

## Box 2

**THE IMPACT OF THE FINANCIAL MARKET TURMOIL ON MONEY AND CREDIT DEVELOPMENTS**

Since mid-July 2007, financial markets have experienced an episode of turmoil that is associated with a reappraisal of the price of credit risk and reflected, more generally, in a lack of confidence on the part of investors. Different market segments have been affected to varying degrees. Credit institutions and, more broadly, financial intermediaries have been at the epicentre of the turmoil, given continued uncertainty regarding the nature and extent of the institutions' exposure to credit risk.

Developments in broad monetary and credit aggregates throughout September 2007 – which includes the important end-quarter milestone – do not, at least not as yet, point to any significant effect of the continued uncertainty on the overall pace of monetary dynamics. Nonetheless, some impact of the turmoil may be visible in specific positions on the MFI consolidated balance sheet, which are closely related to the tensions in the money markets that are central to the turmoil. In particular, an impact can be identified in the development of loans and deposits of other non-monetary financial intermediaries (OFIs), in the holdings of money market funds shares/units and in the evolution of MFIs' short-term debt securities. This box analyses the components and counterparts of M3 that have been influenced by the turmoil. It does not discuss balance sheet items with an evolution in August and September that was broadly in line with recent patterns, such as loans to the private sector, although the continued strength of their dynamics may be open to a number of interpretations.

### **Developments in other financial intermediaries' borrowing and holdings of money**

September 2007 saw the highest monthly net demand for MFI loans by OFIs observed since the start of Stage Three of EMU, resulting in a very high annual growth rate of loans to (and short-term deposits of) these intermediaries (see Chart A). Although this was partly linked to seasonal effects, the high demand for credit seems to stem mainly from investment funds. This is corroborated by looking at the maturity breakdown of OFI loans, which indicates that the strengthening of the annual growth rate in September was mainly driven by loans with a maturity of more than one and up to five years. This maturity bracket exceeds the typical duration of repurchase agreement operations and loans granted in the context of stand-by facilities. Nevertheless, there is evidence that some of the loans to OFIs can be attributed to the turmoil.

First, a proportion of these loans to OFIs was directed towards conduits. These conduits are entities usually set up by credit institutions for issuing highly rated short-term notes in order to secure a funding advantage for the sponsoring banks, to help manage the respective bank's balance sheet so as to allow it to gain regulatory capital relief and to arbitrage the return between long-term securities and short-term paper. In order to obtain a high rating on the commercial paper issued by these conduits, the vast majority of such entities have committed credit lines with credit institutions for 100% of the issued amount. As a result of the reappraisal of the risks embedded in the underlying assets held by these conduits, investors became reluctant to continue to fund these conduits, thereby inducing them to resort to the stand-by credit facility for funding. These loans are thus linked to a re-intermediation of loans onto MFI balance sheets as markets for various asset-backed securities became illiquid.

In addition, part of the demand for loans by OFIs in September can be attributed to a relatively strong demand for secured interbank lending, instead of for unsecured lending, given the turmoil in the money market. In principle, interbank activities are netted out when deriving monetary and credit aggregates. However, any secured interbank lending that is settled via electronic trading platforms that are classified as non-monetary financial intermediaries will be visible in the loans to OFIs and be reflected, on the liability side of the MFI balance sheet, in an increase in the holdings of deposits, including repurchase agreements.

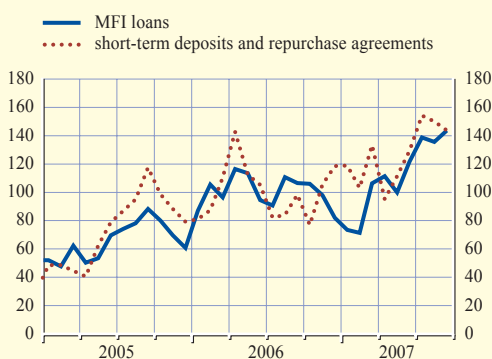
Furthermore, it cannot be excluded that the turmoil triggered substitution between OFI-subcategories within short-term lending to OFIs, as some financial operations that would previously have been undertaken were put on hold, while the transactions described above came to the fore.

### **Developments in money market fund shares/units**

The impact of the turmoil on monetary and credit aggregates was visible in the significant reduction of around €25 billion in the holdings of money market fund shares/units by the money-holding sector in August and September. This reduction may reflect the increased apprehension of investors with respect to these instruments, as their perception of the risk profile of money market funds evolved. In recent quarters, some money market funds took on risk exposure through holdings of asset-backed securities, largely to boost returns so as to outperform their benchmark money market rate. The well-publicised concerns about the quality of the assets of a small number of funds resulted in widespread sales of money market fund shares/units as investors appeared not to discriminate between the asset holdings of individual funds.

**Chart A Annual flow of MFI loans to, and short-term deposits and repurchase agreements of, other financial intermediaries**

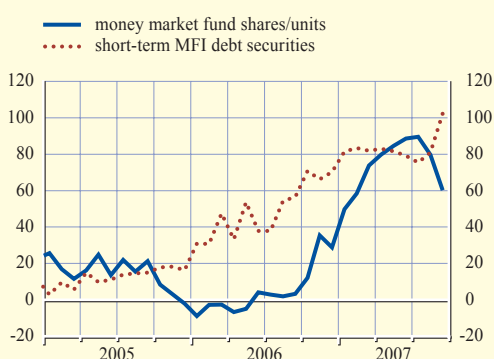
(EUR billions; not adjusted for seasonal and calendar effects)



Source: ECB.

**Chart B Annual flow into money market fund shares/units and short-term MFI debt securities**

(EUR billions; adjusted for seasonal and calendar effects)



Source: ECB.

At the same time, overall developments in monetary aggregates suggest that the reduction in the holdings of money market shares/units was mirrored by a corresponding increase in short-term time deposits of retail investors. Institutional investors seem, in part, to have replaced money market fund shares/units with short-term MFI debt securities, which supported issuance by MFIs. Overall, these developments can be seen to signal a continued willingness on the part of the money-holding sector to invest in MFI securities throughout the period of turmoil. There is thus no evidence that this source of funding for MFIs has dried up.

### The relationship between the ECB's additional open-market operations and money and credit aggregates

In order to alleviate tensions in the money market in August and September, the ECB conducted a number of additional open-market operations with varying maturities of up to three months.<sup>1</sup> The additional operations changed the timing of liquidity provision within the maintenance period, as well as lengthening the maturity of the Eurosystem's outstanding operations. It is important to note that these operations did not change the total amount of liquidity provided in the respective reserve maintenance periods.

Like all ECB market operations, the additional money market operations conducted by the ECB since the start of August were transactions between the Eurosystem and MFIs, creating deposits with the Eurosystem. In the context of the consolidated MFI balance sheet, which is the basis for the compilation of monetary aggregates, all inter-MFI positions as well as positions between MFIs and the central bank are netted-out. Therefore, operations conducted by the ECB cannot, strictly speaking, have any direct impact on M3, irrespective of the volume involved.

Nonetheless, the change in the timing and maturity composition of the operations appears to have facilitated the orderly conduct of banking business during the financial turmoil, which would otherwise have been impaired by the dislocation in the interbank market. In particular,

<sup>1</sup> See the box entitled "The ECB's additional open market operations in the period from 8 August to 5 September 2007" in the September 2007 issue of the Monthly Bulletin.

the stabilisation of the overnight interest rate at levels close to the minimum bid rate in the Eurosystem's regular refinancing operations has contributed to ensuring that the Governing Council's monetary policy decisions are transmitted to the money and credit creation process in a manner closer to normal circumstances than would otherwise be the case.

### **Conclusions**

The monetary and credit data available up to September 2007 show that the financial market turmoil has had an impact on some items of the MFI consolidated balance sheet that are closely related to the nature of the turmoil. In particular, the development of loans to, and deposits of, other non-monetary financial intermediaries, the holdings of money market funds shares/units and MFI debt securities were affected.

At the same time, based on a broad set of detailed information, there has not been any visible effect on broad monetary and credit aggregates. Looking forward, the turmoil might have a more profound influence also on overall M3 developments, if it were to trigger a more widespread rise in risk aversion.