

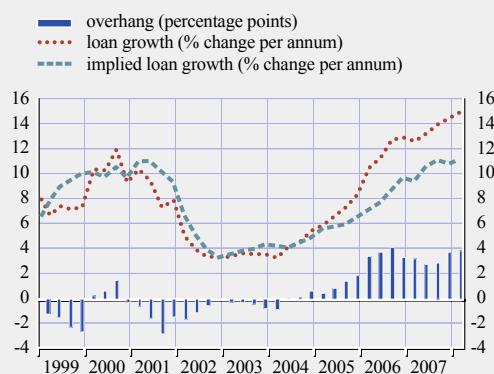
Box 7

IS THE CORPORATE BANK LENDING CYCLE TURNING?

Non-financial corporate lending in the euro area has expanded strongly since 2002, and reached a nominal annual growth rate of 15% in March 2008. In spite of the tensions in global credit markets, bank lending to euro area non-financial corporations has thus remained strong, suggesting that firms, so far, have weathered the turbulence well. The resilience in loan growth observed up to early 2008 is unusual as financial institutions' lending criteria tend to tighten in periods of financial stress, resulting in lower credit growth and a slowdown in economic activity. Looking ahead, ECB bank lending survey data show that the trend towards euro area banks tightening their credit standards on loans to enterprises that began in late 2007 continued in early 2008. This may, in due course, indicate a turn in the corporate credit cycle, as it becomes more costly and difficult for non-financial corporations to gain access to bank financing. This box evaluates the state of the current corporate credit cycle by comparing observed loan growth with implied credit growth suggested by a simple model.

A standard gauge of the vulnerability of current credit growth to future corrections is to compare actual loan growth to the loan growth implied by fundamental factors. Based on this approach, Chart A shows the annual growth rate of loans extended to non-financial firms by euro area banks over the period from 1999 to early 2008 along with the annualised model-based loan growth using the following explanatory variables: GDP, non-residential investment, gross operating surplus of the corporate sector (a measure of firms' internal financing ability), the cost of lending, the cost of non-bank external financing, and the policy rate. The first three variables can be said to reflect firms' financing needs and the last three are included to capture the actual and relative cost of bank financing compared with external non-bank sources.

Chart A Actual and model-implied annual growth rate of MFI loans to non-financial corporations in the euro area



Sources: ECB and ECB calculations.

Note: The co-integrating equation is $\text{realloans} = 1.0 * \text{realgdp} - 0.04 * (\text{real loan rate} - \text{real cost of alternative financing}) + 14.5$, where realloans is the log of real loans to non-financial corporations (seasonally adjusted and deflated with the GDP deflator) and realgdp is the log of real GDP. The model includes two additional co-integrating vectors expressing an investment equation and a long-run loan rate mark-up, respectively.

Three notable features can be seen from the results of the analysis. First, over the past five years a strong upward trend in corporate loan growth has been observed, probably reflecting both the economic recovery and the decline in both policy and market rates during this period. Second, since 2005 loan growth has exceeded the average growth rate over the sample period (of around 8%), surging from around 6% to 15% in the first quarter of 2008. Third, since 2005 the model-implied loan growth has also trended upwards, spurred by a more favourable economic outlook and low financing costs. However, the upturn in actual loan growth has been persistently more pronounced than the increase in the model-implied credit growth. In the first quarter of 2008 only part of the actual loan growth can be explained by the model.

The large and persistent difference between actual and model-implied loan growth (the so-called "overhang") suggests that factors other than fundamental business cycle developments, such as M&A financing, country-specific developments in the construction and real estate sectors and financial innovation, have played an important role in explaining euro area MFI lending to the non-financial corporate sector since 2005. However, the abrupt repricing of risk that has occurred in global credit markets since mid-2007 may have reduced to some extent the importance of these special factors in explaining corporate loan growth. In particular, leveraged finance activity in the euro area slowed down considerably in the second half of 2007. Accordingly, the overhang has stabilised in the course of 2007 and early 2008.

All in all, according to the model employed in this analysis, credit growth may have reached its peak, and in recent months it has become less buoyant relative to its fundamental determinants.