Box 5

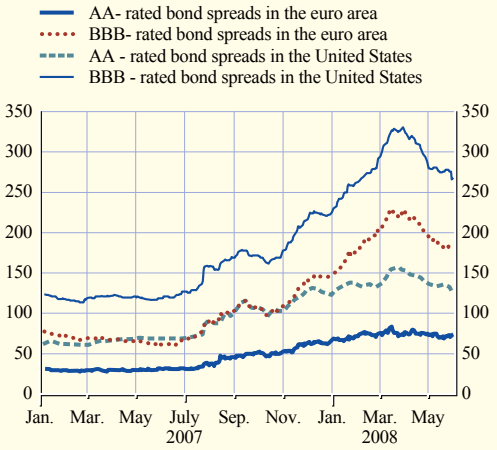
A COMPARISON OF SPREADS ON CORPORATE DEBT FINANCING IN THE EURO AREA AND THE UNITED STATES

This box compares developments in the cost of debt financing for non-financial corporations in the euro area with those in the United States since the start of the financial turmoil, focusing on the spreads in corporate bond yields and bank interest rates. When interpreting the differences between the euro area and the United States, it is important to keep in mind that the comparison of such data is constrained not only by the differences in the statistical methodology used (such as sampling, definitions and data coverage), but also by the pronounced differences in the financing behaviour of non-financial corporations on the two sides of the Atlantic. Non-financial corporations in the euro area rely predominantly on bank loans, which accounted for around 85% of their total debt at the end of 2006. In the United States, the combined share of commercial and industrial loans (C&I loans) and mortgage loans was 57% of total debt in the same period, with C&I loans accounting for only around 20% of total debt, as market-based debt is more widely used by non-financial corporations there, while mortgage loans are separately accounted for.

Corporate bond spreads for non-financial corporations across all rating classes in both the euro area and the United States have increased markedly since the outbreak of the financial turmoil. However, more pronounced increases were observed for issuers of bonds falling into the BBB rating category, where option-adjusted spreads (OAS)[1] have widened by 115 basis points in the euro area and by more than 140 basis points in the United States since end-June 2007 (see Chart A). It should be borne in mind, however, that these spreads have been calculated on the basis of government bond yields. Since the start of the financial turmoil, "safe haven" flows into government bonds have contributed to driving the level of government bond yields lower than would normally have been expected.[2] In addition, movements in US Treasury bond yields were more affected by

Chart A Option-adjusted bond spreads for non-financial corporations in the euro area and the United States

(basis points)



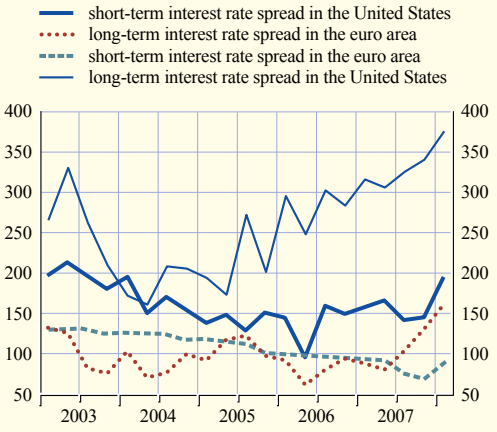
Sources: Bloomberg and Merrill Lynch.

1 These spreads are purged of any embedded optionality priced into a callable or puttable bond, of coupon effects or of the effects of index re-balancing.

2 See also Box 3 in the May 2008 issue of the Monthly Bulletin.

Chart B Spreads of interest rates on bank loans in the euro area and the United States

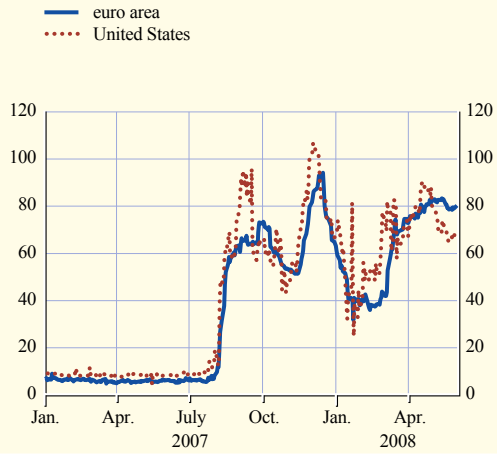
(basis points)



Sources: ECB and Federal Reserve System.
Note: Short-term interest rate spreads are calculated using the three-month Euribor in the euro area and the three-month Libor in the United States. For long-term interest rate spreads the five-year and the three-year government bond yields are used for the euro area and the United States respectively. Short-term bank loan rate in the United States is a simple average between the categories: "zero interval", "daily", "2 to 30 days", "31 to 365 days". Long-term bank loan rates for the United States belong to the "over 365 days" category.

Chart C Spreads between three month money market rates and overnight index swap rates in the euro area and the United States

(basis points)



Sources: ECB.
Note: The euro area spread is calculated as the difference between the three-month Euribor and the Eonia swap rates. The US spread is calculated as the difference between the three-month Libor and the overnight index swap rates.

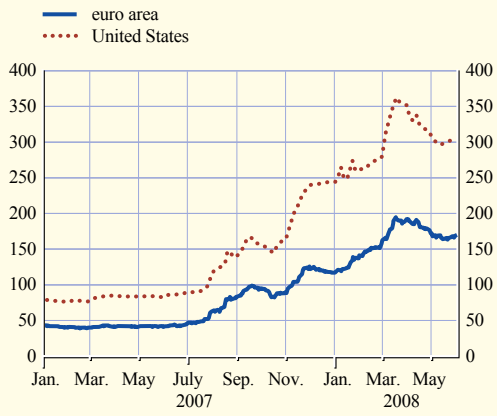
such "safe haven" flows, reflecting also the significant policy loosening by the Federal Reserve, and this could partly explain why the spreads in the United States were larger than those in the euro area.

Turning to the developments in bank financing costs, short-term interest rate spreads (over comparable market rates) on corporate loans in the United States have increased by around 30 basis points since end-June 2007, while they have remained broadly stable in the euro area. Long-term interest rate spreads have increased in both areas (see Chart B).

The broad stability in short-term interest rates spreads in the euro area, and the small increase in the United States, can be explained by the fact that, on account of the continued tensions in the money markets, the gap between three-month money market rates and the overnight index swap rates peaked at around 80 basis points in the euro area, and at 70 basis points in the United States (see Chart C). Thus spreads between short-term lending rates and banks' short-term funding costs have remained compressed, in the face of larger increases in the cost of wholesale funding.

Chart D Option-adjusted bond spreads for banks in the euro area and the United States

(basis points)



Sources: Bloomberg and Merrill Lynch.
Note: Investment banks are excluded.

Widening long-term bank interest rate spreads could eventually reflect higher costs in funding by banks for non-financial corporations on both sides of the Atlantic. Chart D shows that spreads of bonds issued by banking entities have also increased since the end of June 2007. In the United States, the increases were more pronounced, as the spreads widened by 210 basis points, while spreads of bank bonds increased by only 120 basis points in the euro area. It is also worth noting that differences in the characteristics of the products could also play a role, given, for example, that bank lending rates in the United States cover commercial and industrial loans only, while bank lending rates in the euro area also include mortgage loans.