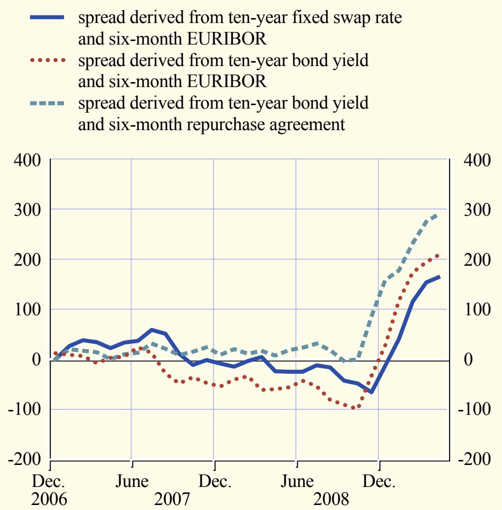
Source: ECB.

2 While this consideration appears to be the main factor driving MFIs' demand for these securities, governments' issuance activity could in principle constrain MFIs' purchases of such securities. Although this would ultimately still be reflected in the yield curve, it would, however, arise from changes in long-term yields, rather than changes in short-term interest rates.

transaction (see Chart D). In the current situation, banks may prefer to purchase government bonds directly, as owning those bonds has the additional advantage that they can be used as collateral in banks' funding operations. Thus, banks may currently be reacting to the fact that secured money market rates, such as the rate on a six-month repurchase agreement, are much lower than the corresponding unsecured EURIBOR rates.

Chart D Spreads between long and short-term interest rates

(basis points)



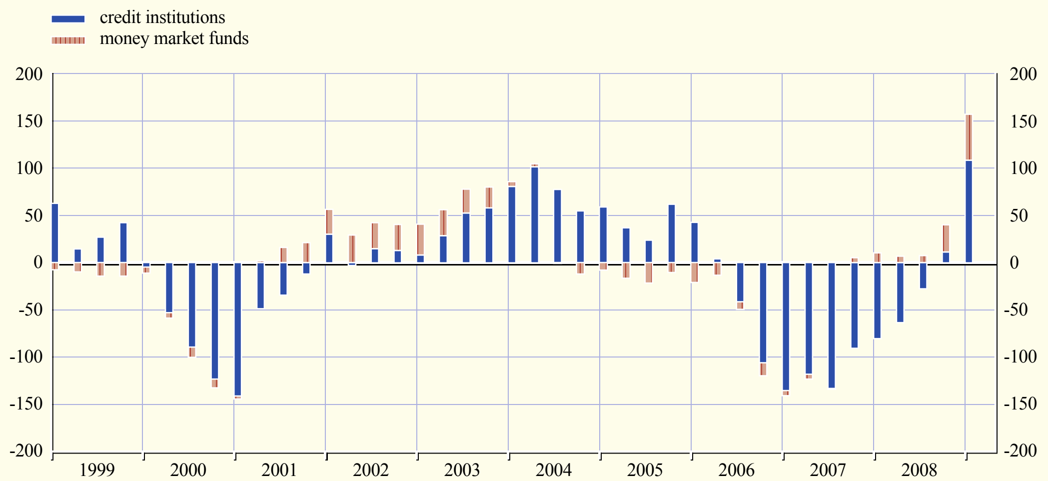
Sources: ECB and ECB estimates.
Note: The ten-year bond yield refers to AAA-rated euro area government bonds.

Third, the period of financial turmoil has, at times, seen money market funds experiencing strong redemption activity and being forced to reallocate their portfolios. In addition, several newly launched money market funds resident in the euro area have specific mandates requiring that they invest only in government bonds. Consequently, these entities have limited credit risk. This shift in terms of the approach adopted is visible in the increased purchases of government bonds by money market funds, which, together with increased purchases by credit institutions, have contributed strongly to the overall purchases of the MFI sector (see Chart E).

Overall, the euro area MFI sector's recent strong purchases of government bonds are in line with historical regularities over the interest rate cycle, but have additionally been affected by the specific interest rate developments and risk considerations observed during the period of financial turmoil.

Chart E Sectoral breakdown of MFIs' purchases of debt securities issued by the euro area general government sector

(annual flows; EUR billions; not adjusted for seasonal or calendar effects)



Source: ECB estimates.