

## Monetary policy and banking business

### Interest rate policy and the money market

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After having initially left the Eurosystem's key interest rates unchanged at their historically low levels over the autumn months, the ECB Governing Council decided at its meeting in early December to raise rates by a quarter percentage point. Accordingly, since 6 December 2005 the main refinancing operations have been conducted as variable rate tenders with a minimum bid rate of 2¼%, the interest rate for the marginal lending facility is 3¼% and 1¼% for the deposit facility. This adjustment had become necessary following an increase in inflation risks during recent months. This had been indicated by the acceleration in monetary and credit growth over quite some time. In the last few months, however, non-monetary indicators – used in economic analysis to assess price risks – have also pointed to stability risks.

*Interest rate  
change in  
December*

For the most part, the ECB Governing Council's somewhat less expansionary policy was able to be implemented smoothly and reliably, apart from the usual short-term fluctuations at year-end and the end of the reserve maintenance periods. The EONIA overnight rate was generally quite close to the minimum bid rate in the main refinancing operations. This may also be attributable to the new monetary policy framework introduced in March 2004 which largely prevents market participants' expectations regarding impending interest rate changes from affecting conditions on the market for overnight money. By contrast, developments in the somewhat longer-term maturity segment of the money

*Money market  
rates*

## Money market management and liquidity needs

In the three maintenance periods between 12 October 2005 and 17 January 2006, euro-area credit institutions' need for central bank money arising from the autonomous factors determining liquidity increased by €25.3 billion in net terms. This was due mainly to the sharp rise in banknote circulation of €27.6 billion in the euro area, particularly in December, as usual for the time of year and to a similar extent to 2004, albeit at a lower growth rate. Liquidity needs arising from general government deposits declined by €3.7 billion net. If, in order to eliminate valuation effects, the changes in net reserve assets and other factors are taken together, these two items resulted in a liquidity absorption of €1.4 billion. The minimum reserve requirement went up by €2.5 billion and resulted in growing demand for central bank liquidity.

The greater need for liquidity was covered primarily by the main refinancing operations (MROs) being topped up by €27.8 billion. Although the volume of longer-term refinancing operations (LTROs) aimed for by the Governing Council of the ECB for the period under review remained unchanged, an erroneous bid in the LTRO tender procedure on 22 December caused a liquidity gap of €17.5 billion for one day, even though it was immediately corrected. Nevertheless, owing to the stabilising effect of meeting the minimum reserve on average, the lack of liquidity led to the EONIA temporarily increasing by 6 basis points just on that day. Standing mostly between 7 and 9 basis points above the minimum bid rate, the EONIA interest rate was at a slightly higher level in the period under review.

A special feature of the period under review was the ECB's loose allotment policy, particularly in order to narrow the spread between the EONIA and the minimum bid rate after it had been increasing slightly in September/October 2005. The ECB therefore allotted liquidity volumes above the benchmark, with the exception of the last MRO in each maintenance period. However, the ECB departed from this practice in the MRO being conducted directly before the Governing Council of the ECB put up interest rates on 1 December 2005. The increase in the allotment generally amounted to €1 billion, although it was €3 billion immediately before and after Christmas. Last year, too, the ECB supplied banks with ample liquidity in the period from before the beginning of the run-up to Christmas through to the New Year, with the deviations from the benchmark allotment taking effect as early as October 2005, one month earlier than in 2004.

Increases in the EONIA at the end of the month as well as deviations following the last MRO in each reserve period were characteristic of all the reserve periods.

In the reserve maintenance period which started on 12 October, market participants seemed to expect a slight liquidity shortage following the allotment in the last MRO, with the result that the EONIA rose to 2.09% on 4 November and remained at this level on the following day. However, as liquidity conditions were largely balanced on the last day of the reserve period, no fine-tuning operation was necessary. The reserve period ended with the EONIA at 1.87%.

In the reserve period which began on 9 November, there was a particular development in the EONIA in advance of the Governing Council of the ECB raising interest rates by 25 basis points to 2.25% on 1 December 2005. The EONIA had already gone up to 2.19% one week earlier following comments by Jean-Claude Trichet, President of the ECB, despite banks having sufficient liquidity. One reason for this is likely to be the fact that not all market participants had yet taken in the distinction which has been enshrined in the new monetary policy framework since March 2004 between banks' interest rate expectations and liquidity conditions within an ongoing reserve period. Following the allotment of the last MRO – which was €1 billion above the benchmark on this exceptional occasion – the market anticipated excess liquidity, with the result that the EONIA fell to 1.80% on 2 December. After a liquidity-absorbing fine-tuning operation of €7.5 billion was carried out on the last day of the reserve period, the EONIA rate stood at 1.85%.

On 6 December, a reserve maintenance period, extended to 43 days, began. Owing to the generous allotment policy and the extended reserve period, things went smoothly at the turn of the year. At the end of the year, the EONIA stood at 2.42%, just 17 basis points above the minimum bid rate. Following the allotment of the last MRO, the market initially assumed that there was ample liquidity, as a result of which the EONIA fell to 2.21% on 13 January. When, in fact, a liquidity deficit became apparent, the ECB conducted a liquidity-providing fine-tuning operation on the last day of the reserve period amounting to €7.0 billion. On 17 January, the EONIA stood at 2.30% and the December/January reserve period ended with a small net recourse to the deposit facility of €785 million. At the start of the new January/February reserve maintenance period, the EONIA rate stood at 2.33%, 8 basis points above the minimum bid rate.

### Factors determining bank liquidity <sup>1</sup>

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

Item	2005/2006		
	12 Oct to 8 Nov	9 Nov to 5 Dec	6 Dec to 17 Jan
I Provision (+) or absorption (–) of central bank balances due to changes in autonomous factors			
1 Banknotes in circulation (increase: –)	– 4.0	– 4.2	– 19.4
2 General government deposits with the Eurosystem (increase: –)	– 2.5	– 0.6	+ 6.8
3 Net foreign reserves <sup>2</sup>	+ 7.2	– 1.9	+ 4.4
4 Other factors <sup>2</sup>	– 6.7	+ 1.7	– 6.1
<b>Total</b>	<b>– 6.0</b>	<b>– 5.0</b>	<b>– 14.3</b>
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	+ 4.8	+ 7.9	+ 15.1
(b) Longer-term refinancing operations	+ 0.0	+ 0.0	– 0.4
(c) Other operations	+ 0.2	– 0.3	+ 0.5
2 Standing facilities			
(a) Marginal lending facility	+ 0.0	– 0.1	+ 0.2
(b) Deposit facility (increase: –)	– 0.0	– 0.0	+ 0.0
<b>Total</b>	<b>+ 5.0</b>	<b>+ 7.5</b>	<b>+ 15.4</b>
III Change in credit institutions' current accounts (I + II)	– 1.2	+ 2.8	+ 1.1
IV Change in the minimum reserve requirement (increase: –)	+ 1.2	– 2.4	– 1.3

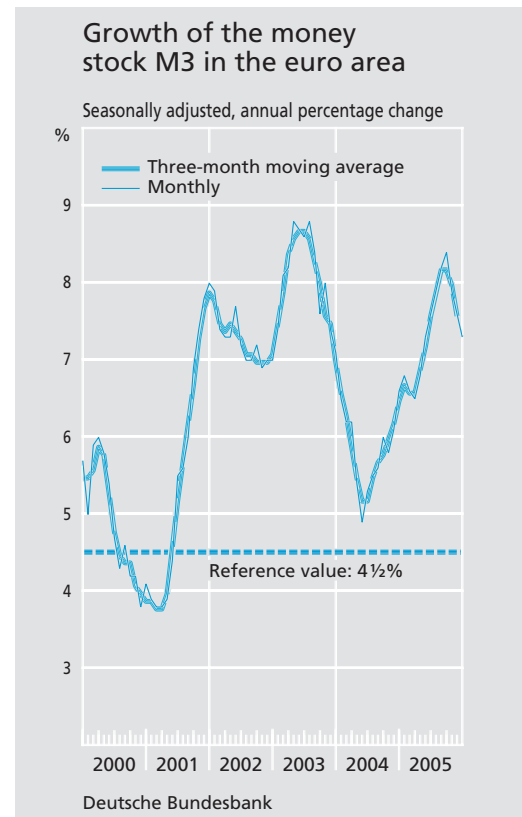
<sup>1</sup> For longer-term trends and the contribution of the Deutsche Bundesbank, see pages 14\* and 15\* of the Statistical Section of this *Monthly Report*. — <sup>2</sup> Including end-of-quarter valuation adjustments with no impact on liquidity.

market were marked by ongoing expectations of interest rate increases in the period under review which persisted after the rate move. Accordingly, there was a noticeable rise in the three-month forward rate; on a nine-month view, the market had priced in an increase in the overnight rate of almost three-quarters of a percentage point to about 3%. In mid-February, the rate of interest for twelve-month funds was more than half a percentage point higher than for overnight money.

### Monetary developments in the euro area

#### Monetary growth

Following strong expansion in the two previous quarters, euro-area M3 growth weakened in the final quarter of 2005. Money holdings increased at a seasonally adjusted annual rate of only just under 3½% in October-December. However, they were still 7.3% up on the year at the end of 2005. Measured in terms of the real money gap which is adjusted for portfolio effects, the liquidity surplus in the euro area almost doubled from around 3% to 5% year-on-year. A principal contributor to this is likely to have been the decidedly low interest rates across all maturities, which supported the sharp rise in the demand for credit in the private sector. Yet, recently, this rise has been set against considerable outflows of funds in foreign payments, strong monetary capital formation and a marked expansion in holdings of central governments, which are not assigned to M3 and, furthermore, are subject to substantial short-term fluctuations. Even so, monetary growth



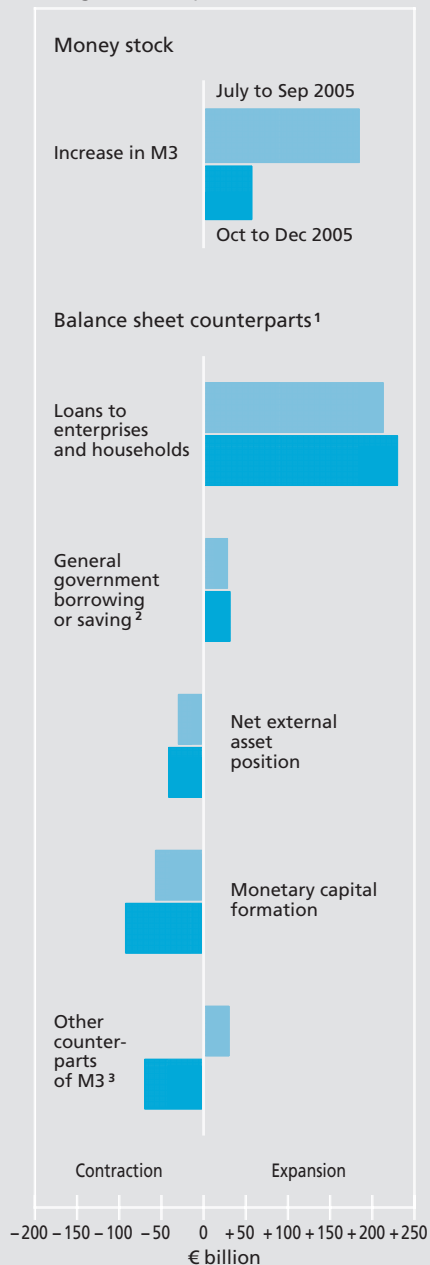
in 2005 was higher than it had been in the past three years.

In particular, the especially liquid components contained in M1 increased strongly again in the quarter under review. Demand was greatest for overnight deposits, which continued to grow robustly, at a seasonally adjusted annual rate of just under 9%. By comparison, final-quarter annualised expansion in currency in circulation halved on the quarter to 6%. When measured against longer-term benchmarks, however, this still represents a considerable rise. Overall, other short-term bank deposits were only increased by comparably small amounts in the last quarter of 2005. This was mainly the result of a decline in deposits redeemable with a notice period of up to three months which,

*Mixed  
developments  
among M3  
components*

### 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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given the rebound in short-term interest rates, appear to have lost much of their appeal. By contrast, short-term time deposits, which are largely remunerated at close to market rates, were increased significantly again in the period under review; alongside other financial institutions, households also contributed to this development. Among marketable instruments, money market fund shares and repo transactions were reduced heavily towards the end of the year. In contrast, there was a noticeable increase in short-term bank debt securities.

Robust demand for credit in the private sector remained the main driving force behind monetary expansion in the quarter under review. Non-securitised bank loans increased by a seasonally adjusted annual rate of 10% in the fourth quarter, a similarly sharp rise to that in the third quarter. Broken down by sectors, loans were given mainly to households for house purchases and to non-financial corporations. There was also a marked increase in loans to financial enterprises and for consumer credit. Demand was greatest for long-term loans, a reflection of low capital market rates. According to the results of the quarterly bank lending survey in the euro area, much of the lending was used to finance mergers, corporate and debt restructuring.

*Further sharp rise in loans to the private sector...*

Lending to the public sector also expanded considerably in the final quarter of 2005 with domestic banks purchasing a large volume of government bonds, in particular. By contrast, the usual expansion in loans towards the end of the year was somewhat down on previous years. The strong rise in central government

holdings also dampened the expansive effect on M3 of government borrowing per se.

*... and significant capital formation of late*

M3 expansion in the final quarter was also contained by a recovery in capital formation. Long-term bank deposits and securities issued, which are not included in M3, and banks' capital increased of late to an annualised rate of just under 8%. Alongside sales of longer-term bank debt securities, there was mainly demand for longer-term time deposits. However, banks' capital and reserves were also significantly increased of late. This was compounded by outflows of funds in foreign payments in connection with sizable purchases of foreign securities by euro-area residents.

### Deposit and lending business of German banks with domestic customers

*Substantial increase in overnight deposits ...*

Growth in German banks' deposits declined somewhat more sharply than in the euro area in the fourth quarter of 2005. However, overnight deposits rose again strongly, with a seasonally adjusted annualised growth rate of 6% of late, though this was down on the third-quarter increase (14½%). The level of investment by other financial institutions, which heavily reduced their overnight deposits with domestic banks in the quarter under review, was the principal dampener.

*... and a net fall in other short-term deposits*

There was also a significant decline in deposits redeemable with an agreed notice period of three months. Above all, short-term savings deposits at a rate of interest above the minimum rate of return perceptibly

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

€ billion		
Item	2005	2004
	Oct to Dec	Oct to Dec
<b>Deposits of domestic non-MFIs 1</b>		
Overnight	+ 13.2	+ 1.8
With agreed maturities		
of up to 2 years	+ 11.0	+ 14.6
of over 2 years	+ 3.9	+ 8.4
Redeemable at agreed notice		
of up to 3 months	+ 4.1	+ 9.7
of over 3 months	+ 0.5	+ 2.6
<b>Lending</b>		
to domestic enterprises and households		
Unsecuritised	- 9.2	- 0.6
Securitised	+ 10.7	+ 7.3
to domestic government		
Unsecuritised	- 1.9	- 3.2
Securitised	- 1.9	- 6.2

\* 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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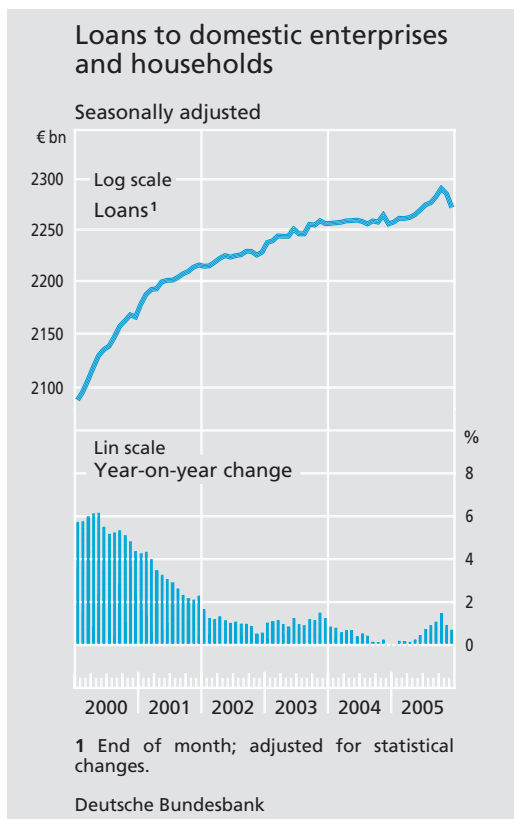
undershot their usual levels of year-end growth.

By contrast, longer-term time deposits (with an agreed maturity of more than two years) were increased significantly. As well as employed persons, such deposits attracted interest from insurance enterprises, in particular. This contrasts with longer-term savings deposits (with an agreed notice period of more than three months), which continued to fall considerably in the quarter under review.

*Scant increase in longer-term bank deposits*

The credit granted by German banks to domestic non-banks fell slightly overall in the fourth quarter, following a noticeable increase in the previous quarter. German banks again purchased a large volume of securities from domestic issuers, adding shares in Ger-

*Slight fall in credit granted ...*



man enterprises as well as fixed-interest German public-sector bonds to their holdings. Against this, however, there were sharp declines in loans to public borrowers, enterprises and individuals.

... and a decline in importance of special effects

Much as in the previous quarter, in the period under review the trend among non-securitised loans to the domestic private sector was strongly characterised by credit granted to other financial institutions. After these borrowers had taken up a high volume of short-term loans in the third quarter as part of large-scale securities lending transactions with German banks, they reduced them again towards year-end. Additionally, non-financial corporations scaled back their loans in the last quarter. Loans for consumer credit also declined of late, whereas loans for house

purchases saw increased demand in the final quarter of 2005, presumably owing to the abolition of the grant to homebuyers at the start of 2006.

For the most part, German banks' rates for new lending rose slightly in the fourth quarter of 2005 in anticipation of and following the rise in the ECB key interest rates. The cost of loans to non-financial enterprises and loans to households for house purchases increased over all periods of interest rate fixation. German banks were charging less than at the end of the previous quarter only for consumer credit. As a result, German non-financial enterprises had to pay between 4.1% and 4.5% for new long-term lending depending on the loan amount; for housing loans with an interest rate fixed for more than ten years German banks charged 4.3% and 7.8% for long-term consumer loans.

Lending rates mostly increased

The banks have also adjusted interest rates upwards for deposit business. In particular, there was an increase in rates for time deposits. Depending on the maturity, the banks were paying between 2.0% and 2.4%.<sup>1</sup> By contrast, the rates were left unchanged at 2.0% for savings deposits redeemable with a notice period of up to three months, and 2.3% for those with longer notice periods.

Interest rates for time deposits also higher

<sup>1</sup> The level of 2.7% for time deposits with an agreed maturity of over one year and up to two years reported in December 2005 was also influenced by one-off and large transactions. The rates of interest paid in this category typically lie between those for short-term time deposits (most recently 2.0%) and those for long-term time deposits (most recently 2.4%).

Credit standards almost unchanged

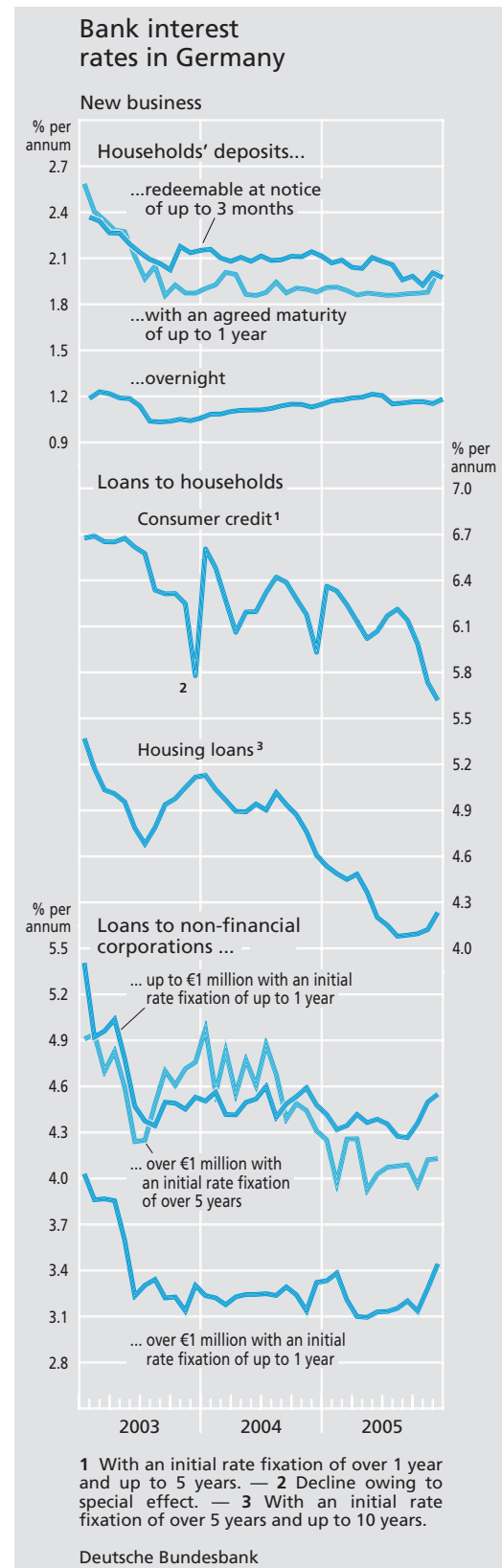
According to the results of the Eurosystem Bank Lending Survey,<sup>2</sup> credit standards for corporate and consumer loans at the German banks polled were largely unchanged; there was only a slight tightening for private housing loans. At the same time, the banks reported a further modest cut in their margins for average loans; margins for higher-risk loans remained almost unchanged.

Signs of a possible upturn in credit demand

For the current quarter, German banks expect a further increase in the demand for credit from enterprises and consumers in the light of brighter sentiment in industry and among households. By contrast, they anticipate a noticeable slowdown in demand for housing loans in the first few months of 2006 following the anticipatory effects in the fourth quarter of 2005 in connection with the abolition of the grant to new housebuyers at the start of 2006. Moreover, they also expect a tendency for a slight loosening of credit standards, particularly for corporate loans. All things considered, the results for Germany on the supply-side and demand-side alike are in line with those for the euro area as a whole.<sup>3</sup>

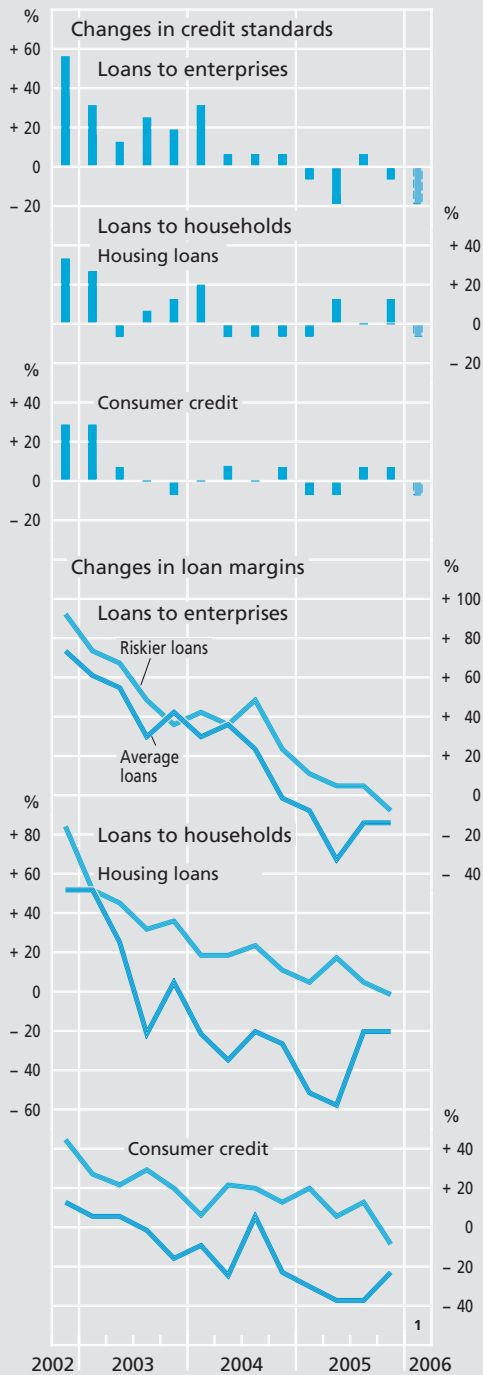
<sup>2</sup> See Deutsche Bundesbank, German results of euro-area bank lending survey, *Monthly Report*, June 2003, pp 67ff. The aggregate survey results for Germany can be viewed under [http://www.bundesbank.de/volkswirtschaft/vo\\_veroeffentlichungen.en.php](http://www.bundesbank.de/volkswirtschaft/vo_veroeffentlichungen.en.php).

<sup>3</sup> See European Central Bank, *Monthly Bulletin*, February 2006, pp 15ff.



**1** With an initial rate fixation of over 1 year and up to 5 years. — **2** Decline owing to special effect. — **3** With an initial rate fixation of over 5 years and up to 10 years.

### 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". — 1 Expectations for Q1.

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