# Monetary policy and banking business

## Interest rate policy and the money market

*Interest rate rises in June and in August*

In the summer months, the Governing Council of the ECB further reined back its accommodating monetary policy in two stages. Following the interest rate rises in December of last year and in March of this year, two further interest rate rises, each of 25 basis points, followed in mid-June and at the beginning of August. With effect from 9 August, the minimum bid rate of the main refinancing operations has amounted to 3%. Likewise, the interest rates for the marginal lending facility and the deposit facility were adjusted upwards accordingly, and currently amount to 4% and 2%, respectively.

These interest rate adjustments were warranted, given the expansionary European monetary policy stance on the one hand, and the increasing inflation risks on the other. The continuing rise in energy prices, as well as the planned increase in administrative prices and indirect taxes, are not just worsening the overall price climate, but are also increasing the risks of second-round effects in wage and price developments that are particularly worrying in terms of stability policy. Secondly, the monetary analysis has, for a long time, signalled inflationary risks in the medium to long term.

*Money market rates*

Like the preceding interest rate rises, the latest monetary policy measures were also implemented smoothly on the money market on the whole. Apart from short-term fluctuations at the end of the first half of the year and at the end of the reserve maintenance

## Money market management and liquidity needs

During the three reserve maintenance periods between 12 April and 11 July 2006, the liquidity needs arising from the autonomous factors determining bank liquidity increased markedly by €24.5 billion (net). As usual at this time of year, the main reason for this was the strong growth in banknotes in circulation of €22.4 billion altogether. Demand for banknotes increased, particularly in the April-May reserve period before the Easter holidays and the holiday on 1 May. Government deposits likewise increased owing to seasonal factors with the increase coming exclusively in the June-July reserve period. Primarily, this can be traced back to the effect of the end of the first half of the year, which had an even stronger impact than in the previous year. However, the liquidity needs were slowed by the development of the remaining autonomous factors throughout the observation period. If the changes in net foreign reserves and in other factors are taken together, a move which eliminates valuation effects, €13.3 billion net flowed into the market via such transactions. This essentially occurred as a result of Eurosystem purchases of euro-denominated financial assets which were not linked to monetary policy.

In the April-May period, there was an increase in the provision of liquidity via longer-term refinancing operations of €6.3 billion after the transaction of 30 March 2006 had completed the topping up process from €90.0 billion to €120.0 billion that was started in late January. The volume of the main refinancing operations was noticeably increased by €26.4 billion to €316.5 billion in the period under review, which served to balance out the increased liquidity requirement owing to the increase in general government deposits at central banks in the June-July reserve period. On balance, credit institutions' central bank balances rose to such an extent as to offset the perceptible increase of €6.7 billion in the required reserves to €165.6 billion.

In the period under review, the EONIA stood mostly at between 2.60 % and 2.62 % until the interest rate rise took effect on 15 June 2006. With the new minimum bid rate of 2.75 %, the EONIA stood mostly at 2.83-2.84 %. Hence, the spread between the EONIA and the minimum bid rate went down from between 10 and 12 basis points most of the time to between 8 and 9 basis points during the three reserve periods. Amongst other things, this can be attributed to the fact that, starting with the main refinancing operation (MRO) settled on 27 April 2006, the ECB extended its policy of increasing allotment from €1.0 billion to €2.0 billion above the benchmark amount. Since the MRO settled on 4 May 2006, this policy has also applied to the last MRO of the reserve maintenance period. The stated objective of the increased allotment policy is to contain the recently increased EONIA spread. At the same time, the ECB gave an assurance that it would continue to ensure balanced liquidity conditions on the last day of the reserve maintenance period.

Ultimately, this procedure temporarily led to a slight reduction in rates towards the end of each of the three reserve maintenance periods, with liquidity-absorbing fine-tuning operations ensuring that the EONIA was very close to, or even equal to the minimum bid rate at the end of the reserve maintenance period.

The volumes of the fine-tuning operations amounted to €11.5 billion, €4.9 billion and €8.5 billion in the period under review. Only in the middle operation of the three was there very slight underbidding, with the result that the desired volume of €5.0 billion was not quite achieved. However, the EONIA of 2.50 % in the reserve maintenance period ending on 14 June indicated balanced liquidity conditions.

The temporary slight increase in rates in the course of the period under review were limited to days at the end of the month and half year when market participants displayed an increased liquidity preference.

### Factors determining bank liquidity [1]

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

| Item | 2006<br>12 Apr to 9 May | <br>10 May to 14 June | <br>15 June to 11 July |
|---|---|---|---|
| I Provision (+) or absorption (–) of central bank balances due to changes in autonomous factors | | | |
| 1 Banknotes in circulation (increase: –) | – 12.7 | – 2.9 | – 6.8 |
| 2 General government deposits with the Eurosystem (increase: –) | + 0.5 | + 5.6 | – 21.5 |
| 3 Net foreign reserves [2] | + 9.1 | – 0.1 | – 2.6 |
| 4 Other factors [2] | – 1.7 | + 3.5 | + 5.1 |
| Total | – 4.8 | + 6.1 | – 25.8 |
| II Monetary policy operations of the Eurosystem | | | |
| 1 Open market operations | | | |
| (a) Main refinancing operations | + 1.2 | – 4.3 | + 29.5 |
| (b) Longer-term refinancing operations | + 6.3 | + 0.0 | – 0.0 |
| (c) Other operations | – 1.1 | + 0.3 | – 0.2 |
| 2 Standing facilities | | | |
| (a) Marginal lending facility | + 0.1 | – 0.1 | + 0.1 |
| (b) Deposit facility (increase: –) | + 0.1 | + 0.1 | – 0.5 |
| Total | + 6.6 | – 4.0 | + 28.9 |
| III Change in credit institutions' current accounts (I + II) | + 1.7 | + 2.1 | + 3.0 |
| IV Change in the minimum reserve requirement (increase: –) | – 1.5 | – 2.2 | – 3.0 |

**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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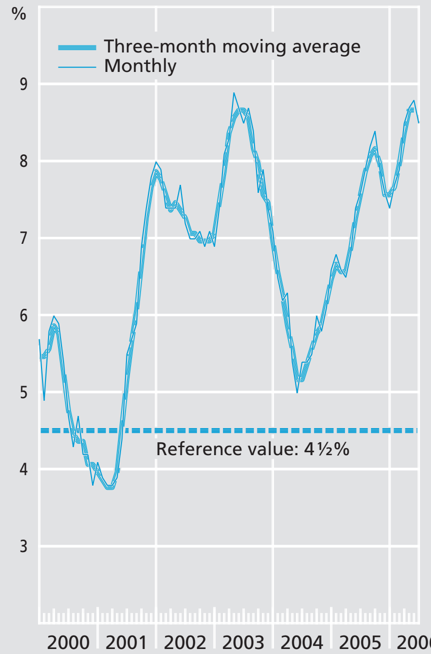
periods, the overnight market interest rate (EONIA) was close to the marginal allotment rate for the main refinancing operations in the period under review. In expectation of the monetary policy measures, the remaining money market interest rates tended to go up overall in the period under review. Whereas, in doing so, longer-term interest rates rose by just under 30 basis points between the start of May and the start of August, short-term rates rose by more than 40 basis points – the money market yield curve has therefore flattened somewhat. This tendency also continued after the most recent interest rate rise at the start of August. The three-month forward rate, in which interest rate expectations are also reflected, likewise suggested that the market is expecting further interest rate rises until spring. The premium of the three-month forward rates due in six to nine months remained at around ½ a percentage point at the beginning of August; as before, the premium of the three-month forward rates due in three to six months amounted to just over ¼ a percentage point.

**Growth of the money stock M3 in the euro area**

Seasonally adjusted, annual percentage change

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## Monetary developments in the euro area

*Money holdings again up sharply*

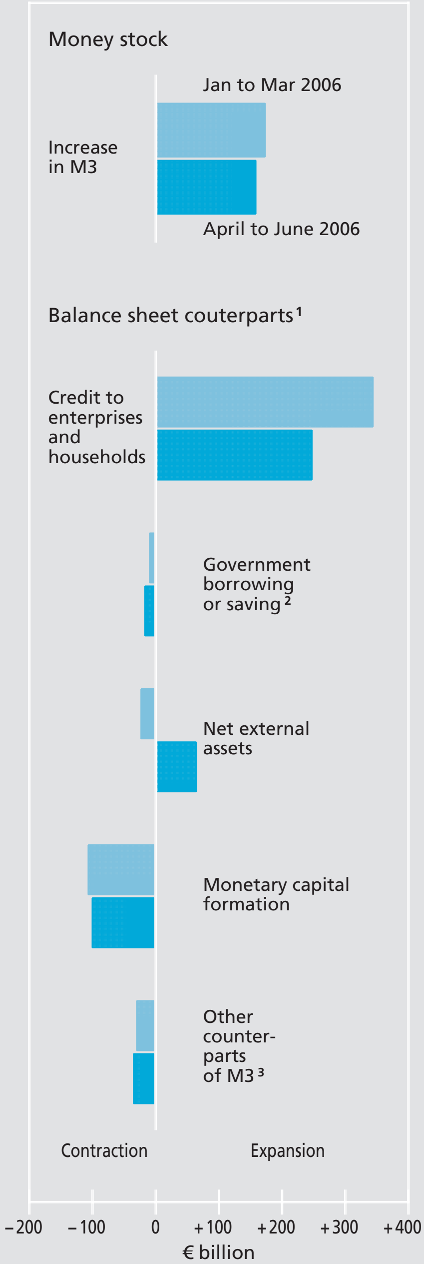
Low money market rates shaped monetary developments up to the end of the period under review. Between April and June, the monetary aggregate M3 in the euro area increased at a seasonally adjusted annual rate of 9%. In a balance sheet context, the ongoing strong credit growth was the main contributor to this. Furthermore, large amounts of funds from cross-border payment transactions accrued to German non-banks in the quarter under review for the first time in a year. Longer-term investments by German non-banks in the domestic banking sector, which likewise rose sharply, formed something of a counterweight to this, without which monetary growth would have been even stronger.

*M3 components broadly up*

In this context, the especially liquid components of the monetary aggregate, in particular, increased markedly in the quarter under review. For example, the amount of cash in circulation continued to grow sharply in the second quarter at a seasonally adjusted and annualised growth rate of just under 9½%, and the corresponding rate for overnight deposits came to just over 8%, similar to that of the previous quarter. However, deposits with a maturity of up to two years have also risen

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 credit 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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sharply recently. These are likely to have benefited from the marked rise in interest rates in this market segment in the second quarter. Marketable instruments – especially money market fund shares and repo transactions – were broadly expanded in the quarter under review, whereas deposits redeemable at notice of up to three months stagnated.

*Continuing heavy lending to the private sector*

The sharp increase in money holdings in the euro area was – as mentioned previously – again accompanied by a considerable increase in demand for credit from the private sector. The seasonally adjusted annual bank lending rate to domestic enterprises and households amounted to 10½% in the second quarter, despite the banks' interest rate rises up to then. In particular, there was continuing high demand for bank loans to non-financial enterprises and housing loans. In addition, banks added a considerable amount of securities issued by enterprises resident in the euro area to their portfolios.

*Decline in credit to general government*

In return, credit institutions noticeably reduced their holdings of euro-area government bonds in the second quarter, having already reduced them in the first quarter. Overall, the weakening effect of public sector net borrowing on M3 was minor in the quarter under review, since central governments markedly reduced their bank deposits (that are not part of M3) and unsecuritised bank lending to the public sector remained largely constant in seasonally adjusted terms.

*Inflows of funds from abroad*

Besides the very strong growth of credit of domestic banks overall, in the second quarter, extensive inflows of funds from abroad advanced monetary expansion once again for the first time in a year. In any case, the net external asset position of the banking sector, which reflects foreign payment transactions by non-banks with other euro-area countries, rose sharply.

*Monetary expansion dampened by strong monetary capital formation*

By contrast, the renewed strong monetary capital formation had a dampening effect on monetary growth. Longer-term investments of resident non-banks in the banking sector expanded at a seasonally adjusted and annualised rate of 8% in the second quarter. For example, banks were able to sell large holdings of longer-term bank debt securities outside the banking sector. Furthermore, longer-term time deposits (with an agreed maturity of over two years) rose sharply. By contrast, growth of longer-term savings deposits (with an agreed notice period of more than three months) was only moderate.

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

*Sharp rise in bank deposits*

In line with developments throughout the euro area, the balances of German investors at German banks also went up sharply in the second quarter. For example, it was not just highly liquid deposits that increased unusually sharply. Their seasonally adjusted and annualised growth rate rose to 7½% at the end of the quarter under review, up from just over 5% in the previous quarter. In addition, long-term time and savings deposits were again up sharply.

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

€ billion

| Item | 2006 April to June | 2005 April to June |
|---|---|---|
| Deposits of domestic non-MFIs 1 | | |
| Overnight | + 14.6 | + 18.5 |
| With agreed maturities | | |
| of up to 2 years | + 19.0 | + 3.9 |
| of over 2 years | + 7.7 | – 0.6 |
| Redeemable at agreed notice | | |
| of up to 3 months | – 7.9 | – 1.0 |
| of over 3 months | + 2.7 | – 1.6 |
| Lending | | |
| to domestic enterprises and households | | |
| Unsecuritised | + 8.0 | + 8.4 |
| Securitised | – 3.0 | + 0.6 |
| to domestic government | | |
| Unsecuritised | – 10.3 | – 4.7 |
| Securitised | + 2.3 | – 13.4 |

* 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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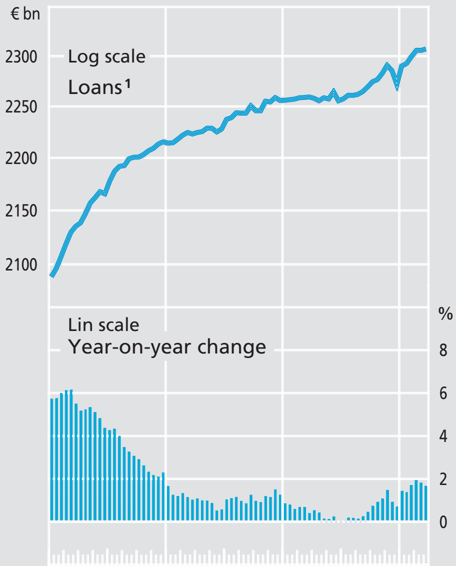
*Marked increase in overnight deposits and...*

Between April and June, overnight deposits grew at a seasonally adjusted annual rate of 5½% as other financial institutions and non-financial enterprises, in particular, sharply increased their higher-interest-bearing overnight deposits. In addition, short-term time deposits rose exceptionally sharply in the quarter under review. Even more noticeably than in the previous quarter, this sharp rise was shaped by social security funds, into which considerable "additional" revenue was paid in the first half of 2006 as a result of the shortened deadline for transferring social security contributions adopted last year. By contrast, short-term savings deposits (with a notice period of three months) were further reduced.

*... exceedingly sharp increase in short-term deposits owing to special effect*

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*

Besides short-term deposits, longer-term bank deposits also increased markedly in the domestic business of German credit institutions recently. In particular, time deposits redeemable at notice of over two years were responsible for the rise, as in the previous quarter. However, longer-term savings deposits (with an agreed period of notice of over three months) were increased sharply as well.

*Growth in lending only moderate, ...*

In comparison with credit growth in the euro area as a whole, lending by German banks to domestic non-banks again rose only moderately in the second quarter, even though German banks' lending to residents, which had long been stagnant or even in decline, has shown a noticeable recovery. Their annualised growth rate amounted to just over 1½%. There was demand from non-financial enterprises for medium to longer-term bank loans, in particular. Housing loans and household consumer credit granted by banks also increased somewhat. According to the Bank Lending Survey, anticipatory effects with regard to the impending rise in VAT played a role in this respect. Overall, however, demand for lending to the private sector in Germany was still very subdued. As a substitute for the comparatively weak demand for lending to the private sector, banks evidently purchased a noticeable amount of securities, with the result that there were also marked increases in the figures for the euro area as a whole (as reported above). German enterprises accounted for most of these securities in the domestic business of German banks; holdings of government bonds were topped up only slightly. By contrast, there was again a reduction in loans to general government of late, with the result that the public sector actually slightly reduced its net debt to the German banking system in the second quarter.

*... but nevertheless overstated by special effects*

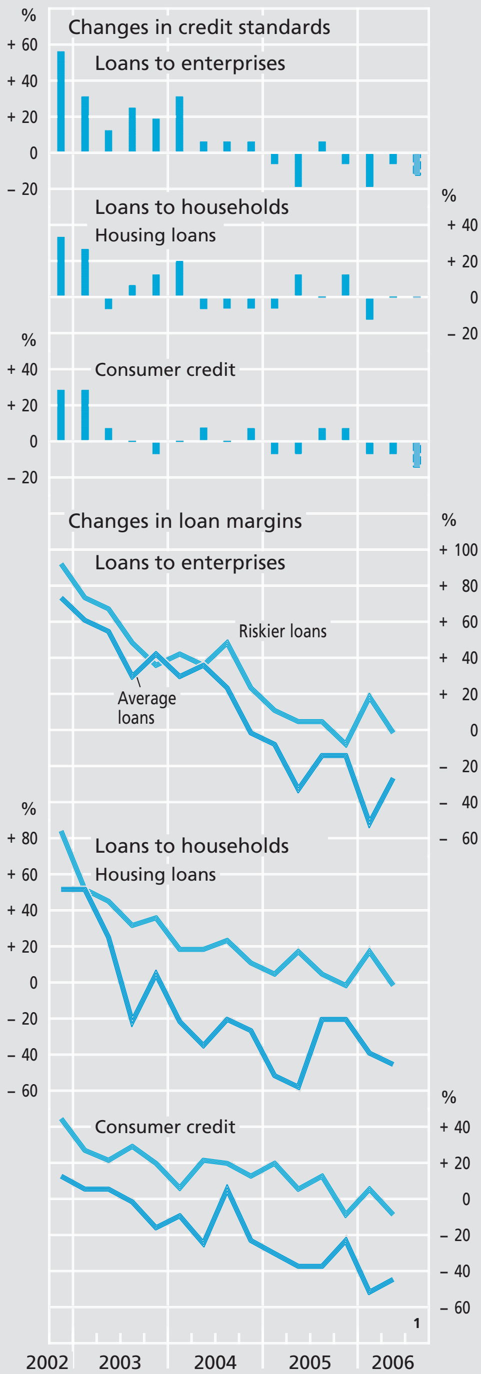
In addition, the figures for lending in Germany again recorded sizeable securities lending transactions (reverse repos) in the second quarter, which cover non-monetary financial intermediaries (particularly securities trading houses) as a counterparty in connection with the settlement of secured interbank loans. Ultimately, no funds were transferred to the domestic private non-bank sector in this case. If, therefore, the effect on growth in domestic credit associated with such operations is eliminated, the year-on-year growth in lending to the German private sector was around ½ a percentage point lower.

*Lending rates continuing to rise*

The banks have adjusted their lending rates further upwards following the ECB's interest rate rises at the start of March and in mid-June. On average, the German institutions most recently charged between 4 and 5 per cent for short-term loans to enterprises, depending on volume; ie just under ½ a percentage point more than before the interest rate rise in March. As expected, the longer-term lending rates have also increased in the last few months, after capital market rates rose continuously until May. By contrast, the subsequent and temporary sharp fall in capital market rates did not have any discernible impact on the relevant bank interest rates. For example, German credit institutions charged between 4.5% and 4.8% for long-term loans to enterprises in June, depending on credit volume, and 4.6% for long-term housing loans. By contrast, there was a slight slackening in conditions for consumer lending overall. With an interest rate fixed over five years, the banks were demanding 8.6% for these loans at the end of the quarter under review. Strong competitive pressure may have been a factor, particularly in trade with borrowers with a good credit rating. In any case, the institutions reporting to the Eurosystem's Bank Lending Survey reported smaller margins in this business area. By contrast, banks' general credit standards remained largely unchanged over the second quarter according to the results of the survey after the participating institutions had previously talked about relaxing the conditions for issuing loans.

Interest rate developments for German banks' deposit business were also shaped by

## 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 Q3.

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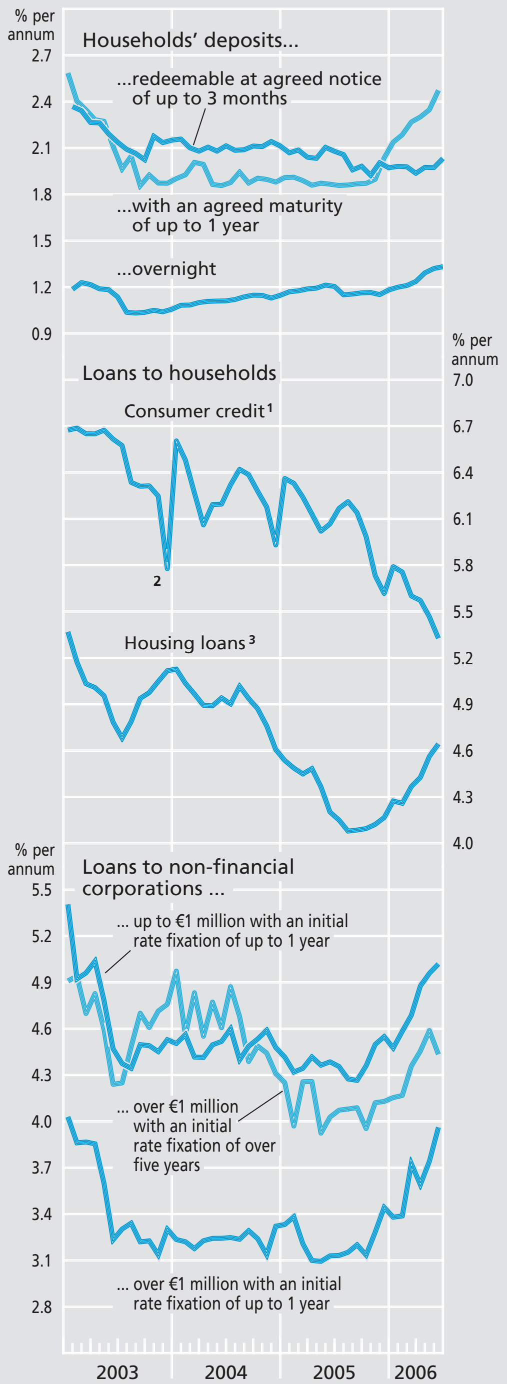
**Bank interest rates in Germany**

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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*Deposit rates mainly increasing*

the interest rate rises. For example, the banks further adjusted their rates upwards for short-term deposit business with households in the second quarter of 2006. The rates offered by credit institutions ranged between 2.5% and 3.2% for time deposits, depending on the maturity, 1.4% for overnight deposits and 2.1% for savings deposits with notice periods of up to three months. Only interest rates on deposits with an agreed maturity of over two years went down slightly after capital market rates had come under pressure affected by reassessments on the stock markets over the second quarter.