Box 2

FACTORS AFFECTING LENDING TO THE PRIVATE SECTOR AND THE SHORT-TERM OUTLOOK FOR MONEY AND LOAN DYNAMICS

The intensification of the financial crisis in the fourth quarter of 2011 had a considerable impact on bank funding at that time, with an incipient risk of disorderly deleveraging and hence an adverse impact on the ability of banks to support the real economy. This assessment is supported by particularly weak flows in broad money and credit to the private sector in the fourth quarter (although the figures for December in large measure also reflected special factors, including end-of-year operations) and by the results of the euro area bank lending survey for the fourth quarter of 2011, which indicated both a tightening of credit standards and a decrease in credit demand. While subdued money and credit growth may in part reflect an ongoing correction of excess liquidity and past excesses in loan supply, the speed of the adjustment observed in the fourth quarter of 2011 was a cause of concern.

Loans to the private sector are usually the main driver of broad money growth in the euro area. The analysis of lending dynamics is key to the assessment of monetary developments and the pace of underlying money growth, and thus the implications for price stability over the medium run. Looking through short-term volatility, the slow growth of credit to the private sector in the past few months, together with weak growth in broad money, supports the view that the underlying pace of monetary expansion has remained subdued and that risks to price stability over the medium term have not changed substantially.

This box provides an overview of some of the main factors which are likely to affect developments in loans to the non-financial private sector in the next few months. While survey data and model-based estimates indicate that loan supply factors are likely to continue to exert an adverse impact on loan growth in the next few months, weak loan demand will probably remain the main determinant. Leading indicators suggest that demand for loans on the part of both households and non-financial corporations (NFCs) is likely to remain weak, at least during the first half of 2012, in line with subdued economic activity. Persistent funding pressures resulting from an uncertain economic and financial environment, as well as changes to the capital ratio requirements for banks arising from the Basel III regulatory framework, may also dampen the supply of loans. At the same time, the full supportive impact of the three-year longer-term refinancing operations (LTROs) conducted by the Eurosystem in December 2011 and February 2012 on loans to the non-financial private sector will take some time to unfold. Close monitoring of credit market developments is thus warranted. Nonetheless, these operations have already supported the adjustment of banks' balance sheets, with clear signs of a stabilisation in the monetary data in January and February pointing to an alleviation of deleveraging pressures.

Credit supply and demand factors

From a policy perspective it is important to gauge the relative contributions of credit supply and credit demand forces to developments in loans to the private sector. Unfortunately, the impact of these forces is difficult to isolate and estimate. However, some indications can be gleaned from survey data and model-based estimates. For example, according to the results of the euro area bank lending survey for the fourth quarter of 2011, both supply and demand developments may continue to weigh adversely on lending. In particular, credit standards for both loans to households and loans to enterprises are expected to have tightened further in the first quarter of 2012, although to a lesser extent than in the fourth quarter of 2011, while demand is expected to have fallen significantly further.[1] At the same time, following the three-year LTROs, loan supply may be less dependent on the availability of market funding and more closely linked to the risk-bearing capacity of banks and thus their capital positions. However, the supportive impact of the easing of funding strains on lending conditions and loans to the private sector may take time to unfold.

This picture is backed by other survey data relating to NFCs. For example, according to the European Commission survey on limits to production in the first quarter of 2012, financial

1 For more details, see the box entitled "The results of the euro area bank lending survey for the fourth quarter of 2011", *Monthly Bulletin*, ECB, February 2012.

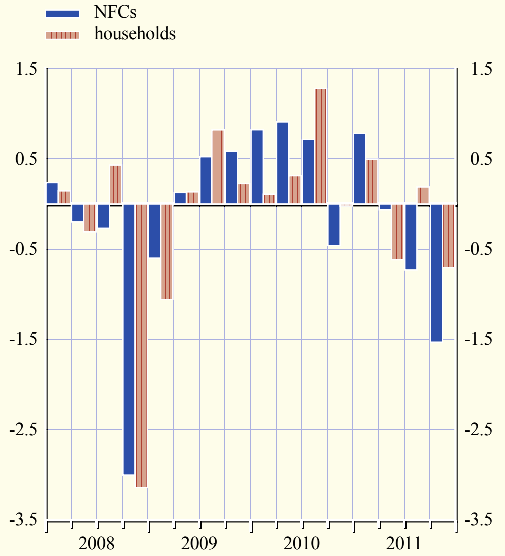
constraints remained broadly unchanged as a factor limiting production for euro area enterprises operating in services or manufacturing, while a slight increase in the impact of this factor was recorded for construction. However, overall, financial constraints constitute only a minor factor limiting production for all sectors, similarly to a shortage of labour, space, equipment and/or material, with insufficient demand remaining by far the most important factor.

Model-based estimates suggest that credit supply factors played a relatively limited role in explaining the growth of loans to both households and NFCs up to the fourth quarter of 2011. However, looking ahead, the impact of recent credit supply shocks may be yet to materialise. For example, according to a structural vector autoregressive (VAR) model which identifies credit supply shocks with sign restrictions, series for loan supply shocks show that in the fourth quarter of 2011 new adverse shocks appeared (see Chart A). According to the model, the impact of these shocks would appear only gradually and become fully visible only from mid-2012. However, the impact of such contractionary forces on the broader economy is likely to be mitigated by the non-standard monetary policy measures taken in late 2011.

The level of indebtedness of both households and NFCs is also likely to affect loan demand, as well as the creditworthiness of potential borrowers as assessed by banks. Levels of indebtedness as a ratio to nominal GDP are very high by historical standards and while firms have managed to reduce this ratio, households have only stabilised it (see Chart B). This is likely to be a further factor weighing on loans to households, particularly in some countries, given the strong heterogeneity in the extent of household indebtedness across euro area countries.

Chart A Supply shocks in lending to NFCs and households based on a structural VAR model

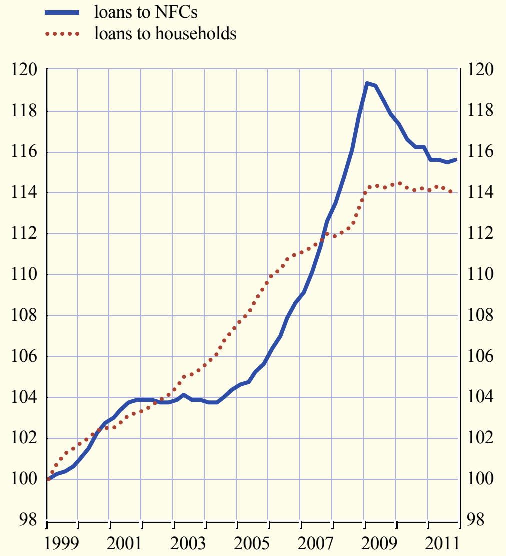
(percentages; standard deviations)



Source: ECB.
Note: The series of loan supply shocks is estimated using a structural VAR model with sign restrictions. For more details on the model, see the article entitled "Recent developments in loans to the private sector", *Monthly Bulletin*, ECB, January 2011.

Chart B Outstanding amounts of MFI loans as a ratio to nominal GDP

(percentages; Q1 1999 = 100)



Source: ECB.
Note: The ratios are normalised.

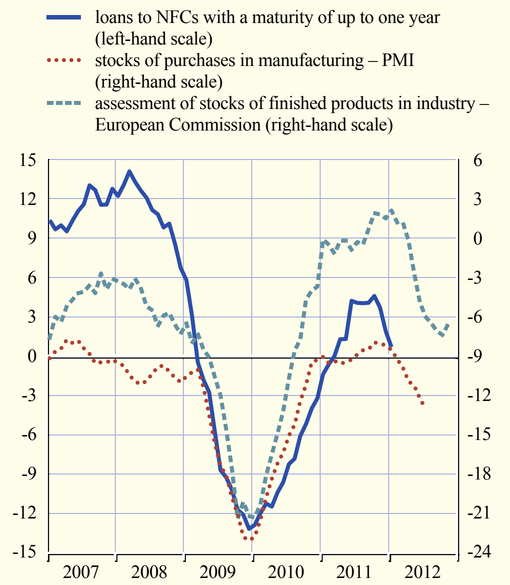
Leading indicators of developments in loans to the non-financial private sector

Leading indicators provide useful information on likely developments in lending to the private sector in the next few months, although it should be borne in mind that they relate mainly to loan demand and their reliability is limited.

As regards MFI loans to NFCs, short-term loans have been the main driver of the recent decline in the annual growth of total MFI loans to NFCs (adjusted for sales and securitisation). Survey indicators of changes in inventories, which tend to be relatively reliable leading indicators of short-term developments in loans to NFCs, suggest that the growth of these loans may continue to decrease during the first half of 2012 (see Chart C). Another factor which is likely to affect developments in the external financing of NFCs is that currently large enterprises with access to the financial market can issue corporate bonds relatively easily. While small and medium-sized enterprises rely heavily on bank loans, they can also benefit indirectly from a benign issuance environment via trade credit or inter-company loans extended by larger firms. In the first three months of 2012 many NFCs issued significant amounts of marketable debt in an environment of strong demand for corporate securities, thus reducing their need for bank loans. Finally, ample availability of internal funds may also dampen demand for external financing.[2]

Chart C Short-term loans to NFCs and leading indicators

(annual percentage changes; percentage balances)



Sources: European Commission and ECB.
Note: The indicator for stocks of finished products in industry is shown with an inverted sign. This indicator and the indicator for stocks of purchases in manufacturing, which is derived from the survey for the Purchasing Managers' Index (PMI), are shown as deviations from the long-run average and are shifted ahead by six and ten months respectively so that the correlation with loan growth is maximised.

Regarding MFI loans to households, the decline in the annual growth rate in the last quarter of 2011 and the stabilisation in the first two months of 2012 are broadly in line with developments in the European Commission's consumer confidence indicator over the same period. Data on consumer confidence in March, as well as the pattern of other survey indicators over the first quarter of 2012, such as the Commission's indicator of consumers' willingness to make major purchases in the next year, point to some signs of a stabilisation in confidence, although at low levels. Thus, on the basis of these leading and coincident demand indicators, the growth of loans to households is likely to remain relatively weak in the next few months.

The adjustment of banks' balance sheets, monetary policy measures and the implications for broad money growth

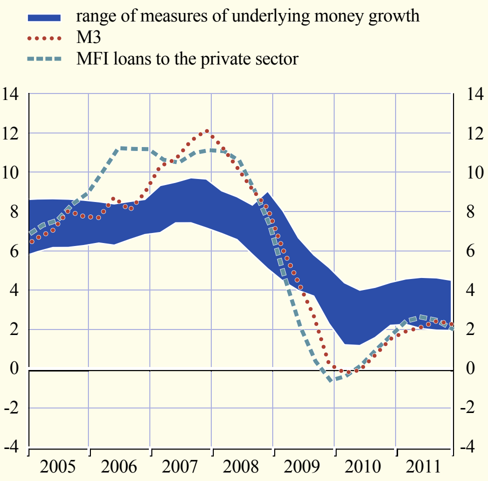
Looking ahead, the evolution of loans to the private sector will in part depend on the capacity of the euro area banking sector to provide intermediation services. In this respect, the Eurosystem's non-standard monetary policy measures have been instrumental in easing immediate liquidity

2 For a fuller discussion of sectoral financial flows and balance sheets, see the box entitled "Integrated euro area accounts for the third quarter of 2011", *Monthly Bulletin*, ECB, February 2012.

and funding constraints for the euro area banking sector, thereby preventing abrupt deleveraging that might have led to a sizeable curtailment of credit. Since the first three-year LTRO was conducted, the costs of debt market funding for banks have declined at the short end of the yield curve, thereby providing some relief as well as asset valuation benefits. Moreover, debt issuance gained momentum, possibly to provide collateral for use in the second three-year LTRO.

Chart D M3 and underlying money growth

(annual percentage changes)



Sources: ECB and ECB calculations.

Nevertheless, the liquidity provided by the Eurosystem is only an incomplete and imperfect substitute for market funding. Moreover, while this liquidity has averted an abrupt contraction in banking operations, it will not fully restore the normal transmission of monetary policy impulses. The latest figures in banks' balance sheets indicate that banks have made some progress in terms of recapitalisation and the creation of liquidity buffers, especially in some countries. However, it is imperative that further adjustment be made by the banking sector to enable it to provide intermediation services over the medium term.

The slow growth of broad money and credit in recent months supports the view that the underlying pace of monetary expansion has been subdued (see Chart D). At the same time, the strong expansion of Eurosystem liquidity has resulted in a sharp acceleration in the growth of base money. However, this is not mirrored in a marked increase in broad money or credit growth, which would indicate a materialisation of inflationary risks. In order for the very ample provision of central bank reserves to result in a strengthening of broad money and credit growth, a sustained return of confidence and a strengthening of economic activity are needed to underpin demand for credit on the part of firms and households, together with a banking system that is able and willing to supply credit to the real economy.