Box 1

LONGER-TERM DEVELOPMENTS IN LOANS TO THE PRIVATE SECTOR

The annual growth rate of loans to the private sector increased further in the first few months of this year, to stand at 10.8% in March 2006. These strong growth rates match those observed at the peak of previous credit cycles. This box reviews longer-term developments in loans to the private sector and their co-movement with two other key macroeconomic variables – economic activity and money – in order to assess whether the current period of strong loan growth is markedly different in nature to those observed in the past.

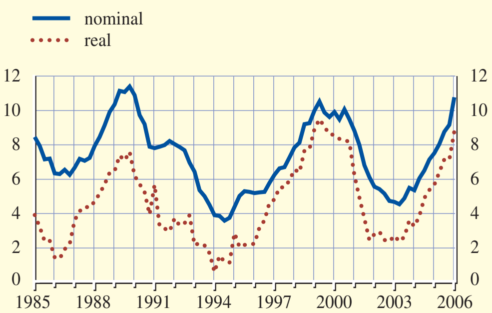
The current growth of loans to the private sector is high from a historical perspective

When looking at the longer-term developments in the annual growth rate of loans to the private sector in the euro area, two broad cycles can be distinguished. The first cycle extends from a trough in the mid-1980s to a trough in the mid-1990s, with a peak of close to 12% in 1989. The second cycle extends from the mid-1990s to the early 2000s, with a peak of close to 11% in 1999. Following a continued strengthening since mid-2003, loan growth in early 2006 reached similar magnitudes to those seen at the previous peaks (see Chart A).

The picture of a historically high growth rate also emerges when looking at developments in real loans, i.e. taking into account inflation developments. Although, at around 8%, annual real loan growth is currently somewhat below the peak rate observed in 1999, it is clearly higher

Chart A MFI loans to the private sector

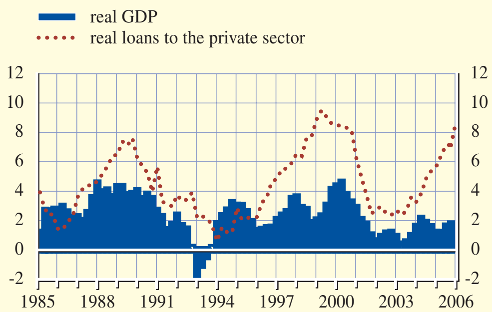
(annual percentage changes; not adjusted for seasonal and calendar effects; quarterly data)



Source: ECB.
Note: Real series have been derived by deflating the nominal series with the GDP deflator.

Chart B MFI loans to the private sector and real GDP

(annual percentage changes; not adjusted for seasonal and calendar effects; quarterly data)



Source: ECB.

than that seen at the peak recorded in 1989. In this respect, it must be kept in mind that the level of nominal as well as real interest rates is currently much lower than at the end of the 1990s.

The current high growth of loans comes together with only moderate growth in GDP

Looking at the co-movement between growth in loans to the private sector and growth in aggregate economic activity suggests that, in line with business cycle theory, a broad relationship exists between the two, although it is not close on a year-to-year basis. For instance, the peaks in real loan growth in 1989 and 1999 coincided with periods when real GDP growth also attained a peak, and the troughs in real GDP growth in the early 1990s and early 2000s more or less coincided with periods of subdued loan growth (see Chart B).

Against this background, the return to historically high rates of growth in loans in recent quarters may be somewhat surprising, given that in the current recovery phase real GDP growth in the euro area has remained well below the growth rates seen at earlier peaks in real loan growth. One explanation could be that the driving forces behind the strengthening of loan growth observed since mid-2003 have been different from those in earlier periods. Sectoral developments may have played an important role here. For example, the broader movements of growth in loans to the private sector are typically determined to a large extent by the dynamics of loans to non-financial corporations, which exhibit a much more cyclical pattern than those of loans to households.[1] However, one feature of loan developments since the end of the 1990s has been the relatively high amplitude of swings in the annual growth rate of loans to households. Over the last five years, the strengthening of growth in total loans to the private sector was driven at the outset by stronger growth of loans to households, which appears to have been related to the robust dynamics of house prices rather than to activity and income. The rise in the contribution from loans to non-financial corporations came only at a later stage (see Chart C).

1 Concerning the cyclical pattern of growth in loans to non-financial corporations, see Box 1 entitled “Recent developments in loans to non-financial corporations” in the June 2004 issue of the Monthly Bulletin.

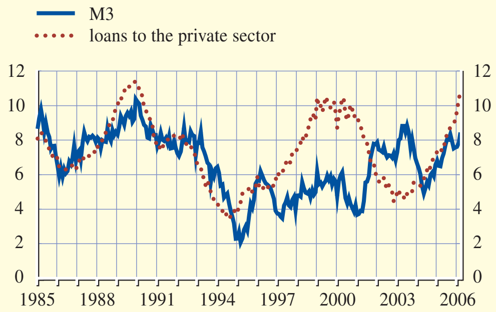
Chart C MFI loans to households and non-financial corporations

(annual percentage changes; not adjusted for seasonal and calendar effects; quarterly data)

Source: ECB.

Chart D MFI loans to the private sector and M3

(annual percentage changes; not adjusted for seasonal and calendar effects; monthly data)



Source: ECB.

The developments in money and loans are less connected than in the past

Banks' extension of loans to the private sector is the main source of money creation. This suggests that M3 and loans to the private sector would typically be expected to move closely together, since they represent the largest components of the two sides of the consolidated balance sheet.

This relationship was clearly visible in the first of the two broad cycles under review, with coinciding peaks in annual loan growth and annual M3 growth in the late 1980s and coinciding troughs in the mid-1990s (see Chart D). Yet, the two series show a much less close relationship over the second cycle, with the peak in loan growth at the end of the 1990s coinciding with subdued growth in M3.

Likely factors underlying the looser relationship between money and loans since the mid-1990s are increased globalisation and structural changes in financial markets. These have had a significant impact on the size and the amplitude of international capital flows, which, in turn, are reflected, at least in part, in the net external asset position of MFIs (one of the M3 counterparts).[2] One example of this impact is the strong capital outflows from the euro area at the end of the 1990s, driven to a large extent by M&A activities of euro area residents in the United States, and the subsequent repatriation of these funds during the period of heightened global uncertainty between 2001 and mid-2003. This means that the strong movements in loan growth have to a large extent been counterbalanced by movements in the net external asset position and have thus diverged from movements in M3 growth.

Overall, loans are closely monitored as part of the monetary analysis. This requires a continual updating of the assessment of their relationship with economic activity and money.

2 With regard to the impact of net external assets on M3, see Box 2 entitled "Recent developments in MFI net external assets" in the July 2005 issue of the Monthly Bulletin.

Table 2 MFI loans to the private sector

(quarterly figures are averages; not adjusted for seasonal and calendar effects)

	Outstanding amount as a percentage of the total [1]	Annual growth rates					
		2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Feb.	2006 Mar.
Non-financial corporations	**41.3**	**6.2**	**7.0**	**7.7**	**9.2**	**9.7**	**10.4**
Up to one year	30.2	4.8	5.8	5.3	6.5	7.0	7.8
Over one and up to five years	17.8	6.5	6.4	8.3	11.5	12.6	14.7
Over five years	51.9	6.9	7.9	8.9	10.0	10.3	10.5
Households [2]	**50.0**	**8.1**	**8.6**	**9.0**	**9.5**	**9.5**	**9.7**
Consumer credit [3]	13.0	6.5	6.9	7.8	8.1	8.4	7.8
Lending for house purchase [3]	70.2	10.2	10.7	11.0	11.7	11.7	12.1
Other lending	16.8	2.1	2.2	2.3	2.1	1.9	2.2
Insurance corporations and pension funds	**1.0**	**14.4**	**16.5**	**29.3**	**33.0**	**27.4**	**40.7**
Other non-monetary financial intermediaries	**7.7**	**11.2**	**15.5**	**14.2**	**16.2**	**18.9**	**16.9**

Source: ECB.
Notes: MFI sector including the Eurosystem; sectoral classification based on the ESA 95. For further details, see the relevant technical notes.
1) As at the end of the last month available. Sector loans as a percentage of total MFI loans to the private sector; maturity breakdown and breakdown by purpose as a percentage of MFI loans to the respective sector. Figures may not add up due to rounding.
2) As defined in the ESA 95.
3) The definitions of consumer credit and lending for house purchase are not fully consistent across the euro area.