

Monetary policy and banking business

Interest rate policy and the money market

Given increased risks for price stability and a tendency towards rising inflation expectations, in early July the Governing Council of the ECB decided to tighten the reins of monetary policy somewhat and therefore raised each of the Eurosystem's central bank rates by $\frac{1}{4}$ percentage point. The minimum bid rate for the Eurosystem's main refinancing operations in the form of variable rate tenders has since stood at 4.25%. The credit institutions will now have to pay 5.25% to use the marginal refinancing facility, while credit balances under the deposit facility are remunerated at 3.25%. The money market rates increased correspondingly in July. Apart from transient and short-lived fluctuations towards the end of the month, the EONIA overnight rate stood at around 4.3% compared with around 4% in the preceding months. The longer-term money market rates had risen already in June in anticipation of the ECB Governing Council's interest rate adjustment in early July. On average, the three-month rates, at just under 5%, were up around 0.1 percentage point on the month in June. In the run-up to the latest interest rate decision, further interest rate hikes were factored into forward rate agreements up to the end of this year and further beyond. These expectations have already receded, however.

ECB Governing Council increases each key interest rate by $\frac{1}{4}$ percentage point

As earlier, the rates for uncollateralised three-month money and for longer-term money still contain high premiums over comparable collateralised loans. Even a year after the onset of the financial market turmoil in August 2007, the situation in the euro money

Risk premiums on money market down

Money market management and liquidity needs

During the three reserve maintenance periods from 16 April 2008 to 8 July 2008, euro-area credit institutions' need for central bank liquidity determined by autonomous liquidity factors fell by €6.8 billion in net terms. Although banknotes in circulation rose sharply, as is usual for the time of year, by a total of €15.5 billion, the overall liquidity needs were reduced throughout the reporting period owing to the development of the remaining autonomous factors, with general government deposits with the Eurosystem falling by a net total of €5.3 billion. In addition, if the net foreign reserves and the other factors are taken together, a move which eliminates liquidity-neutral valuation effects, an additional decline in the liquidity needs of €17.0 billion is apparent. This was caused particularly by the sharp rise in net foreign reserves. The increase in the minimum reserve requirement caused the demand for central bank liquidity to rise by a total of €4.9 billion.

In the three reserve maintenance periods during the reporting period, the Eurosystem continued its policy, introduced in August 2007, of providing ample liquidity to credit institutions in order to enable the money markets to function with a minimum of friction and to hold the EONIA close to the minimum bid rate. To this end, the Eurosystem continued to give institutions the opportunity to fulfil their minimum reserve requirements at an early stage within the reserve maintenance periods. However, overall, no more liquidity was provided than the amount necessary to enable banks to exactly meet their reserve requirements. With regard to the maturity of monetary policy operations, the percentage of longer-term operations fell slightly on balance in the three reserve maintenance periods during the reporting period. Although two supplementary three-month refinancing operations were renewed, at the same time the intended operation volume for both of these special tenders was reduced by €10.0 billion.

In the first main refinancing operation (MRO) of the April-May maintenance period, the ECB allotted credit institutions €35.0 billion more than the calculative liquidity need (i.e. the benchmark), thereby providing them with a generous supply of liquidity. In the subsequent MROs of the period, the ECB continued this policy, albeit progressively reducing the auctioned amounts above the benchmark to €4.0 billion in the last MRO. In that particular maintenance period, the EONIA was somewhat more volatile; on most days, it was within a band of 10 basis points on either side of the 4.00% minimum bid rate. The April end-of-month effect and the abundance of liquidity at the end of the maintenance period caused a respective increase to 4.21% and decrease to 3.73% in the EONIA. However, a liquidity-absorbing fine-tuning operation of €23.5

billion on the last day of the period led to this maintenance period closing with an EONIA fixing of 4.00%.

In the subsequent May-June maintenance period, the ECB stayed on its chosen track and continued to allot abundant liquidity above the benchmark in its MROs, albeit in successively smaller excess amounts. The ECB progressively reduced the above-benchmark allotments from €25.0 billion in the first MRO of the period to €3.5 billion in the last. From having been fixed very close to the minimum bid rate at the beginning of the period, the EONIA gradually climbed to 4.11% by the end of May. In early June, however, the EONIA spread (the difference between the EONIA and the minimum bid rate) fell back down, totalling not more than four basis points in the subsequent days. It was only on the last day of the maintenance period that the EONIA once again went up to 4.18%, although a liquidity-absorbing fine-tuning operation conducted by the ECB of €14.0 billion had the proper volume and this desired volume was absorbed completely.

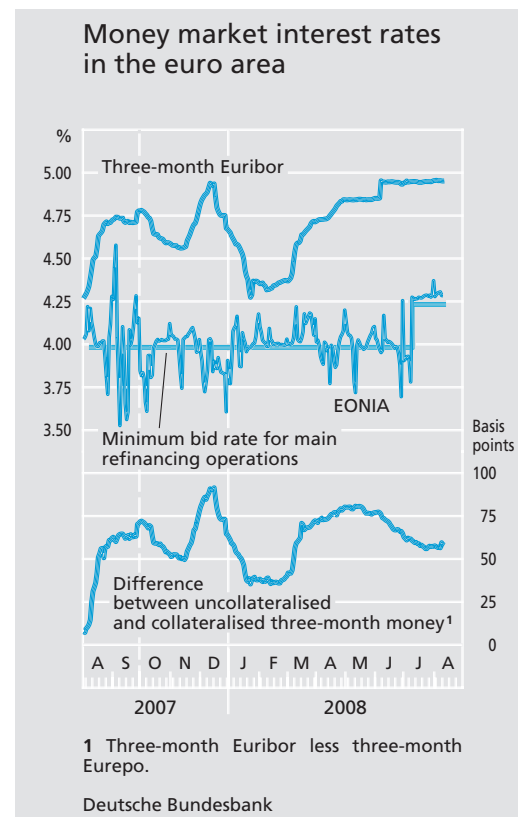
The end-of-semester provision of liquidity to credit institutions was the focal point of the June-July maintenance period. In its announcement of the first MRO of the period on 9 June, the ECB stated that it "continues to closely monitor liquidity conditions and notes some tensions in money market rates for maturities over the end-of-semester", and that it "remains ready, if needed, to smooth conditions around the end-of-semester". The ECB accordingly allotted €20 billion above the benchmark in each of the first two MROs. During this period, the EONIA spread was not more than four basis points. In the third MRO of the maintenance period, which covered the end of the semester, the ECB increased the above-benchmark amount to €35.0 billion in order to ensure an ample supply of liquidity at the end of the month and the semester simultaneously. Owing to the abundance of liquidity, EONIA initially fell distinctly to rates of 3.71% before then going back up to 4.27% on the last day of the month. At the beginning of July, the EONIA once again fell to eight basis points below the minimum bid rate and held firm at this level on nearly all the remaining days in the reserve period. It was only on the last day of the period in which the EONIA once again fell somewhat more sharply, to 3.79%, after the intended volume of €21.0 billion had been underbid by €6.4 billion during a liquidity-absorbing fine-tuning operation.

In the first MRO of the July-August maintenance period, the minimum bid rate of 4.25% adopted at the 3 July meeting of the Governing Council of the ECB took effect for the first time.

markets has not returned to normal. In the past few months, however, the situation has eased slightly. Unlike during the first quarter of 2008, which had still been dominated by negative reports on European and US banks, some credit institutions initially issued surprisingly positive news during the second quarter. The risk premium on uncollateralised three-month money, which more than doubled by 0.4 percentage point to just over 0.8 percentage point between mid-February and mid-May, subsequently shrank again distinctly. Even the publication of news in July of the difficulties encountered by two major US mortgage financing agencies did not cause this interest rate differential to increase any further. The yield spread between the uncollateralised three-month Euribor and the collateralised Eurepo of the same maturity is currently just under 0.6 percentage point. This makes it, however, still much higher than its long-term average prior to the onset of tension on the money markets (0.06 percentage point). It must be noted, however, that this interest rate spread is probably of only limited value for assessing risk in the money market given that interbank market turnover has been small.

Unchanged orientation of liquidity policy measures ...

The distinct decline in the gap between the marginal allotment rate and the minimum bid rate for main refinancing operations (MROs) can be regarded as a further cautious signal of an easing of the tensions in the euro money market. This differential, after having stood at up to 25 basis points prior to the meeting of the ECB Governing Council in June, subsequently fell to below 10 basis points before then stabilising somewhat



above that level as this report went to press. Generous liquidity allotments during MROs once again gave credit institutions the option to fulfil their minimum reserve requirements at an early stage in the minimum reserve maintenance period (frontloading). In addition, the Eurosystem continued to fulfil banks' requests for longer-term liquidity and, alongside the additional three-month refinancing operations, once again conducted a six-month operation in July.¹ At the end of the reserve maintenance period, the Eurosystem disposed of surplus liquidity through liquidity-absorbing fine-tuning operations; therefore, on average over the minimum reserve period,

¹ The ECB also once again provided US dollar-denominated liquidity under a Term Auction Facility. In early August, an 84-day operation was also conducted for the first time (in addition to the 28-day operation).

Factors determining bank liquidity *

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

Item	2008		
	16 April to 13 May	14 May to 10 June	11 June to 8 July
I Provision (+) or absorption (-) of central bank balances due to changes in autonomous factors			
1 Banknotes in circulation (increase: -)	- 5.9	- 3.8	- 5.8
2 General government deposits with the Eurosystem (increase: -)	+ 1.3	+ 1.6	+ 2.4
3 Net foreign reserves ¹	+ 15.4	+ 10.5	+ 1.4
4 Other factors ¹	- 16.3	- 0.8	+ 6.8
Total	- 5.5	+ 7.5	+ 4.8
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	- 7.1	- 1.6	+ 12.6
(b) Longer-term refinancing operations	+ 16.4	- 7.1	- 12.5
(c) Other operations	- 3.0	+ 0.3	- 0.0
2 Standing facilities			
(a) Marginal lending facility	- 0.0	+ 0.2	- 0.2
(b) Deposit facility (increase: -)	+ 0.3	+ 0.1	- 0.2
Total	+ 6.6	- 8.1	- 0.3
III Change in credit institutions' current accounts (I + II)	+ 1.1	- 0.5	+ 4.6
IV Change in the minimum reserve requirement (increase: -)	- 0.9	+ 0.5	- 4.5

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

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no more liquidity was provided than that necessary to meet reserve requirements.

On average, the overnight interest rate in the European interbank market (the EONIA) was also successfully stabilised during the reporting period at a rate close to the minimum bid rate for MROs. However, the EONIA still remained highly volatile up until the first MRO after the increase in the key monetary policy interest rates. Since then, however, interest rate fluctuations have receded back to the usual levels prior to the onset of the money market turmoil.

*... continued
to stabilise the
overnight rate*

Monetary developments in the euro area

Euro-area money holdings rose again sharply in the second quarter of 2008. The broad monetary aggregate M3 grew at a seasonally adjusted and annualised rate of just under 8% compared with 7% in the first quarter. As in the preceding quarter, it was primarily the components remunerated close to market rates which increased. The reporting period saw a rise in deposits with an agreed maturity of up to two years, which for some time now have been popular not just among households but also among non-financial enterprises, and in repo transactions. This investment form, which is economically comparable to a securitised bank deposit, has been traditionally preferred by other non-bank financial intermediaries. Increases in higher-yielding investment forms were accompanied to a greater extent than in earlier quarters by portfolio shifts away from less well-remunerated but more liquid M3 components, with

*Strong
monetary
growth
continues*

Open market operations of the Eurosystem *

Value date	Type of transaction 1	Maturity in days	Actual allotment in € billion	Deviation from the benchmark in € billion	Marginal rate/fixed rate %	Allotment ratio %	Weighted rate %	Cover ratio 2	Number of bidders
16.04.08	MRO	7	204.5	35.0	4.21	13.91	4.26	1.22	310
23.04.08	MRO	7	173.0	20.0	4.21	67.67	4.25	1.26	302
30.04.08	MRO	7	170.0	20.0	4.26	76.18	4.29	1.46	316
02.05.08	LTRO	90	50.0	–	4.67	59.49	4.75	2.02	177
07.05.08	MRO	7	150.0	4.0	4.26	79.83	4.29	1.53	304
13.05.08	FTO (–)	1	–23.5	–	4.00	72.39	–	1.38	29
14.05.08	MRO	7	191.5	25.0	4.18	40.52	4.26	1.09	287
21.05.08	MRO	7	176.5	18.0	4.15	78.94	4.22	1.15	326
22.05.08	S-LTRO	84	50.0	–	4.50	92.66	4.68	1.73	138
28.05.08	MRO	7	170.0	15.0	4.19	56.47	4.23	1.32	330
29.05.08	LTRO	91	50.0	–	4.51	63.41	4.62	1.95	171
04.06.08	MRO	7	153.0	3.5	4.17	28.70	4.22	1.37	516
10.06.08	FTO (–)	1	–14.0	–	4.00	75.66	–	1.32	15
11.06.08	MRO	7	191.0	20.0	4.03	57.92	4.18	1.06	343
12.06.08	S-LTRO	91	50.0	–	4.60	72.62	4.72	2.00	128
18.06.08	MRO	7	188.0	20.0	4.03	28.65	4.13	1.19	425
25.06.08	MRO	7	208.0	35.0	4.07	47.34	4.25	1.17	439
26.06.08	LTRO	91	50.0	–	4.50	40.26	4.67	1.80	174
02.07.08	MRO	7	154.5	3.0	4.10	64.53	4.15	1.65	433
08.07.08	FTO (–)	1	–14.6	–	4.00	100.00	–	1.00	12

* For more information on the Eurosystem's operations from 16 January 2008 to 15 April 2008, see Deutsche Bundesbank, Monthly Report, May 2008, p 29. — 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). — 2 Ratio of total bids to the allotment amount.

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not just short-term savings deposits but also overnight deposits being reduced during the reporting period. The latter caused the M1 money stock, which comprises not just overnight money but also currency in circulation, which had grown further, to fall from April to June by a seasonally adjusted and annualised rate of 1.7%.

Strong loan dynamics...

The strong growth of M3 was fostered anew by a sizeable expansion of credit to the private sector. Although borrowing by enterprises and individuals weakened, especially compared with the second half of 2007, loans to the private sector once again rose visibly, at a seasonally adjusted and annualised rate of just over 7%. This is all the more striking considering that, in June, loan securitisations led to extensive selling of loans to

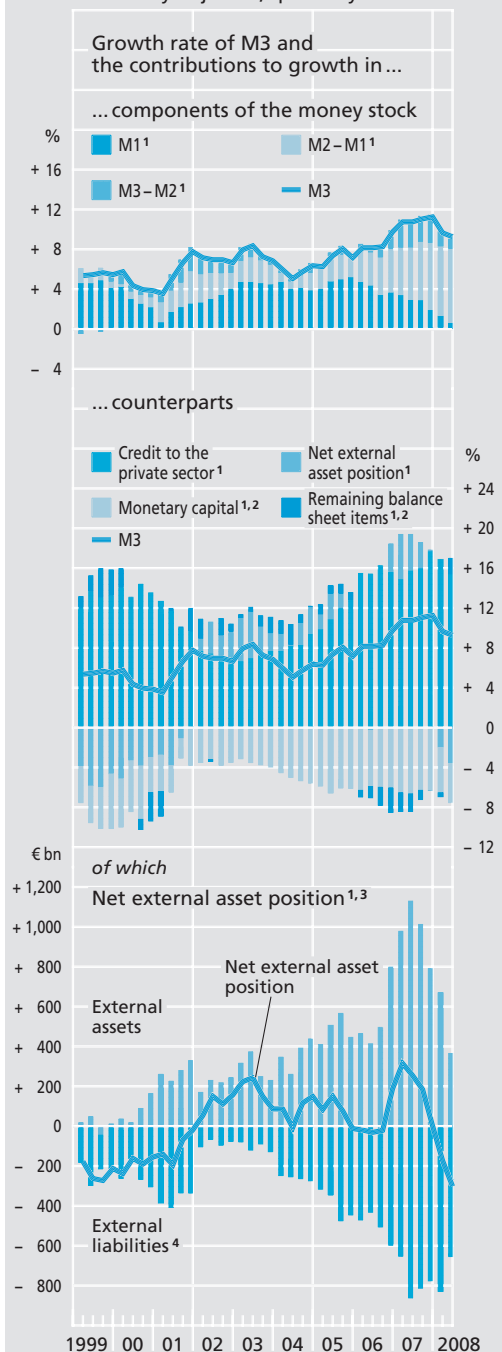
non-bank financial intermediaries, which in isolation caused those banks' reported stocks of loans to the private sector to decline by around ¼%, with the amount of funds provided to the relevant borrowers remaining constant.

The unabated strong loan dynamics in the euro area were supported once again by non-financial enterprises' borrowing. However, the further tightening of credit standards in the second quarter, the renewed rise in bank lending rates and the imminent economic downturn in the euro area are likely, in future, to put a damper on enterprises' willingness to borrow additional funds from banks. Loan dynamics have already fallen in those countries which had until recently shown particularly high rates of expansion; for the euro area ex-

... especially owing to heavy demand among non-financial enterprises

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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cluding Germany, the annual growth rate of loans to non-financial enterprises last stood at 14.7% after a record high of 16.6% in March.

By contrast, the growth of bank lending to households was sluggish as this report went to press; this was, however, due not only to the visibly slumping real-estate markets in some euro-area countries but also to extensive securitisation. Growth of loans to households for house purchase, which are a prime target for securitisation, stood at a mere annualised rate of 4.4% at the end of June; at the end of March, the 12-month rate had been as high as 6.1%. This was mirrored by a strong increase in credit institutions' seasonally adjusted holdings of fixed-income securities issued by the private sector in the quarter under review since the banks took on the newly created instruments in their books. Banks' holdings of government bonds, by contrast, stagnated, whereas institutions visibly increased their loans to euro-area public sector entities. Taken together, euro-area banks' lending to domestic public-sector entities therefore was up again noticeably for the first time since the end of 2006 – by an annualised rate of 4% in the second quarter.

Extensive securitisation, especially of housing loans

Monetary capital formation in the euro area was up noticeably in the second quarter from the first quarter of 2008 yet, in a long-term comparison, remained muted during the reporting period. In the period under review, the seasonally adjusted and annualised growth rate still managed to return to 5% after having dwindled just below the 2% mark in the January-March period. Among

Demand for banks' longer-term liabilities up slightly of late

the components of monetary capital formation, longer-term time deposits (with an agreed maturity of over two years) and longer-term bank debt securities grew visibly again, unlike in the previous quarter.

Large outflows of funds to foreign countries

In the second quarter of 2008, too, the euro-area non-bank sector, on balance, was a net sender of large amounts of funds to foreign countries. The attendant drop in the net external asset position of euro-area banks, in isolation, dampened euro-area monetary growth, as in the first three months of the year.

Inflation risks remain from monetary perspective

The risks to medium and long-term price developments in the euro area resulting from monetary developments remain high. Although the sharp monetary growth has tailed off from its 2007 levels, the longer-term inflation forecasts based on monetary variables remain well above the level that is associated with price stability by the Governing Council of the ECB. This verdict also holds if one considers that the price risks emanating from monetary developments might have been distorted upwards by the financial market turmoil. Monetary policy has the job of ensuring that the higher price risks do not lead to permanently higher inflation rates.

Deposit and lending business of German banks with domestic customers

Growth rate of short-term bank deposits subsiding

Monetary developments in Germany have been marked by varying trends in banks' lending and deposit business. Whereas institutions active in the German market once

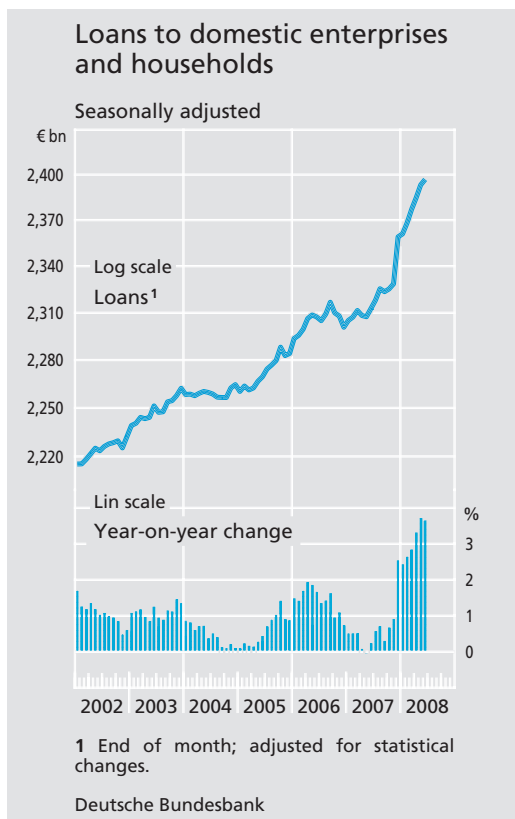
Lending and deposits of monetary financial institutions (MFIs) in Germany *

€ billion		
Item	2008	2007
	April to June	April to June
Deposits of domestic non-MFIs ¹		
Overnight	- 1.4	+ 13.7
With agreed maturities of up to 2 years	+ 37.6	+ 36.0
of over 2 years	+ 0.7	+ 5.5
Redeemable at agreed notice of up to 3 months	- 6.8	- 12.4
of over 3 months	- 3.5	+ 0.6
Lending to domestic enterprises and households		
Unsecuritised	+ 18.8	+ 1.2
Securitised	- 5.5	- 16.9
to domestic government		
Unsecuritised	- 1.7	- 6.8
Securitised	- 6.4	- 4.2

* 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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again saw relatively lively credit demand from the corporate sector, their deposit business growth subsided distinctly. The seasonally adjusted and annualised growth rate of domestic non-banks' deposits with domestic credit institutions fell in the second quarter of 2008 to 2½% following just over 4% in the previous quarter. Short-term bank deposits, which in the first quarter still managed to grow at a seasonally adjusted annual rate of 6½%, saw their growth in the April-June period fall to merely just under 4½%. In the month under review the only net additions were in short-term time deposits (with an agreed maturity of up to two years), whereas overnight deposits and short-term savings deposits (redeemable at notice of up to three months) were, in some cases, reduced noticeably. Shifts within short-term bank deposits, espe-



cially by households, were also a contributory factor. This was also the case with those banks that traditionally remunerate overnight money at relatively near-market rates.

On the whole, longer-term bank deposits were reduced in the second quarter, a development which is probably attributable mainly to the very flat or even inverted yield curve in the reporting months. Although longer-term savings deposits (redeemable at notice of over three months) only grew at a seasonally adjusted and annualised rate of 8% in the reporting quarter, following just under 11% in the previous quarter, at the same time the growth of the quantitatively much more important longer-term time deposits (with an agreed maturity of over two years) continued its slide. The second-quarter growth of these

Renewed reduction in longer-term bank deposits

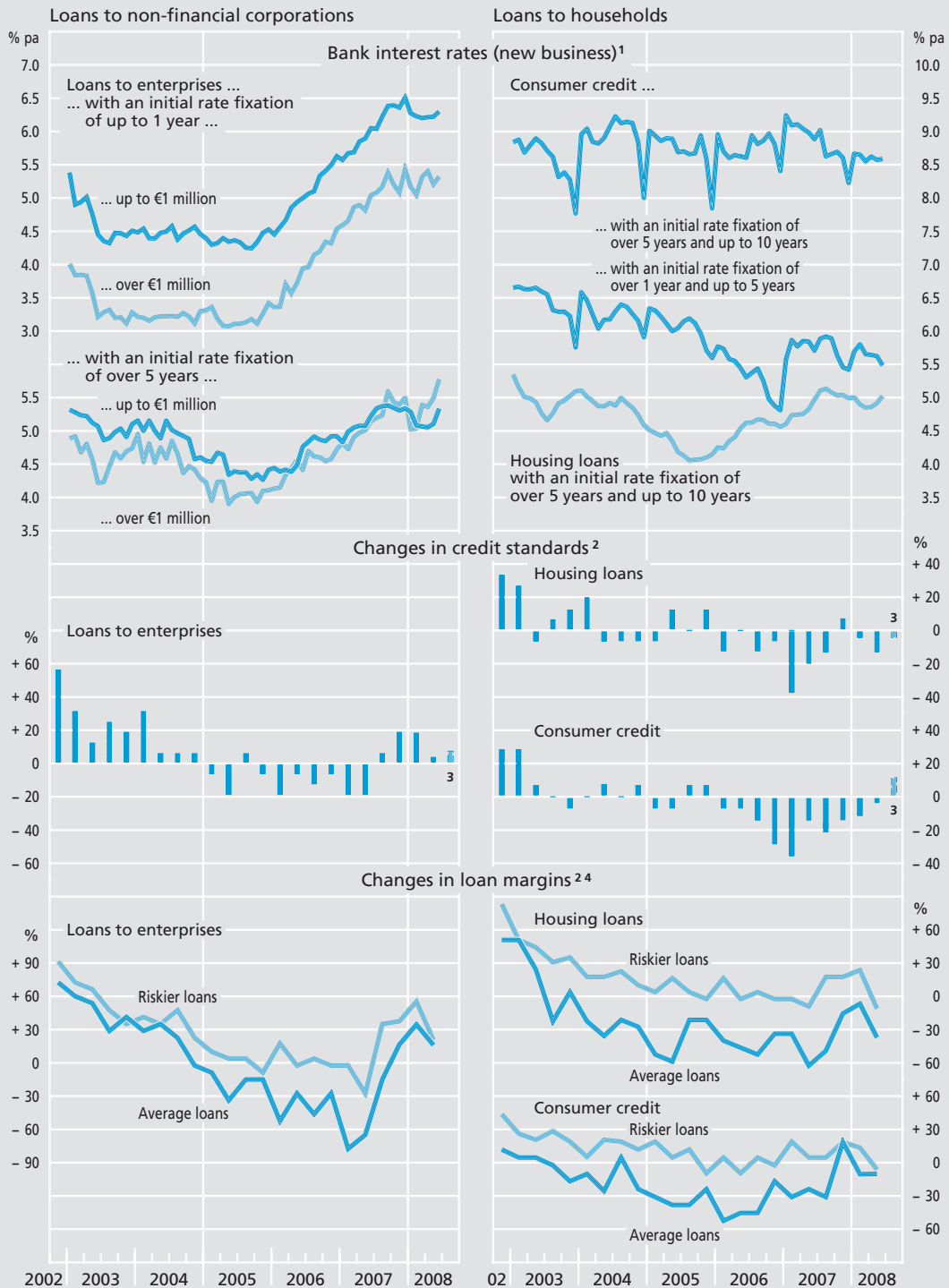
deposits was a paltry seasonally adjusted annual rate of just under ½%. It was particularly insurance companies, traditionally the most significant group of holders, which grew their longer-term time deposits visibly less extensively than over the same time period of the preceding years.

Banks' lending to their domestic private customers once again grew strongly in the second quarter of 2008 following years of stagnation up until the autumn of last year. Although lending to domestic enterprises and households only grew at a seasonally adjusted, annualised rate of just over 3½%, loans to non-financial enterprises again experienced particularly dynamic growth. Lending to other financial intermediaries likewise grew strongly of late, a development due particularly to large volumes of reverse repos. The situation was different for households, which once again were reluctant to borrow additional funds from domestic banks. On balance, housing loans were even reduced slightly. This also impacted on the maturity structure of lending to the private sector. Whereas longer-term unsecured lending, in which housing loans feature heavily, grew at a seasonally adjusted and annualised rate of only 1½% during the period under review, the annualised growth rate of short-term loans stood at just under 16% in the second quarter.

Further increase in loans to private sector

In addition to loans, domestic banks increased their holdings of securities issued by domestic private sector entities at a seasonally adjusted annual rate of 6½%. By contrast, they reduced their net holdings of domestic

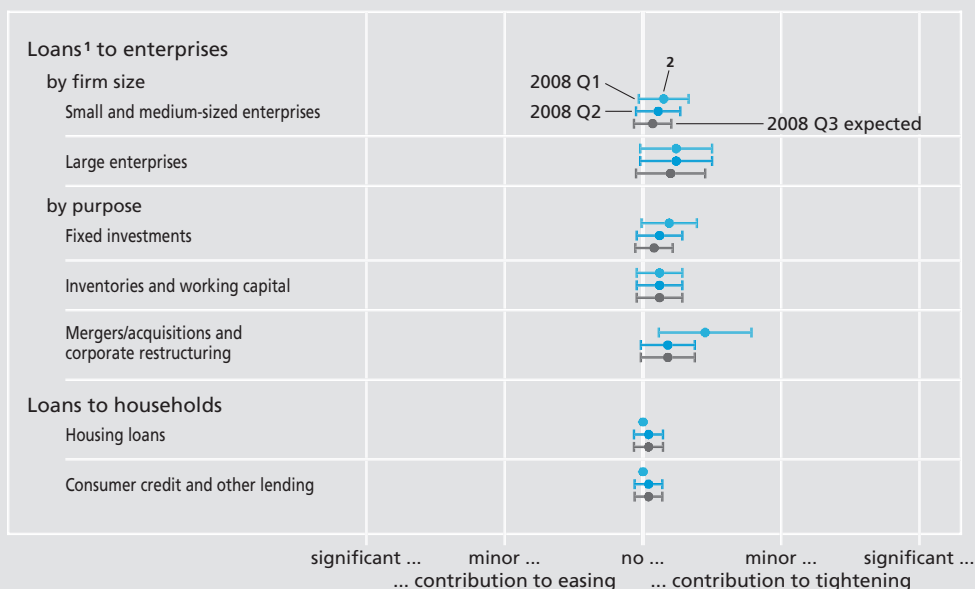
Banking conditions in Germany



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 2008 Q3. — ⁴ Reduced scale.

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Effects of financial market turbulence on credit standards*



* Selected results of the quarterly Bank Lending Survey for Germany. Full survey results can be viewed at www.bundesbank.de/volkswirtschaft/vo_veroeffentlichungen.en.php. — 1 Including credit lines. — 2 ● = mean; — = the range shown includes one standard deviation.

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public sector securities. They elected instead to increase their loans to domestic central, state and local government slightly for the first time in three years.

According to the Bank Lending Survey (BLS) results for Germany, the expansionary trend in domestic lending to the private sector has also been supported by the surveyed banks' lending behaviour. Despite the persistent tension in the money and credit markets during the quarter under review, institutions left their standards in commercial banking business, on the whole, virtually unchanged. However, they perceptibly grew their margins in this area of business – albeit at a significantly slower pace than in the preceding quarter. All in all, they were once again visibly less restrictive than those in other euro-area

countries in how they adjusted their credit conditions. This applied to lending to households for house purchase and consumption purposes – for which German BLS banks, by their own account, largely even eased their lending conditions – much more strongly than it did to commercial banking business.

As has already been the case since the third quarter of last year, the round of surveys for the second quarter of 2008 contained some additional questions on the isolated impact of the financial market turmoil on the participating banks' lending policies. The respondents stated that the tension once again failed to have a noticeable impact on the terms and conditions for loans to households. In lending to enterprises, however, the survey revealed that, during the quarter under review as well,

Credit standards relatively unchanged

the surveyed banks' problems in refinancing in the money and capital markets tended to contribute to stricter credit standards.

Bank lending rates increased in second quarter of 2008

Bank lending rates for lending business with non-banks largely rose during the quarter under report in connection with the development of banks' refinancing costs across all

maturity bands. This was especially the case with longer-term lending to households and enterprises as a result of capital market rates going back up after bottoming out in spring. Consumer loans, for which the German BLS banks have been reporting persistently high competitive pressure for quite a long time already, are the sole exception.