Monetary policy and banking business

Interest rate policy and the money market

Interest rate rise in June

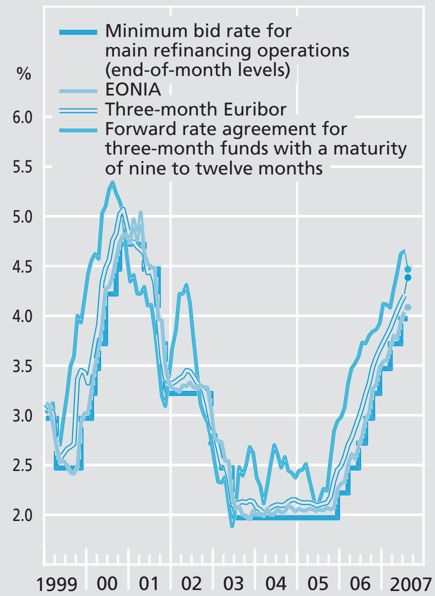
The monetary policy reins have been tightened again. At the start of June, the Governing Council of the ECB again raised central bank rates by ¼ percentage point, thus countering the longer-term price risks in the euro area, which are indicated not only by the sharp monetary expansion, but also by the outcome of the economic analysis. Since 13 June, the main refinancing operations have been conducted with a minimum bid rate of 4%, while interest rates on the marginal lending facility and the deposit facility have been 5% and 3% respectively. Given the favourable development in the economy as a whole, the monetary policy stance is tending to remain on an expansionary trend following this interest rate move.

Money market rates

As with the earlier interest rate rises, the interest rate move in June was implemented smoothly in the money market. During the period under review, the EONIA overnight rate, in which banks trade overnight liquidity, was, in most cases, initially only slightly above the marginal allotment rate, while the other money market rates increased slowly and steadily throughout. Owing to liquidity impasses caused by uncertainty associated with the problems in the US subprime mortgage loan market, however, there were severe tensions in the European money market on 9 August, which led to the overnight rate going up to 4.7% for a short time. To ensure orderly conditions in the money market, the ECB, with the aid of quick tenders, provided the banks with – in some cases, extensive – liquidity on this date and the following three trading days. In doing so, the functional efficiency of the market was restored, with the result that EONIA stood between 4.1% and 4.2% (see the explanatory notes on page 26). The longer-term interest rates in the money market remained well above this level. For 12-month funds, 4.6% was paid at the end of the period under review.

Money market interest rates in the euro area

Monthly averages



• = Average of the period from 1 to 16 August 2007.

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Monetary developments in the euro area

Continued strong monetary growth

After the very sharp rise in M3 in the euro area in the first quarter, monetary growth slowed somewhat in the second quarter, but remained high, at a seasonally adjusted annualised rate of 9%. In particular, there was a large-scale build-up of the M3 components remunerated close to market rates, mainly short-term time deposits and money market fund shares. These forms of investment were still evidently benefiting to a particular extent from the interest rate differential between the money market and the capital market, which, despite increasing in the period under review, is still fairly flat. In some cases, there are likely to be shifts away from short-term savings deposits and overnight deposits, which tend to earn little interest. As there has only been a comparatively small increase in the amount of cash in circulation recently, M1, consisting of the very liquid money components of cash and overnight deposits, went up at a seasonally adjusted annualised rate of just 4% in the reporting quarter. This meant that its contribution to the 12-month rate of M3 has shown a further decline and, at 3 percentage points at the end of the period under review, was roughly as high as in mid-2000, when short-term interest rates were at much the same level as now.

Persistent heavy lending to private sector, ...

The low short-term and long-term interest rates are continuing to make a key contribution to the very high borrowing by the private sector from banks in the euro area. Borrowing went up by a seasonally adjusted and annualised rate of 13½% in the second quarter, compared with 11½% in the previous quarter. Lending to the private sector therefore remains the key driving force behind the monetary expansion in the euro area. In particular, non-financial corporations significantly increased their unsecuritised borrowing from domestic banks, in some cases to acquire or merge with other enterprises. At the same time, loans to financial enterprises continued

Money market management and liquidity needs

During the four reserve maintenance periods between 18 April and 7 August 2007, the liquidity needs arising from the autonomous factors determining bank liquidity increased by €15.3 billion net. As usual at this time of year, the main reason for this development was the strong growth in the volume of banknotes in circulation (up by €24.9 billion). General government deposits likewise grew owing to seasonal factors; the increase was strongest in the June-July reserve period. This was attributable primarily to the half year end effect. However, liquidity needs were curbed by developments in the remaining autonomous factors throughout the period under review. If the changes in net foreign reserves and in other factors are taken together – a move which eliminates valuation effects – €13.7 billion net flowed into the market via such transactions. This essentially occurred as a result of Eurosystem purchases of euro-denominated financial assets unrelated to monetary policy.

In the April-May period, there was an increase of €4.3 billion in the provision of liquidity through longer-term refinancing operations after the transaction of 29 March 2007 had completed the topping-up process from €120.0 billion to €150.0 billion started at the end of January. The volume of the main refinancing operations (MRO) was expanded by €20.0 billion to €295.4 billion in the period under review. This served above all to balance out the greater liquidity requirement arising from the increase in general government deposits at central banks in the June-July reserve period. On balance, credit institutions' central bank balances rose in parallel to the perceptible increase of €9.4 billion in the minimum reserve requirement to €191.3 billion.

In the period under review, the EONIA stood mostly at 3.83% until the key interest rate rise took effect on 13 June 2007. With the new minimum bid rate of 4.00%, the EONIA stood mostly at between 4.06% and 4.08%.

In order to offset a liquidity deficit at the end of the June-July period, the ECB conducted a liquidity-providing fine-tuning operation totalling €2.5 billion.

As liquidity conditions were virtually balanced at the end of the July-August period, the ECB did not conduct a fine-tuning operation on the last day of the reserve maintenance period for the first time since January 2007. However, market participants had expected a liquidity-providing quick tender and thus the EONIA rose to 4.23%; it fell again to 4.09% on the following day.

The temporary increase in the EONIA rates in the course of the period under review were initially limited to days at the end of the month and half year when market participants displayed a greater liquidity preference. In the current August-September reserve period, however, the overnight rates rose as high as 4.70% on 9 August triggered by liquidity shortages in the US money market. In order to calm the markets, the ECB carried out liquidity-providing fine-tuning operations on that day as well as on the next three business days. In the first quick tender, a fixed rate tender with a minimum bid rate of 4.00%, the ECB allocated the complete volume of bids totalling €94.8 billion. In the next three operations, which were conducted as variable rate tenders, the ECB progressively reduced the volume from €61.1 billion to €47.7 billion and finally €7.7 billion. This intervention ensured that the money market continued to function and that the EONIA rates could be maintained within a range of 4.10% to 4.20%.

Factors determining bank liquidity [1]

€ billion; changes in the daily averages of the reserve maintenance periods vis-à-vis the previous period

Item	2007 18 Apr to 14 May	15 May to 12 June	13 June to 10 July	11 July to 7 Aug
I Provision (+) or absorption (–) of central bank balances due to changes in autonomous factors				
1 Banknotes in circulation (increase: –)	– 5.2	– 5.2	– 6.1	– 8.4
2 General government deposits with the Eurosystem (increase: –)	– 3.1	+ 2.2	– 4.8	+ 1.6
3 Net foreign reserves [2]	+ 2.5	+ 0.3	– 3.4	– 6.3
4 Other factors [2]	+ 2.0	+ 2.2	+ 7.0	+ 9.4
Total	– 3.8	– 0.5	– 7.3	– 3.7
II Monetary policy operations of the Eurosystem				
1 Open market operations				
(a) Main refinancing operations	– 0.1	+ 3.3	+ 10.5	+ 6.3
(b) Longer-term refinancing operations	+ 4.3	+ 0.0	+ 0.0	+ 0.0
(c) Other operations	+ 0.8	– 0.1	+ 0.3	– 0.1
2 Standing facilities				
(a) Marginal lending facility	– 0.2	– 0.0	– 0.1	– 0.1
(b) Deposit facility (increase: –)	– 0.2	+ 0.3	– 0.1	– 0.1
Total	+ 4.6	+ 3.5	+ 10.6	+ 6.0
III Change in credit institutions' current accounts (I + II)	+ 0.6	+ 3.0	+ 3.4	+ 2.4
IV Change in the minimum reserve requirement (increase: –)	– 0.4	– 3.1	– 3.0	– 2.9

1 For longer-term trends and the Deutsche Bundesbank's contribution, see pages 14* and 15* of the Statistical Section of this Monthly Report. — **2** Including end-of-quarter valuation adjustments with no impact on liquidity.

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to show a sharp increase. Housing loans of private households likewise rose sharply in the quarter under review. However, their growth slowed again, probably as a result of a rise in financing costs, as well as a certain cooling of the property boom in some euro-area countries. There was only a moderate increase in other bank loans to private households in the euro area; not only consumers in Germany, but also those in France and the Netherlands increased their consumer loans only to a marginal extent.

... in particular, strong securities purchases by the banks

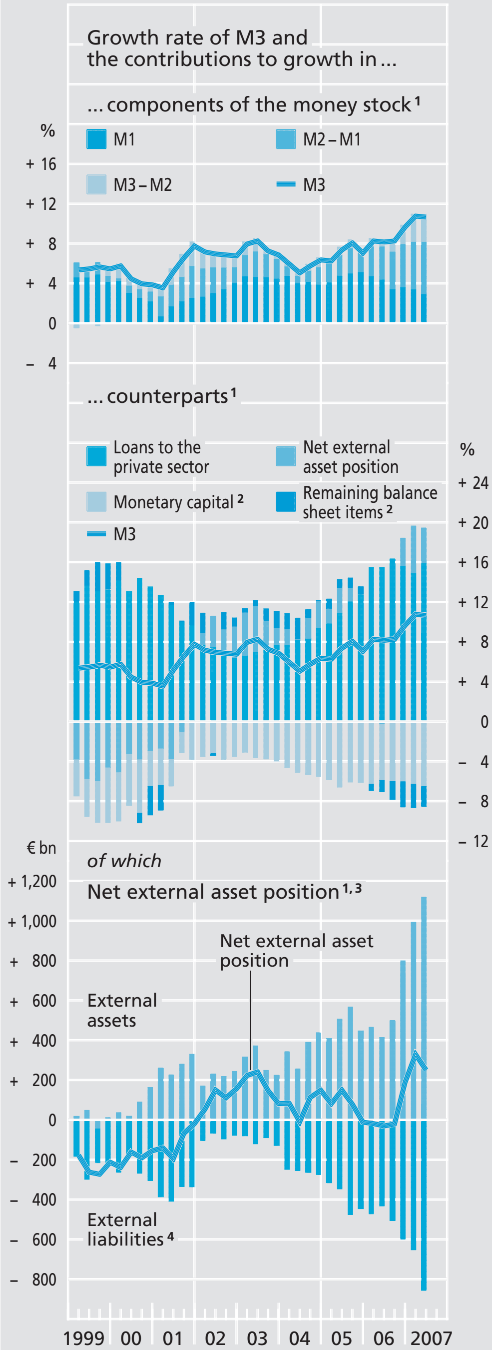
In seasonally adjusted terms, the banks also purchased securities issued by domestic enterprises to a much larger extent in the second quarter than in the previous quarters. In particular, they expanded their portfolios of fixed-interest euro-denominated corporate debt securities. Their increase in yield in the period under review probably made them even more interesting to banks. In addition, the credit institutions also built up their portfolios of domestic shares and other equity again, having sold net amounts of such paper – like government bonds – on a fairly large scale in the preceding quarter.

Fall in banks' net external asset position

In some cases, the banks purchased these securities from non-residents, which is likely to have contributed to a marked decline in the banks' net external asset position in the second quarter, as compared with a very sharp rise in the two previous quarters. Here, there was strong demand from non-residents for fixed-rate securities issued by residents, which was probably a result, in particular, of the interest rate hike in the euro area and the prevailing expectations that the euro would

Components and counterparts of the money stock in the euro area

Seasonally adjusted, quarterly



1 Calculated from the changes cumulated over 12 months. — 2 Taken in isolation, an increase curbs M3 growth. — 3 Not seasonally adjusted. — 4 Increase: –.

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appreciate, especially against the US dollar. Banks' issues also benefited from this strong demand.

As part of the consolidated balance sheet of the euro-area banking sector, the sharp overall rise of €262 billion in the net external asset position during the last 12 months is also likely to be reflected mainly in a change in the other counterparts and not to have led to an equally large rise in M3. For example, the banks sold government bonds in net terms to the value of €76 billion between July 2006 and June 2007. And sales of long-term bank debt securities, which have increased significantly since the fourth quarter of 2006, are also likely to have satisfied mainly the high foreign demand for such paper. By contrast, the current interest rate and exchange rate situation is also likely to have led to domestic investors withdrawing from foreign currency-denominated balances with banks abroad and investing in M3-relevant euro assets in the euro area. In addition, domestic non-banks which have sold domestic securities to non-residents may have invested their profits chiefly in the M3 components remunerated close to market rates. This is likely to have contributed to the acceleration in annual M3 growth since the fourth quarter of last year.

Very large long-term investment of funds with banks continues

Domestic investors were very willing to invest funds with domestic banks in the long term in the second quarter, too, which, taken in isolation, curbed monetary growth. By the end of the period under review, it was chiefly long-term time deposits which had shown a sharp seasonally adjusted rise, going up at an annualised rate of 13½% between April and June. However, this was due solely to other financial institutions, which had been forming such deposits on a large scale for some months. This is likely to be associated with their involvement in the very buoyant securitisation activities of the banks, which use such financial institutions to securitise their loans and place them with investors. In return, the financing institutions provide the banks with the sales proceeds as a long-term time deposit. In addition, savings deposits with a notice period of more than three months were also built up further, albeit to a much smaller extent than in the previous quarter. There was a further sharp increase in the circulation of long-term bank debt securities outside the domestic banking sector, going up at a seasonally adjusted annualised rate of 10½% in the second quarter. Its somewhat weaker momentum than in the two preceding quarters and the decline in the banks' net external asset position suggest that the contribution of non-residents to the increase in bank debt securities has been somewhat smaller of late.

Clear sign of longer-term inflation risks

All in all, the monetary data therefore continue to signal inflation risks in the euro area in the medium to long term. On the basis of previous experience, the mainly credit-driven high monetary growth, which has persisted for a long time now, suggests that the inflation rate will be noticeably higher than 2% on an average of the next three years. Owing to the renewed sharp M3 increase in the period under review, the deviation from the Governing Council of the ECB's stability benchmark has actually increased of late, even if the average inflation rate forecast with the aid of monetary data has been subject to major uncertainty for some years.

Deposit and lending business of German banks with domestic customers

Sharp increase in shorter-term bank deposits

The deposit business of German banks with domestic customers again expanded more slowly in Germany than in the euro area as a whole. With a seasonally adjusted annualised growth increase of just over 7%, it picked up noticeably in the second quarter, however. Domestic investors preferred mainly short-term deposits. Much as in the euro area as a whole, they funded predominantly short-term time deposits remunerated at market rates, the interest rates of which, following the ECB interest rate hikes, went up by around ¼ percentage point on average in the period under review. In some cases, there are likely to be shifts again away from short-term savings deposits in Germany, too. These were recently reduced at a seasonally adjusted annualised rate of 7½%, which comes as no great surprise, given the fact that their remuneration was almost stagnating in the period under review. Overnight deposits, for which the banks do not pay any interest in some cases, showed only a moderate increase.

Longer-term bank deposits also up

At the same time, longer-term bank deposits were also built up further in the second quarter. Above all, time deposits with an agreed maturity of more than two years benefited from this. In particular, domestic insurance corporations, which traditionally constitute the strongest group of depositors, formed large amounts of such deposits. But other financial institutions, too, provided German banks with funds for the longer term in this way. By contrast, there has been little demand of late for savings deposits with an agreed notice period of more than three months. This is striking, especially in comparison with the preceding quarters, in which such deposits were increased at annualised growth rates of almost 25% in some cases. As the decline in short-term savings deposits was much less sharp at the end of the period under review, there are some indications that distinctly fewer shifts into longer-term savings deposits were made in the reporting period.

Lending and deposits of monetary financial institutions (MFIs) in Germany *

€ billion

Item	2007 April to June	2006 April to June
Deposits of domestic non-MFIs 1		
Overnight	+ 13.7	+ 14.5
With agreed maturities		
of up to 2 years	+ 36.1	+ 18.9
of over 2 years	+ 5.6	+ 7.7
Redeemable at agreed notice		
of up to 3 months	– 12.4	– 7.9
of over 3 months	+ 0.6	+ 2.7
Lending		
to domestic enterprises and households		
Unsecuritised	+ 1.2	+ 7.9
Securitised	– 16.9	– 3.0
to domestic government		
Unsecuritised	– 6.8	– 10.3
Securitised	– 4.2	+ 2.3

* As well as banks (including building and loan associations, but excluding the Bundesbank), monetary financial institutions (MFIs) here also include money market funds; see also Table IV.1 in the Statistical Section of the *Monthly Report*. — **1** Enterprises, households and government excluding central government.

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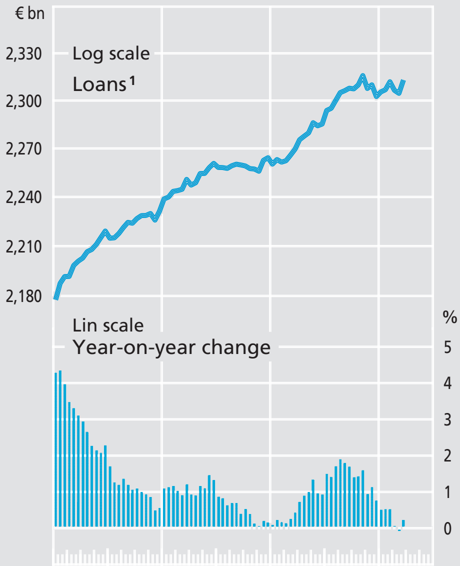
Credit declining

The lending business of German banks with domestic non-banks fell by a seasonally adjusted and annualised 2% in the second quarter. The sale of domestic securities by do-

Loans to domestic enterprises and households

Seasonally adjusted



1 End of month; adjusted for statistical changes.

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mestic banks had a particular impact in this respect. As well as government securities, they sold mainly shares issued by domestic enterprises. Furthermore, general government continued to reduce its loans with banks. By contrast, there was a marginal rise in loans to enterprises and private households, which had also risen somewhat in the previous quarter. In particular, non-financial enterprises again borrowed from domestic banks, whereas financial enterprises reduced their borrowing. Households, too, reduced their debt to German banks. As in the previous quarter, housing loans were redeemed on balance. Other lending to households, which covers mainly loans to self-employed persons, likewise continued to fall. By contrast, consumer loans rose slightly.

Low demand for credit

In line with the data from the Bank Lending Survey, the bifurcated growth of credit in the private sector evidently reflects the different borrowing demands of households and non-financial enterprises. On the one hand, the banks reported a further fall in demand for lending to households for house purchase. On the other, they recorded a slight rise in demand for loans to enterprises. In addition, they also witnessed increased demand for consumer credit, but qualified this by pointing out that this was likely to be less a national German trend than the consequence of the attempt to gain market share with special campaigns.

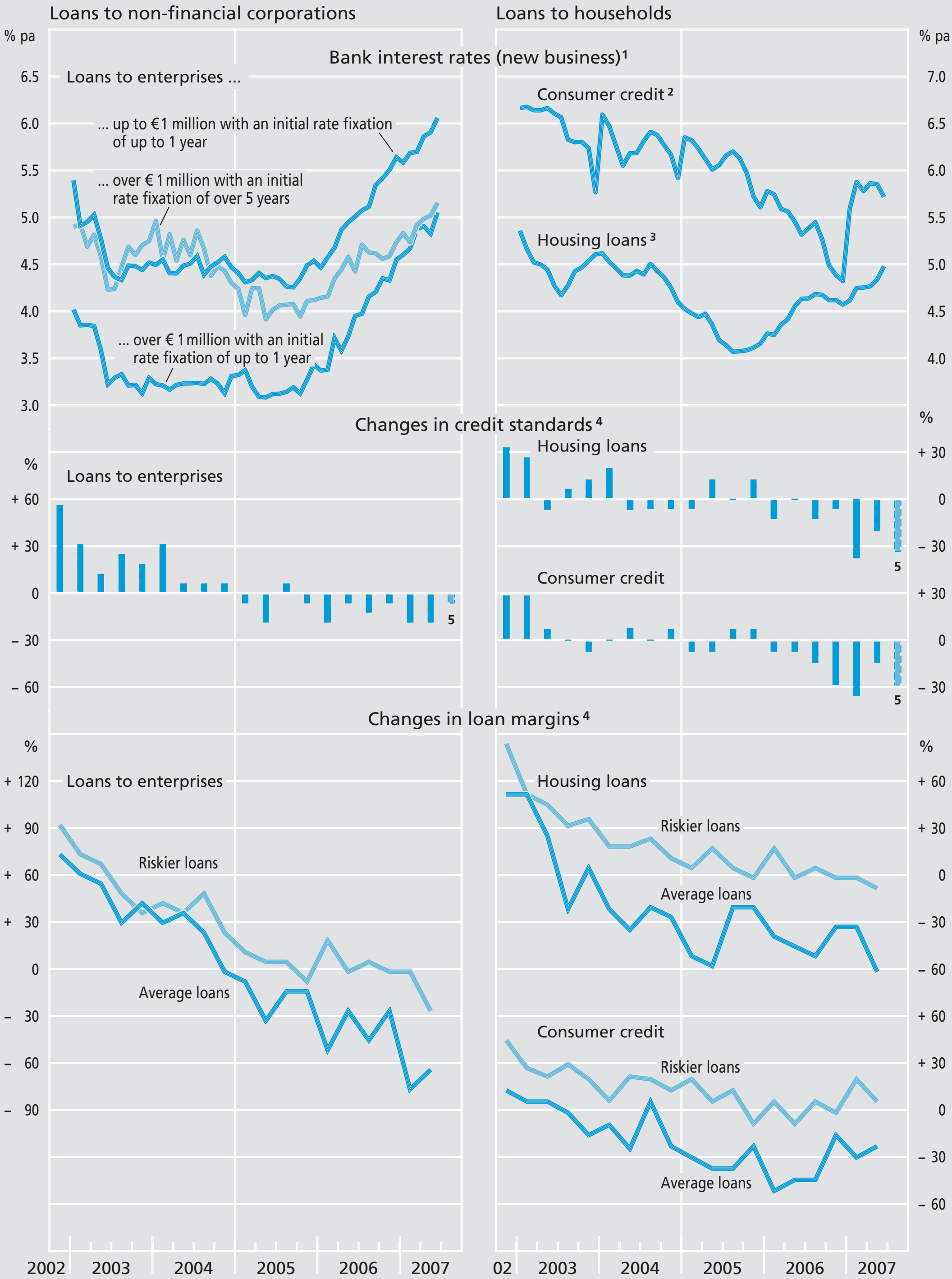
Moderate easing of credit supply conditions

The fairly weak overall growth in domestic credit contrasts to a certain extent with the more expansionary credit supply policy of the German banks. Thus, credit standards in both retail and corporate business were once again eased moderately in the second quarter according to Bank Lending Survey data. Added to this was a further broad narrowing of the margins on average-risk exposures. Furthermore, according to information from the surveyed institutions, the margins on riskier loans were also lowered slightly for the first time since the survey was introduced, whereas the margins on riskier loans to households remained almost unchanged. The changes in the credit supply conditions were therefore altogether somewhat more expansionary in Germany than in the euro area as a whole.

Nearly all lending rates up

German banks' lending rates were clearly influenced by the continued monetary policy tightening and the rise in capital market interest rates in the second quarter. Lending to en-

Banking conditions in Germany



1 According to harmonised MFI interest rate statistics. — 2 With an initial rate fixation of over 1 year and up to 5 years. — 3 With an initial rate fixation of over 5 years and up to 10 years. — 4 According to Bank Lending Survey; percentage difference between the numbers of respondents reporting "tightened considerably" and "tightened somewhat" and the numbers of respondents reporting "eased somewhat" and "eased considerably". — 5 Expectations for 2007 Q3.

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terprises, in particular, increased by an average of 28 basis points in the second quarter, which meant that the institutions were demanding between 5.1% and 6.1% for short-term loans to enterprises, depending on the size of the loan. For long-term loans, the rates in question amounted to 5.2% and 5.3% respectively. Interest rates on loans for house purchase also went up noticeably in the second quarter, by 18 to 27 basis points. The conditions for loans with an interest rate fixation of over ten years stood at 5.0% at the end of the quarter. Only in the case of consumer credit was there a countervailing effect in parts. In particular, there was a fall in interest rates for longer-term loans. This should probably be seen in connection with the special campaigns to increase the market share of some institutions in this market sector, which were also mentioned in the Bank Lending Survey.