Box 2

RECENT SHIFTS BETWEEN DIFFERENT CATEGORIES OF FINANCIAL ASSET HELD BY HOUSEHOLDS

Increases in key ECB interest rates since end-2005 have led both to a flattening of the euro area yield curve, as short-term market interest rates have risen more strongly than long-term rates, and to the emergence of larger spreads between the interest rates paid on different types of short-term deposit (see Chart A). These interest rate developments have affected monetary developments in several ways. On the one hand, they have led, at least temporarily, to wealth portfolios being shifted from longer-maturity and riskier assets outside M3 to instruments in M3, thereby boosting M3 growth at least in the short term. On the other hand, they have also led to asset shifts within M3, namely from relatively poorly remunerated overnight deposits into "other short-term deposits" (i.e. M2-M1), leading to a downward trend in the growth rate of M1.

This box reviews these shifts between the various categories of financial asset and relates them to interest rate developments. It focuses on households, as this sector accounts for the bulk of

M3 deposits (i.e. short-term deposits and repurchase agreements) and as the portfolio behaviour described above is particularly relevant for households.

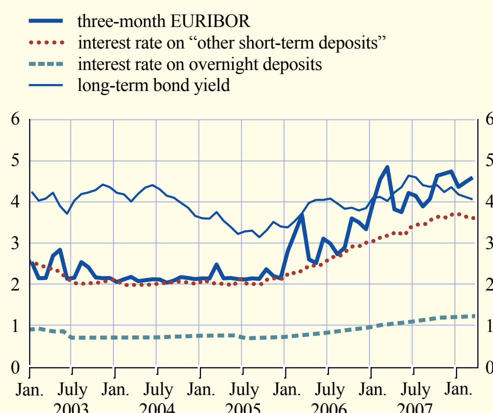
Shifts in flows into M3 from longer-term assets outside M3

Developments in market interest rates since end-2005 have led to a narrowing of the spread between the long-term bond yield and the interest rate on “other short-term deposits”,[1] giving rise to a relatively flat yield curve. As Chart B shows, this spread has more than halved, reaching levels around 0.5 percentage point at the start of 2008.

A relatively flat yield curve implies that short-term deposits (for example, deposits with an agreed maturity of up to one year) offer a rate of remuneration which is similar to that of longer-term assets. Since the latter are less liquid and holding them typically implies somewhat greater risk, a flat yield curve tends, overall, to increase the relative attractiveness of shifting funds into monetary assets (rather than non-monetary assets).

Chart A Euro area market interest rates and rates on households’ short-term deposits

(percentages per annum)



Source: ECB.
Note: See footnote 1 for a definition of “other short-term” interest rates and long-term bond yields.

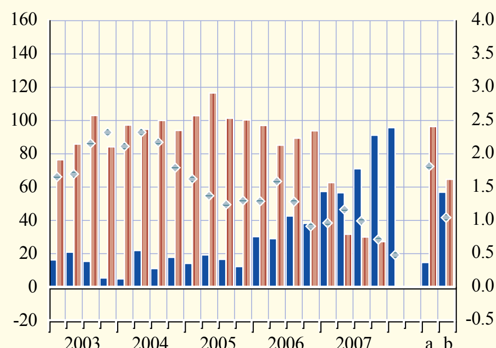
1 The long-term bond yield is the yield on ten-year bonds or bonds with the closest available maturity. “Other short-term” interest rates are calculated as the average of interest rates on: (a) deposits redeemable at notice of up to three months; (b) deposits with an agreed maturity of up to one year; and (c) deposits with an agreed maturity of between one and two years.

Chart B Euro area households’ financial asset flows

(flows in EUR billions and interest rate spreads in percentage points; quarterly data; seasonally adjusted)

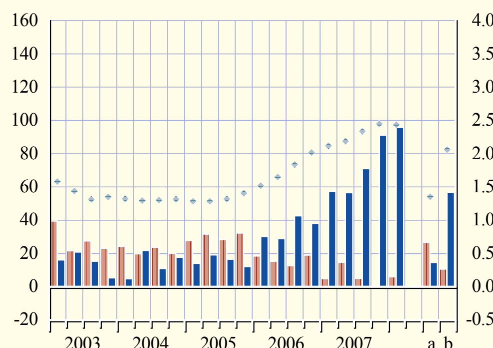
longer-term assets

- “other short-term deposits” and repurchase agreements (left-hand scale)
- longer-term financial assets (left-hand scale)
- spread between long-term bond yield and interest rate on “other short-term deposits” (right-hand scale)



short-term deposits

- “other short-term deposits” and repurchase agreements (left-hand scale)
- overnight deposits (left-hand scale)
- spread between interest rates on “other short-term deposits” and overnight deposits (right-hand scale)



Source: ECB.
Notes: Data on longer-term financial assets, which are derived from the integrated euro area accounts, are available until the fourth quarter of 2007. Data labelled “a” and “b” are averages for the periods 2003-05 and 2006-08 respectively.

These developments in interest rates have translated into both sustained declines in flows into longer-term financial assets, especially in 2007, and, at the same time, sustained and increasing flows into short-term deposits other than overnight deposits.[2] Quarterly flows into "other short-term deposits" and repurchase agreements have increased from around €15 billion on average between 2003 and 2005 to around €50 billion on average from 2006 onwards, while quarterly flows into longer-term financial assets have fallen from around €100 billion on average between 2003 and 2005 to less than €70 billion on average from 2006 onwards.

Shifts in flows from overnight deposits into other M3 deposits

Developments in market interest rates since 2005 have also led to significant increases in the spread between rates on "other short-term deposits" and rates on overnight deposits, with this spread rising from an average of around 1.5 percentage points between 2003 and 2005 to around 2.5 percentage points in the first quarter of 2008.

This has increased the opportunity cost of holding relatively poorly remunerated overnight deposits and increased the incentive to shift funds into the better remunerated – but still liquid – "other short-term deposits" and repurchase agreements. Indeed, flows into overnight deposits have recorded sustained declines since 2006, with quarterly flows falling from more than €25 billion on average between 2003 and 2005 to significantly below €10 billion on average in 2007 and early 2008 (see Chart B). This has implied a rebalancing of portfolios, with shifts from M1 to other instruments within M3.

Overall, recent developments in M3 and its components appear to have been significantly influenced by the interest rate developments resulting from the increases in key ECB interest rates and the turbulence seen in the money markets. In particular, these interest rate developments have led to households' portfolios being shifted from assets outside M3 to instruments included in M3, as well as to portfolio flows within M3. Both types of shift have benefited "other short-term deposits" and repurchase agreements, which have witnessed continued strengthening and recorded an annual growth rate slightly above 20% in April 2008.

2 Longer-term financial assets are obtained by deducting monetary assets from total financial assets, which are themselves derived from the integrated euro area accounts. These include shares and other equity, which implies that the relevant interest rate indicator should include expected returns from shares in addition to long-term interest rates. However, the same exercise excluding shares and other equity gives a similar result, i.e. a marked decline in flows into longer-term financial assets in the course of 2007, with flows in that year reaching the lowest levels seen in the period considered in this box.