Box 2

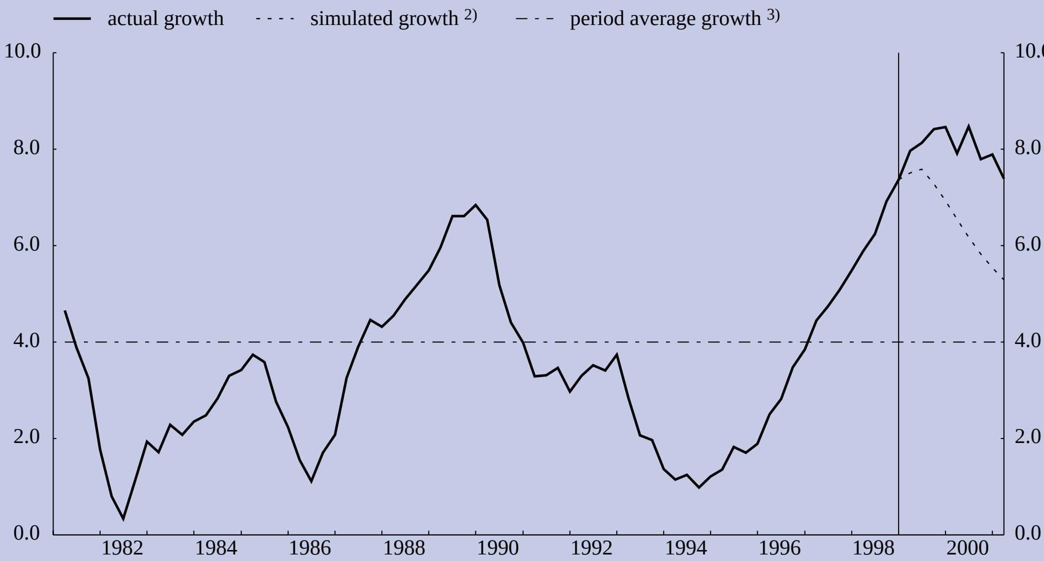
Factors explaining the development of loans to the private sector

Since the start of Stage Three of Economic and Monetary Union (EMU), loans to the euro area private sector have been growing at a relatively fast pace. The growth in loans has also been very significant in real terms. Over the period from January 1999 to April 2001 the annual growth rates of real loans to the private sector (deflated by the GDP deflator) ranged between 7.4% and 8.5%, which was significantly above their average over the past 20 years (around 4%).

The strong growth in loans to the private sector in 1999 and 2000 was fostered, to differing extents, by robust growth in economic activity (in both nominal and real terms) and low real interest rates by historical standards. The top panel of Chart 7 in the main text of this issue shows that, since the start of Stage Three of EMU, the increase in real loans has been accompanied by robust growth in real GDP. The bottom panel illustrates that

Growth in real loans to the private sector [1)]

(annual percentage changes; quarterly data)



1) *Growth rates of nominal loans to the private sector deflated by means of the GDP deflator.*
2) *Out-of-sample forecast from Q1 1999 based on model in Calza et al. (2001).*
3) *Average growth rate over the period Q1 1980 to Q1 2001.*

favourable financing conditions in the euro area supported the demand for real loans by the private sector in the run-up to Stage Three of EMU and in 1999, when the real composite lending rate (a weighted average of sectoral lending rates over different maturities) declined to around 4%.

The subsequent stabilisation and slight decline in the rates of growth in loans can also be linked to these factors. Real GDP growth weakened somewhat during the second half of 2000, while the real composite lending rate increased from autumn 1999 onwards and reached 5.4% in the first quarter of 2001.

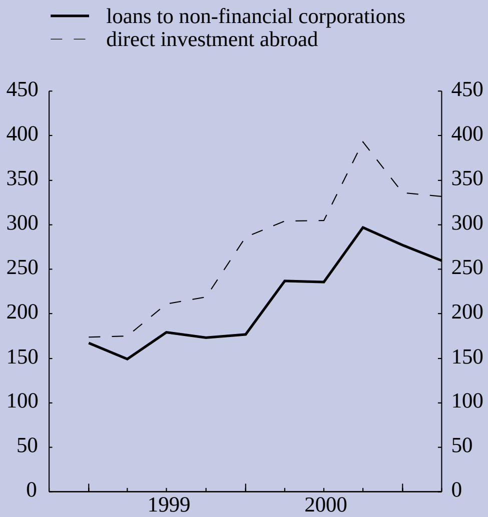
In fact, historically, the behaviour of real loans to the private sector in the euro area can be explained reasonably well by developments in economic activity and the real cost of loans. Formal econometric evidence provided in a recent ECB study shows that the behaviour of real loans to the private sector in the euro area over the period from 1980 to 1999 can be explained by a model including real GDP and real interest rates as the main explanatory variables.[1] Nevertheless, there are indications that these fundamental determinants can only partly capture the developments in real loans to the private sector since the start of Stage Three of EMU. Indeed, the chart above shows that from the first quarter of 1999 to the first quarter of 2001 the model systematically predicted lower annual rates of growth in real loans to the private sector than those recorded. This seems to imply that, after the start of Stage Three of EMU, growth in loans was fuelled by factors not taken into account by the model.

Several specific factors have been identified as driving euro area demand for loans, notably to non-financial corporations, over the past two years. Those which were – albeit to varying degrees – relevant over the whole period include intense merger and acquisition activity, including large direct investment outside the euro area, and high rates of growth of property and land prices in some fast-growing euro area countries. In addition to these, other factors which may temporarily have fostered the demand for loans include the increased need for funds from telecommunications companies to finance the UMTS licence auctions, especially in the third quarter of 2000.

1 *See A. Calza, C. Gartner and J. Sousa, "Modelling the demand for loans to the private sector in the euro area", ECB Working Paper No. 55, 2001.*

Loans to non-financial corporations and direct investment abroad

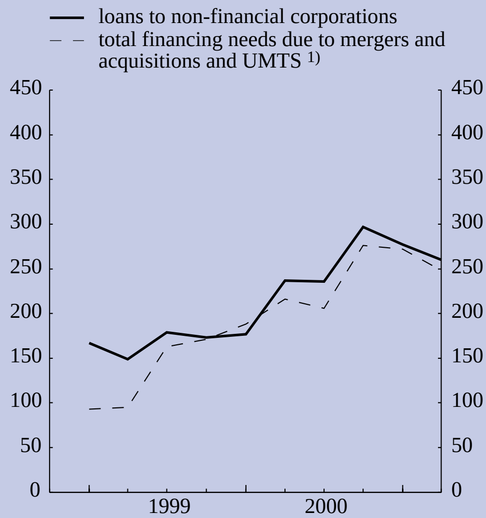
(EUR billions, annual flows)



Source: ECB.

Loans to non-financial corporations and total financing needs arising from mergers and acquisitions (cash payments) and UMTS

(EUR billions, annual flows)



Source: ECB, Thomson Securities.

1) Part of these needs were covered by financing sources other than loans.

While it is difficult to obtain a sufficiently reliable quantification of the effects of all these factors, the charts above provide an indication that the impact of merger and acquisition activity (including acquisitions outside the euro area) and the UMTS auctions on the development of loans to the private sector, especially on those to non-financial corporations, was sizeable. In particular, the chart above on the left shows that direct investment abroad may have represented an important factor in the growth of loans since the start of Stage Three of EMU. In addition, the chart above on the right illustrates that over the past few years developments in the demand for funds to finance mergers and acquisitions involving cash payments and to finance UMTS licences appears to have had a clear impact on the increase in loans to the private sector. While it is not possible to identify exactly which part of these transactions were financed via loans and which part through other sources of finance (e.g. bond issuance, equity finance or internal financing sources), there was a remarkable correlation between the evolution of the total financing needs due to mergers and acquisitions and UMTS auctions and the pattern of the expansion of loans.

The financing of the specific factors mentioned is not likely to affect aggregate spending and future price developments in the euro area significantly. This is immediately obvious in the case of foreign direct investment. Moreover, to the extent that the funds received from the proceeds of UMTS auctions have been used to gradually redeem public debt, they do not imply risks to price stability. It is also plausible to assume that large proportions of cash payments made to the holders of shares in the acquired company in a merger are re-invested in (non-monetary) financial assets, thus not directly adding to domestic spending. Furthermore, even though loans for house purchase financed aggregate demand in the form of residential construction, the major part of the increase in loans for house purchase over the period seems to have been related to transactions on the secondary housing market and to the rise in property prices over that period. Although account should also be taken of second mortgages financing consumer spending, it can reasonably be assumed that part of the loan financing is not used for aggregate spending. Taking into account all the special factors, it appears that the high level of the growth rates of loans to the private sector may no longer signal risks to price stability.