Monetary policy and banking business

Interest rate policy and the money market

ECB resolutely cuts interest rates

The Governing Council of the ECB has cut the main refinancing rate for the Eurosystem by a total of 2¼ percentage points since October 2008. By easing the monetary policy stance, the supreme decision-making body of the Eurosystem has exploited the scope for discretionary action created by significantly reduced inflation risks. At the same time, it was responding to the much gloomier outlook for the real economy in the euro area in the wake of the financial market crisis. Since 21 January, banks have had to pay an interest rate of 2% for the weekly main refinancing operations, which are still being conducted as fixed-rate tenders with full allotment for the time being. The Eurosystem charges 3% interest for recourse to the marginal lending facility. The interest rate for credit in connection with the deposit facility amounts to 1%. The Eurosystem has thus returned to the usual interest rate corridor of 200 basis points after a temporary narrowing of the symmetric interest rate corridor around the main refinancing rate to 100 basis points.

Fixed-rate tenders with full allotment pushes EONIA below main refinancing rate

The looser monetary stance adopted since October 2008 has also resulted in a considerable decline in interest rates on the euro money market. The overnight rate (EONIA) fell sharply – also as a consequence of the switch to full allotment in all Eurosystem refinancing operations and the widening of the gap between the main refinancing rate and the deposit facility rate – and it is now clearly below the main refinancing rate. By historical standards, however, the trading volume in interbank lending, on which EONIA is based,

Money market management and liquidity needs

During the three reserve maintenance periods from 8 October 2008 to 20 January 2009, euro-area credit institutions' need for central bank money arising from autonomous liquidity factors increased very sharply by €132.7 billion in net terms. This was largely attributable to the very significant rise of €68.8 billion in the volume of banknotes in circulation in the euro area. The strong growth in banknotes in circulation which began in October, shortly after the financial crisis worsened, was particularly noticeable, as was the usual seasonal increase in the run-up to Christmas. At the turn of the year, the volume of banknotes in circulation in the euro area reached a new record high of €766.2 billion. In addition, the remaining autonomous factors also increased the liquidity need in the period under review. First, there was an increase of €44.7 billion in general government deposits with the Eurosystem and, second, if the net foreign reserves and the other factors are taken together, a move which eliminates liquidity-neutral valuation effects, there was an additional increase in the liquidity needs of €19.2 billion. In the three periods under review, there was also an increase in the minimum reserve requirement of €5.5 billion in total. Alongside this regular need, there was also a sharp, crisis-induced increase in the demand for liquidity.

After the insolvency of US investment bank Lehman Brothers had led in mid-September to a marked escalation of the tensions on the interbank money market, on the first day of the October-November reserve period, the ECB – in coordinated action with other leading central banks – announced immediate and massive steps to further stimulate the money market. Along with a reduction of 50 basis points in the key interest rate to 3.75%, the ECB also approved the immediate symmetrical narrowing of the corridor of the standing facilities from 200 basis points to 100 basis points (limited until 20 January 2009). As a further key measure, the ECB moved, for a limited period, from a variable rate tender system to a fixed rate tender system with full allotment in its main refinancing operations. This step was then extended to the longer-term refinancing operations a few days later. Conducting additional long-term tenders, including operations with a duration of one reserve period, ensured that there was supplementary liquidity provision in the maturities of up to six months (see the table on page 25). Other important measures were additional US dollar and Swiss franc refinancing operations as well as an extension of the collateral framework. The main aim of all of these measures and the related liquidity management activities was to ensure that there was a sufficient supply of central bank liquidity. The appropriateness of the measures carried out was confirmed by the heavy demand for liquidity from credit institutions in the period under review, the marked increase in the number of bidders in open market operations and a further shift in the maturity structure towards longer-term refinancing operations. In addition, the ECB adhered to its policy of using fine-tuning operations to absorb excess liquidity on the last day of each reserve period. On the whole, the monetary policy framework of the Eurosystem proved that it was also capable of responding effectively and flexibly to these special liquidity situations.

The October-November 2008 reserve period began, as usual, with a main refinancing operation which was carried out as a variable rate tender with a minimum bid rate of 4.25%. Although the ECB allotted €209.5 billion above the benchmark amount, there were very high allotment rates, which clearly reflected the high degree of tension on the money market. The extraordinary decision to reduce interest rates on the first day of the period as well as the announcement of the aforementioned measures prompted the ECB to implement immediately a liquidity-providing fine-tuning operation with a duration of six days and at the new key interest rate of 3.75% in order to carry out at once the agreed adjustments in the monetary policy operational framework. As a result of the subsequent switch from variable to fixed rate tenders with full allotment, from this point onwards the amount of liquidity provided was based solely on demand from credit institutions. This led to large allotment volumes in the main refinancing operations in this reserve period, with above-benchmark amounts of up to €360

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billion. One consequence of such abundantly available excess liquidity in the market was the very high degree of recourse to the deposit facility, which averaged €214 billion in the October-November reserve period. The simultaneous heavy use of the marginal lending facility (averaging €12.7 billion) underlined the existing segmentation in the interbank money market. Another consequence was that the above-benchmark surplus in liquidity reduced the EONIA to well below the fixed interest rate for main refinancing operations.

In the November-December reserve period, the main refinancing operations were carried out at the new fixed rate of 3.25% after the Governing Council of the ECB had agreed to an interest rate reduction of 50 basis points at its meeting on 6 November. Liquidity provision continued to be determined by the strong demand from credit institutions for central bank money. This was apparent, above all, in the main refinancing operations, which had fairly constant bid volumes (and allotment amounts) of around €340 billion, leading to high above-benchmark amounts (up to €300 billion). Credit institutions showed less interest in the longer-term refinancing operations, which were likewise carried out as fixed rate tenders with full allotment and included, for the first time, the parallel allotment of three and six-month tenders. While high levels of overnight deposits (averaging €201 billion) continued to be lodged with the Eurosystem as a result of the abundant levels of liquidity, recourse to the marginal lending facility decreased markedly in this reserve period (on average €2.7 billion). During this period, the EONIA was always well below the main refinancing rate, on average by 30 basis points.

Despite being 42 days in length and encompassing the Christmas and New Year holidays, the December-January reserve period, from a liquidity management point of view, changed very little this year compared with the same period last year. The demand for liquidity from credit institutions remained strong. Very high above-benchmark amounts were almost invariably recorded in the main tenders (up to €370 billion), and this continued to result in a high degree of recourse to the deposit facility of, on average, €238 billion. The liquidity shortages feared at Christmas and New Year did not arise owing to the extremely generous supply of liquidity. Instead, the abundant supply of liquidity led to EONIA fixes which, at an average of 28 basis points, were significantly below the new main refinancing rate of 2.50% which the Governing Council of the ECB had agreed at its meeting on 4 December. The accession of Slovakia to the euro area on 1 January 2009 went smoothly in terms of liquidity management.

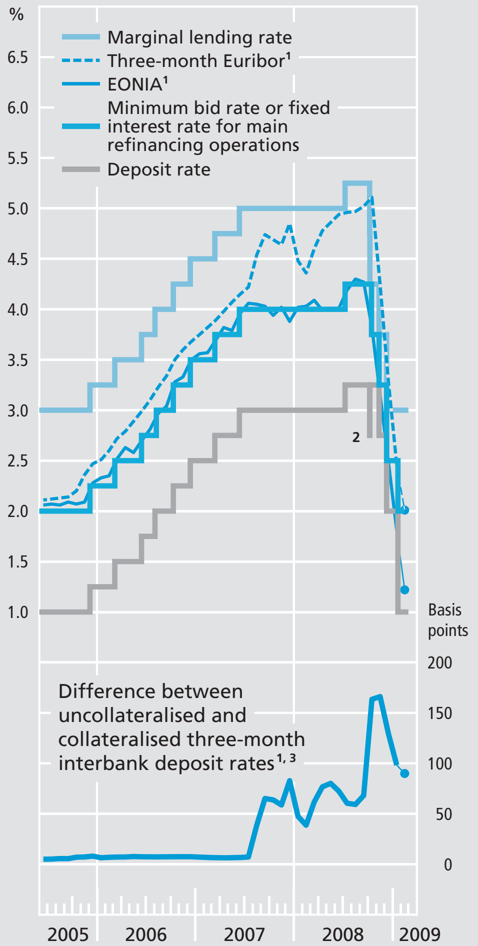
Factors determining bank liquidity [1]

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

Item	2008		2009
	8 Oct to 11 Nov	12 Nov to 9 Dec	10 Dec to 20 Jan
I Provision (+) or absorption (–) of central bank balances due to changes in autonomous factors			
1 Banknotes in circulation (increase: –)	– 37.8	– 9.0	– 22.0
2 General government deposits with the Eurosystem (increase: –)	– 29.8	– 22.8	+ 7.9
3 Net foreign reserves [2]	+ 131.7	+ 31.5	+ 0.8
4 Other factors [2]	– 160.8	– 36.1	+ 13.7
Total	– 96.7	– 36.4	+ 0.4
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	+ 127.5	+ 35.7	– 118.1
(b) Longer-term refinancing operations	+ 118.2	+ 4.7	+ 156.4
(c) Other operations	+ 41.5	– 6.8	+ 1.6
2 Standing facilities			
(a) Marginal lending facility	+ 5.2	– 10.0	+ 0.2
(b) Deposit facility (increase: –)	– 193.8	+ 12.8	– 37.6
Total	+ 98.6	+ 36.4	+ 2.5
III Change in credit institutions' current accounts (I + II)	+ 1.8	+ 0.1	+ 2.8
IV Change in the minimum reserve requirement (increase: –)	– 1.3	– 1.2	– 3.0

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.

Money market interest rates in the euro area



1 Monthly averages. — **2** Only on 8 October 2008 2.75%. — **3** Three-month Euribor less three-month Eurepo. — ● = Average from 1 to 13 February 2009.

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remained low. While this can probably be attributed partly to the generous provision of liquidity by the Eurosystem, it also points to ongoing tensions in the interbank market.

Risk premiums receding

Longer-term euro money market rates have also dropped appreciably in recent months. This was accompanied by a significant narrowing in the relevant risk premiums. For instance, the yield spread between unsecured three-month interbank deposits (three-month Euribor) and its secured counterpart (Eurepo) has narrowed distinctly by around 1 percentage point since the end of October, despite more bad news from the European and US banking sectors. As this report went to press, the spread stood at just over 0.9 percentage point.

Monetary developments in the euro area

Slower monetary expansion

M3 growth slowed perceptibly in the fourth quarter. In seasonally adjusted and annualised terms, the broad monetary aggregate expanded by 6% from October to December 2008, after rising at a rate of more than 8% in the preceding quarter. Monetary momentum continued to weaken on a slightly longer-term view, too. The moving three-month average of the annual growth rates for the period from October to December was 7.9%, 1 percentage point lower than in the preceding quarter and 4 percentage points down on the year.

Highly liquid M3 components particularly in demand

Of the monetary assets component, it was the highly liquid components cash and overnight deposits, which make up the monetary aggregate M1, in particular, that increased during the period under review. At over 9½%, M1 expanded by a far greater amount than in the previous quarter (just under 3%). This was due predominantly to the sharp rise in October when the financial market crisis intensified again and investors shifted assets *en masse* to these monetary components. Overall, the volume of currency in circulation increased in the final quarter of 2008 at an an-

Open market operations of the Eurosystem *

Value date	Type of transaction 1	Maturity in days	Actual allotment in € billion	Deviation from the benchmark 2 in € billion	Marginal rate/fixed rate %	Allotment ratio %	Weighted rate %	Cover ratio 3	Number of bidders
08.10.08	MRO	7	250.0	209.5	4.70	94.69	4.99	1.09	436
09.10.08	S-LTRO	182	50.0	–	5.36	86.94	5.57	2.28	181
09.10.08	FTO (+)	6	24.7	–	3.75	100.00	–	1.00	99
15.10.08	MRO (MT)	7	310.4	357.4	3.75	100.00	–	1.00	604
22.10.08	MRO (MT)	7	305.4	358.4	3.75	100.00	–	1.00	703
29.10.08	MRO (MT)	7	325.1	309.4	3.75	100.00	–	1.00	736
30.10.08	LTRO (MT)	91	103.1	–	3.75	100.00	–	1.00	223
05.11.08	MRO (MT)	7	312.0	243.5	3.75	100.00	–	1.00	756
07.11.08	S-LTRO (MT)	33	20.4	–	3.75	100.00	–	1.00	55
11.11.08	FTO (–)	1	– 79.9	–	3.60	100.00	3.51	1.87	117
12.11.08	MRO (MT)	7	334.4	111.9	3.25	100.00	–	1.00	848
13.11.08	S-LTRO (MT)	91	66.8	–	3.25	100.00	–	1.00	139
13.11.08	S-LTRO (MT)	182	41.6	–	3.25	100.00	–	1.00	127
19.11.08	MRO (MT)	7	338.0	297.0	3.25	100.00	–	1.00	851
26.11.08	MRO (MT)	7	334.5	234.0	3.25	100.00	–	1.00	836
27.11.08	LTRO (MT)	91	42.2	–	3.25	100.00	–	1.00	161
03.12.08	MRO (MT)	7	339.5	261.0	3.25	100.00	–	1.00	787
09.12.08	FTO (–)	1	– 137.5	–	3.05	100.00	2.94	1.11	95
10.12.08	S-LTRO (MT)	42	134.9	–	2.50	100.00	–	1.00	139
10.12.08	MRO (MT)	7	217.9	22.4	2.50	100.00	–	1.00	783
11.12.08	S-LTRO (MT)	91	55.9	–	2.50	100.00	–	1.00	105
11.12.08	S-LTRO (MT)	182	38.1	–	2.50	100.00	–	1.00	96
17.12.08	MRO (MT)	6	209.7	296.2	2.50	100.00	–	1.00	792
18.12.08	LTRO (MT)	98	50.8	–	2.50	100.00	–	1.00	169
23.12.08	MRO (MT)	7	223.7	335.2	2.50	100.00	–	1.00	640
30.12.08	MRO (MT)	7	238.9	362.9	2.50	100.00	–	1.00	629
06.01.09	MRO (MT)	8	216.1	373.1	2.50	100.00	–	1.00	600
08.01.09	S-LTRO (MT)	98	9.5	–	2.50	100.00	–	1.00	45
08.01.09	S-LTRO (MT)	182	7.6	–	2.50	100.00	–	1.00	39
14.01.09	MRO (MT)	7	203.8	331.8	2.50	100.00	–	1.00	614
20.01.09	FTO (–)	1	– 140.0	–	2.30	100.00	2.15	1.03	103

***** For more information on the Eurosystem's operations from 9 July 2008 to 7 October 2008, see Deutsche Bundesbank, Monthly Report, November 2008, p 24. — **1** MRO: main refinancing operation, LTRO: longer-term refinancing operation, S-LTRO: supplementary longer-term refinancing operation, FTO: fine-tuning operation (+: liquidity providing operation, –: liquidity absorbing operation). MT: fixed-rate tender. — **2** Since 22 October 2008, excluding (S-)LTRO allotted in the same week and various foreign exchange swap operations. — **3** Ratio of total bids to the allotment amount.

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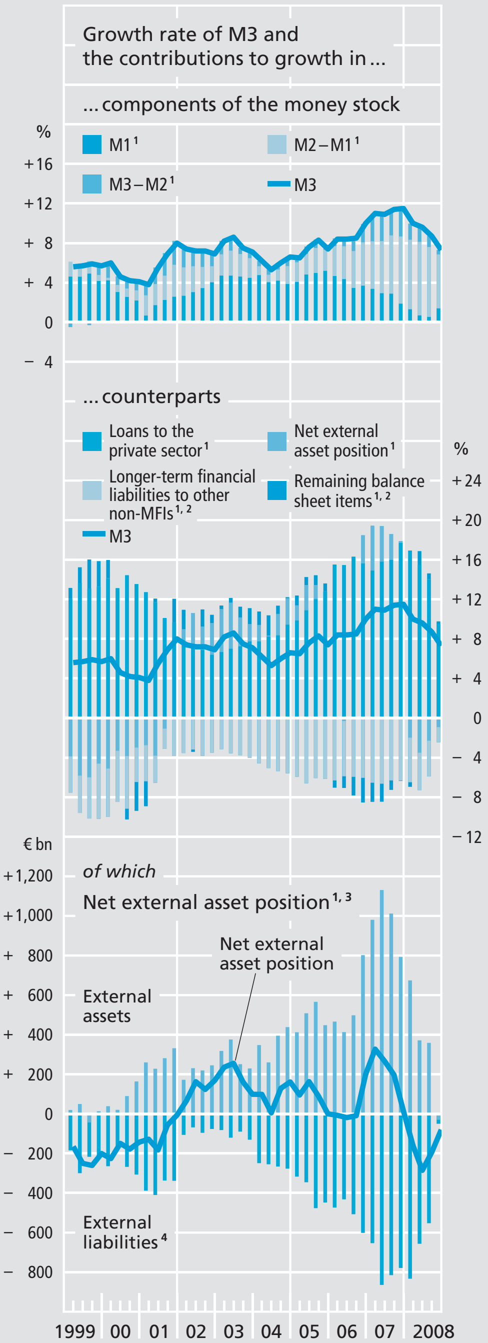
nualised rate of just over 32%, compared with 8½% in the third quarter, and the corresponding growth rate of overnight deposits went up from just over 1½% in the third quarter to 5½%. However, short-term time deposits (with agreed maturities of up to two years) recorded a sharp slowdown in growth. Owing to exceptionally heavy outflows of funds in December, they rose at an annualised rate of only 2% in the fourth quarter of 2008, compared with over 29% in the third quarter. By contrast, there was barely any overall increase in the stocks of marketable instruments during the reporting period. The sharp drop in short-term bank debt securities was offset by a similar rise in money market fund shares and repurchase agreements.

Lending to the euro-area private sector waned considerably in the period under

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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review. From October to December 2008, unsecuritised lending even declined somewhat; the seasonally-adjusted and annualised growth rate amounted to -½% in the reporting period following an increase of 6½% in the third quarter. However, this slowdown can be explained in part by substantial securitisation transactions. As a result of this, the relevant loans are no longer booked as loans to the private sector in the banks' balance sheets. In particular, both loans to households and loans to monetary financial institutions (MFIs) declined in non-seasonally adjusted terms, whereas lending to non-financial corporations rose marginally in October and November. At the end of the year, the corresponding 12-month growth rates were 1.7% for loans for house purchase (compared with 4.1% in September), 2.1% for other loans to households (compared with 3.3%), and 9.4% for non-financial corporations (compared with 12.2%).

Lending to private sector greatly subdued

The net external assets of the MFI sector, which reflect foreign payment transactions by non-banks, increased by €91 billion in the period from October to December following inflows of €29 billion in the previous quarter. This probably also reflects the shifts into domestic bank balances to which government guarantees in various euro-area countries are also likely to have contributed. Bank loans to euro-area governments *per se* also aided monetary expansion. In seasonally adjusted terms, these loans went up by €114 billion from October to December. In the period under review, however, the only rise was in securitised lending to the public sector. This most likely also reflects the public sector's

Other counterparts

greater financing needs. During this same period from October to December, central governments sharply increased their deposits with domestic credit institutions by €142½ billion (these are not included in M3).

Moderate decline in longer-term investment with banks

Monetary capital in the euro area declined slightly during the period under review; in seasonally adjusted and annualised terms, it fell by just over 2%. Without the huge topping-up of banks' capital and reserves, which was largely a result of government rescue measures to stabilise the financial sector, the fall in longer-term investment with domestic banks in the final quarter of 2008 would have been much greater (in seasonally adjusted and annualised terms, just short of 6½%). Given the tension on the markets, the outstanding volume of long-term bank debt securities decreased by 12½% in seasonally adjusted and annualised terms. By contrast, investor interest in long-term savings deposits increased significantly during the reporting period; longer-term time deposits (with agreed maturities of over two years) recorded only marginal growth.

Medium-term price risks down considerably from monetary perspective

Despite the increase in M3 growth in the final quarter of 2008, which was driven primarily by pronounced investor uncertainty particularly at the beginning of the period under review, the underlying rate of monetary expansion – that is the monetary expansion that is ultimately relevant to inflation – has tended to weaken. Accordingly, the longer-term threats to price stability associated with monetary growth receded discernibly during the fourth quarter. This can also be seen in the monetary-based inflation forecasts which recently came close to the Eurosystem's definition of price stability. However, the high degree of uncertainty which is currently inherent in such inflation forecasts should not be overlooked.

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

€ billion

Item	2008 Oct to Dec	2007 Oct to Dec
Deposits of domestic non-MFIs 1		
Overnight	+ 49.8	+ 1.5
With agreed maturities		
of up to 2 years	+ 22.7	+ 71.8
of over 2 years	+ 28.5	+ 3.3
Redeemable at notice		
of up to 3 months	+ 5.6	– 2.5
of over 3 months	+ 10.4	+ 3.1
Lending		
to domestic enterprises and households		
Loans	– 6.3	+ 12.5
Securities	+ 28.0	– 1.4
to domestic government		
Loans	– 0.9	– 5.3
Securities	+ 0.2	– 6.9

* 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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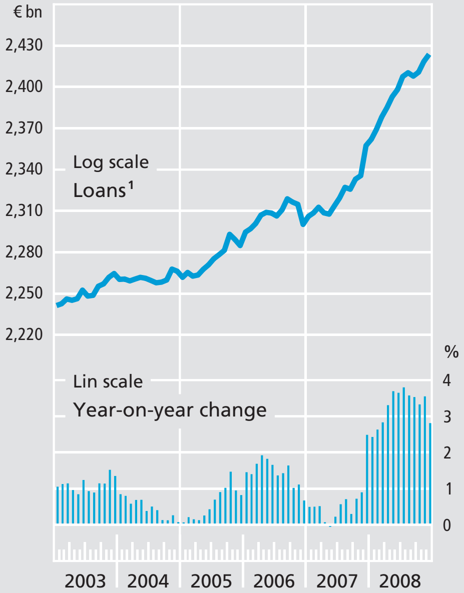
German banks' deposit and lending business with domestic customers

Perceptible rise in short-term and longer-term bank deposits

Domestic private non-banks' deposits soared in the final quarter of 2008. In total, they rose at an annualised rate of almost 14%. This is most likely due to the guarantee for bank deposits announced by central government, a move which was reflected, above all, in October's surge in overnight deposits. These deposits increased at a seasonally adjusted and annualised rate of almost 29% over the

Loans to domestic enterprises and households

Seasonally adjusted



1 End of month; adjusted for statistical changes.

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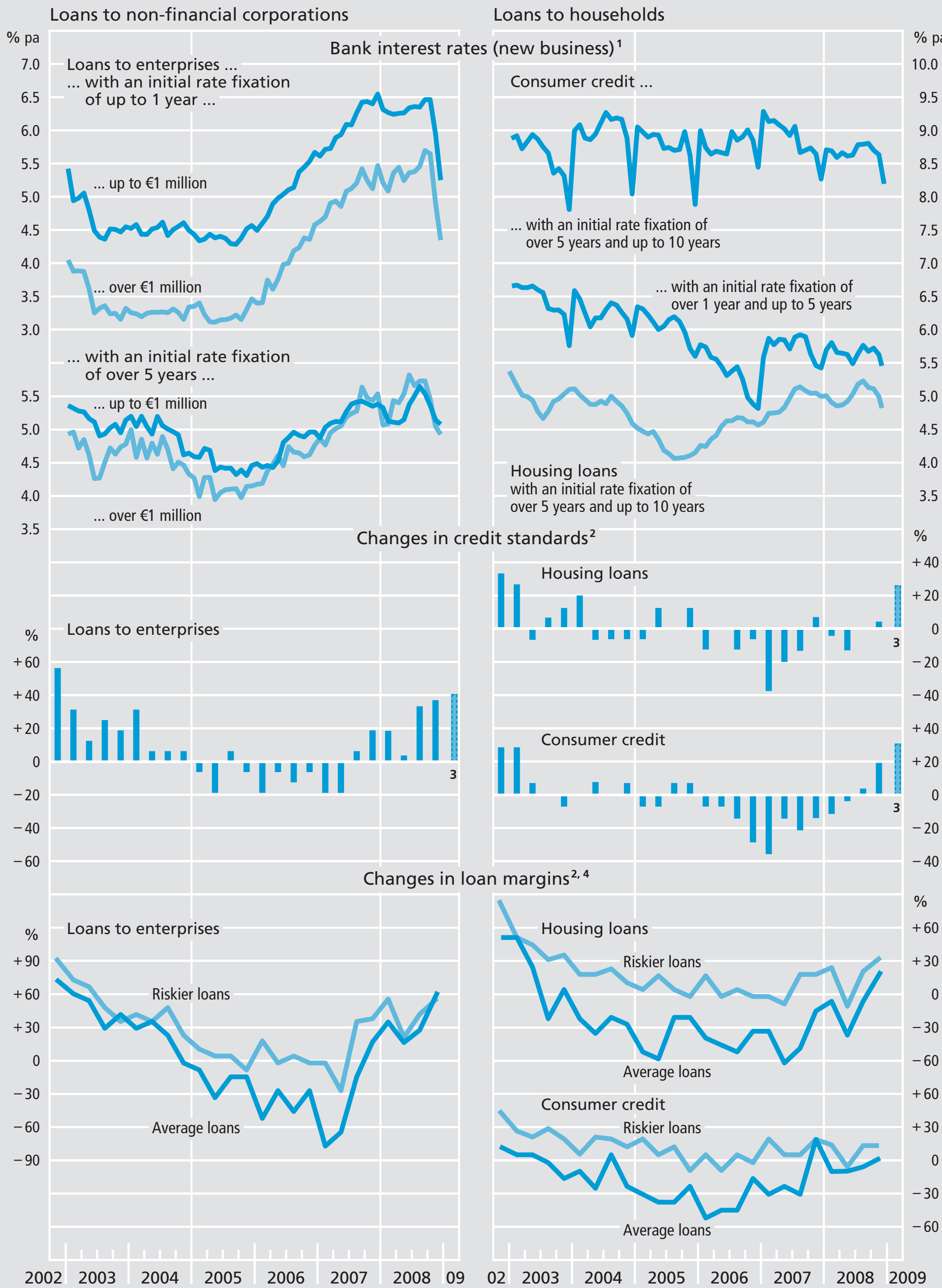
fourth quarter as a whole. By contrast, short-term time deposits, which had experienced sharp growth in the previous quarters, fell slightly in the fourth quarter in seasonally adjusted and annualised terms. The Eurosystem's 1¾ percentage point cut in interest rates in the final quarter of 2008 is likely to have significantly reduced the attractiveness of short-term time deposits which are traditionally remunerated close to market rates; their interest rate advantage over other bank deposits declined noticeably in the period under review. Short-term savings deposits (redeemable at notice of up to three months) thus benefited from this situation; in seasonally adjusted terms, they grew again for the first time since mid-2005.

The longer-term time deposits (with an agreed maturity of over two years) expanded at an exceptionally strong rate during the period under review. This growth predominantly demonstrates German banks' substantial securitisation transactions, which are recorded in the statistics partly as an increase in the longer-term time deposits of the securitising special purpose vehicles (SPVs) – which are not assigned to the banking sector – for their parent institution. In this case, the bank takes the securitised paper of its special purpose vehicle into its own balance sheet and records it against longer-term time deposits. In addition, longer-term savings deposits (redeemable at notice of over three months) also increased sharply in the quarter under review.

Credit growth determined by banks' holdings of securities

In the final quarter of 2008, total bank loans to the private sector in Germany continued to grow at a strong pace. In this period, they rose at a seasonally adjusted and annualised rate of almost 7%. The most recent rise resulted to a great extent from a sharp increase in bank holdings of securities issued by domestic entities. The securitisation transactions mentioned above also contributed to this development as banks added those securities newly created by their SPVs to their portfolios. At a seasonally adjusted and annualised rate of just over 2½%, loans to domestic enterprises and households increased at a far slower pace than overall lending. Loans issued by German banks to domestic non-financial corporations were 6.4% up on the year at the end of the period under review compared with 7.5% at the end of the previous quarter. By contrast, loans to non-

Banking conditions in Germany



1 According to harmonised MFI interest rate statistics. — **2** According to the Bank Lending Survey; difference between the numbers of respondents reporting "tightened considerably" and "tightened somewhat" and the numbers of respondents reporting "eased somewhat" and "eased considerably" as a percentage of the responses given. — **3** Expectations for 2009 Q1. — **4** Reduced scale.

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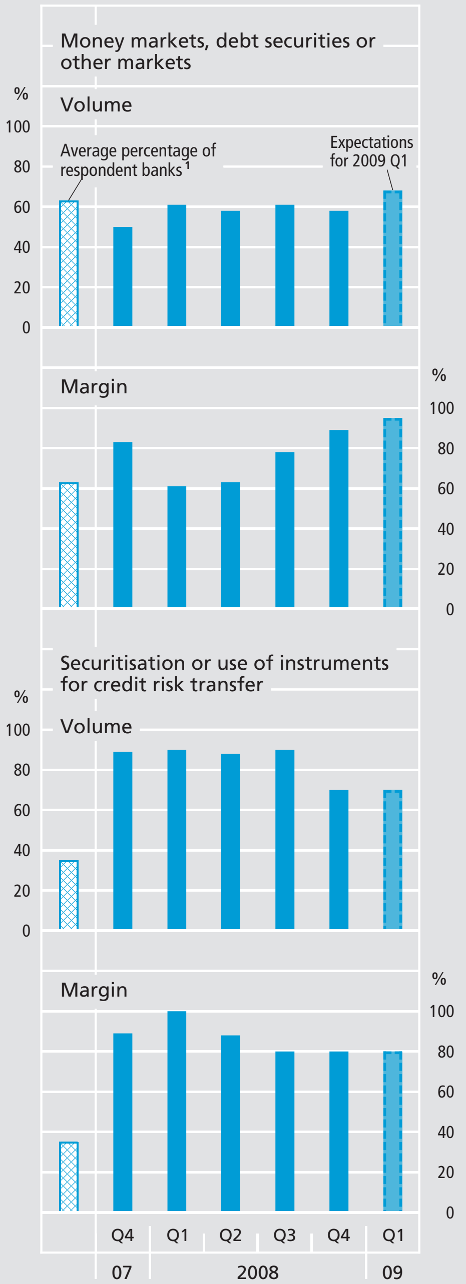
Funding options and lending for German BLS banks during the financial market crisis *



* Banks which reported significant or insignificant effects of the financial crisis as a percentage of all banks claiming to be active on the relevant market. — 1 Banks claiming to be active on the relevant market as a percentage of all German BLS banks; average from 2007 Q4 to 2009 Q1.

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monetary financial corporations recorded the usual large seasonal fall. However, they were still 25.0% up on the year; this was almost solely due to the sharp rise in reverse repurchase agreements. From an economic point of view, these transactions are interbank loans which do not constitute net lending to the non-bank sector. Households also reduced their loans from German banks during the period under review. This reflects, in particular, the sustained decline in loans for house purchase.

Borrowers across the board affected by more restrictive credit standards

The fact that the Bank Lending Survey (BLS) results for Germany identified that the tightening of credit standards observed in previous quarters had become more widespread may also have played a part in this. In the final quarter of 2008, households, too, were confronted with tighter lending conditions from banks surveyed in the BLS. These were felt mainly in margins for loans for house purchase and consumer credit which, on balance, increased considerably, especially for riskier loans. In view of the fact that competitive pressure has eased for the first time in five years, the margins for average loans for house purchase have also expanded. At the same time, the institutions surveyed also stated that they were faced with a further decline in demand for loans for house purchase and a more or less stagnating demand for consumer credit. In the reporting period, the credit standards for loans to enterprises were also tightened considerably. However, as in the case for loans to households, these adjustments were smaller than those in the euro area as a whole. According to the banks surveyed in Germany, increased refinancing costs and balance sheet constraints have again been playing an important role in the development of credit standards; yet, the negative effect of the general assessment of the outlook for the economy as well as sector and firm-specific factors have had a far larger impact. The survey round in the fourth quarter of 2008 also contained a set of *ad hoc* questions on the impact of the financial market crisis on the surveyed institutions' credit standards. The responses indicated that the problems in the wholesale funding of German BLS banks and also with regard to their capital position tended to have intensified and that this was being reflected more and more in the lending policy of the banks surveyed.

Bank lending rates in 2008 Q4 fall significantly

By contrast, the development of bank lending rates for new loans *per se* is likely to have supported domestic lending to the private sector. In the wake of interest rate cuts by the Eurosystem, short-term loans to households and non-financial corporations, in particular, became much cheaper despite the wider margins mentioned above. However, the interest rates for longer-term bank loans also sank in line with developments on the capital markets. At the end of 2008, banks charged 5.2% or 4.3% for short-term loans to enterprises and 5.1% or 4.9% for long-term loans to enterprises depending on volume. They demanded 5.4% for loans for house purchase with short-term interest fixation and 4.7% for loans with interest rate fixation of more than ten years.