

Monetary policy and banking business

Interest rate policy and the money market

On the basis of its regular economic and monetary analyses, the Governing Council of the ECB raised central bank rates by a further $\frac{1}{4}$ percentage point at its meeting on 8 March. Since 14 March, main refinancing operations have been conducted with a minimum bid rate of $3\frac{3}{4}\%$, while interest rates on the marginal lending facility and the deposit facility have been $4\frac{3}{4}\%$ and $2\frac{3}{4}\%$, respectively. In raising interest rates for the seventh time in a row, the Governing Council of the ECB has taken account of the increased risks to price stability and further reduced the expansionary stance of monetary policy.

Interest rate rises in March

Like the previous interest rate hikes, the latest rise in key interest rates, which market participants had been expecting, was also implemented smoothly in the money market. For the most part, the EONIA overnight rate, at which banks trade overnight liquidity, was slightly above the marginal allotment rate in the period under review. The other money market rates increased almost continuously during the period under review, with the effect that the remuneration for 12-month funds was $\frac{1}{2}$ percentage point higher than for overnight money. As a result, the money market yield curve is again around as steep as it was at the start of February when the aforementioned interest rate rise of $\frac{1}{4}$ percentage point in March was expected with high probability by the markets. The three-month forward rates, which also express interest rate expectations, have risen further

Money market rates

Money market management and liquidity needs

In the three maintenance periods between 17 January and 17 April 2007, euro-area credit institutions' need for central bank liquidity determined by autonomous liquidity factors fell by €21.8 billion in net terms. The demand for liquidity from banknotes in circulation declined by €4.7 billion. After the sharp rise around Christmas, the increase in banknotes declined significantly. At €14.9 billion, it was actually greater than in the previous year. By contrast, liquidity needs arising from general government deposits with the Eurosystem rose by a net €3.2 billion. If the net foreign reserves and the other factors are taken together, a move which eliminates liquidity-neutral valuation effects, there is a considerable decline of €20.3 billion in these two categories over the three periods. This was caused both by the continued purchase of euro-denominated financial assets unrelated to monetary policy and also by the disbursements of central bank profits, which have an effect on liquidity, including the Bundesbank profit of around €4.2 billion paid on 13 March.

In the light of the diminishing liquidity needs from autonomous factors, the Eurosystem reduced the volume of its monetary policy operations by €14.5 billion net. There was a shift away from main refinancing operations (MROs), which were reduced by €40.6 billion, towards longer-term refinancing operations (LTROs) with a three-month maturity, which – on average over the three maintenance periods – were topped up by €25.7 billion. This occurred by increasing the volume of the LTROs from €40.0 billion to €50.0 billion each, starting in January 2007. In increasing the LTROs, the Eurosystem's intention was to increase the proportion of LTROs in the overall refinancing volume slightly, notwithstanding the fact that liquidity needs are expected to rise during the remainder of 2007. The change to higher LTRO volumes went smoothly.

Since, on balance, monetary policy operations were reduced by less than the fall in the need for liquidity owing to autonomous factors, credit institutions' average central bank balances rose by €7.3 billion. Credit institutions were therefore comfortably able to meet the minimum reserve requirement, which continued to expand strongly in the period March-April (by 13.1% year-on-year to €179.8 billion).

EONIA stood mostly at 3.57% until the key interest rate rise took effect on 14 March. With the new minimum bid rate of 3.75%, EONIA stood mostly at between 3.81% and 3.83%.

Early in the January-February reserve period, the spread between the EONIA and the minimum bid rate was 7 basis points. The ECB continued its policy of allotting liquidity volumes €1.0 billion above the benchmark in all MROs in each maintenance period. A liquidity surplus at the end of the period led to a narrowing of the EONIA spread to no more than three basis points. After a liquidity-absorbing fine-tuning operation on 13 February worth €2.0 billion, the smallest volume to date, the period ended with an increased EONIA spread of 21 basis points, as market participants had expected a liquidity shortage, despite the fact that the volume of the operation was measured correctly.

However, the EONIA spread was reduced to seven basis points again at the beginning of the subsequent February-March period. On 28 February, the spread increased somewhat – as is usual at the end of the month – amounting to 10 basis points. At the end of the February-March period, however, EONIA was 39 basis points below the old interest

rate. This was caused by underbidding in the liquidity-absorbing fine-tuning operation on 13 March, which was able to absorb only €2.3 billion, not the intended €10.5 billion.

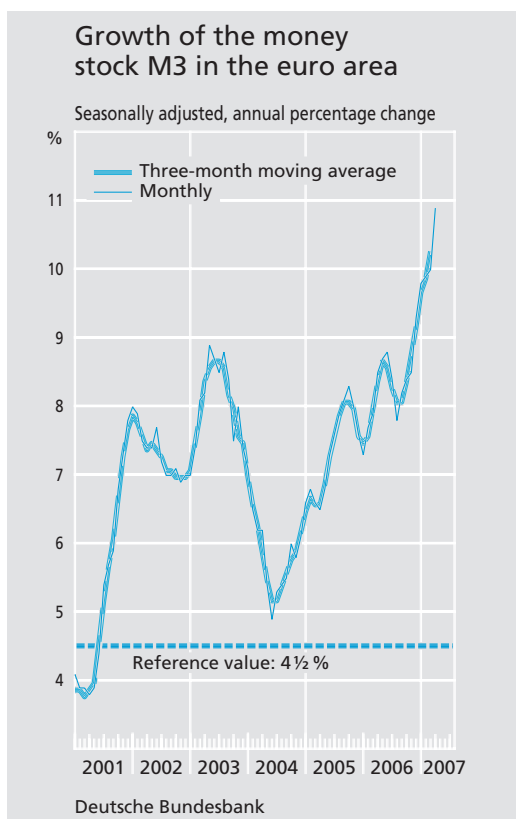
At the start of the March-April reserve period, the EONIA spread was 7 basis points. However, in the two weeks prior to Easter, there was another perceptible widening in the spread to a maximum of 15 basis points by the end of the month (30 March). A fine-tuning operation conducted on 17 April, the last day of the maintenance period saw that the EONIA, at 3.79%, was just 4 basis points above the minimum bid rate. In this fine-tuning operation, the desired volume of €22.5 billion, the largest volume to date, was completely absorbed.

Factors determining bank liquidity ¹

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

Item	2007		
	17 Jan to 13 Feb	14 Feb to 13 Mar	14 Mar to 17 Apr
I Provision (+) or absorption (-) of central bank balances due to changes in autonomous factors			
1 Banknotes in circulation (increase: -)	+ 14.9	- 1.6	- 8.6
2 General government deposits with the Eurosystem (increase: -)	- 2.9	+ 0.8	- 1.1
3 Net foreign reserves ²	- 3.7	- 0.5	+ 2.0
4 Other factors ²	+ 10.4	+ 6.9	+ 5.2
Total	+ 18.7	+ 5.6	- 2.5
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	- 21.8	- 11.8	- 7.0
(b) Longer-term refinancing operations	+ 4.6	+ 10.0	+ 11.1
(c) Other operations	- 0.4	+ 0.6	- 0.1
2 Standing facilities			
(a) Marginal lending facility	- 0.0	- 0.1	+ 0.5
(b) Deposit facility (increase: -)	+ 0.1	- 0.4	+ 0.2
Total	- 17.5	- 1.7	+ 4.7
III Change in credit institutions' current accounts (I + II)	+ 1.2	+ 4.1	+ 2.0
IV Change in the minimum reserve requirement (increase: -)	- 1.5	- 4.0	- 2.1

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.



since the hike in interest rates in March as well. Over a six-month time horizon, market participants are expecting further interest rate increases.

Monetary developments in the euro area

Further acceleration in monetary growth

Monetary growth in the euro area accelerated further in the first quarter of 2007. The monetary aggregate M3 increased at a seasonally adjusted annual rate of 14% in the three months to March, compared with a rate of just over 10% in the three months to December. The M3 components remunerated close to market rates were in particular demand. In addition to short-term time deposits, these comprise money market fund shares and short-term bank debt securities, as

well as repurchase agreements. Whereas the latter two components are held mainly by institutional investors and non-financial corporations, money market fund shares and short-term time deposits are used primarily by households as interest-bearing investments. They have also evidently shifted resources from their short-term savings deposits (with an agreed notice period of up to three months) into these more highly remunerated investments. Households' short-term time deposits were remunerated at between 3.5% and 3.6% in the first quarter.

The private sector's demand for credit in the euro area is still the main driving force behind monetary expansion. After some weakening in the fourth quarter, banks' lending to domestic enterprises and households increased markedly again in the first quarter of 2007. The annualised growth rate amounted to 11½%, compared with just over 8½% in the three months to December 2006. In particular, loans to the private sector were in noticeably greater demand than in the previous quarter. Corporate financing is becoming increasingly important in the euro area, whereas lending for house purchase is tending to become less significant with the slowdown in the housing markets in the various euro-area countries.

Heavy lending to private sector continues

As well as bank lending to domestic private non-banks, net external assets of the credit institutions also increased significantly in the first quarter. This is attributable primarily to inflows of funds to domestic non-banks from payment transactions with non-residents, which result from foreign trade relations and

Very large net inflows of funds from abroad

financial transactions with foreign partners. Furthermore, the euro-area banks sold large amounts of domestic securities from their own holdings to non-resident investors in the first quarter. This is also likely to have contributed to the reduced level of general government debt in the euro area vis-à-vis resident banks during the period under review.

Very large long-term investment of funds with banks continues

The continuing strong monetary capital formation at banks in the euro area put a dampener on monetary expansion in the first quarter, which rose at a seasonally adjusted annual rate of 11½% and thereby even more sharply than in the fourth quarter (just over 9%). However, the acceleration resulted exclusively from a very sharp rise in banks' capital and reserves. Both are assigned to monetary capital on the consolidated balance sheet of the banking system, as they represent a form of long-term provision of funds to the banks. But even excluding these items, monetary capital formation of euro-area credit institutions continued to rise sharply.

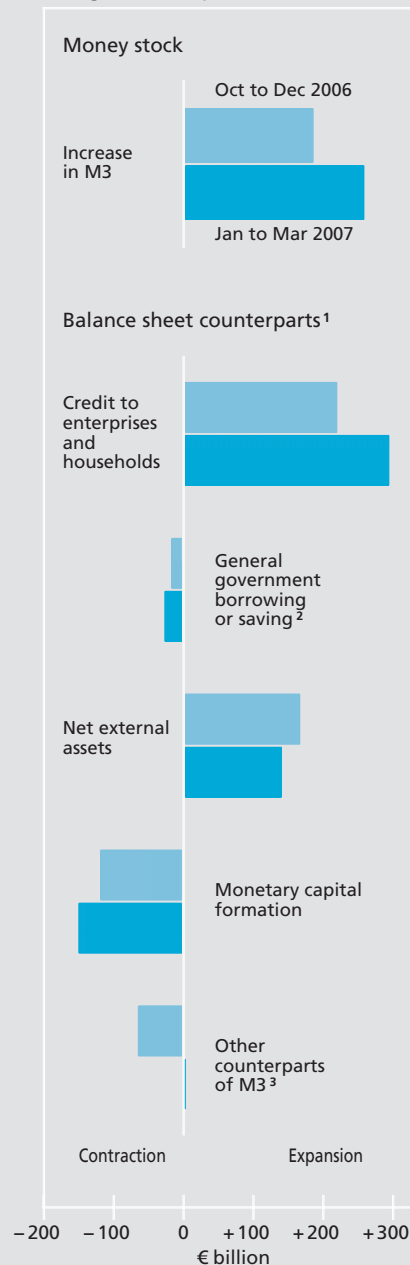
Deposit and lending business of German banks with domestic customers

Increase in shorter-term bank deposits

Credit and deposit growth was much weaker in Germany in the first quarter of 2007 than in the euro area as a whole. German investors built up their deposits (excluding repurchase agreements) with domestic banks at a seasonally adjusted annual rate of 3½%. In the euro area, the comparable rate was 10%. Irrespective of the different underlying rates in Germany and the euro area, however, domestic investors also preferred short-term

Euro-area M3 and its balance sheet counterparts

€ billion, seasonally adjusted change over the period indicated



1 Changes in balance sheet counterparts are shown in terms of whether they expand (+) or contract (-) the money stock. — 2 Bank loans to general government less euro-area central government deposits with MFIs and holdings of securities issued by the MFI sector. — 3 Calculated as a residual of the other items of the consolidated balance sheet of the MFI sector.

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

€ billion

Item	2007	2006
	Jan to Mar	Jan to Mar
Deposits of domestic non-MFIs 1		
Overnight	+ 0.2	+ 5.3
With agreed maturities		
of up to 2 years	+ 14.3	+ 4.2
of over 2 years	+ 2.7	+ 8.8
Redeemable at agreed notice		
of up to 3 months	- 13.3	- 3.7
of over 3 months	+ 5.3	+ 1.7
Lending		
to domestic enterprises and households		
Unsecuritised	+ 19.9	+ 21.6
Securitised	+ 4.6	+ 20.5
to domestic government		
Unsecuritised	- 11.0	- 7.6
Securitised	+ 7.1	- 2.4

* 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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bank deposits, particularly short-term time deposits. They evidently benefited from their remuneration at market rates, reflected in bank interest rates of between 3.5% and 4.1% at the end of the period under review. As in the case of euro aggregates, there were clearly also shifts away from savings deposits with a notice period of three months, the remuneration of which, at 2.3%, was significantly lower at the end of the period under review. Overnight deposits, some of which are also non-interest-bearing, were also built up only slightly.

*Increase in
 longer-term
 savings deposits*

The increase in German investors' longer-term bank deposits was limited to savings deposits redeemable at notice of over three months, which rose at a seasonally adjusted annual rate of just under 23% in the three

months to March. Shifts away from lower-interest short-term savings deposits are also likely to have been a factor.

Institutions active in the German market recorded a marked upturn in lending to domestic private non-banks after the turn of the year. Unsecuritised bank lending rose by a seasonally adjusted and annualised rate of 4½% in the first quarter. There was an increase in demand for financial resources at domestic banks, particularly from non-financial enterprises. However, borrowing by other financial intermediaries as part of security lending transactions with German banks also contributed to the increase in lending. Finally, insurance companies also stepped up their borrowing from German banks. By contrast, households' demand for housing loans fell in the first quarter, after the anticipatory effects on the demand for housing construction resulting from the abolition of the grant to homebuyers and the increase in VAT had petered out at the beginning of this year.

*Marked
 increase
 in lending*

According to the results of the Bank Lending Survey for Germany, the banks promoted domestic credit growth by further relaxing their credit standards both for business and private customers¹, with the result that credit supply conditions evolved more expansionary than in the euro area overall. According to this information, the relaxation can be attributed mainly to the increase in competitive pressure in lending, as well as to the improved general

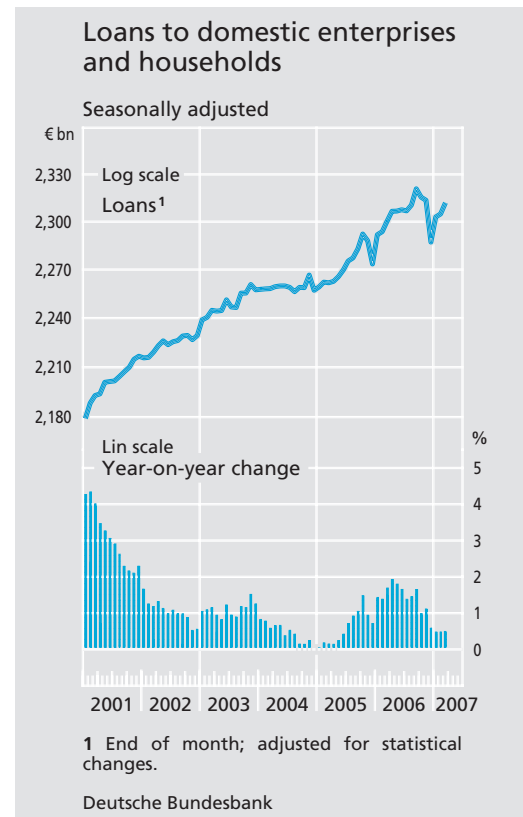
*Clear relaxation
 of credit supply
 conditions*

¹ The aggregate survey results for Germany can be viewed at http://www.bundesbank.de/volkswirtschaft/vo_veroeffentlichungen.en.php

economic outlook. As well as the easing of credit standards, the margins for average loans were significantly lowered, particularly in the area of loans to enterprises, whereas the margins on riskier loans remained largely unchanged. Survey participants are expecting a further relaxation of credit supply conditions in the second quarter.

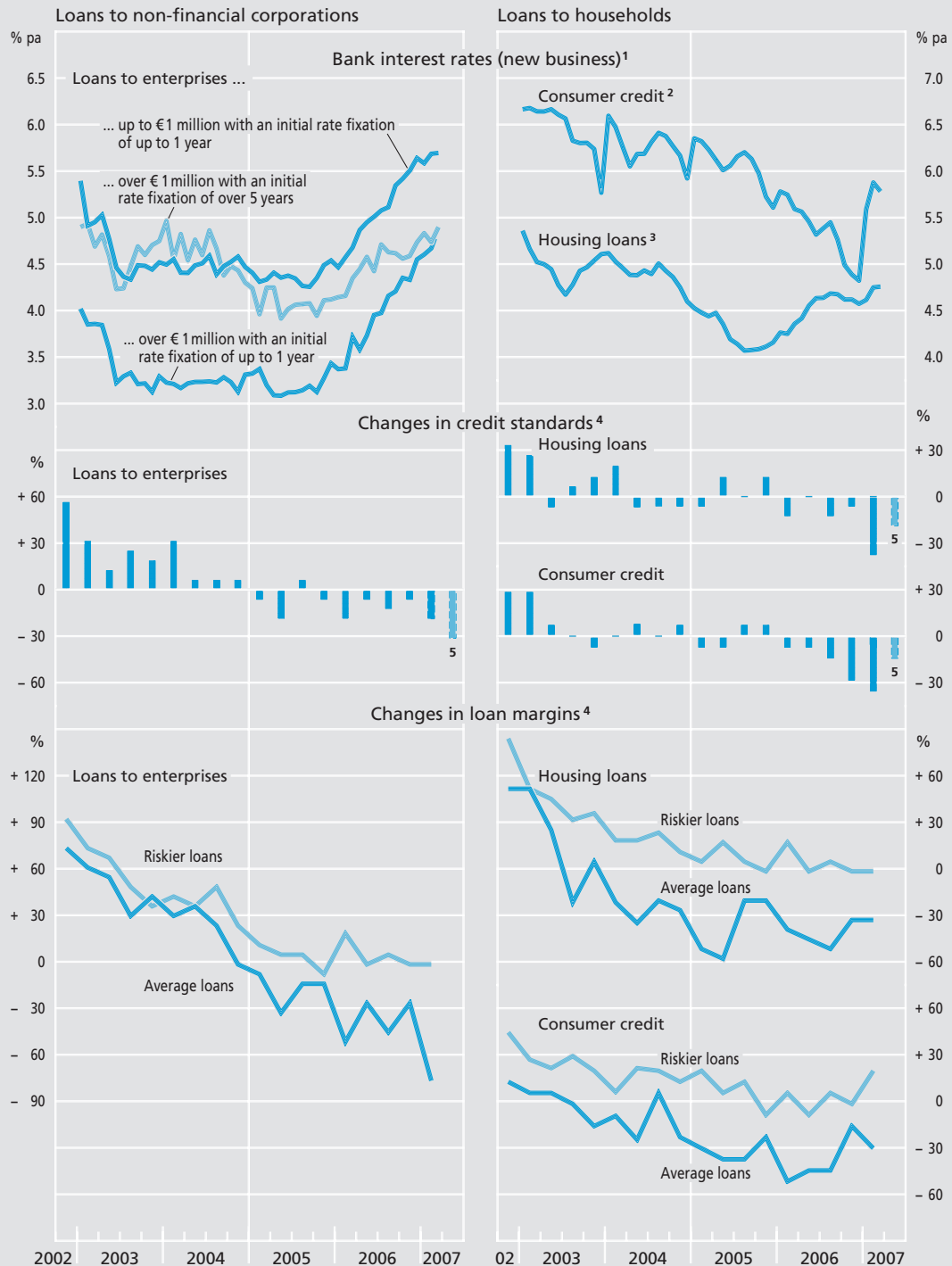
*Nearly all
lending rates
up*

All in all, in their lending business, German credit institutions tended, through their terms and conditions, to pass on to customers the higher refinancing costs resulting from the increased money and capital market interest rates in the first quarter. For example, institutions were demanding between 4.9% and 5.7% for short-term loans to enterprises at the end of March 2007. The equivalent rates for long-term loans to enterprises were between 4.9% and 5.1%, which is equivalent to a rise of around 15 basis points on December 2006. The rates for housing loans rose somewhat more sharply. They



went up by 20 basis points for housing loans with a rate fixation of over ten years, to 4.8%.

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 Q2.

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