

## FINANCING CONDITIONS OF NON-FINANCIAL CORPORATIONS IN THE EURO AREA

Overall, the financing conditions of euro area non-financial corporations are, at present, favourable. However, in 2004 the financing flows of non-financial corporations have thus far been subdued. This box focuses on the costs of financing of non-financial corporations and identifies a number of factors that could explain the still moderate growth of financing flows to non-financial corporations in the euro area.

### The costs of debt financing

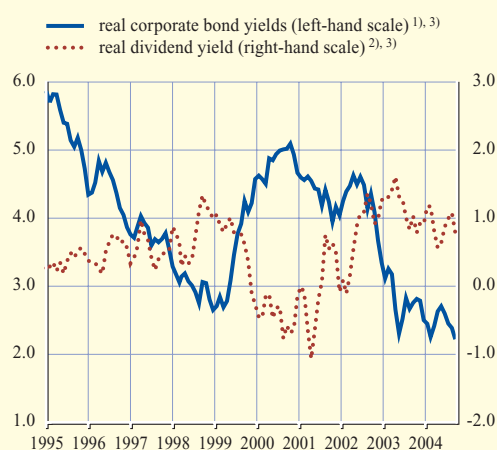
The real costs of debt financing of non-financial corporations remain at a very low level. For example, the real cost of market-based debt (measured as a weighted average of investment-grade bond yields and high-yield bond yields deflated by the Consensus Economics inflation expectations for four years ahead<sup>1</sup>) currently stands at a historically low level (see Chart A). This development reflects the general decline in interest rates over the period and, more recently, the improvement in the credit risk outlook of the corporate sector (as also reflected in the low corporate bond spreads (see Chart 24 in Section 2.6)).

The current favourable cost of debt financing is also reflected in low real MFI interest rates on loans to non-financial corporations (see Charts B and C). It is difficult to make a historical comparison because the statistical definition of bank interest rates has changed since the introduction of the new harmonised MFI interest rate statistics in January 2003. Nevertheless, focusing on changes, real long-term bank interest rates declined by around 4 percentage points between 1995 and end-2002 (see Chart B). Moreover, the downward trend has continued in 2003 and 2004, albeit at a somewhat more moderate pace (see Chart C, based on the new MFI interest rate statistics).

As regards more recent developments, the real rates on MFI loans to non-financial corporations increased slightly in the third quarter of 2004, but remained at a very low level overall. There is also some evidence that, while non-financial corporations have recently lengthened the maturity of their debt, the relative share of loans taken with a short-term rate fixation, or even a floating rate, has increased in parallel.

**Chart A Real market-based financing costs of non-financial corporations**

(percentages per annum)

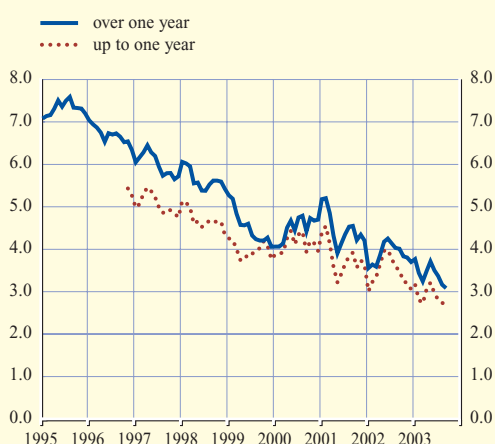


Sources: Thomson Financial Datastream and ECB calculations.  
 1) Bond yields of non-financial corporations rely on an index by Merrill Lynch referring to investment grade non-financial corporations as well as on a high yield index. Prior to April 1998, only national data are available (Belgium, France, Germany, Italy, the Netherlands and Spain). Yields are aggregated using GDP weights corresponding to the purchasing power parity in 2001.  
 2) Dividend yield is defined as the annual dividend, anticipated by market participants, as a percentage to the share price.  
 3) Deflated by the Consensus Economics inflation expectations.

<sup>1</sup> See also Box 3 entitled "Measuring real interest rates in the euro area countries" in the September 2004 issue of the Monthly Bulletin for a discussion of deflation measures.

**Chart B Real retail bank lending interest rates to enterprises<sup>1)</sup>**

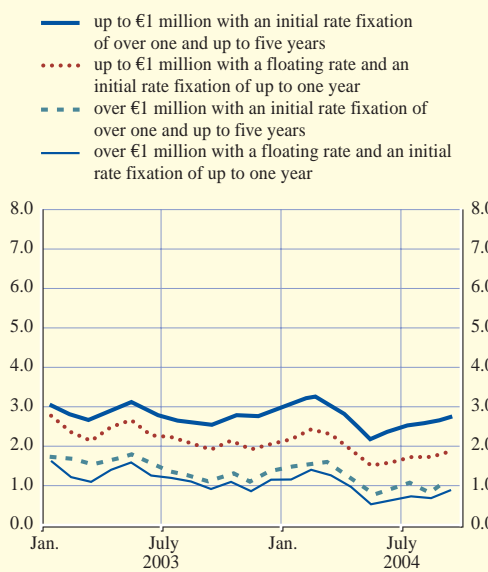
(percentages per annum)



Source: ECB.  
1) Corporate bank lending rates are deflated by the actual HICP.

**Chart C Real MFI interest rates on loans to non-financial corporations<sup>1)</sup>**

(percentages per annum, weight-adjusted<sup>2)</sup>)



Source: ECB.  
1) Corporate bank lending rates are deflated by the actual HICP.  
2) For the period from December 2003 onwards, the weight-adjusted MFI interest rates are calculated using country weights constructed from a 12-month moving average of new business volumes. For the preceding period, from January to November 2003, the weight-adjusted MFI interest rates are calculated using country weights constructed from the average of new business volumes in 2003. For further information, see the box entitled "Analysing MFI interest rates at the euro area level" in the August 2004 issue of the Monthly Bulletin.

In addition, the spreads between MFI interest rates on loans to non-financial corporations and comparable market rates have either remained stable or declined somewhat in the course of 2004, most probably reflecting banks' perception of a more positive corporate credit risk outlook (as also confirmed by the October 2004 bank lending survey<sup>2)</sup>). Nevertheless, bank-based credit spreads have declined more moderately in recent years and remain somewhat higher than market-based credit spreads, in particular as regards the spreads on smaller-sized loans. This could indicate that MFIs have been more reluctant than market participants in general to take risks on lending to non-financial corporations, reflecting, in part, the different nature of non-financial corporations that obtain debt financing through banks (predominantly small and medium-sized enterprises) and through capital markets (i.e. larger companies).

Overall, bank interest rate costs of non-financial corporations have declined in recent years. For example, in September 2004 the interest payments bill on outstanding MFI loans to non-financial corporations (as measured by the outstanding amounts multiplied by their corresponding interest rates) amounted to around €131 billion. This compares with €145 billion in January 2003.

2 See Box 2 entitled "The results of the October 2004 bank lending survey for the euro area" in the November 2004 issue of the Monthly Bulletin.

## The costs of equity financing

By contrast with real debt financing costs, measures of the real cost of equity financing currently stand at a higher level than in 2000 and 2001. As illustrated in Chart A, a measure of the real cost of equity (approximated as the real dividend yield<sup>3</sup>), while having declined from its peak in early 2003, remained considerably higher than the (very low) level observed in 2000 and early 2001. However, taking a longer-term perspective this measure of the current real cost of equity is only moderately higher than the level observed in the second half of the 1990s.

## Financing flows

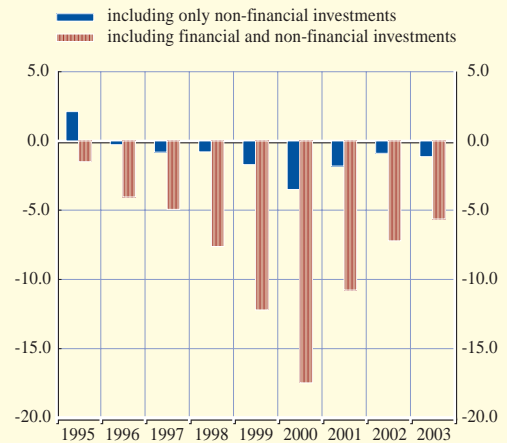
Despite the benign overall developments in debt financing conditions, non-financial corporations have only to a limited degree assumed new debt in 2004. Thus, for most of 2004, the annual growth rate of debt financing of euro area non-financial corporations has been relatively subdued, at a level below 4% (see Section 2.4). While it has picked up in recent quarters, mainly owing to an increase in loan financing, it remains at a relatively low level from a historical perspective.

Several factors may explain the continued moderate rate of growth of financing flows to non-financial corporations. First, there is some evidence that profitability has increased, boosting internal savings and lowering firms' demand for external financing (see Chart 27 in Section 2.8 and the results of the October 2004 bank lending survey). Second, the still high corporate indebtedness (see Chart E in Box 3) is likely to have induced many firms to spend their retained profits on restructuring and reducing their debt, for example by buying back (redeeming) their outstanding debt securities. Third, non-financial corporations may have adopted a cautious "wait and see" approach with regard to the financing of additional large capital investments. This interpretation is supported by evidence of a reduced financing gap as compared with the peak of 2000 (see Chart D). Preliminary estimates suggest that the financing gap was further reduced in 2004.

Turning to equity financing, the primary equity market in the euro area continued to be sluggish in 2004 (see Chart 11 in Section 2.2), reflecting both subdued investor demand and indications of a still relatively high cost of equity (see Chart A). The somewhat uncertain environment was also reflected in the postponement of a number of planned initial public offerings (IPOs). It is likely that the low net issuance of quoted shares to some extent also reflects the limited need for external financing sources at the current juncture of the economic cycle, in particular as M&A activity in 2004 has thus far remained subdued. At the same time, it has to be noted that while

Chart D Net lending/borrowing of non-financial corporations<sup>1)</sup>

(as a percentage of GDP)



Source: ECB.

1) Net lending (+) or net borrowing (-) is calculated as the sum of gross savings and net capital transfers minus either non-financial investments only or the sum of non-financial and financial investments. Non-financial investments comprise gross capital formation and acquisitions less disposals of non-produced, non-financial assets.

<sup>3</sup> A rise in the dividend yield is assumed to imply a higher cost of equity; see also Box 5 entitled "Activity in the euro area initial public offering market" in the December 2002 issue of the Monthly Bulletin.

current primary equity market activity may look weak by comparison with 1999-2001, the latter was heavily influenced by extremely buoyant issuance by the telecommunications, media and technology sectors.

All in all, the costs of various sources of debt financing have declined over the past few years. The nevertheless still relatively moderate external financing flows to the corporate sector are consistent with the picture of an only gradual economic recovery, in which companies are on average recording rising profits but have not yet started to invest in fixed capital on a large scale.