Monetary policy and banking business

Interest rate policy and the money market

Eurosystem interest rates unchanged

The Governing Council of the European Central Bank did not change key interest rates in the past few months. The main refinancing operations continued to be conducted as variable rate tenders with a minimum bid rate of 2%; a rate of 3% was charged for the marginal lending facility and a rate of 1% was paid on the deposit facility. On the basis of its regular economic and monetary analyses, the Governing Council has concluded that the monetary policy stance is still appropriate. Inflation risks have been increasing recently. In particular, the further increase in money and loan growth in the euro area calls for a lot of monetary policy vigilance.

Money market interest rates initially performed calmly...

In line with the steady interest rate course, the overnight rate (Eonia) continued to move sideways in the period under review with the exception of the temporary fluctuations at the end of the quarter and at the end of the reserve maintenance periods. It was mostly close to the marginal lending rate, which was only five basis points above the minimum bid rate. The other money market rates were similarly calm until the end of September.

... before rising sharply since the end of September

Since then, however, the interest rates have picked up markedly in the somewhat longer-term maturity range in the money market. Interest rates on twelve-month deposits have accordingly reached 2.7%, a level last seen in January 2003. Compared to the start of August this corresponds to a rise of almost 50 basis points. Three-month money market rates went up by almost 25 basis points during the same period. As a result, the yield

Money market management and liquidity requirement

In the three maintenance periods between 13 July and 11 October 2005, euro-area credit institutions' need for central bank liquidity determined by autonomous liquidity factors fell by €12.4 billion in net terms. Although banknotes in circulation absorbed an additional €9 billion, the growth was considerably weaker than in the corresponding maintenance periods last year, when banknotes in circulation had increased by €16 billion. By contrast, the decline in general government deposits with the Eurosystem, which should be seen in connection with the levels of the preceding periods, some of which were relatively high, led on balance to a €19.5 billion drop in liquidity needs. A joint examination of net foreign reserves and other factors, a move which eliminates valuation effects with no impact on liquidity, also shows a decline in liquidity needs of €1.9 billion here, which as in the preceding periods was caused by purchases of euro-denominated financial assets which were not linked to monetary policy.

The Eurosystem offset the changes in the liquidity needs arising from autonomous factors by adjusting the volumes of its main refinancing operations; these were initially expanded by €11.9 billion to €309.5 billion in the July/August maintenance period before the average allotment amount was reduced by €6 billion and €14.9 billion respectively in the two following periods. The minimum reserve requirement rose by €3.5 billion and hence considerably more sharply than in the same period last year when growth of just €0.7 billion had been registered. Since, however, the Eurosystem had reduced the volume of the main refinancing operations by a sum that was lower than the drop in liquidity needs arising from autonomous factors, the credit institutions were on balance able to fulfil their increased reserve requirements smoothly.

The overnight rate measured in terms of the weighted average Eonia rate was mostly around 2.08% in the past three reserve maintenance periods. As well as the usual slight increase in prices at the end of the month or quarter, deviations mainly occurred in the last few days of each reserve maintenance period. At the end of the July/August reserve maintenance period the Eurosystem intended to absorb the emerging liquidity overhang of €6.5 billion by means of a fine-tuning operation. However, owing to underbidding by the credit institutions it was only possible to absorb €0.5 billion from the market. Market participants cited as the reason for this the fact that on the morning of 9 August there was still too much uncertainty prevailing with regard to their own liquidity situation. They also did not find the operation's fixed interest rate of 2% to be attractive enough. In retrospect it turned out that the Eurosystem had forecast the liquidity overhang with almost perfect accuracy, since a net recourse to the deposit facility in the amount of €5.4 billion took place. This would imply that the optimal volume of the fine-tuning operation lay at just under €6 billion and hence only marginally below the volume being targeted. As this became evident in the course of the trading day, the overnight rate fell to a level close to the rate of the deposit facility. Eonia stood at 1.63%.

By contrast, at the end of the August/September reserve maintenance period there was a liquidity deficit that was offset by a liquidising fine-tuning operation in the amount of €9.5 billion. Net recourse to the deposit facility amounted to just €0.3 billion. Since, however, the liquidity situation was still incorrectly assessed as too tight even after the operation, Eonia finally closed at 2.18% on 6 September.

The September/October period closed with another liquidity overhang, which owing to unexpected inflows arising from autonomous factors the Eurosystem was unable to absorb fully by means of a fine-tuning operation in the amount of €8.5 billion, as illustrated by a net recourse to the deposit facility of €1.3 billion. Despite this, at 1.93% Eonia was only marginally below the minimum bid rate of 2%. This time the operation drew a large amount of interest from the credit institutions, which submitted bids in the amount of €24 billion at a fixed rate of 2.00%.

Factors determining bank liquidity [1]

€ billion; changes of daily averages of reserve maintenance periods to the previous period

	2005		
Item	13 July to 9 Aug	10 Aug to 6 Sep	7 Sep to 11 Oct
I Provision (+) or absorption (–) of central bank balances by changes of autonomous factors			
1 Banknotes in circulation (increase: –)	– 10.0	+ 1.1	– 0.1
2 General government deposits with the Eurosystem (increase: –)	+ 0.0	+ 4.3	+ 15.2
3 Net foreign reserves [2]	+ 12.2	– 0.7	+ 3.1
4 Other factors [2]	– 12.3	+ 1.2	– 1.6
Total	– 10.1	+ 5.9	+ 16.6
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	+ 11.9	– 6.0	– 14.9
(b) Longer-term refinancing operations	– 0.0	– 0.0	+ 0.0
(c) Other operations	+ 0.3	+ 0.3	– 0.5
2 Standing facilities			
(a) Marginal lending facility	– 0.1	+ 0.0	+ 0.1
(b) Deposit facility (increase: –)	– 0.1	+ 0.2	– 0.0
Total	+ 12.0	– 5.5	– 15.3
III Change in credit institutions' current accounts (I + II)	+ 1.9	+ 0.4	+ 1.2
IV Change in the minimum reserve requirement (increase: –)	– 2.0	– 0.5	– 1.0

1 For longer-term trends and the contribution of the Deutsche Bundesbank, 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.

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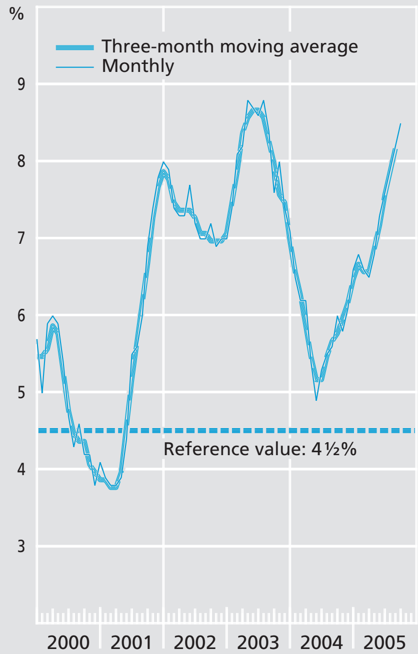
Growth of the money stock M3 in the euro area

Seasonally adjusted, annual percentage change



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curve on the money market, which at the end of June was for a time slightly inverted and at the start of August was very flat, steepened considerably by the end of the reporting period. This reflects the rising interest rate expectations of market participants.

Monetary developments in the euro area

Renewed strong monetary growth

The low level of interest rates has stimulated monetary expansion in the euro area also in the last few months. The increase in monetary growth seen over several quarters continued to hold up in the third quarter of 2005. M3 grew at a seasonally-adjusted annual rate of 11½% from July to September, up from just under 10% in the months April to June. As was previously the case, the monetary expansion was primarily upheld by a continuing increase in loans to the domestic private sector. Alongside this, general government borrowing or saving also boosted monetary growth. In addition, the dynamic growth of short-term assets contained in M3 during the third quarter was accompanied by a significant drop in investors' willingness to invest assets on a longer-term basis with banks in the euro area. At a seasonally-adjusted annual rate of 4%, monetary capital formation therefore expanded over the quarter under review at its slowest rate since the start of 2003. Overall, the money stock M3 was ultimately up 8.5% on the year. The average 12-month rate over the months July to September therefore amounted to 8.2%.

Strong growth of particularly liquid components of M3

The increase in the money stock in the third quarter once again primarily concerned the particularly liquid components contained in M1. In addition, however, the other short-term bank deposits and marketable instruments also expanded strongly. In view of low capital market rates, expectations at the end of the quarter of a rise in interest rates, and increased uncertainty on the stock markets, domestic investors displayed a large amount of interest in temporarily parking funds in the form of short-term bank deposits in a secure and liquid way. With a seasonally adjusted annual rate of 12%, overnight deposits accordingly rose somewhat stronger again in the period from July to September than in the preceding quarter (+11½%). For the first time since the introduction of euro banknotes and coins they even grew slightly faster than currency in circulation, which rose at a seasonally-adjusted annual rate of 11½%, down from over 14% in the previous quarter. In addition, deposits with an agreed maturity of up to two years also expanded very sharply. Deposits redeemable at notice of up to three months likewise benefited from domestic investors' marked preference for liquidity. Money market fund shares which over the last few years have been in particular demand from private households wishing to temporarily hold funds in a liquid form at market interest rates were topped up strongly in the quarter under review together with repurchase agreements and short-term bank bonds.

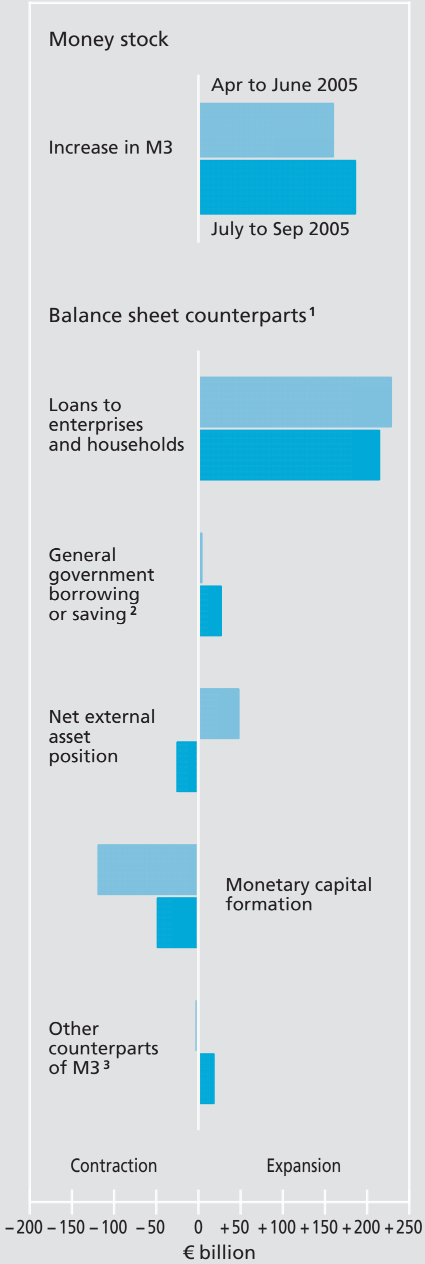
Ongoing strong expansion of loans to the private sector...

The main driving force behind monetary expansion in the third quarter was once more the sharp increase in credit to the private sector in the euro area. This also includes banks' purchases of securities issued by domestic enterprises, which expanded significantly in the quarter under review. Above all, however, their unsecuritised lending to domestic enterprises and households again rose sharply. At just over 10%, the annualised growth rate was even higher than in the preceding quarter (just under 9½%). Broken down by sectors, housing loans were once more granted on a large scale and accounted for over half of the overall private credit expansion in the quarter under review. On top of this, loans to the corporate sector also rose strongly.

In the third quarter, general government borrowing or saving per se likewise exerted an expansionary effect on monetary growth in the euro area. This was held up by both the increase in loans by banks to public sector borrowers and a rather sharp decline in cen-

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	2005 July to Sep	2004 July to Sep
Deposits of domestic non-MFIs [1]		
Overnight	+ 11.5	+ 5.7
With agreed maturities		
of up to 2 years	+ 3.3	+ 1.3
of over 2 years	+ 1.7	+ 5.2
Redeemable at agreed notice		
of up to 3 months	– 0.5	+ 1.4
of over 3 months	– 3.2	– 0.2
Lending		
to domestic enterprises and households		
Unsecuritised	+ 17.2	+ 2.7
Securitised	+ 7.6	– 5.6
to domestic government		
Unsecuritised	– 5.5	– 0.4
Securitised	– 0.7	+ 6.1

* 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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tral governments' deposits which are not included in M3.

... while monetary capital formation was modest

Monetary expansion in the third quarter was further boosted by the fact that the longer-term liabilities of banks only increased moderately. In particular, the demand for bank bonds with a maturity of more than two years was considerably lower between July and September than in the two preceding quarters. In Germany, Italy and Austria the outstanding amount of such bonds actually decreased in the quarter under review after having expanded sharply in these countries in the first half of the year. Longer-term bank deposits and banks' capital and reserves also increased at a slower pace in the third quarter. Viewed in isolation, however, substantial outflows of funds to other countries curbed monetary expansion.

Deposit and lending business of German banks with domestic customers

Further sharp rise in short-term bank deposits

The pronounced liquidity preference that could be observed in the euro area in the third quarter of 2005 also dominated the deposit business of German banks. In view of the small interest rate advantage of longer-term bank deposits and the considerable rise in stock market uncertainty since the middle of the year, which is reflected in an increase in stock market volatility, German investors on balance invested almost exclusively in short-term bank deposits. With a seasonally adjusted growth rate of 8%, these funds belonging to monetary aggregate M3 therefore rose again more sharply in the period under review than in the preceding quarter (+6½%). At the same time, longer-term bank deposits stagnated, thereby reflecting German investors' current low propensity for investing in such assets.

Sharp growth in overnight deposits ...

Turning to short-term bank deposits, overnight deposits have increased particularly sharply recently, expanding at a seasonally-adjusted annual rate of 14½% over the summer months. The short-term liquidity arrangements of other financial intermediaries had a strong impact here. On top of this, households and non-financial corporations also increased their sight deposits considerably. By contrast, the overall rise in short-term time and savings deposits was somewhat subdued. Although non-financial corporations in par-

... and moderate growth in other short-term deposits

ticular formed short-term time deposits on a relatively large scale, domestic households further reduced their short-term time deposits. Households' interest in deposits with a period of notice of three months was likewise comparatively small in view of a continued drop in rates in this segment and partially attractive rates for overnight deposits.

Longer-term bank deposits virtually unchanged

Longer-term savings deposits with a period of notice of over three months were considerably reduced in the period under review after having still attracted moderate demand in the preceding quarters. By contrast, time deposits with an agreed maturity of over two years increased sharply. This asset class, which also includes appropriate fixed-term registered bank debt certificates, is particularly popular with insurance companies. This meant that, on balance, longer-term deposits among German banks remained approximately constant.

Loans are up ...

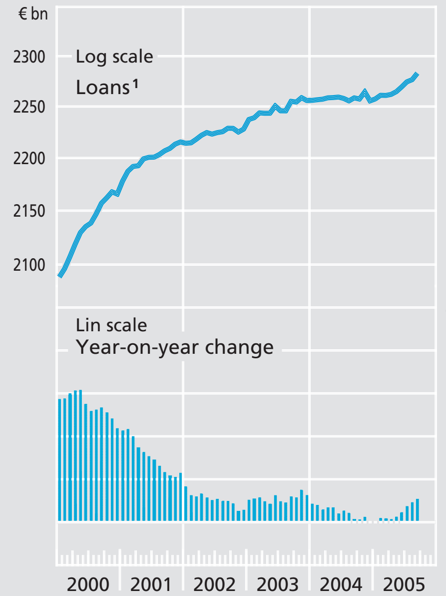
Loans by German banks to domestic non-banks increased noticeably (by 2½%) during the third quarter for the first time following a long period of stagnation. Thus loans to the domestic private sector picked up more strongly over the quarter. As well as granting traditional loans, German banks also purchased stocks of domestic enterprises on a larger scale. By contrast, they reduced loans to the German public sector on balance.

... but overstated by special development

The increase in loans to the domestic private sector should not be overstated, however, as this is due primarily to the sharp rise in short-term non-securitised loans to other financial intermediaries. This increase was for the most part based on extensive securities lending transactions by German banks where a major German custodian institution not only supplied the trading platform but also acted as the counterparty. As a result, both repurchase agreements of other financial institutions and short-term loans to this sector went up significantly in the last few months without any additional liquidity flowing to private non-banks. Factoring this effect into domestic credit development brings down the 12-month growth rate of loans to the private sector in Germany by a quarter to half a percentage point.

Loans to domestic enterprises and households

Seasonally adjusted



1 End of month; adjusted for statistical changes.

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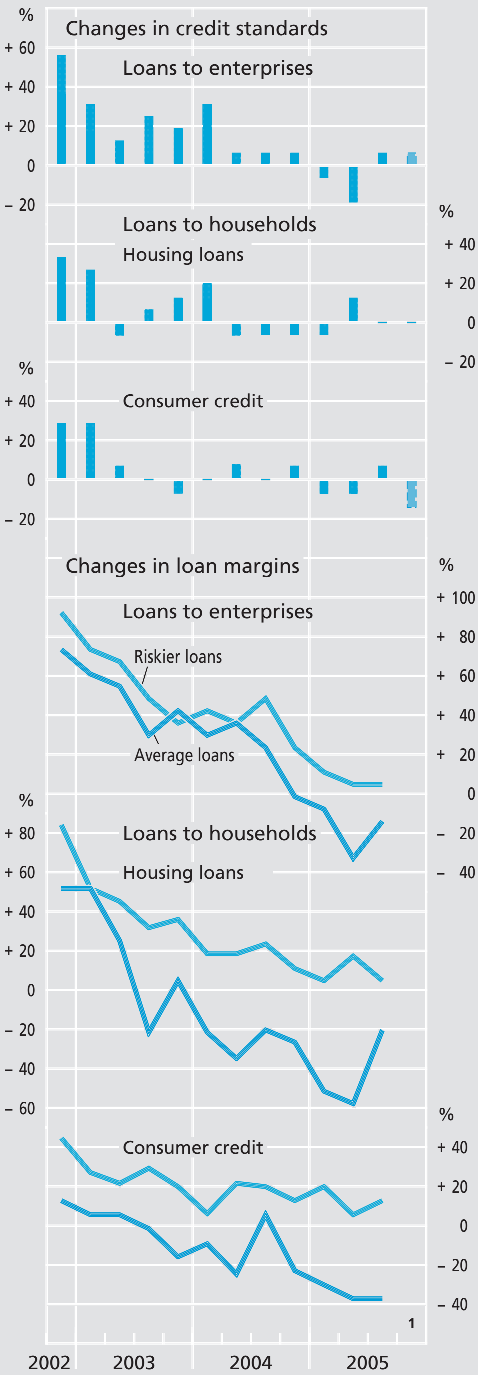
Broadly unchanged credit standards in all lending categories

According to the German results of the Eurosystem's bank lending survey,[1] the respond-

1 See Deutsche Bundesbank, German results of euro-area bank lending survey, *Monthly Report*, June 2003, pp 69ff. The aggregate survey results for Germany can be viewed under http://www.bundesbank.de/volkswirtschaft/vo_veroeffentlichungen.en.php.

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 Q4.

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ent banks left their credit standards for both corporate loans and loans to households largely unchanged. Nevertheless, the banks reported a further slight reduction in the margins on average loans in their corporate and household lending business, particularly in the area of consumer loans. Margins charged on riskier loans were only widened slightly in a small number of cases and the other lending terms also underwent no further changes.

First signs of a possible upturn in credit demand

Following the very weak preceding quarter, the participating institutions reported a slight upturn in the demand for corporate loans in the third quarter of 2005. The banks cited a rise in the borrowing needs of their customers arising from mergers and corporate restructuring as one of the reasons for the increase in credit demand. The demand for loans to households at the participating institutions even went up markedly, albeit that this is attributed by the banks primarily to their more aggressive distribution strategies. The survey results for both the demand and supply sides of the lending business in Germany were thus similar to those of the euro area as a whole.[2] For the fourth quarter of 2005 the German institutions are expecting by and large unchanged credit standards. Furthermore, they expect the credit demand, in particular for corporate and housing loans, to continue to increase.

Long-term lending rates down again

The long-term lending rates of German banks largely continued to decline in the third quarter of 2005, although the drop in interest rates was noticeably smaller than in the previ-

2 See European Central Bank, *Monthly Bulletin*, November 2005, pp 22ff.

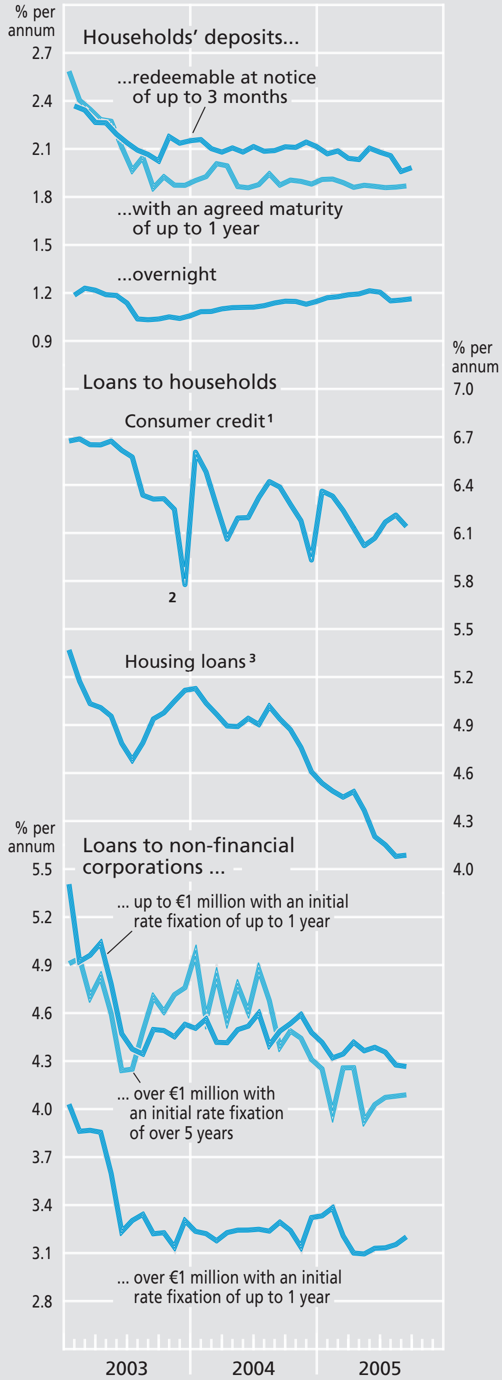
ous quarter. In particular, the conditions for both new lending to households and small corporate loans were eased. Reported interest rates increased moderately only for large corporate loans, where individual transactions and hence the creditworthiness of individual borrowers typically have a larger impact on the reported credit conditions. In the period under review, German banks charged non-financial enterprises between 4.1% and 4.3% for new long-term lending depending on the loan amount; for long-term consumer loans they charged 8.7% and for housing loans with an interest rate fixed for more than ten years they charged 4.2%. Developments in short-term lending were, by contrast, mixed; here banks only charged somewhat lower interest rates than at the end of the previous quarter for small corporate loans and for housing loans.

Slight drop in deposit rates as well

The interest rates paid on households' deposits at domestic banks fell slightly again in the third quarter of 2005. Credit institutions offered 2.0% for savings deposits with a notice period of up to three months and 2.3% for longer maturities in the quarter under review. Depending on the maturity, the rate of interest paid on households' time deposits ranged between 1.9% and 2.2%.[3]

Bank interest rates in Germany

New business



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.

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3 The level reported in September 2005 of 2.4% for time deposits with an agreed maturity of over one year and up to two years was also influenced by special transactions. The rates of interest paid in this category typically lie between those for short-term time deposits (most recently 1.9%) and those for long-term time deposits (most recently 2.2%).