Monetary policy and banking business

Interest rate policy and the money market

Further interest rate increase in March

After raising interest rates at the start of December 2005 the ECB Governing Council, at its meeting in early March 2006, raised rates by another ¼ percentage point. With effect from 8 March, the new minimum bid rate on the main refinancing operations is now 2½%, while the interest rates for the marginal lending facility and the deposit facility went up to 3½% and 1½% respectively.

A further adjustment to the rate of monetary policy expansion became necessary after the economic and monetary policy analyses both pointed to the emergence of medium and long-term inflation risks in the euro area. In this respect, accelerated monetary growth, which has been driven by a strong rise in demand for credit in the euro area since mid-2004, is a warning sign that should be taken seriously. Moreover, direct inflationary risks are primarily associated with the increase in oil and energy prices worldwide and the planned value added tax increase in Germany. In terms of anti-inflation policy, it is of paramount importance that the resulting price increases not be used as an opportunity for second-round effects. A stability-oriented monetary policy can make a crucial contribution to this by keeping inflation expectations at a level that is conducive to stability.

Interest rate developments on the money market affected by interest rate hike

Broadly speaking, the slight tightening of the ECB Governing Council's monetary policy stance was implemented smoothly on the money market. For the most part, the EONIA overnight rate was slightly above the margin-

Money market management and liquidity needs

In the three maintenance periods between 18 January and 11 April 2006, euro-area credit institutions' need for central bank liquidity determined by autonomous liquidity factors fell by €7.4 billion in net terms. The fall in banknotes in circulation in the January-February period, by €10.8 billion, was somewhat sharper than in 2005. Over the three periods, the demand for liquidity from banknotes in circulation declined by almost €3 billion. By contrast, liquidity needs arising from general government deposits with the Eurosystem rose by €7.4 billion in net terms. Taking the net foreign reserves and the other factors together, which eliminates liquidity-neutral valuation effects, indicates a decline in liquidity needs in these two categories over the three periods by a substantial €12.0 billion. 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 €2.9 billion paid on 21 March.

In the light of the diminishing liquidity needs from autonomous factors, the Eurosystem slightly reduced the volume of its monetary policy operations by €2.0 billion net. There was a shift from main refinancing operations (MROs), which were reduced by €26.3 billion, towards longer-term refinancing operations (LTROs) with a three-month maturity, which – on average over the three maintenance periods – were topped up by €24.1 billion. This occurred by increasing the volume of the LTROs from €30.0 billion to €40.0 billion each starting in January 2006. In increasing the LTROs, the Eurosystem's intention was to increase the proportion of LTROs in the refinancing volume slightly, notwithstanding the fact that liquidity needs are expected to rise during the remainder of 2006. 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 €5.4 billion. Credit institutions were therefore comfortably able to meet the minimum reserve requirement, which continued to expand strongly in the period March-April (by 11.4% year-on-year to €158.9 billion).

Early in the January-February reserve period, the spread between the EONIA and the minimum bid rate was 8 basis points. The ECB continued its policy of allotting liquidity volumes slightly above the benchmark in all but the final MRO in each maintenance period, a practice it began in October 2005 with the aim of narrowing the EONIA spread. However, a liquidity deficit at the end of the period caused the spread to expand to up to 15 basis points. After a liquidising fine-tuning operation on 7 February worth €6.5 billion, the period ended with a more moderate spread of 9 basis points. However, that spread remained unchanged at the start of the subsequent February-March period and expanded to 15 basis points once again by the end of the month (28 February). The interest rate hike by the Governing Council of the ECB on 2 March, which was expected, has evidently played a part, although interest rate adjustments that only take effect in the subsequent period are not usually supposed to affect money market conditions in the current period. At the end of the February-March period, however, EONIA was 17 basis points below the old interest rate, which was still in effect. This was caused by underbidding in the liquidity-absorbing fine-tuning operation on 7 March, which was able to absorb only €2.6 billion, not the intended €5.0 billion. At the start of the March-April reserve period, the EONIA spread was 8 basis points, down by 1 basis point compared with the spread at the start of the previous period. However, in the two weeks prior to Easter, there was another perceptible widening in the spread to a maximum of 21 basis points on 10 April. Owing to an unexpectedly large rise in autonomous factors and increased recourse to the deposit facility, triggered by payment transaction difficulties suffered by a single credit institution, there was a relatively large liquidity deficit, which was fully offset by a €26.0 billion fine-tuning operation on 11 April. On the same day, however, the spread only narrowed to 13 basis points and was still at a somewhat elevated level (10 basis points) at the start of the new period.

Although the widening in the EONIA spread seen in the last few months in no way threatens the implementation of Eurosystem monetary policy, it remains undesirable. As a result, the ECB altered its allotment policy once again, allotting €2.0 billion above the benchmark in each of the MROs since 27 April. It did likewise in the last MRO of the period and repeatedly signalled to the market its determination to narrow the EONIA spread.

Factors determining bank liquidity [1]

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

Item	2006 18 Jan to 7 Feb	8 Feb to 7 Mar	8 Mar to 11 Apr
I Provision (+) or absorption (–) of central bank balances due to changes in autonomous factors			
1 Banknotes in circulation (increase: –)	+ 10.8	– 2.4	– 5.6
2 General government deposits with the Eurosystem (increase: –)	– 12.4	+ 3.3	+ 1.7
3 Net foreign reserves [2]	+ 7.6	– 0.5	+ 3.2
4 Other factors [2]	– 4.8	+ 5.3	+ 1.2
Total	+ 1.2	+ 5.7	+ 0.5
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	– 6.4	– 10.7	– 9.2
(b) Longer-term refinancing operations	+ 6.6	+ 8.5	+ 9.0
(c) Other operations	+ 0.1	– 0.4	+ 0.8
2 Standing facilities			
(a) Marginal lending facility	– 0.2	+ 0.1	+ 0.0
(b) Deposit facility (increase: –)	– 0.0	– 0.1	– 0.1
Total	+ 0.1	– 2.6	+ 0.5
III Change in credit institutions' current accounts (I + II)	+ 1.3	+ 2.9	+ 1.2
IV Change in the minimum reserve requirement (increase: –)	– 1.4	– 3.0	– 1.2

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.

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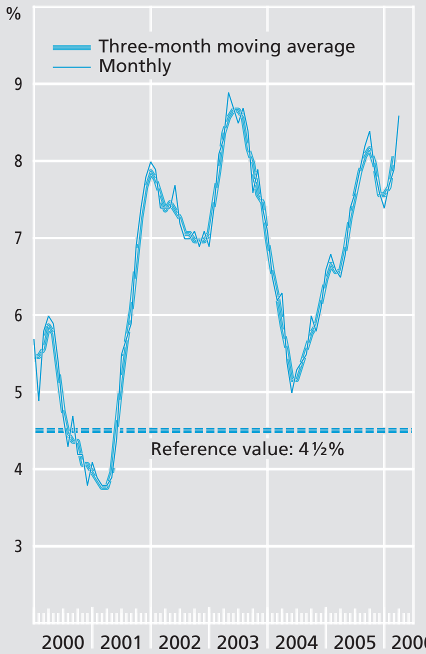
Growth of the money stock M3 in the euro area

Seasonally adjusted, annual percentage change



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al allotment rate which, in turn, was around six basis points higher than the minimum bid rate. The shorter-term money market rates rose by just under 30 basis points following the interest rate increase. Interest rates in the longer-term maturity segments of the money market increased even more sharply. Recently, banks were paying 3.3% for twelve-month funds, up by 0.4 percentage point. As a result, the money market yield curve has become considerably steeper and the implied interest rate expectations are currently distinctly positive. In terms of the forward rates, market participants expect the overnight rate to increase to 3½% on a 12-month view.

Monetary developments in the euro area

Perceptible acceleration in monetary growth

Under the spectre of the low level of interest rates, M3 grew very strongly in the euro area between January and March, having risen somewhat more modestly for a time in the final quarter of 2005. Money holdings once again expanded as strongly as they had in the third quarter of 2005, at a seasonally adjusted annual rate of 10½%; by contrast, they had merely risen by just over 4% in the October-December 2005 period. Owing to strong monetary growth, surplus liquidity in the euro area increased further. Measured in terms of the real money gap, which is adjusted for portfolio shifts, it rose by one percentage point to around 6% in the first quarter of 2006. In a climate of rising, yet generally low, interest rates, monetary expansion was driven primarily by a sharp increase in lending to the private sector. Despite the fact that investors were very willing to invest in longer-term time and savings deposits and bank debt securities, the dynamic monetary capital formation and decline in lending to general government were not sufficient to offset the expansive effect of the large volume of lending to enterprises and households in the euro area.

Substantial growth in most M3 components

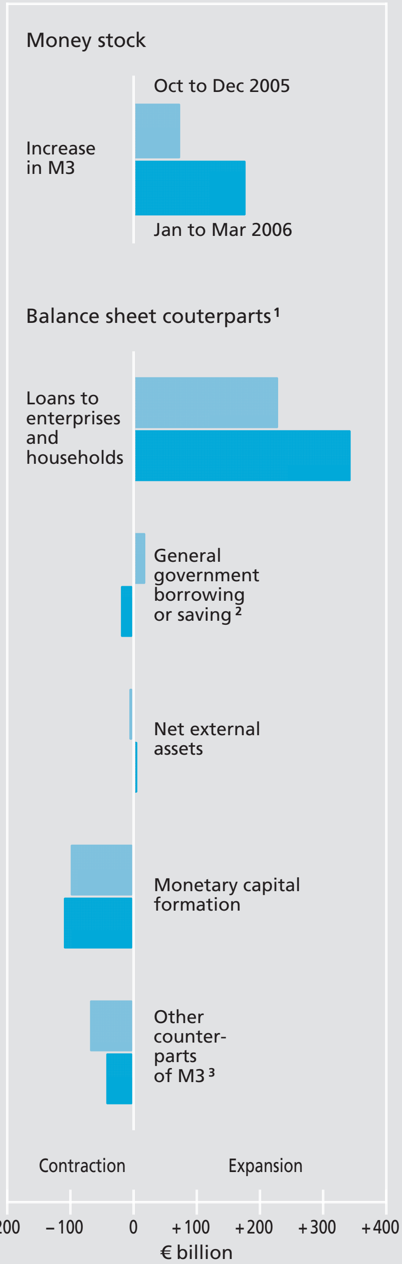
As in the previous quarters, the especially liquid components contained in M1 grew sharply. Currency in circulation expanded at a seasonally adjusted annual rate of just over 12%, while overnight deposits grew by an annualised rate of 8½% in the first three months of the year. The more rapid rate of expansion in M3 compared with the previous quarter was, however, mainly due to considerably stronger growth in other short-term bank deposits. Having grown by only just over 3½% in the fourth quarter of 2005, they expanded around three times as quickly in the first quarter of 2006, at a seasonally adjusted annualised rate of almost 11½%. In this context, both short-term time deposits and deposits with an agreed notice of up to three months were increased by a significantly greater margin than in the final quarter of 2005. Among marketable financial instruments, only short-term bank debt securities had shown net gains at the end of the reporting period. The issue of these papers, mainly held by institutional investors, is also likely to have benefited of late from the fact that their interest rate disadvantage was very low for a time compared with longer-term fixed-interest securities and has only recently become somewhat larger again.

Further acceleration in already strong private lending

Once again, the very strong expansion in lending to the private sector was the main source of money creation in the euro area. Enterprises and households' credit demand grew by a seasonally adjusted annualised rate of 15% between January and March; the comparable figure for the fourth quarter of 2005 was 10%. The banks mainly – and sharply – increased their loans to the private sector in the euro area. In addition, they also further topped up their securitised lending portfolio by purchasing securities issued by domestic corporations. Broken down by sectors, demand for bank loans has recently come from private contractors and non-financial corporations alike. Moreover, some of this money is again likely to have been used to finance mergers and both corporate and debt restructuring. In addition, lending to non-monetary

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	2006 Jan to March	2005 Jan to March
Deposits of domestic non-MFIs 1		
Overnight	+ 5.1	+ 26.2
With agreed maturities		
of up to 2 years	+ 4.1	– 25.0
of over 2 years	+ 8.8	+ 9.2
Redeemable at agreed notice		
of up to 3 months	– 3.7	+ 0.3
of over 3 months	+ 1.7	+ 0.2
Lending		
to domestic enterprises and households		
Unsecuritised	+ 20.6	– 0.6
Securitised	+ 20.5	+ 2.7
to domestic government		
Unsecuritised	– 7.6	– 2.3
Securitised	– 2.4	+ 7.4

* 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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financial intermediaries also grew robustly. The fairly favourable macroeconomic environment and the fact that interest rates remain low are likely to have boosted the demand for credit in the euro area.

Decline in credit to general government

Lending to general government was reduced in the first quarter of 2006, having been increased fairly sharply in the final quarter of 2005. Not only have public authorities recently cut back their loans, but – after adjustment for seasonal variation – domestic banks also sold government bonds. However, as central government's monetary holdings also fell at the same time, the dampening effect on M3 of general government borrowing or saving was somewhat milder than initially suggested by the decline in bank lending to the public sector.

Strong monetary capital formation a counterweight of sorts to credit development

Strong monetary capital formation was the principal dampener on monetary expansion. Long-term investment of funds with banks grew at a seasonally adjusted annualised rate of 9% in the reporting period. In particular, there was strong growth in the longer-term time deposits (with an agreed notice of more than two years) that are not part of M3. The outstanding volume of longer-term bank debt securities outside the domestic banking sector also rose robustly. As in the previous quarter, a further contributor to strong monetary capital formation was the fact that banks noticeably increased their capital and reserves. In a balance sheet context, this is classified as monetary capital formation.

Deposit and lending business of German banks with domestic customers

Sharp increase in bank deposits

Much as in the euro area as a whole, domestic investors' deposits with German banks grew strongly in the first quarter. It was not just short-term investments of funds that expanded between January and March. Longer-term time and savings deposits also grew markedly. The seasonally adjusted annualised growth rate of the deposits with German banks that are included in M3 was 5% in March, after 1½% in December 2005.

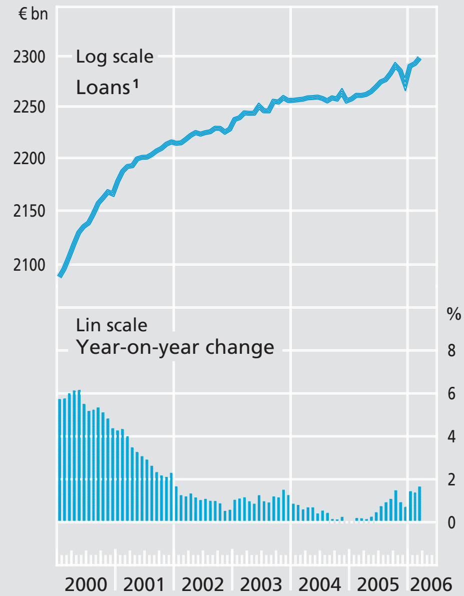
Moderate increase in overnight deposits and ...

However, overnight deposits with German banks increased only moderately in the first quarter of 2006. Their seasonally adjusted annual growth rate was a mere 3½% whereas, in the two previous quarters, they had grown by 5½% and almost 14½% respectively. For one thing, employed persons topped up these investments of funds far less than in the same period in previous years. In addition, a dampening effect was caused, in particular, by non-financial corporations' notable reduction of overnight holdings. In an environment of rising short-term interest rates, non-financial corporations have evidently shifted more of their (mostly comparatively low-yield) sight deposits into short-term time deposits. As non-monetary financial corporations also recently topped up their deposits with an agreed notice of up to two years, thereby breaking their usual seasonal pattern, short-term time deposits grew very strongly overall in the reporting period. By contrast, short-term savings deposits fell slightly. Likewise affected were deposits at notice with a yield above the minimum rate of return.

... very strong rise in short-term time deposits

Loans to domestic enterprises and households

Seasonally adjusted



1 End of month; adjusted for statistical changes.

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Marked growth in longer-term bank deposits

Longer-term deposits at domestic banks were also topped up significantly for the first time in a year. In particular, time deposits with an agreed notice of more than two years rose strongly between January and March. In addition, there was also a perceptible expansion in longer-term savings deposits (redeemable at an agreed notice of over three months) in the period under review.

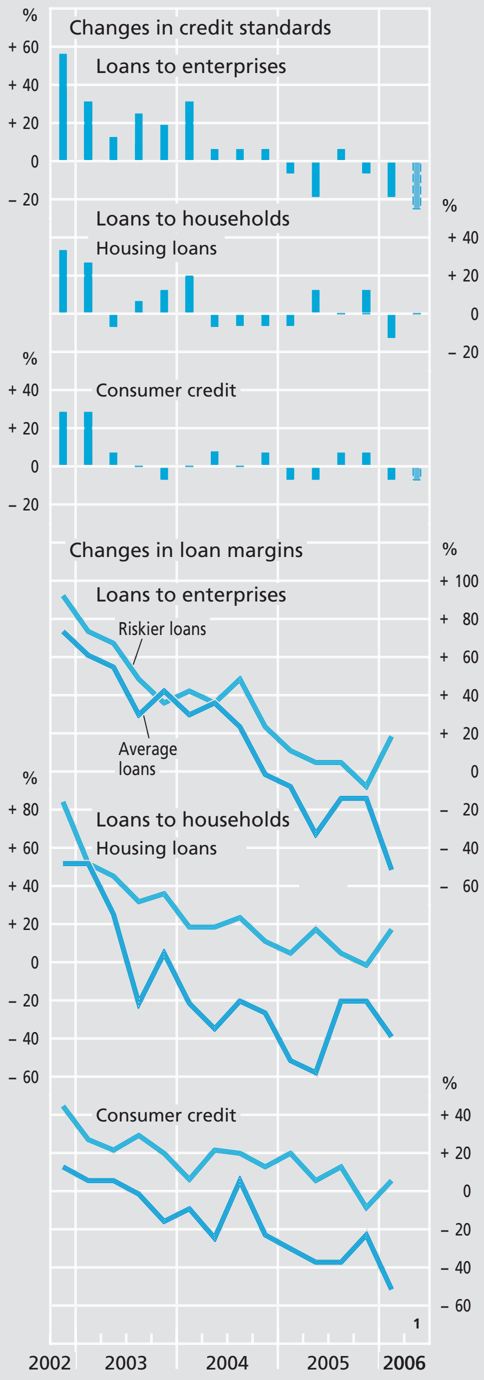
Loans increased ...

After falling in the previous quarter, loans by German banks to domestic non-banks went back up again in the first quarter of 2006. Yet the trends in credit granted to public and private sector borrowers diverged. Whereas banks reduced their loans to domestic general government and, in net terms, also sold German government bonds, they heavily increased their holdings of domestic private securities. Moreover, loans to German enterprises and households also went back up considerably again for the first time in a while. With an annualised growth rate of just under 5%, however, the acceleration in lending in Germany remained noticeably below the particularly dynamic expansion seen in the rest of the euro area.

... yet noticeably distorted by special effects

While households continued to reduce their outstanding loans to domestic banks, there was something of a revival in German banks' corporate lending. Once again, however, the largest private borrowers on the corporate side were non-monetary financial intermediaries, whose attention was focused mainly on short-term loans. Since these loans are mainly the result of securities lending transactions with German banks, they are not associated with the flow of any funds into the domestic

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 Q2.

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private non-bank sector. Thus, when the effect on domestic lending developments associated with such transactions is eliminated, the year-on-year rate of lending to the domestic private sector is around ¾ percentage point lower.

Bank Lending Survey ...

The still relatively moderate trend in unsecuritised lending to domestic non-financial corporations and households contrasts somewhat with the German results of the Bank Lending Survey. These indicate a moderate fall in credit standards for corporate loans in Germany. Households also benefited from a slight loosening of the standards for housing loans, whereas those for consumer credit remained virtually unchanged. According to the participating institutions, banks' tendency to pursue a more expansive lending policy was mainly caused by increased competition. For the second quarter of 2006, the institutions expect a further easing of credit standards for corporate customers and no change for retail customers.

... reports slight upturn in demand for corporate loans

In addition, the banks surveyed reported another slight rise in demand for corporate loans. The outlook for demand for business loans is also quite positive. By contrast, demand for consumer credit was almost flat in the first quarter of 2006, while demand for housing loans fell markedly following its fairly noticeable rise in the final quarter of 2005, itself probably due to anticipatory effects caused by the abolition of the grant to homebuyers at the start of this year. For the second quarter of 2006, the banks surveyed expect a perceptible stimulus in retail banking to be provided only by consumer lending.

In respect of corporate loans in particular, the German results point to an easing of supply conditions that is somewhat stronger than that indicated by the results for the euro area as a whole. The assessment of the shift in demand for corporate loans was also somewhat more positive in Germany than the euro-area average. By contrast, the developments with regard to retail customers broadly match those contained in the euro-area survey results.[1]

Another increase in lending rates ...

Not least as a result of the further ECB key interest rate increase in early March, the rise in German bank lending rates for new loans to the private sector, which was already evident in the previous quarter, continued in the first quarter of 2006. Business loans, housing loans and consumer loans, for which credit conditions had slackened in the previous quarter against the prevailing trend, were more expensive across almost all interest rate fixation periods. The interest rate increase tended to be higher for short fixation periods than for longer ones. At the end of the period under review, German banks charged non-financial enterprises between 4.4% and 4.5% for new long-term lending depending on the loan amount; for long-term consumer loans they charged 8.6%; and for housing loans with an interest rate fixed for more than ten years, they charged 4.4%.

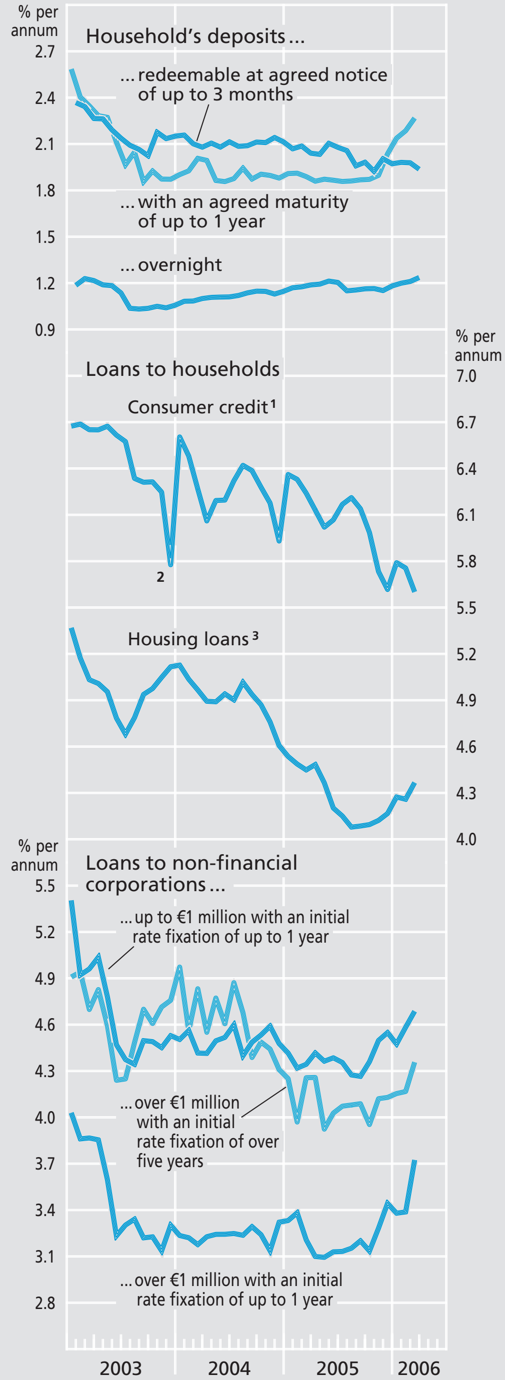
... with further decrease in margins for average-risk loans

In spite of the interest rate hikes, German results reported by domestic banks in the euro-area Bank Lending Survey indicated a continuation of the reduction in their margins for

1 See European Central Bank, Monthly Bulletin, May 2006, pp 20-24.

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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Development of direct banks in Germany

In Germany, as in other developed countries, there has been a sharp increase in the sale of banking services by non-branch banks (direct banking) over the past few years, especially via the internet. Besides existing banks establishing a new distribution channel, another type of bank, for which the branch network plays a virtually non-existent role, has gained in importance: direct banks.

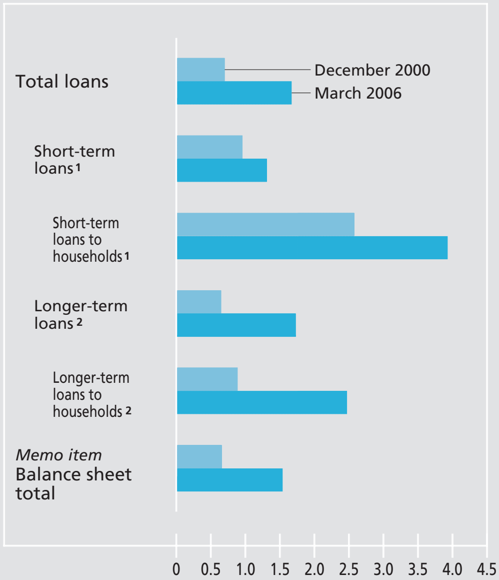
Statistics on the direct banking activity of traditional branch banks are difficult to isolate since they are typically included in the aggregate data of the respective institution. By contrast, the data of independent direct banks provide a possible starting point, to which the present investigation necessarily confines itself, for analysing direct banking activity in Germany. Consequently, a brief overview of the development of direct banking over the past few years is given below based on the reports of these banks to the balance sheet statistics. The comparison with all German banks is mainly designed to identify the differences between direct banks and branch banks in terms of their business focus.

A group of independent direct banks was put together for this study. For Germany, a strict approach, with the inclusion only of banks operating entirely on a non-branch basis and without the use of representatives, would mean that there would be virtually no measurable business activity in the case of direct banks. A more pragmatic approach to defining direct banks was therefore chosen here. This includes those institutions that primarily sell their products directly. In addition, only banks which offer their products and services to a wide range of customers were included. Specialised institutions for specific counterparties were not taken into consideration. The same applies to online brokers who sell mainly off-balance sheet banking services via the internet.

Measured by the percentage of their balance sheet total in the aggregate balance sheet total of the German banking industry, the direct banks under consideration here accounted for a market share of 1.5% in March 2006, a share which has more than doubled in the period since the end of 2000 under investigation here (see chart below). On the asset side of the balance sheet, direct banks' share of overall lending business with the domestic private sector, at 1.7%, roughly corresponds to their balance sheet share. While a breakdown of maturities indicates only marginal differences when compared with the German banking industry as a whole, the sectoral

Selected assets (loans to domestic enterprises and households) of direct banks

As a percentage of all banks



1 Up to and including 1 year. — **2** Over 1 year. — **3** Up to and including 2 years. — **4** Over 2 years. — **5** Redeemable at notice of up to 3 months. — **6** Redeemable at notice of over 3 months. — **7** For example, the share of long-term securities held by direct banks (maturity of over 2 years), which accounted for 36% of their total assets at the end of the period under review, was more than twice as large as the correspond-

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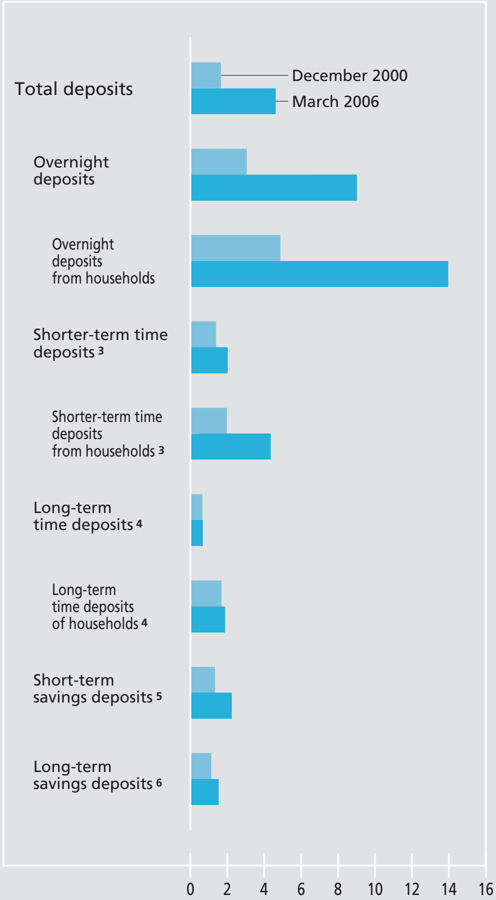
breakdown of lending business shows a clear concentration by the direct banks on lending to households. For example, both their share of total short-term loans to this group of customers, at latterly 3.9%, and the corresponding figure for longer-term maturities, at 2.5%, were clearly larger than their balance sheet share. By contrast, their lending to enterprises is negligible.

During the past few years, the direct banks under consideration here have managed to increase their market share particularly in deposit business with the domestic private sector. At latterly 4.6%, their market share was perceptibly larger than these banks' corresponding share of the balance sheet total of German credit institutions (see adjacent chart). Here, too, it is evident that expansion has been mainly in business with domestic private customers, with shorter-term bank deposits held by households at the direct banks under consideration here, in particular, having been increased sharply over the past few years. This applies to a lesser extent to short-term time and savings deposits. Above all, however, the direct banks analysed here take in overnight deposits from domestic households on a scale which, in relation to the total deposits of this category, corresponds to slightly less than ten times their balance sheet share.

In summary, it may be said that, with direct banks, a new type of bank has gained in significance in Germany over the past few years, one which pursues a selective business model, particularly in deposit and lending business with households. While these institutions were initially able to achieve substantial increases, especially in liability-side business, lending to households has recently been growing at a rapid pace. Financial resources not issued as loans are typically invested by direct banks in (long-term) securities.[7] Owing to a lack of more extensive data on branch banks' direct banking activity, it is difficult to determine how far the development of the direct banks considered here may be assumed to be representative of non-branch banking as a whole in Germany.

Selected liabilities (domestic enterprises' and individuals' deposits) of direct banks

As a percentage of all banks



ing figure for all German banks (16½%). Long-term securities held by direct banks as a share of those held by the German banking sector as a whole was 3½% at the end of the period under review (compared with direct banks' balance sheet share of 1½%).

average-risk loans to retail and business customers alike. According to the banks, the majority of (slight) margin increases were in the segment of riskier loans.

Deposit rates mostly increased

On the liabilities side of domestic banks' business with households, remuneration was adjusted upwards once again in the first quarter of 2006 – mostly on time deposits, but also on overnight deposits. The rates offered by credit institutions on households' time deposits ranged between 2.3% and 2.8% depending on the maturity and 1.3% for overnight deposits. By contrast, the rates for savings deposits remained virtually unchanged; they stood at 2.0% for notice periods of up to three months and 2.4% for longer notice periods.