

Monetary policy and banking business

Monetary policy and money market developments

ECB Governing Council lowers key interest rates again to new record low

On 4 September 2014, the ECB Governing Council adopted an additional package of monetary policy measures against the backdrop of slackening growth and a persistently subdued inflation outlook in the euro area. Together with the decisions taken in June 2014, these measures are intended to help anchor medium and long-term inflation expectations and to bring the inflation rate back up to a level closer to 2%. As part of its package of measures, the Governing Council lowered key interest rates by 10 basis points to 0.05% for its main refinancing operations, -0.20% for the deposit facility and 0.30% for the marginal lending facility.

The interest rate decision was based on the ECB Governing Council's view that annual HICP inflation, which fell to 0.3% in August according to a flash estimate, would remain low in the months ahead and increase only gradually by the end of 2016. This view is supported by sluggish real growth and the continuously subdued development of the monetary aggregate M3 and lending.

ECB Governing Council adopts purchase programmes for ABS and covered bonds

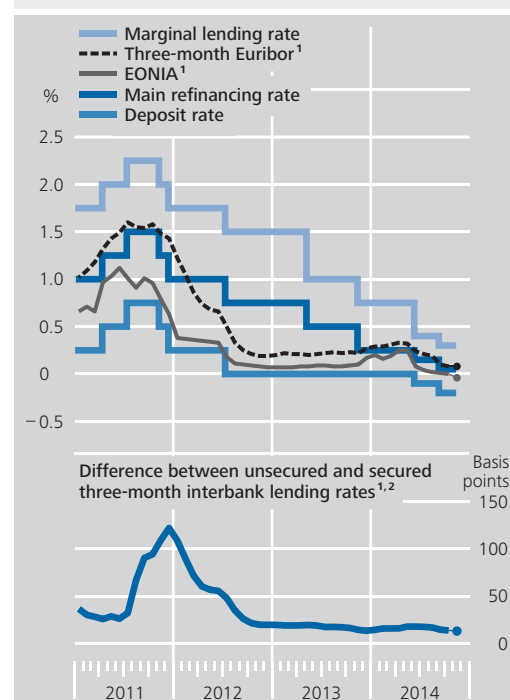
In addition to lowering interest rates, the ECB Governing Council also adopted purchase programmes for asset-backed securities (ABS) and covered bonds. These measures are intended to improve the functioning of monetary policy transmission, support the provision of credit to the real economy and contribute to an even more accommodative monetary policy stance. The ECB Governing Council expects that these purchase programmes, along with the targeted longer-term refinancing operations (TLTROs) adopted in June with a maturity of up to four years, will significantly expand the Eurosystem's balance sheet. Specifically, the ECB Governing Council announced on 6 November 2014 that it expects the balance sheet volume to move

towards the dimensions it had at the beginning of 2012. However, the chief factor determining the monetary policy course going forward is and remains the inflation outlook.

Following its meeting on 2 October 2014, the ECB Governing Council published further details on the two new purchase programmes for ABS (Asset Backed Securities Purchase Programme, ABSPP) and covered bonds (Covered Bond Purchase Programme, CBPP3). Each programme will last for at least two years, and the eligibility criteria for purchasing securities are aligned with the requirements of the Eurosystem's collateral framework for monetary policy

Purchase programme details

Money market interest rates in the euro area



Source: ECB. 1 Monthly averages. 2 Three-month Euribor less three-month Eurorepo. • Average 1 to 12 November 2014.
 Deutsche Bundesbank

Money market management and liquidity needs

The three reserve maintenance periods from 9 July to 7 October 2014 saw a marked decrease in euro-area liquidity needs stemming from autonomous factors. In the September-October 2014 reserve period, the figure averaged €475.1 billion, which was €40.5 billion below its average level in the June-July 2014 reserve period. The €13.2 billion net increase in the volume of banknotes in circulation served to absorb liquidity, while the €31.6 billion net decline in government deposits and changes in the other autonomous factors (including net foreign assets) totalling €22.1 billion had a liquidity-providing effect. Minimum reserve requirements went up by €0.9 billion over the three maintenance periods, triggering a slight rise in the calculated liquidity needs (see table below).

On 24 September, a volume of just under €83 billion was made available for the first targeted longer-term refinancing operation (TLTRO). Shifts from the main refinancing operation (amounting to €15 billion at the end of September) coupled with early repayments of liquidity allotted in the three-year LTROs (totalling €87 billion during the period under review) caused the outstanding volume for tender operations on the value date of the first TLTRO to grow, but only by just over €47 billion to €519 billion. Overall, the average outstanding tender volume fell from a level of €572 billion in the June-July reserve period (not taking into account the SMP liquidity-absorbing operation conducted in the first week) to stand at €497 billion in the September-October period (see the chart on page 30).

Factors determining bank liquidity¹

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

Item	2014		
	9 July to 12 Aug	13 Aug to 9 Sep	10 Sep to 7 Oct
I Provision (+) or absorption (–) of central bank balances due to changes in autonomous factors			
1 Banknotes in circulation (increase: –)	– 9.5	– 4.2	+ 0.5
2 Government deposits with the Eurosystem (increase: –)	+ 17.6	+ 26.2	– 12.2
3 Net foreign assets ²	+ 7.6	+ 0.2	+ 4.2
4 Other factors ²	+ 11.1	+ 3.4	– 4.4
Total	+ 26.8	+ 25.6	– 11.9
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	– 5.1	+ 8.1	– 15.8
(b) Longer-term refinancing operations	– 45.4	– 27.3	+ 10.8
(c) Other operations	+ 20.4	– 5.9	– 1.6
2 Standing facilities			
(a) Marginal lending facility	+ 0.2	– 0.1	+ 0.0
(b) Deposit facility (increase: –)	– 0.7	– 0.6	+ 0.9
Total	– 30.6	– 25.8	– 5.7
III Change in credit institutions' current accounts (I + II)	– 4.1	– 0.1	– 17.5
IV Change in the minimum reserve requirement (increase: –)	– 0.6	– 0.2	– 0.1

¹ For longer-term trends and the Bundesbank's contribution, see pp 14* and 15* of the Statistical Section of this Monthly Report. ² Including end-of-quarter liquidity-neutral valuation adjustments.

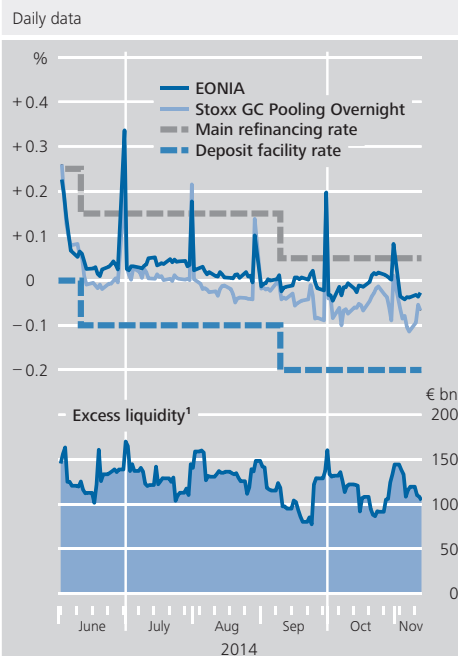
Deutsche Bundesbank

During the period under review, the level of excess liquidity continued to be primarily influenced by open market operations, including, in particular, the additional demand for the main refinancing operation which arose at the end of each month, as well as by repayments of funds provided in the three-year LTROs and autonomous factors. Having averaged €130 billion in the two preceding reserve periods, the level of excess liquidity fell perceptibly in the September-October period, following the renewed interest rate cut, to an average figure of €112 billion. The latter period was, however, characterised by two phases. Up to the settlement of the first TLTRO on 24 September, the excess liquidity figure habitually hovered below €100 billion, reaching its lowest level at €77 billion. Following settlement of the TLTRO, this figure swelled considerably, subsequently rising to as much as €160 billion.

The balance sheet holdings of securities acquired through already completed purchase programmes fell further during the period under review in light of maturities and taking into account end-of-quarter revaluations (CBPP1 and CBPP2 declined by €3.0 billion to €31.7 billion and by €0.6 billion to €13.5 billion respectively, while the SMP volume was down by €7.2 billion to €149.1 billion).

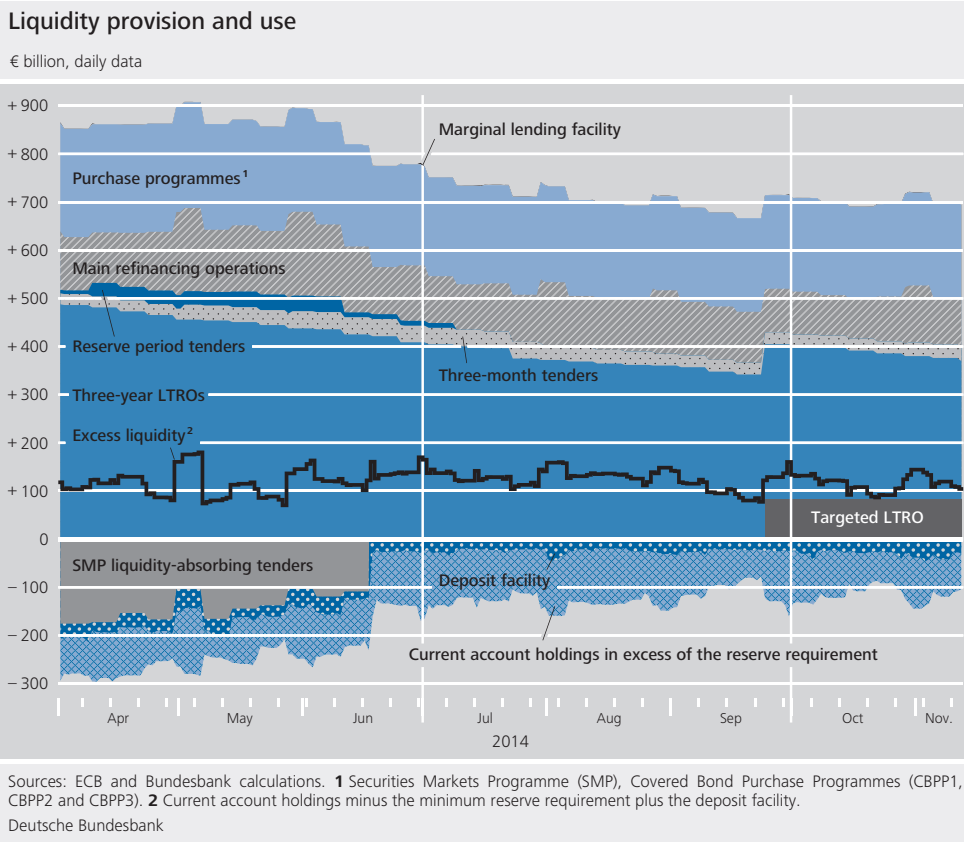
Overnight rates only partially mirrored the renewed reduction of the main refinancing rate and of the deposit rate by 10 basis points. The secured overnight money market rate (GC Pooling, ECB basket) averaged -0.04% during the September-October reserve period and was thus no more than 9 basis points below the main refinancing rate. At the same time, EONIA recorded an average rate of 0.00%, placing it no more than -5 basis points apart from the key interest rate. These interest rate spreads

Central bank interest rates, money market rates and excess liquidity



Sources: ECB, Eurex Repo and Bundesbank calculations. ¹ Current account holdings minus the minimum reserve requirement plus the deposit facility.
 Deutsche Bundesbank

were narrower than in the previous two reserve periods, due not only to the overall lower level of excess liquidity but also quite probably to efforts by numerous credit institutions to avoid, wherever possible, (markedly) negative overnight rates when trading on the euro money market. However, the September cut in the key interest rates had a stimulatory effect on overnight turnover, particularly in the secured segment. In the September-October reserve period, GC Pooling's overnight turnover (ECB basket) rose by a substantial margin to an average of €19.9 billion (previous two periods: €14.4 billion and €14.7 billion). Unsecured EONIA turnover barely grew, its level remaining relatively low at an average of €29.8 billion. The sharp increases in overnight rates seen at the end of each month persisted as banks limited their lending (relatively low turnover) although the liquidity situation on these days was very favourable (see the chart above).



Halfway through the October-November 2014 reserve period that followed the period under review, the reduced level of excess liquidity (around €90 billion) caused overnight rates to rise. While the secured overnight money market rate (GC Pooling, ECB basket) remained negative, EONIA rose to enter positive territory where it stayed until the end of October. During the final week of the reserve period, at which point credit institutions have usually come close to meeting their minimum reserve requirements and therefore have less need for liquidity, there was a further marked drop in overnight rates, which saw the secured GC Pooling overnight rate (ECB basket) fall to a new all-time low of -0.114%. However, over the period as a whole, overnight rates averaged -0.01% (EONIA) and -0.06% (GC Pooling) and were therefore only slightly below their levels in the preceding period. The underlying turnover likewise fell short of the previous-period levels on average over the

period, however in the secured segment these amounts remained elevated. At an average of €114 billion, excess liquidity stood marginally above its level in the previous period but remained volatile. Balance sheet holdings under the new purchase programme CBPP3, which was launched during this period, amounted to €7.4 billion as at 7 November 2014 and thus have had no major impact on the liquidity situation so far. At that juncture, the ABS Purchase Programme (ABSPP) had not yet commenced.

refinancing operations.¹ As a rule, this requires a minimum credit assessment equivalent to an external rating agency's rating of BBB-. Whereas two such ratings are needed for ABS, only one is required for covered bonds. Exceptions apply to ABS with underlying claims against private non-financial corporations which are resident in Greece or Cyprus. It is impossible for these ABS to obtain the minimum credit assessment since rating agencies apply upper limits linked to the individual country ratings. In these cases, the ABS must have received at least the highest possible rating for the respective country. Similar exceptions were also agreed for covered bonds issued in Greece and Cyprus. However, both securities categories in these countries must conform with additional requirements which go beyond the Eurosystem's temporary collateral framework and are intended to lower the risk associated with this type of paper.²

further compound the above-mentioned side effects. The Eurosystem must not lose sight of these side effects when conducting the purchase programmes.

Following the second meeting of the ECB Governing Council in September 2014, the ECB announced the result of the draw for the Governing Council's voting rotation system, which will enter into force in January 2015. Under this system, the group of Governors representing the national central banks of the euro area's largest member states, which includes the Bundesbank President as well as the Governors of the Spanish, French, Italian and Dutch central banks, will take turns in relinquishing their voting rights for one ECB Governing Council meeting.

Voting rotation system for ECB Governing Council to begin in January 2015

The first of eight TLTROs was carried out on 18 September 2014. 255 of the 382 authorised institutions borrowed a total volume of €82.6 billion from the Eurosystem. The second TLTRO will be carried out on 11 December 2014. In these first two TLTROs, participating banks can take out central bank loans amounting to up to 7% of their outstanding credit volume (not including loans to households for house purchase) to the non-financial private sector as at 30 April 2014, ie around €400 billion at the most. The interest rate for TLTROs is ten basis points above the main refinancing rate applicable at the time of allotment.

255 banks borrow €82.6 billion in first TLTRO

After excess liquidity generally fluctuated between €100 billion and €150 billion in July and August, demand in the area of main refinancing operations waned following the allotment and settlement of the first TLTRO. At the same time, a slight rise in the early repayments of three-year tenders was recorded. On the whole, the first TLTRO did not lead to any per-

No persistent increase in excess liquidity from first TLTRO allotment

Eurosystem has already begun purchasing covered bonds

The Eurosystem began purchasing covered bonds in mid-October 2014 and had obtained paper worth €7.4 billion by 7 November. ABS purchases will commence in the course of November now that the external service providers with which the Eurosystem will be collaborating in this context have been selected. Senior tranches, which are regarded as comparatively safe, will initially be the only purchase option. The option of purchasing mezzanine tranches may be introduced at a later stage, provided that the state can provide sufficient guarantees for these.

Side effects of inflated purchase prices, particularly in the case of high or unlimited purchase volumes

Monetary policy purchases of privately issued securities can have wide-ranging negative side effects. For example, if purchase prices are too high, sellers can benefit from a transfer of resources akin to a subsidy, thereby placing other market participants at a disadvantage. This would result in distortions of competition and inefficiencies resulting from misallocation. Moreover, private investors could potentially be crowded out by central banks, which could adversely affect the sustainability of these markets. Announcing a specific high target volume for a central bank's balance sheet total could

¹ However, a number of adjustments will have to be made to take into account the difference between buying assets outright and accepting them as collateral for monetary policy operations.

² For further details, see the ECB press release of 2 October 2014.

Excess liquidity and short-term money market rates

The level of short-term interest rates in the interbank money market depends to a great extent on the level of the Eurosystem's key interest rates. Apart from the main refinancing rate, these comprise the interest rates set for the marginal lending facility and for the deposit facility, which usually form a symmetrical corridor around the main refinancing rate. While this interest rate corridor limits fluctuations in interbank overnight rates, the position of these rates within the corridor hinges primarily on the prevailing liquidity situation in the banking sector, which can largely be gauged by the level of excess liquidity.¹ The term "excess liquidity" should be understood as meaning that banks' overnight balances at the Eurosystem's central banks, both in terms of their total amounts and average levels throughout the reserve period, exceed the minimum reserve requirements, meaning that, in aggregate, bank's central bank reserves may be much higher than actually necessary.

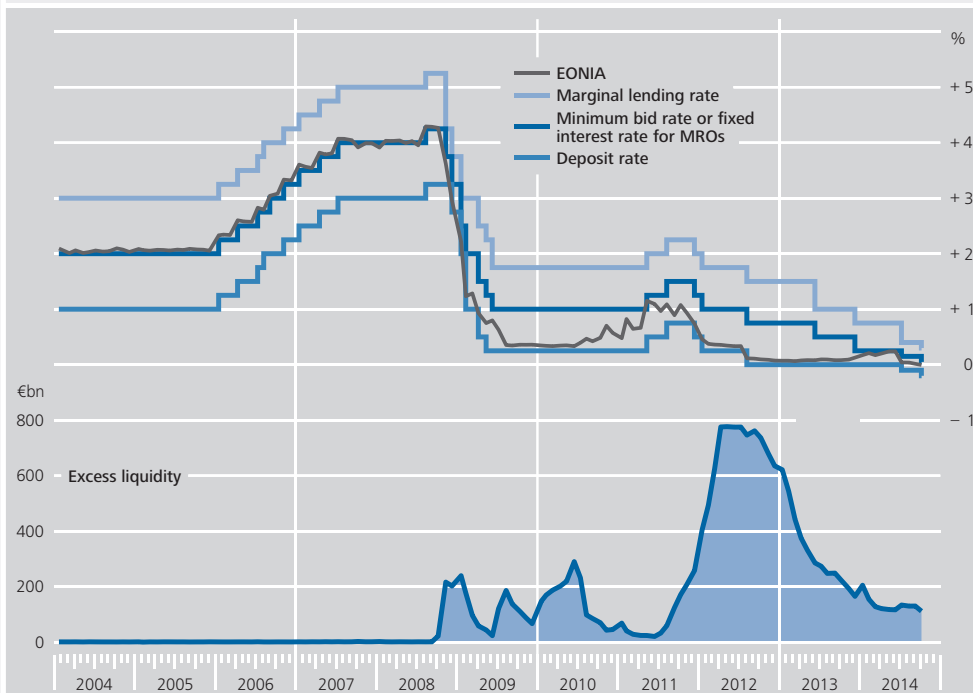
Prior to the financial crisis, the interest rate corridor boasted a symmetrical width of ± 100 basis points around the main refinancing rate. This made it relatively wide, thus providing strong incentives for a horizontal distribution of liquidity via the interbank money market. At that time, by restricting the size of allotments, the Eurosystem was able to ensure balanced liquidity conditions in aggregate terms, in other words a negligible level of excess liquidity, which allowed it to anchor short-term money market rates close to the main refinancing rate and therefore roughly at the centre of the interest rate corridor (see chart below).

The escalation of the financial crisis in the fourth quarter of 2008 made it more difficult for a large number of banks to procure liquidity via the interbank money market. The Eurosystem reacted to this situation by

¹ Excess liquidity = deposit facility plus current account deposits minus the reserve requirement.

Money market rates and excess liquidity

On average during the reserve period



Sources: ECB and Bundesbank calculations.
 Deutsche Bundesbank

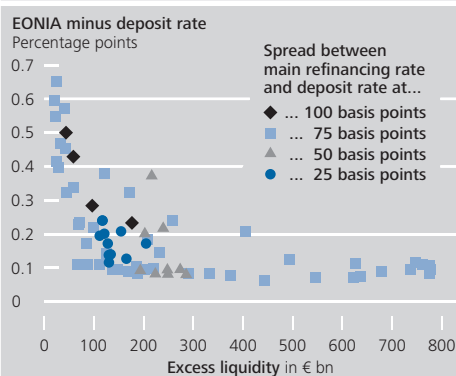
switching its refinancing operations to a fixed-rate full allotment format. Since then, allotment volumes have no longer been subject to Eurosystem restraints and have instead been geared to counterparties' aggregate demand. As a result, monetary policy refinancing and consequently the pool of excess liquidity have risen sharply. To date, the biggest increase in excess liquidity, which took its level up to nearly €800 billion at the beginning of 2012, was generated by the large-scale recourse to the two three-year refinancing operations conducted at the end of 2011 and the beginning of 2012.

Against a background of exceedingly high excess liquidity, the interbank overnight rates tend to closely shadow the deposit facility rate.² Under such circumstances, a declining level of excess liquidity will usually tip the balance back to an increase in demand in the interbank money market, and EONIA will move closer to the main refinancing rate, typically amid some fluctuation. Moreover, the negative status of the deposit facility since June 2014 has not fundamentally changed this inverse relationship between excess liquidity and money market rates. As the Eurosystem has progressively narrowed the gap between the main refinancing rate and the deposit rate since 2009 from its original width of 100 bp to its current size of 25 bp, the maximum width between EONIA and the deposit rate has likewise diminished (see adjacent chart).

Overall, therefore, the current situation is characterised by relatively close interaction between excess liquidity and EONIA. Should a rise in market interest rates induced by declining excess liquidity cause short-term money market transactions to become less attractive to individual institutions than monetary policy refinancing, these institutions will display an intensified demand for funds from the Eurosystem. This results in an increase in the level of excess liquidity, while EONIA will tend to fall. As the aggregate allotment volume for refinancing operations under the current allotment procedure is not controlled by the Eurosystem, any fluctuations in the liquidity situation and in short-term money market rates which might occur should be viewed as perfectly normal and should in no way be interpreted as signalling a modified monetary policy stance.

Excess liquidity and spread between EONIA and deposit rate

On average during the reserve period since October 2008



Sources: ECB and Bundesbank calculations.
 Deutsche Bundesbank

Banks' aggregate demand for liquidity and the resulting excess liquidity will continue to play a significant role with regard to the status of very short-term money market rates within the interest rate corridor, not least because the Eurosystem has already stated its intention to maintain its policy of full allotment up to the end of 2016. In addition, the Eurosystem agreed on a number of measures in the summer and autumn of 2014 (ie the TLTROs and the two new purchase programmes for ABS and covered bonds) which, taken together – and notwithstanding the imminent maturity dates of the two three-year tenders – will have the capacity to create new potential for raising the excess liquidity level, which experience has shown is likely to have a dampening effect on money market rates.

In the longer term, for reasons of efficiency it would nonetheless be desirable to revert to a system of controlled liquidity management entailing limited allotment volumes as this is a more precise means of controlling short-term money market rates which sends out a clearer signal regarding the monetary policy stance.

² Provided the deposit rate is positive, banks are particularly inclined to store excess liquidity in the Eurosystem's deposit facility, where, unlike excess reserves held in current accounts, such liquidity earns interest. Since lowering the Eurosystem's deposit rate to 0% and below, excess reserves held in both current accounts and the deposit facility have earned the same yield.

Consolidated balance sheet of the MFI sector in the euro area*

Changes in € billion, seasonally adjusted

Assets	2014 Q3	2014 Q2	Liabilities	2014 Q3	2014 Q2
Credit to private non-MFIs in the euro area	- 16.1	- 39.2	Central government deposits	- 27.2	16.3
Loans	- 11.6	- 43.8	Monetary aggregate M3	132.2	75.6
Loans, adjusted ¹	- 12.1	12.0	<i>of which: Components</i>		
Securities	- 4.5	4.6	Currency in circulation and overnight deposits (M1)	137.8	56.6
Credit to general government in the euro area	53.7	- 35.3	Other shorter-term bank deposits (M2-M1)	- 10.2	15.6
Loans	- 0.6	- 13.2	Marketable instruments (M3-M2)	4.5	3.4
Securities	54.3	- 22.1	Monetary capital	3.2	- 76.8
Net external assets	8.9	83.4	<i>of which</i>		
Other counterparts of M3	62.2	- 49.6	Capital and reserves	62.3	1.8
			Other longer-term financial liabilities	- 59.2	- 78.6

* Adjusted for statistical changes. ¹ Adjusted for loan sales and securitisation.

Deutsche Bundesbank

sistent increase in excess liquidity. It would appear that incentives still remain for the euro-area banking system to repay excess liquidity to the Eurosystem, also in view of the comparatively narrow interest rate corridor, which currently stands at ± 25 basis points.

Short-term money market rates turn negative after ECB Governing Council's interest rate decisions

Despite the slightly disproportionate reaction to the interest rate cut in June, the unsecured interbank overnight rate EONIA initially remained positive until the end of August. Since then, the EONIA has been both positive and negative – depending, in particular, on the prevailing liquidity conditions. Although the EONIA reached new record lows of up to 0.045% following the further interest rate cut of an additional 10 basis points at the beginning of September, unsecured interbank overnight rates are once again closer to the main refinancing rate than they were in the period from June to August. Overall, when viewed in relation to excess liquidity, the interest rate spread between the EONIA and the Eurosystem deposit rate continues to move in line with historical values (see the box on pages 32 and 33). A situation in which very short-term money market rates are nearing the level of the main refinancing rate following a decline in excess liquidity suggests a return to more normal conditions in the money market within the context of the full allotment of refinancing operations.

Monetary developments in the euro area

Measured in terms of 12-month changes, the deleveraging process in the euro-area MFI sector continued to slow considerably in the third quarter. This was due, in particular, to the grinding to a halt of the substantial reduction in financial derivatives, which began in 2013. Furthermore, euro-area banks on balance expanded their holdings of securities issued by general government and their claims on non-residents. By contrast, the recovery in lending to the private sector, which started in summer 2013 and accelerated noticeably in the first half of 2014, began to sputter in the third quarter owing to weak growth in the real economy. As a result, the sustained growth of M3 was once again buoyed by other counterparts rather than lending to the private sector.

Macroeconomic setting

Following significant inflows in the preceding quarter, M3 increased substantially in the third quarter. This increase was once again attributable to overnight deposits, which benefited from a further reduction in other deposit rates and rose considerably, above all in the non-financial private sector. By contrast, other short-term deposits included in M3 were scaled back slightly on balance in the reporting quarter, mainly as a result of a decline in the short-

Substantial M3 growth driven by overnight deposits

term time deposits of households. As in the previous quarter, holdings of marketable instruments rose slightly on balance, mainly due to an increase in money market fund shares and bank debt securities with a maturity of less than two years in the third quarter.

Renewed upward trend in monetary and credit growth

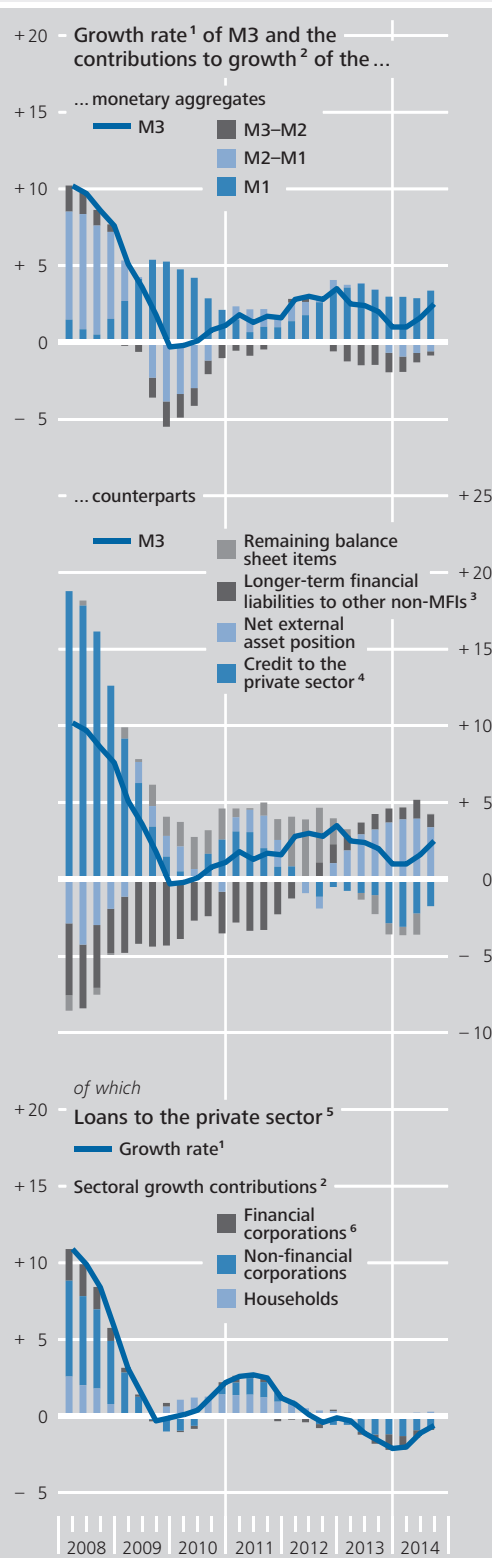
Against this backdrop, the upward trend in monetary growth that has been observed since the beginning of the year gained momentum in the reporting quarter and the annual growth rate of M3 rose markedly to 2.5%. At the same time annual growth (adjusted for loan sales and securitisation) of loans to the euro-area private sector continued to rise perceptibly to -0.6% in September despite slight quarterly outflows. This was because net redemptions slowed considerably during the course of the year as a whole. However, the gap between money and credit growth remained wide in this context. Despite the tentative signs of recovery, underlying monetary dynamics continue to be subdued.

Reduction in loans to non-financial corporations continues

The recovery of loans to the euro-area private sector, which began to rise again slightly in the second quarter for the first time in two years, suffered a temporary setback in the third quarter. This was due to loans to the corporate sector, especially to non-financial corporations, where the robust upward momentum of the previous quarter stalled and the upward trend observed since the third quarter of 2013 started to falter. It should, however, be noted that these loans are generally characterised by certain fluctuations. Besides long-term loans to non-financial corporations, which are usually demanded for investment purposes, marked outflows of medium-term loans were also recorded in the reporting quarter. Nonetheless, there are still signs of a clear recovery in lending compared with the previous year, as a result of which the annual growth rate of loans to non-financial corporations in the euro area rose from -2.8% in the third quarter of 2013 to -1.8% in the reporting quarter.

Monetary aggregates and counterparts in the euro area

Seasonally adjusted, end-of-quarter data



Source: ECB. **1** Year-on-year percentage change. **2** In percentage points. **3** Denoted with a negative sign because, taken in isolation, an increase curbs M3 growth. **4** Adjusted for loan sales and securitisation. **5** Adjusted for loan sales and securitisation from 2010 Q1. **6** Non-monetary financial corporations.
 Deutsche Bundesbank

Differences in dynamics of loans to non-financial corporations in Germany and France

France currently stands out among the four large euro-area countries as the only one to have recorded stable, positive growth in loans to non-financial corporations in the euro area over a period of several quarters (see the chart on page 38). Although credit growth in France can be described as moderate compared with the levels seen during the previous 15 years, lending there is nevertheless perceptibly higher than in Germany, where credit dynamics remain subdued.¹

At first glance, this is surprising as there are currently no indications of the credit supply

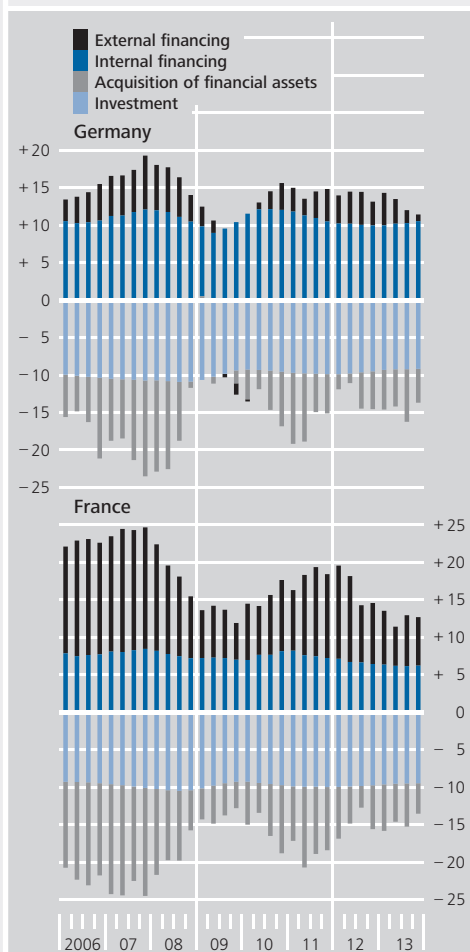
being restricted in Germany, and in recent years the German economy has recorded stronger real GDP growth than the French economy. Between 2010 and the start of 2014 (the most recent data available), the average annual real GDP growth rate in Germany (+2.2%) was significantly higher than in France (+1.2%). This is primarily due to more favourable export growth in Germany and the substantial structural barriers to growth in France.

During the period under review, long-term loans (which are commonly used for investment purposes) were the main driver of growth in loans to non-financial corporations in Germany and France. However, industrial investment patterns in these two countries do not explain the differences in loan dynamics over the past few years. Since 2010, industrial investment in France has on average even increased at a slower pace (+2.9%) than in Germany (+4.0%).

Instead, it seems that the different rates of growth for loans to non-financial corporations in Germany and France are mainly due to differences in the availability of alternative financing sources. According to the national accounts data (including the financial accounts), non-financial corporations in Germany have, for some time now, generated a substantial part of their funds internally (see adjacent chart).² At the current end (data are available up until the fourth quarter of 2013),

Sources (+) and uses (–) of non-financial corporations' funds

As a percentage of GDP, four-quarter moving sum



Sources: ECB and Bundesbank calculations.
 Deutsche Bundesbank

¹ Lending to non-financial corporations in the rest of the euro area has been relatively low in both countries in recent years and is therefore disregarded in the following analysis. French banks, in particular, have reduced their loans to non-financial corporations in the rest of the euro area on balance during the last two years. This is consistent with the general euro-area trend of deleveraging in the banking sector, accompanied by a greater focus on core business, but it also reflects the currently heightened credit risk in the periphery countries.

² For an in-depth discussion of the development of the financing structure of non-financial corporations in Germany, see Deutsche Bundesbank, Long-term developments in corporate financing in Germany – evidence based on the financial accounts, Monthly Report, January 2012, pp 13-27.

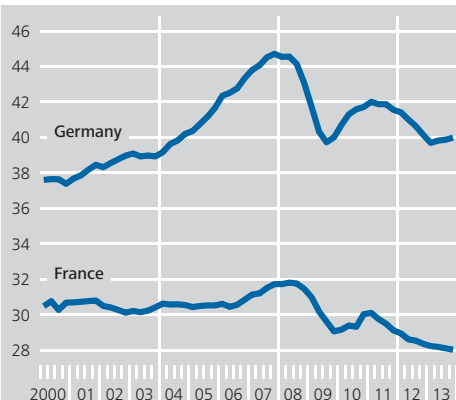
internal financing makes up around 92% of total financing. In France, by contrast, internal financing accounts for a significantly lower share, recently amounting to only 49%. The lesser importance of internal financing in France reflects the downward tendency of the profit ratio of non-financial corporations since the escalation of the financial crisis in 2008 (see the upper of the adjacent charts). The main reason for this was that the slump in gross value added in 2009 was replicated only to a minor extent in the compensation of employees and this discrepancy was not corrected *ex post*. To avoid a further loss in competitiveness, French non-financial corporations only marginally adjusted their sales prices to factor in the increase in wages and non-wage labour costs in excess of productivity gains.

Thus, for some time now, non-financial corporations in France have been more reliant on external funding to finance their equity investments and fixed asset formation. This is reflected not only in a structurally higher demand for loans, but also in the stronger overall dynamics of external financing (see the lower of the adjacent charts). The four-quarter sum of external financing of non-financial corporations in France thus amounts to around €100 billion (~ 4.8% of GDP) according to the latest results (first quarter of 2014). By contrast, the value for their German counterparts only amounts to around €10 billion (~ 0.4% of GDP). The significantly greater use of external financing sources by French non-financial corporations is a key factor which drove up their debt-to-GDP ratio perceptibly in recent years, while the corresponding ratio in Germany has remained at a relatively low level.

Despite the sharper growth in loans in France, their share in total external financing has – like in Germany – fallen noticeably in recent years owing to substitution effects. In France, non-financial corporations have recently been making increasing use of unlisted shares and other equity. Furthermore, debt securities have been gaining significance in both countries in light of falling capital market yields (in relation to bank lending rates).

Profit ratio of non-financial corporations

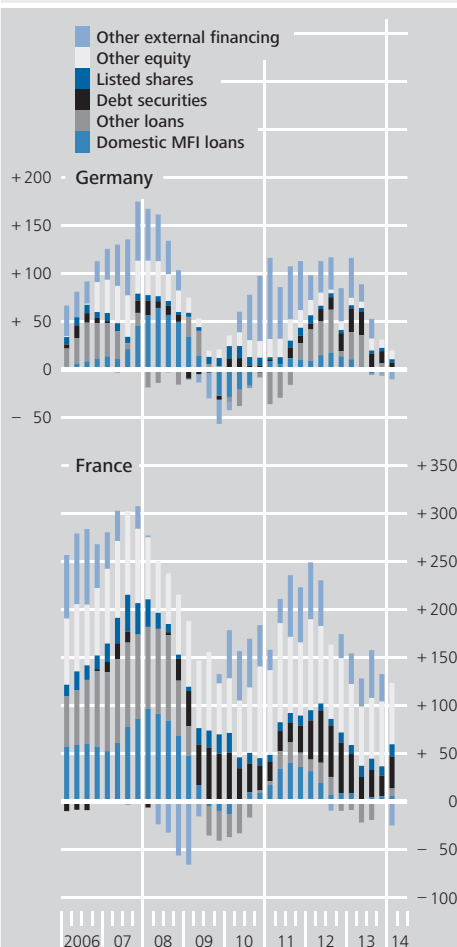
Gross operating surplus as a percentage of gross value added



Sources: ECB and Bundesbank calculations.
 Deutsche Bundesbank

External financing of non-financial corporations

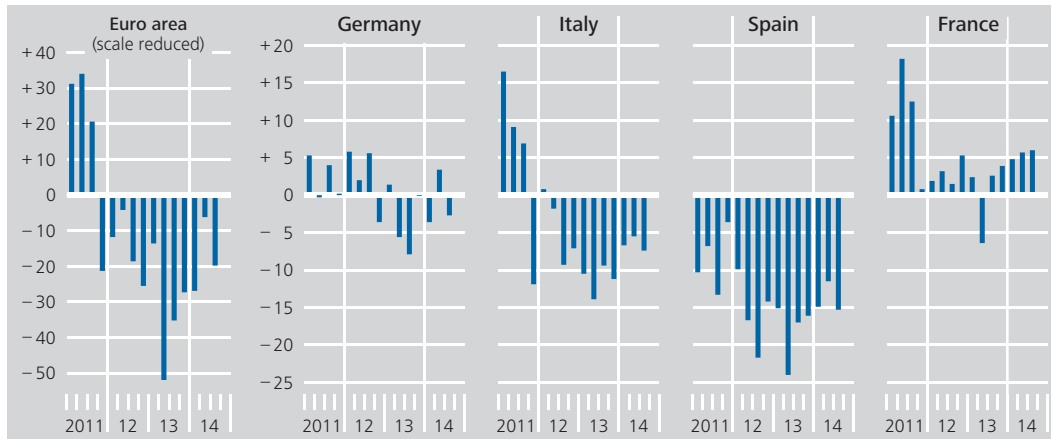
€ billion, four-quarter moving sum



Sources: ECB and Bundesbank calculations.
 Deutsche Bundesbank

Loans to non-financial corporations

€ billion; three-month changes at the end of the quarter, seasonally adjusted and adjusted for loan sales and securitisation



Source: ECB.
 Deutsche Bundesbank

Lending heterogeneity in the four large euro-area countries remains high

At country level, heterogeneity in the development of lending remained high. Of the four large euro-area member states, only French non-financial corporations continued to report positive quarterly inflows (see chart above and the box on pages 36 and 37). German corporations on balance scaled back their loans following the positive quarterly inflow in the second quarter, while the reduction in loans to non-financial corporations picked up in Italy and Spain. There are likely to be many reasons for this development. In Spain, the positive impetus in the domestic economy, which usually supports the development of loans to non-financial corporations with a lag of a few quarters, is being overshadowed by the great need for deleveraging in the non-financial corporate sector. The fact that Italy has slipped back into recession presents a particular risk to loan growth. In Germany (and the euro area as a whole), corporations' demand for bank loans is likely to have been dampened – as in the previous quarters – by an increase in the use of alternative sources of funds, while own funds represent the primary source of financing in Germany.

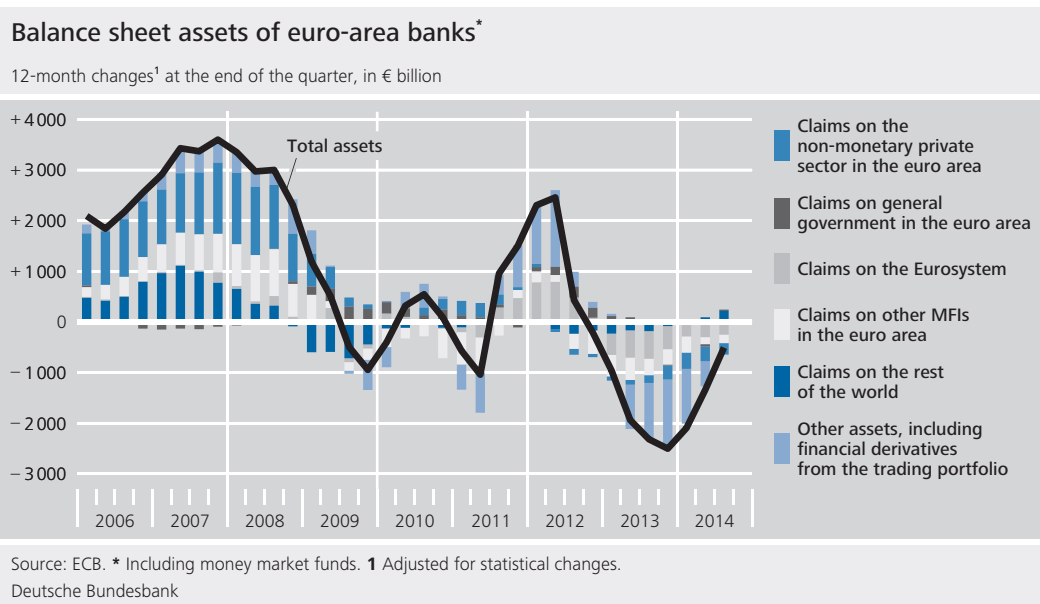
Renewed reduction in the importance of supply-side credit constraints

Survey results suggest that the importance of supply-side credit constraints diminished further in most euro-area member states in the reporting quarter. According to the ECB's re-

cently published SAFE survey, small and medium-sized enterprises (SMEs) in the euro area currently perceive access to bank loans, which had – in their opinion – deteriorated markedly in 2009 and 2012, to be less problematic, not least owing to an overall improvement in enterprise-specific factors. The main exception to this are Italian SMEs, which believe that bank loans are now less readily available. In the Bank Lending Survey (BLS) conducted in the third quarter, the participating euro-area banks on balance indicated that they largely left standards for loans to enterprises unchanged at the previous quarter's level. This affected enterprises of all sizes in a similar way. At the same time, the surveyed euro-area institutions perceived no marked changes in non-financial corporations' demand for bank loans.

Once again, loans to households were instrumental in the development of loans to the euro-area private sector in the third quarter. These have grown at a somewhat faster rate since the beginning of the year, but, with annual growth of 0.6%, are still to be regarded as extremely moderate. In an environment characterised by historically low interest rates, growth continued to be driven by loans for house purchase. Here, too, there was persistent heterogeneity at country level. The increase in the euro-area aggregate masked a considerable in-

Discernible increase in loans to households



crease in loans for house purchase in core euro-area countries, while the periphery countries saw a further overall decline, not least on account of the need for household deleveraging. For the euro area as a whole, the banks surveyed as part of the BLS also reported that demand in this credit segment rose considerably, while standards for loans to households for house purchase in the euro area remained virtually unchanged.

For the first time since 2009, perceptible net inflows of consumer loans were recorded in the third quarter. This gradual upturn reflects the somewhat improved underlying dynamics of private consumption that have been observed since 2013. This development is consistent with the information reported by the institutions surveyed as part of the BLS. They stated that a slight easing of standards was accompanied by a moderate increase in borrowing in the consumer credit segment. However, signs of weaker private consumption are becoming increasingly evident, which is likely to have a dampening effect on credit growth in the coming quarters.

The net external asset position of the MFI sector, which has been the main counterpart supporting M3 for the last two years, grew only slightly in the third quarter. Net outflows were

even recorded in August and September. Since current account surpluses remained largely unchanged over the same period, these reductions are likely to be primarily attributable to net outflows from portfolio transactions with non-residents. While non-banks resident in the euro area continued to buy foreign securities, non-resident investors disposed of domestically issued debt securities on a large scale. The rise in securitised lending to domestic general government on banks' balance sheets and the concurrent increase in the external liabilities of the MFI sector suggest that these were sales of, among other things, government debt securities issued by euro-area countries that were purchased by domestic banks.

In contrast to previous quarters, therefore, securitised lending to government once again had a significant positive impact on monetary growth. Demand for euro-area securities issued by governments outside the respective home country was particularly high. In general, the greater interest in government securities can be interpreted as reflecting the relatively comfortable liquidity situation of domestic banks and the above-mentioned large-scale sale of euro-area securities by foreign investors.

Monetary capital, which increased slightly on balance following a significant decline in the

On balance, marked increase in government securities

Only slight increase in net external asset position

Slight increase in monetary capital on balance

previous quarter, had a negative impact on M3 in the reporting quarter. Appreciable outflows of both long-term time deposits and long-term bank debt securities with a maturity of over two years were offset by another significant increase in capital and reserves in light of the new regulatory and supervisory activities. Despite the distinct improvements in placing longer-term bank debt securities reported by institutions participating in the BLS, outflows were once again recorded in this area by German, Spanish and Italian banks, in particular. This suggests that bank-side factors continue to play a role in this context, too. In addition to some credit institutions requiring little funding on account of deleveraging, a key bank-side factor is that banks have been substituting bank debt securities with alternative sources of financing, such as Eurosystem liquidity provided on favourable terms as well as deposits, which are continuing to grow. This mirrors the information provided by the majority of euro-area banks participating in the BLS which said that they had either already participated in the Eurosystem's TLTROs or that they planned to do so in future. Banks also reported a slight overall improvement in their refinancing situation.

Further significant deceleration in net reduction in asset items

The net reduction in the asset items of euro-area banks observed in 2013 decelerated further in the reporting quarter, measured in terms of 12-month changes (see chart on page 39). The deceleration was spread across various balance sheet items. There were two particularly striking developments. First, the substantial reduction in financial derivatives in the trading portfolio, which began in 2013, ground to a halt. Of the four large euro-area countries, this affected France and Germany most. Second, a deceleration also occurred in the reduction of other asset items in France, Germany and Spain, caused primarily by further net inflows of claims on the rest of the world. In Italy, by contrast, a slight acceleration of the reduction in other asset items was observed.

German banks' deposit and lending business with domestic customers

German banks' deposit business continued to grow in the third quarter of 2014. As in the preceding quarters, sight deposits benefited most from the renewed narrowing of the interest rate spread between deposits of different maturities and the continued marked investor preference for liquid assets. Once again, this development was chiefly driven by the sight deposits of households. In contrast to previous quarters, however, non-financial corporations also made a substantial contribution to the increase in sight deposits.

Increase in deposit business due mainly to sight deposits

The shift from long-term to shorter-term deposit types that has been apparent since the onset of the financial crisis was less pronounced in the third quarter than was previously the case due to household demand for long-term savings deposits, which was observed for the first time in five years. This potentially reflects the search for alternative investment opportunities following the slight deterioration in sentiment in the equity market in the third quarter. On balance, however, longer-term deposits continued to decline as financial corporations – especially insurers and pension funds – once again markedly reduced their investments in time deposits with a maturity of over two years. As in previous quarters, these professional investors are likely to have shifted the freed-up funds towards less liquid and riskier assets outside M3 in search of higher yield.

Demand for long-term savings deposits increases notably for first time in five years

Once again, there was a clear rise in bank lending in Germany in the third quarter of 2014. As was previously the case, this rise was mainly due to an increase in lending to private non-banks. In this context, MFIs in Germany increased their holdings of securities issued by the domestic private sector and granted more loans to the private sector.

Bank lending once again clearly on the rise

Loans to households continued to grow moderately, as they have done since the beginning of

Increase in loans to households continues to be driven by loans for house purchase

2010. This was chiefly due to loans for house purchase, which once again increased at a slightly faster pace than in the preceding quarters. By contrast, banks taking part in the BLS reported that the significant rise in demand for loans for house purchase experienced in the first half of 2014 ground to a virtual halt in the third quarter. According to the surveyed bank managers, the outlook for the housing market improved only slightly on the previous quarter from the perspective of borrowers, and, for the first time in over four years, consumer confidence did not translate into any real increase in demand. Conversely, alternative sources of funding, such as household savings and loans from other banks, had a negative impact on household demand for loans for house purchase at surveyed institutions when viewed in isolation.

Somewhat more restrictive lending policy for loans for house purchase

Banks' lending policies for loans for house purchase were more restrictive in the third quarter than they were in the second. They not only increased their margins – considerably in the case of riskier loans – but also tightened their credit standards somewhat as, unlike borrowers, they were slightly pessimistic about the outlook for the housing market.

Moderate rise in consumer loans, with no change in lending policy

By contrast, lending policy in the consumer loans segment remained largely unchanged. At the same time, the surveyed banks reported a perceptible rise in demand in the third quarter of 2014. According to the surveyed bank managers, this was primarily due to consumers' increased propensity to purchase. This is consistent with the moderate increase in consumer loans recorded in the third quarter in the monthly balance sheet statistics, which include all MFIs in Germany. Conversely, there was a significant decline in other loans. Overall, lending to domestic households continued to rise in the third quarter at a moderate annual rate of 1.4%.

Perceptible decline in loans to non-financial corporations

Loans to domestic non-financial corporations decreased perceptibly in the reporting quarter. Considerable net inflows of long-term loans, which are usually viewed in connection with investment, were offset by the sharp decrease in

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

Changes in € billion, seasonally adjusted

Item	2014	
	Q2	Q3
Deposits of domestic non-MFIs ¹		
Overnight	23.7	35.5
With agreed maturities		
of up to 2 years	0.4	- 5.8
of over 2 years	- 9.2	- 3.5
Redeemable at notice		
of up to 3 months	1.6	2.1
of over 3 months	- 0.8	2.5
Lending		
to domestic general government		
Loans	- 6.5	- 4.1
Securitised lending	4.2	6.4
to domestic enterprises and households		
Loans ²	8.3	6.9
of which to households ³	5.8	5.9
to non-financial corporations ⁴	4.0	- 3.5
Securitised lending	10.4	4.9

* As well as banks (including building and loan associations, but excluding the Bundesbank), monetary financial institutions (MFIs) here also include money market funds. End-of-quarter data, adjusted for statistical changes. **1** Enterprises, households and general government excluding central government. **2** Adjusted for loan sales and securitisation. **3** Including non-profit institutions serving households. **4** Corporations and quasi-corporations.

Deutsche Bundesbank

short-term loans, which increased noticeably in the preceding quarter. This is consistent with the decrease in enterprises' demand for bank loans reported in the quarter under review by banks taking part in the BLS due to lower financing needs for inventories and working capital. Overall, German banks' lending to non-financial corporations has become increasingly volatile in recent quarters. Over the year as a whole, the annual lending rate remained very subdued at -0.5%.

German banks participating in the BLS painted a slightly more optimistic picture with regard to enterprises' demand for loans, which they say increased slightly in the third quarter of 2014. According to surveyed bank managers, this development was driven by increased demand for funding for mergers, takeovers and corporate restructuring. Viewed in isolation, the use of other sources of financing – in addition to the above-mentioned factors – had a negative impact on demand. Such alternative sources of

An international comparison of the importance of bank credit as a debt financing instrument for non-financial corporations

There is a persistently held view among the general public that the euro area's financial system is primarily a bank-based one, particularly so by US or UK standards. It is based on the belief that bank loans are a major source of debt financing for non-financial corporations and borne out by banks' substantial exposures to enterprises. However, a glance at the data would suggest that this view needs to be put into some perspective. Internationally comparable data on the role currently played by bank credit as a form of business finance can be extracted from the financial accounts, while data on the importance of corporate loans for banks can be sourced from the bank balance sheet statistics. The scatter plot on the next page combines both sets of data. The x-axis shows the volume of loans which domestic non-financial corporations owe to domestic credit institutions as a percentage of domestic non-financial corporations' total debt outstanding, while the y-axis plots domestic banks' loan exposures to domestic non-financial corporations as a share of domestic credit institutions' aggregate total assets.¹ To classify the different countries, the system of coordinates is subdivided into four quadrants. The importance of bank credit as a debt financing instrument for non-financial corporations is relatively high (low) in the countries shown in one of the two quadrants on the right (left). The graph also reveals that the importance of corporate loans is comparatively high (low) for the banking sectors of the countries in the upper (lower) quadrants.²

The calculations show that bank loans as a source of non-financial corporations' debt

financing are more important for the euro area as a whole, relatively speaking, than they are for the United States and the United Kingdom. Looking at the countries individually, this is mainly true for Greece and Italy and somewhat lesser so for the Netherlands and Germany. In Spain, the deleveraging process witnessed in recent years has helped to considerably diminish the importance of bank loans for non-financial corporations.³

Appearances would suggest that other lenders, besides banks, are key providers of

¹ For the purpose of this analysis, debt comprises loans (excluding trade credits) and debt securities. Pension fund reserves are omitted to improve international comparability because their importance is highly contingent on each country's institutional setting and, in the euro area, is only noteworthy in Germany and Italy. Other liabilities are excluded for much the same reason. Data on credit institutions' debt components and total assets for the euro-area countries and the United Kingdom are extracted from the flow-of-funds accounts and the monthly balance sheet statistics of banks (MFIs) as provided by Eurostat and the ECB. Data on the volume of loans to non-financial corporations in the United States are based on estimates by the Bank for International Settlements, while credit institutions' total debt figures and total assets are taken from the Federal Reserve Board's financial accounts.

² In keeping with an analysis prepared by the IMF, if bank credit accounts for more (less) than 50 percentage points of total debt, it is assumed to have a high (low) importance. As for the importance of corporate lending in credit institutions' balance sheets, a threshold value is set at 15 percentage points, with a higher (lower) value implying high (low) importance. Given that the IMF uses non-financial corporations' total liabilities as an approximate measure for bank credit, the results exhibit significant discrepancies in some respects. The IMF's definition of debt furthermore includes other liabilities, which are excluded here. See IMF, *Sovereigns, banks, and emerging markets: detailed analysis and policies*, Global Financial Stability Report, April 2012.

³ If the definition of debt were broadened to also cover other liabilities (including trade credits), bank credit would not represent a highly important debt financing instrument for non-financial corporations in any of the euro-area countries, with the exception of Greece.

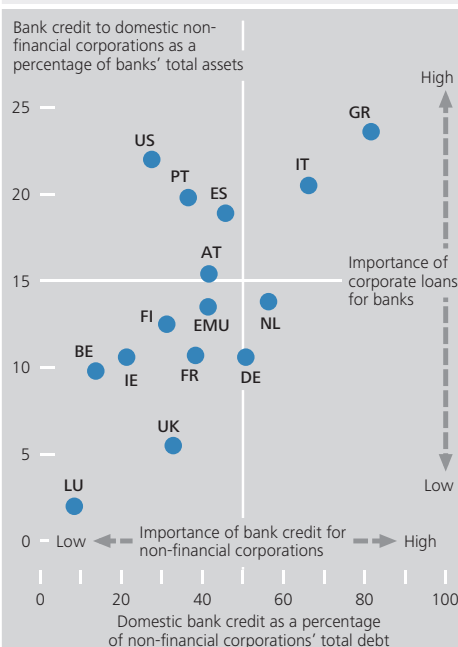
debt finance for non-financial corporations in the euro area. Noteworthy examples include intra-group lending as well as the granting of credit through other financial intermediaries which comprise *inter alia* special purpose vehicles and specialised financing vehicles.⁴ Furthermore, research has found that bank liabilities account for a higher percentage of total debt in the euro area at small and medium-sized enterprises (SMEs) than they do at large firms. However, SMEs likewise procure their debt finance from a wide variety of sources, notably loans from (affiliated) enterprises and trade credits. Looking at SMEs in their entirety, these sources of funding even make up the bulk of their debt financing.⁵ That being said, bank credit can, of course, still be the main source of funding for individual SMEs or in certain segments.

From a credit institution perspective, it can be concluded that loan exposures to domestic non-financial corporations account for a significant percentage of total assets in Italy, Greece, Portugal and Spain, relative to other countries. This percentage is no more than 14% for the euro area as a whole, which would appear low when compared with the figure of 22% for the United States. However, this discrepancy also owes something to differences in the institutional make-up of the euro-area and US banking systems. As a case in point, investment banks in the United States are mostly run as standalone institutions and accordingly, unlike in the euro area, are not consolidated into the commercial banking system.⁶

On the whole, then, the widely held public view that the European financial system is primarily a bank-based one would appear to oversimplify matters. Rather, non-financial corporations procure their external financing from a diversified funding base

Credit ties between non-financial corporations and banks*

%, as at 2014 Q1



Sources: BIS, Eurostat, ECB, Federal Reserve Board and Bundesbank calculations. * Bank credit consists entirely of loans.
 Deutsche Bundesbank

using a variety of debt financing instruments.⁷

⁴ The role of alternative lenders and the shadow banking system in the euro area is discussed in Deutsche Bundesbank, *The shadow banking system in the euro area: overview and monetary policy implications*, Monthly Report, March 2014, pp 15-34.

⁵ See Deutsche Bundesbank, *German enterprises' profitability and financing in 2012*, Monthly Report, December 2013, pp 41-55. These data are available for a restricted group of EU countries in the BACH database of the European Committee of Central Balance-Sheet Data Offices (ECCBSO). For enterprises in Germany see H Friderichs and T Körting (2011), *Die Rolle der Bankkredite im Finanzierungsspektrum der deutschen Wirtschaft*, Wirtschaftsdienst, volume 91, 1, pp 31-38.

⁶ Similarly, the disposal of a significant volume, quantitatively speaking, of mortgage loans granted to households in the course of securitisation business is also likely to have been a factor that diminished commercial banks' aggregate total assets and thus lifted the relative share of loans to non-financial corporations.

⁷ See Eurosystem Working Group (2013), *Corporate finance and economic activity in the euro area*, ECB Occasional Paper, No 151.

Loans of German banks to selected sectors

Seasonally adjusted and adjusted for loan sales and securitisation, end-of-quarter data



1 Year-on-year rate of change. 2 Non-monetary financial corporations. 3 Corporations and quasi-corporations.
 Deutsche Bundesbank

financing are extremely important for enterprises in Germany. In particular, internal financing plays a more prominent role in Germany than in many other euro-area countries (see also the box on pages 36 and 37).

Credit standards for enterprises virtually unchanged

According to the results of the latest BLS round for the third quarter, the corporate lending standards of surveyed institutions remained virtually unchanged on balance across all firm sizes and all maturities. However, institutions tightened their margins, particularly for average loans to large enterprises, and adjusted all other surveyed credit conditions in favour of their borrowers (especially non-interest rate charges, loan covenants and the desired loan maturity). Consequently, there have been no major changes in credit standards, ie changes in the criteria that have to be met by potential borrowers, for more than five years. In the quarter just ended, credit standards remained virtually constant overall due to two opposing effects – the surveyed bank-related factors (in

this case, the financing conditions offered by institutions and their liquidity position) had a slight easing effect, while risk assessment had a marginally restrictive effect on the adjustment of credit standards.

In the third quarter, the survey also contained *ad hoc* questions on the banks' funding situation, the impact of the sovereign debt crisis and participation in TLTROs from 2014 to 2016. The financial institutions reported a slight improvement in their funding environment compared with the previous quarter. They also stated that the sovereign debt crisis was having no more than minor effects on their funding conditions and no effects whatsoever on their lending policy during the reporting quarter. The surveyed institutions showed only a low level of interest in the TLTRO of September 2014. The predominant reason cited for this was that there were no funding constraints. In many cases, the institutions were still uncertain as to whether they would take part in the TLTRO of December 2014 and in the following years, however. Those BLS banks which had already participated in a TLTRO or which are considering doing so in the future intend to use the provided funds chiefly for lending. They anticipate that taking part will lead to a slight improvement in their financial situation, but do not expect any effects on their credit standards.

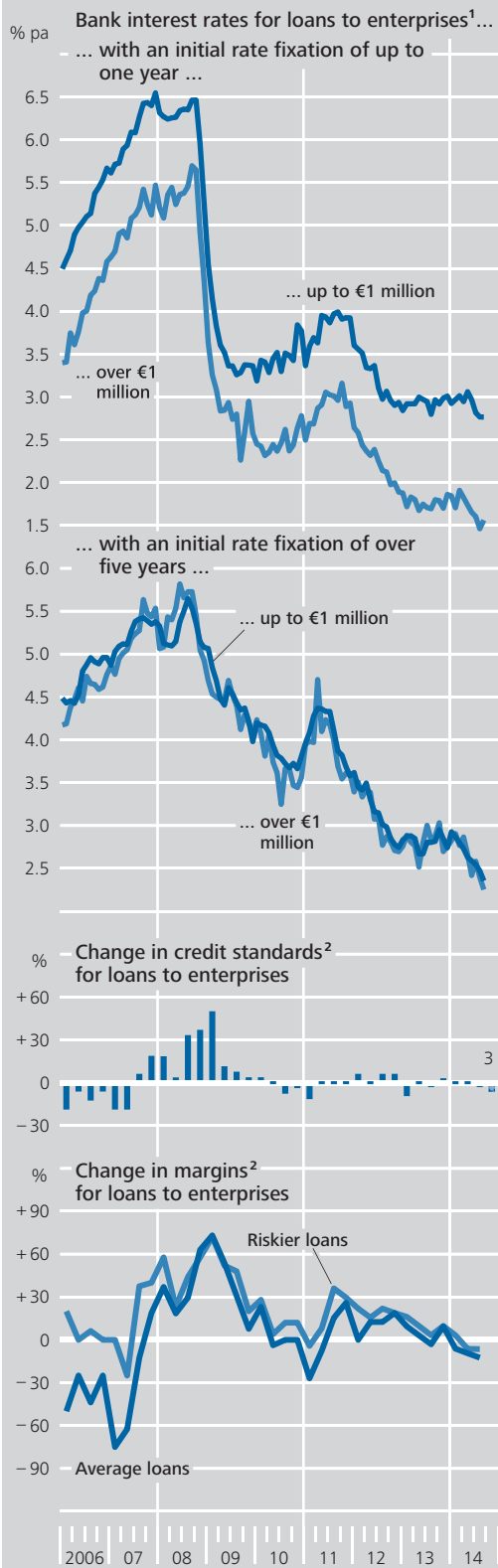
BLS indicates that German banks have relatively little interest in TLTROs

In light of their still very low level, bank lending rates on new business are likely to have supported domestic lending to the private sector. In the third quarter, bank lending rates across all business areas, maturities and volumes largely followed the moderate decline in interest rates in the money and capital markets. For example, the interest rates for small-scale loans to enterprises decreased discernibly, whereas they only fell slightly for large-scale loans. On average, at the end of September, the reporting institutions were charging interest of 2.8% for small-scale and 1.6% for large-scale short-term loans to domestic non-financial corporations. Interest rates on long-term loans to non-financial corporations stood at 2.4% and

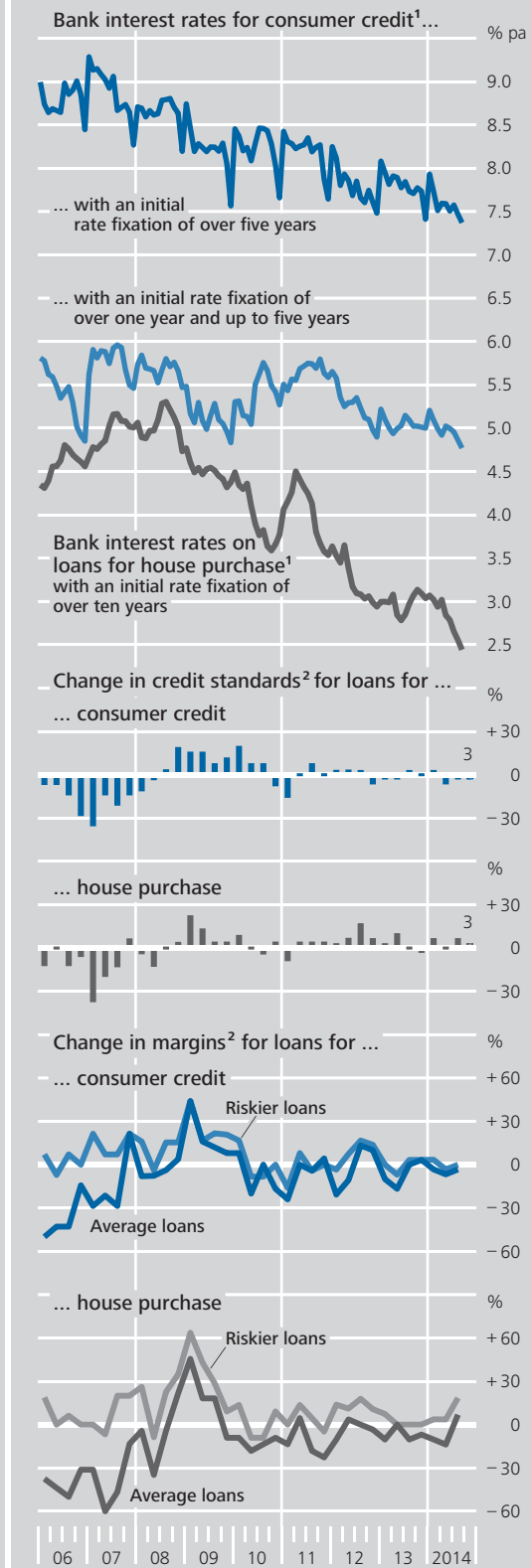
Bank lending rates follow interest rate decline in the capital market

Banking conditions in Germany

Credit to non-financial corporations



Credit to households



1 New business. According to harmonised euro-area MFI interest rate statistics. **2** According to the Bank Lending Survey; for credit standards: difference between the number of respondents reporting "tightened considerably" and "tightened slightly" and the number of respondents reporting "eased somewhat" and "eased considerably" as a percentage of the responses given; for margins: difference between the number of respondents reporting "widened considerably" and "widened slightly" and the number of respondents reporting "narrowed somewhat" and "narrowed considerably" as a percentage of the responses given. **3** Expectations for 2014 Q4.

2.3%, respectively, at the end of the period under review.

Loans to households were also somewhat more favourable in the third quarter. At the end

of September, the interest rate on long-term loans for house purchase stood at 2.4%. Deposits of households and non-financial corporations again almost consistently earned somewhat less interest than in the previous quarter.