Box 2

BANKS' FUNDING CONDITIONS AND THE FINANCING OF NON-FINANCIAL PRIVATE SECTORS IN THE EURO AREA

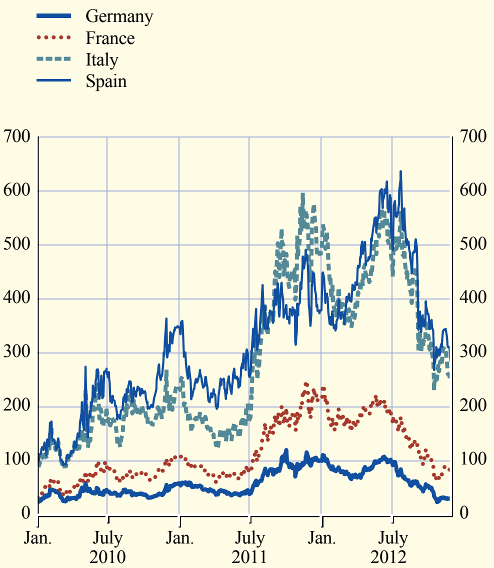
Funding conditions in the euro area have improved since mid-2012. This reflects improving market sentiment and declining risk aversion. More specifically, the cost of insuring sovereign debt against default has declined since the summer of 2012 across euro area countries (see Chart A). Likewise, both hard data and the results of the October 2012 bank lending survey show that euro area banks' funding costs have declined and their access to funding has improved in recent months. These favourable developments may be a sign of the support provided by the announcement of the Outright Monetary Transactions (OMTs) and the non-standard liquidity measures implemented by the Eurosystem. In parallel, the financing costs of non-financial private sectors have also moderated, while bank lending remains weak.

Banks' funding conditions

Funding costs for euro area banks have declined since the summer of 2012 (see Chart B). This has been driven mainly by declining yields on banks' bonds owing to a recovery in market confidence. In addition, spreads between unsecured and secured borrowing costs in the money market have declined significantly across all maturities in the second half of 2012. At the same time, the cost of

Chart A Five-year sovereign credit default swaps in selected countries

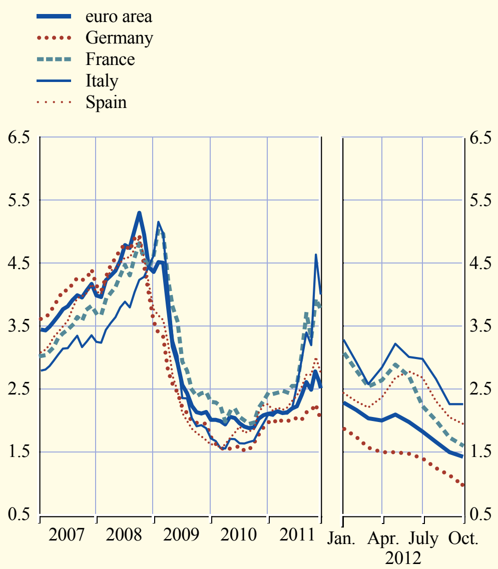
(basis points; daily data)



Source: Thomson Reuters.
Note: Last observations are for 29 November 2012.

Chart B Composite cost of bank funding in the euro area and selected countries

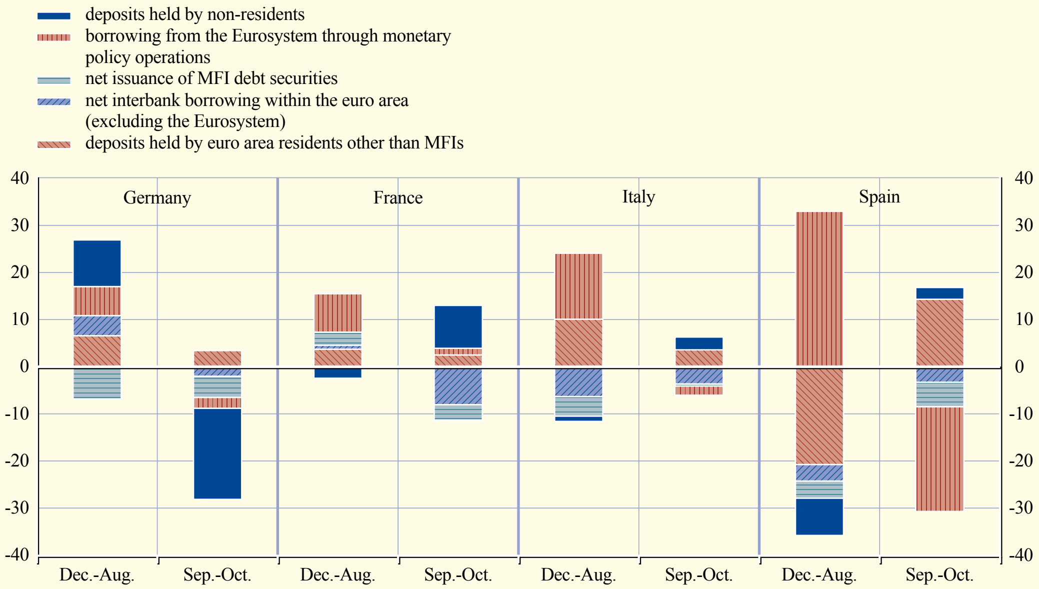
(percentages per annum)



Sources: ECB, Merrill Lynch Global Index and ECB calculations.
Notes: Deposit rates (for both retail and institutional investors) and cost of market-based debt financing, weighted using outstanding amounts taken from BSI statistics. An extreme value relating to the collapse of Lehman Brothers in September 2008 has been smoothed out. Last observations are for October 2012.

Chart C Main liabilities of MFIs resident in selected countries

(EUR billions; not adjusted for seasonal effects)



Sources: Deutsche Bundesbank, Banque de France, Banca d'Italia, Banco de España and ECB calculations based on BSI statistics.
Notes: MFI reporting sector excluding the Eurosystem. Data refer to the average monthly flows observed between December 2011 and August 2012 and September and October 2012 respectively.

deposit funding has stabilised at the euro area level, reflecting a sluggish pass-through of previous cuts in key ECB interest rates in the context of banks' efforts to attract stable funding.

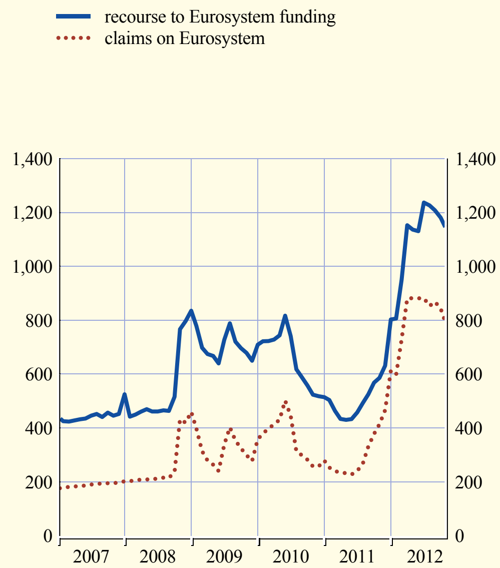
The improvement in banks' funding situation is also reflected in positive flows for domestic and non-resident deposits in France, Italy and Spain (see Chart C). Meanwhile, German banks have seen a decline in deposits held by non-residents, suggesting some moderate rebalancing of portfolios by international investors. Consequently, German banks reduced their claims on the Eurosystem in September and October, while banks in other countries (especially Spain) have reduced their borrowing from the Eurosystem. The results of the October 2012 bank lending survey also show that banks' access to retail funding improved in the third quarter of 2012.[1] Overall, these developments suggest that the degree of financial fragmentation in the euro area may be declining. That can also be seen in the stabilisation of TARGET2 balances since mid-2012.

In autumn 2012 net issuance of long-term debt securities by banks resident in the euro area was significantly less negative than it had been in previous months. This is in line with the results of the bank lending survey, which indicate that banks' access to funding via securities markets improved in the third quarter of 2012. At the same time, interbank trading volumes remain low and concentrated in the shortest maturities. The low levels of activity in bank bond and money markets could be interpreted as a sign of persistent stress in these markets. However, they could also reflect a reduced need to resort to market-based funding given the high levels of central bank liquidity following the Eurosystem's two three-year longer-term refinancing operations (LTROs) in late 2011 and early 2012. Indeed, despite the recent reduction in banks' reliance

1 For more detailed analysis of the results of the October 2012 bank lending survey, see *The euro area bank lending survey: 3rd quarter of 2012*, ECB, October 2012.

Chart D Recourse to the Eurosystem by euro area credit institutions

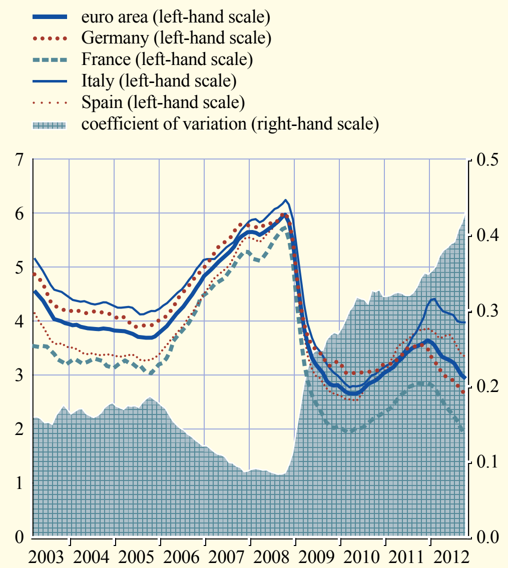
(monthly outstanding amounts; EUR billions)



Sources: ECB and ECB calculations.
Notes: "Recourse to Eurosystem funding" refers to central bank monetary policy refinancing operations. "Claims on Eurosystem" includes bank funds held in the deposit facility and current accounts. Last observations are for November 2012.

Chart E Indicator of the cost of short-term borrowing for non-financial corporations in the euro area

(percentages per annum; three-month moving average; March 2003 to October 2012)



Sources: ECB and ECB calculations.
Notes: The indicator is calculated using interest rates on loans with a maturity of up to one year, floating rates on loans with a maturity of more than one year and interest rates on overdrafts, which are aggregated on the basis of outstanding amounts. A variable's coefficient of variation is the ratio of its standard deviation to its mean. Here, it is calculated for all euro area countries where data are available and reflects the changing composition of the euro area.

on central bank lending, the amount of liquidity provided to euro area credit institutions by the Eurosystem remains substantial (see Chart D).

Financing conditions for non-financial private sectors

The cost of short-term bank lending to euro area non-financial corporations has declined since early 2012, mainly reflecting the pass-through of reductions in key ECB interest rates and market interest rates (see Chart E). A similar development can be observed in the dynamics of rates on bank lending to households for house purchase. This pass-through has been substantially facilitated by the implementation of the two three-year LTROs and other non-standard measures. Still, borrowing costs continue to vary greatly across euro area countries, reflecting differences in banks' funding conditions and country-specific economic developments affecting the creditworthiness of borrowers.[2]

MFI lending flows to non-financial private sectors have declined in the euro area since mid-2011 (see Chart F). This moderation has been broadly based across euro area countries, with the notable exception of Germany (where loan developments have remained moderate throughout that period). In Spain, loan flows have become increasingly negative. In Italy, loan flows were significantly positive in 2010-11, but have turned negative in 2012. In France, loan flows

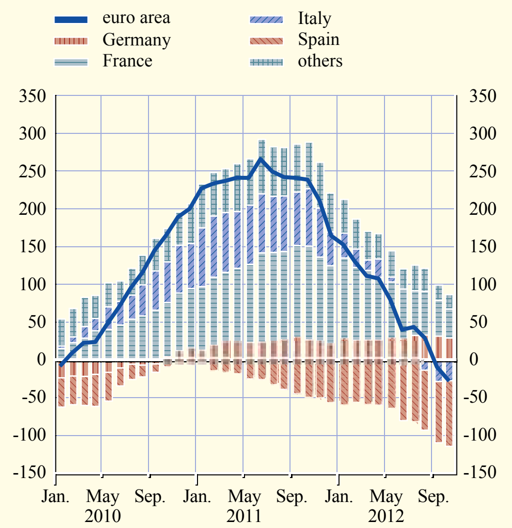
2 For more detailed analysis, see the box entitled "Cross-country heterogeneity in MFI interest rates on loans to non-financial corporations in the euro area", *Monthly Bulletin*, ECB, November 2012.

remain clearly positive, but have moderated markedly since mid-2011. The differing loan developments in the various euro area countries mainly reflect differences between those countries in terms of their respective economic and housing market outlooks, risk aversion levels and government support schemes, as well as the balance sheets of their non-financial private sectors and banking sectors.

Overall, the impact of the sovereign debt crisis on euro area banks' funding conditions has eased in recent months, allowing a number of banks to reduce their reliance on the Eurosystem. The Eurosystem's non-standard measures have helped to alleviate banks' funding pressures and have prevented disorderly deleveraging by banks and non-financial private sectors. This notwithstanding, in a number of countries yields on bank bonds remain elevated and the net issuance of debt securities by banks is still negative. Lending to non-financial private sectors also remains weak. Addressing the balance sheet adjustments that need to be made by governments, credit institutions, households and non-financial corporations in a number of countries is a precondition for the full normalisation of banks' funding conditions and a sustained recovery in lending volumes.

Chart F MFI loans to non-financial private sectors in the euro area and selected countries

(12-month cumulative monthly flows; EUR billions; not adjusted for seasonal effects)



Source: ECB.
Notes: Adjusted for loan sales and securitisation. Last observations are for October 2012.