Monetary policy and banking business

Interest rate policy and the money market

Interest rate increase in December

The Governing Council of the ECB raised the central bank rates by a further ¼ percentage point in December 2006. Since 13 December, main refinancing operations have been conducted with a minimum bid rate of 3½%, and interest rates on the marginal lending facility and the deposit facility have been 4½% and 2½% respectively.

Like the previous interest rate rises, the aim of this sixth increase since December 2005 was to reduce the expansionary stance of monetary policy further and thus to counter the ongoing risks to price stability. The fall in oil prices in the fourth quarter of 2006 led to a somewhat more favourable price outlook in the shorter term; at the same time, however, domestic price dangers tended to increase as a result of the noticeable strengthening in aggregate demand in the euro area. Following the rapid growth in employment over the past few years, the risks to price stability have risen – particularly in terms of wages. Furthermore, monetary growth has been excessively strong for quite some time; this is largely attributable to the continued strength in credit expansion and represents an inflation risk in the longer term.

Money market rates

The interest rate policy was expected by money market participants and implemented smoothly. For the most part, the EONIA overnight rate between the beginning of November and the beginning of February was slightly above the marginal allotment rate which, in turn, was only a few basis points higher

Money market management and liquidity needs

During the three reserve maintenance periods from 11 October 2006 to 16 January 2007, euro-area credit institutions' need for central bank money arising from autonomous factors determining bank liquidity increased by €4.2 billion in net terms. This was due mainly to the steep rise of €31.0 billion in banknotes in circulation in the euro area. The expansion was particularly robust in December, which was usual for the time of year and was similar in extent to 2005, even if the year-on-year rate of growth was declining. However, this sharp increase was almost entirely offset by the remaining autonomous factors. Liquidity needs arising from general government deposits declined by €14.1 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 provision of €12.7 billion. There was a significant increase of €7.8 billion in the minimum reserve requirement and this, along with autonomous factors, led to growing demand for central bank liquidity.

The greater need for liquidity was covered primarily by the main refinancing operations (MROs) being topped up by €13.6 billion, with the greatest increase (€9.2 billion) coming in the December-January period. The volume of longer-term refinancing operations (LTROs) targeted by the Governing Council of the ECB for the period under review remained unchanged at €40 billion per operation. Starting with the LTROs on 1 February 2007, this volume increased to €50 billion.

Until the key interest rate rise took effect on 13 December 2006, the EONIA was fluctuating predominantly between 3.32% and 3.35%. With the new minimum bid rate of 3.50%, the EONIA stood mostly between 3.56% and 3.63%.

As in the final two operations of the previous period, the ECB continued to allot the benchmark amount in the first three MROs of the reserve maintenance period beginning on 11 October. As market participants had become accustomed to the ample allotments since the beginning of the year, the spread between the EONIA and the minimum bid rate (EONIA spread) increased from 6 basis points to up to 13 basis points. The ECB reacted by allotting €1.0 billion above the benchmark in the last MRO of this reserve maintenance period; as a result, the EONIA spread was reduced to 7 basis points at the end of the period. Despite the increased allotment, liquidity conditions were largely balanced on the last day of the reserve period and consequently no fine-tuning operation was necessary.

In the November-December reserve period, the ECB continued to allot €1.0 billion above the benchmark in all five MROs. Consequently, the EONIA spread remained predominantly at 7 basis points. Owing to a liquidity shortfall at the end of the reporting period, which was apparently anticipated by market participants, the spread increased slightly on the last two days of the period. Following the liquidity-providing fine-tuning operation of €2.5 billion conducted by the ECB on the final day, the period came to a close with a low net recourse to the marginal lending facility of €531 million.

As in 2004 and 2005, the December-January reserve period featured a policy of loose allotments, whose main objective was to compensate for seasonally-induced changes in forecasting the banknotes in circulation. While the ECB allotted €2.0 billion above the benchmark in the first MRO, it increased its allotment in the operation before Christmas by €4.0 billion and before New Year by €5.0 billion above the benchmark. The EONIA was at 3.69% at the end of 2006 and thus 19 basis points higher than the minimum bid rate of 3.50% applying since 13 December. The EONIA spread increased slightly by 2 basis points compared to the end of 2005. One possible reason was that there were only three trading days between the Christmas and New Year holidays, with the result that little trading took place and rates increased. At the beginning of 2007, the EONIA fell again to 3.60%, and the ECB allotted €2.0 billion and €1.0 billion above the benchmark in the last two MROs of the period. As liquidity conditions were balanced at the end of the reporting period, no fine-tuning operations were required. On the last day of the reserve period, the EONIA stood at 3.50% and was therefore in line with the minimum bid rate.

Factors determining bank liquidity [1]

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

Item	2006 11 Oct to 7 Nov	2006 8 Nov to 12 Dec	2006/2007 13 Dec to 16 Jan
I Provision (+) or absorption (–) of central bank balances due to changes in autonomous factors			
1 Banknotes in circulation (increase: –)	– 4.3	– 5.8	– 20.9
2 General government deposits with the Eurosystem (increase: –)	– 1.1	+ 5.3	+ 9.9
3 Net foreign reserves [2]	+ 0.7	– 0.4	– 1.2
4 Other factors [2]	+ 1.5	+ 5.8	+ 6.3
Total	– 3.2	+ 4.9	– 5.9
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	+ 3.2	+ 1.2	+ 9.2
(b) Longer-term refinancing operations	± 0.0	– 0.0	± 0.0
(c) Other operations	– 0.3	+ 0.1	– 1.1
2 Standing facilities			
(a) Marginal lending facility	+ 0.0	– 0.0	– 0.0
(b) Deposit facility (increase: –)	+ 0.1	+ 0.0	– 0.1
Total	+ 3.0	+ 1.3	+ 8.0
III Change in credit institutions' current accounts (I + II)	+ 0.0	+ 6.2	– 2.1
IV Change in the minimum reserve requirement (increase: –)	+ 0.1	– 6.2	– 1.7

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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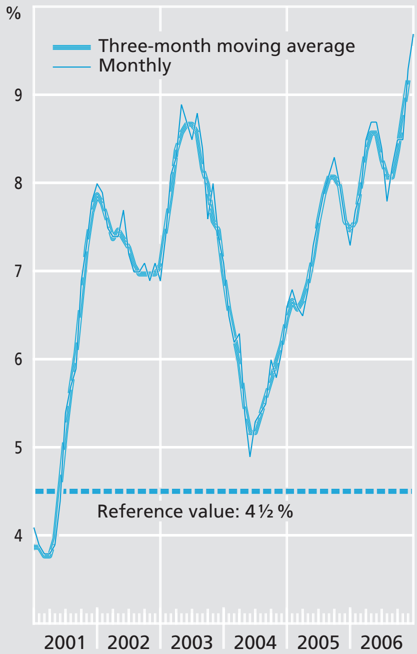
Growth of the money stock M3 in the euro area

Seasonally adjusted, annual percentage change



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than the minimum bid rate. Deviations occurred only at the end of the reserve maintenance periods or in the last week in December, when financial institutions are usually eager to hold more liquidity for accounting reasons. The other money market rates also increased quite steadily in the period under review. Following the central bank interest rate increase in December, the longer maturities rose by up to 20 basis points until the beginning of February; by contrast, the interest rates at the very short end changed only slightly. At the end of the period under review, the remuneration for 12-month funds was about ½ percentage point higher than for overnight money. Thus, the money market yield curve became somewhat steeper. The three-month forward rates, which express interest rate expectations, have also risen slightly since the change in interest rates in December. Over a six-month time horizon, further interest rate increases are being priced in.

Monetary developments in the euro area

Strong monetary growth continues

The strong monetary growth experienced in the euro area over the course of the preceding quarters of 2006 continued in the last three months of the year. From October to December monetary holdings included in M3 increased by an annualised, seasonally adjusted growth rate of just over 9%. Alongside lending to the private sector, which continued to grow at a very high level, it was primarily the sizeable inflow of external funds that encouraged monetary growth in the euro area during the period under review. However, continuing strong monetary capital formation and a considerable reduction in net general government borrowing from banks in the euro area had a dampening effect on monetary growth of late.

Heterogeneous developments in deposits

Of the M3 components, it was the short-term time deposits that again found favour with domestic investors in the period under review. Given their remuneration at market rates, these deposits had already been highly popular since the phase of interest rate increases began in the Eurosystem in December 2005. In addition, cash and overnight deposits – ie very liquid components – also increased to a large extent in the reporting period. Non-financial corporations in particular created overnight deposits; however, other financial intermediaries also accumulated these types of balances in the fourth quarter, thus breaking their usual seasonal pattern. By contrast, short-term savings deposits were further reduced in the fourth quarter, as were repo transactions.

Heavy lending to private sector continues

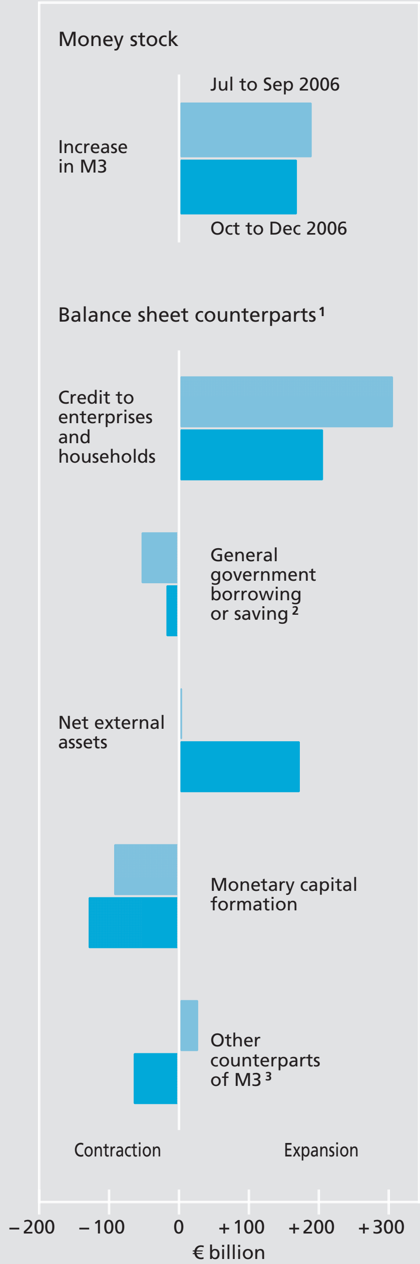
Lending to the private sector in the euro area again rose significantly in the period under review. Even so, growth was noticeably weaker than in the previous quarter. On an annualised basis, credit increased by 8%, a development which constituted the lowest rate of increase since the first quarter of 2005. The perceptible slowdown was due mainly to a strong decline in short-term loans to non-monetary financial intermediaries towards the end of the year. This reduction should be matched by a decline in repo transactions and may be purely temporary. Growth in housing loans was also more subdued; the 12-month rate continued to decrease in the final quarter of 2006 and, at 9.5% at the end of the quarter, was just over 2½ percentage points lower than in the second quarter. By contrast, growth in consumer loans and other lending to households remained unchanged in the period under review. The expansion in lending to domestic non-financial enterprises was again particularly robust. Given the low capital market rates, there was a particularly strong increase in longer-term loans. Furthermore, the banks substantially increased their stocks of securities issued by domestic enterprises, thus indirectly making substantial additional funds available to the corporate sector.

Credit to general government continues to decline

Unlike domestic lending to the private sector, credit from domestic banks to general government continued to fall in the euro area in the final quarter. The banks mainly reduced

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 Oct to Dec	2005 Oct to Dec
Deposits of domestic non-MFIs 1		
Overnight	+ 23.6	+ 13.2
With agreed maturities		
of up to 2 years	+ 30.1	+ 11.0
of over 2 years	+ 5.7	+ 3.9
Redeemable at agreed notice		
of up to 3 months	− 7.9	+ 4.1
of over 3 months	+ 6.7	+ 0.5
Lending		
to domestic enterprises and households		
Unsecuritised	− 33.7	− 9.1
Securitised	+ 3.9	+ 10.7
to domestic government		
Unsecuritised	+ 2.4	− 1.9
Securitised	− 3.6	− 1.9

***** 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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their stocks of public sector securities. At the same time, however, central government deposits (which are not part of M3) also decreased sharply. On balance, general government borrowing or saving curbed the increase in M3 in the fourth quarter.

Monetary capital formation stronger again

Monetary capital formation, which was already strong in the preceding quarters, accelerated again in the final quarter of the year. With a seasonally adjusted annualised rate of 10%, the longer-term inflow of funds clearly surpassed the result from the third quarter (just over 7%). Alongside the longer-term time deposits (with an agreed maturity of more than two years) it was again primarily the longer-term bank debt securities that increased dramatically in the reporting period. A large number of these securities may have been purchased by investors from outside the euro area. This is certainly what the concurrent sharp increase in the net external assets of banks in the euro area in the fourth quarter seems to indicate.

Deposit and lending business of German banks with domestic customers

Sharp increase in shorter-term bank deposits

In the last quarter of 2006, large inflows of funds from abroad also appear to have bolstered the strong growth in shorter-term bank deposits in Germany, which, at a seasonally adjusted annualised rate of just over 6%, was weaker than in the euro area as a whole but significantly stronger than in the previous quarter. Short-term time deposits, on which an interest rate of between 3.2% and 3.6% was paid at the end of the period under review, were in great demand. From October to December the annualised figure increased by more than one-third. The fact that short-term savings deposits, which often earn little interest, were reduced by an annualised rate of just over 11% suggests that households, in particular, continued to aim to achieve a higher interest income by regrouping investments. By contrast, non-financial corporations in Germany favoured overnight deposits towards the end of the year – probably in part for balance sheet reasons – and increased them significantly.

Renewed demand for longer-term bank deposits

As in the previous quarter, longer-term bank deposits were also created in the final quarter of 2006. There was a continuation of the sharp increase in savings deposits with a notice period of more than three months – traditionally formed exclusively by households – which had begun in the second quarter. In addition, financial corporations extended their longer-term time deposits.

Lending reduced significantly overall

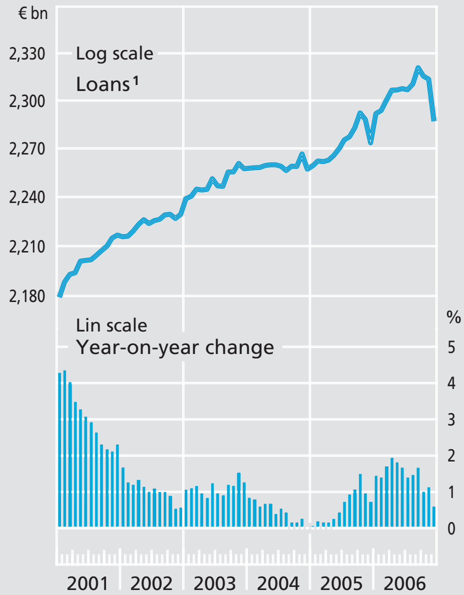
Lending by German banks to domestic non-banks fell significantly in the period under review. It shrank in the fourth quarter at a seasonally adjusted annualised rate of just under 4½%. The main cause behind this development was the notable reduction in short-term loans to other financial intermediaries. Evidently, securities lending transactions with banks were not extended at the end of the year. Short-term loans to other financial intermediaries associated with these transactions had still been rising appreciably in the preceding quarter. In addition, demand for housing loans slackened towards the end of the year. Lending to the public sector likewise decreased in the fourth quarter. By contrast, lending to domestic non-financial enterprises increased further. The year-on-year rate was latterly at 1.5%, compared with 1.1% at the end of the third quarter.

Improved supply conditions for consumer credit

According to the German results of the Bank Lending Survey,[1] however, the general weakness in credit growth in Germany cannot be attributed to tightened credit supply conditions. The institutions surveyed left their credit standards for corporate lending and housing loans largely unchanged in the final quarter of 2006. Households actually benefited from a loosening of credit standards for consumer credit. At the same time, the participating banks reduced their margins for average exposures not only for consumer credit but also for all credit categories. According to some banks, the increasingly competitive conditions played a substantial role in this development. As the margins for riskier loans remained unchanged, the margin spread in the lending business of the German institutions surveyed also continued in the reporting period. For the first quarter of 2007, the participating banks are proceeding on the assumption that the credit standard for households will remain largely unchanged, while predicting a slight loosening in the corporate sector. In corporate finance and consumer credit, the German results pointed to somewhat more relaxed lending policies than in the euro area overall.[2] For the first quarter

Loans to domestic enterprises and households

Seasonally adjusted



1 End of month; adjusted for statistical changes.

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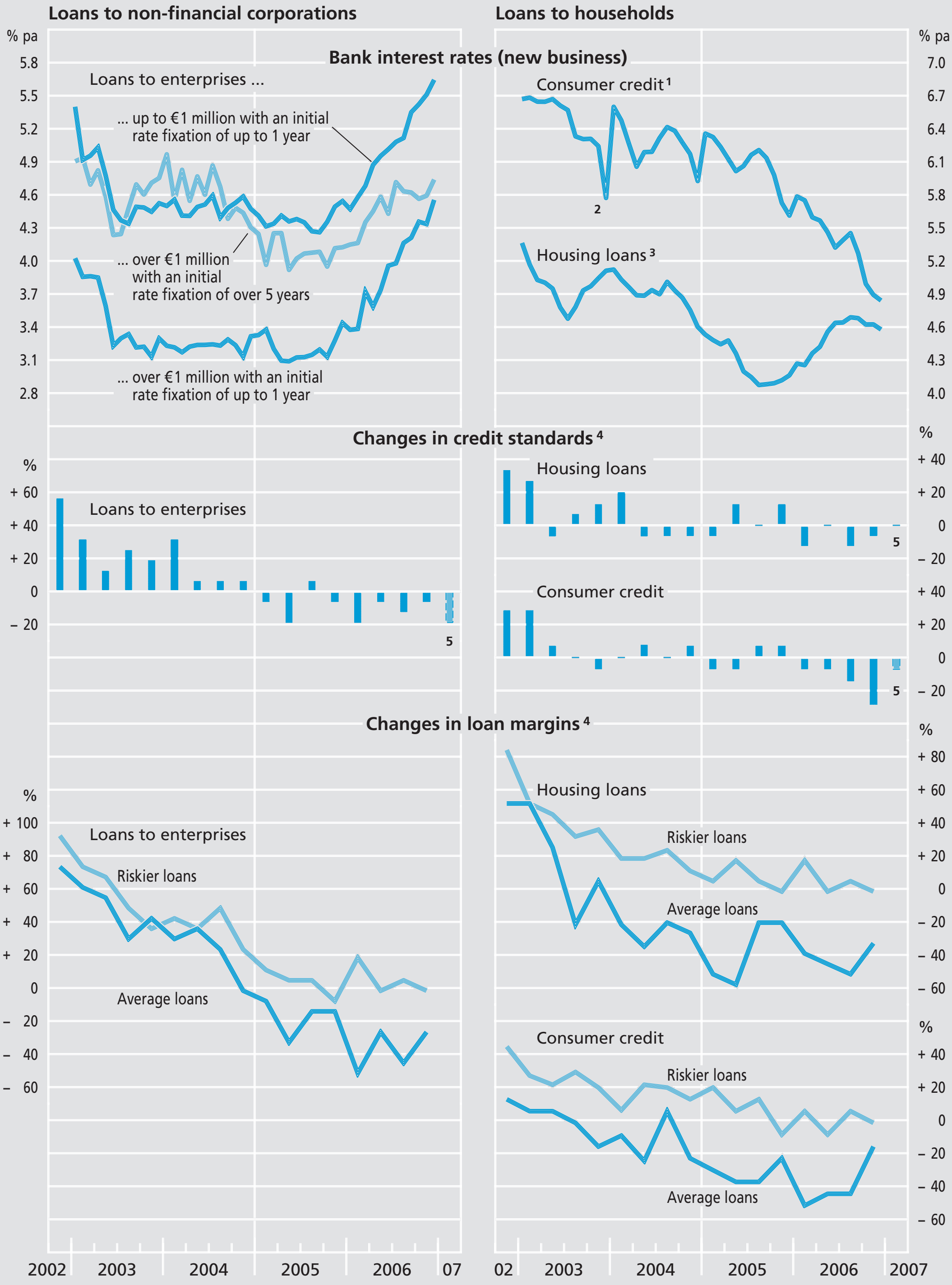
1 The aggregate survey results for Germany can be viewed at http://www.bundesbank.de/volkswirtschaft/vo_veroeffentlichungen.en.php.
2 See European Central Bank, Monthly Bulletin, February 2007, pp 20 ff.

Banking conditions in Germany



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. — 4 According to 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”. — 5 Expectations for Q1 2007.

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of 2007, the banks are expecting an upturn in their lending business, particularly in corporate lending, and, to a lesser extent, in housing loans.

Short-term lending rates rise on the whole, long-term rates vary

The tightening in the Eurosystem monetary policy was passed on by banks, particularly in the case of new short-term loans to the private sector. By contrast, developments in the conditions for long-term bank loans were more heavily influenced by the sometimes opposing trend in capital market rates. The rates for lending to households were latterly somewhat lower than at the end of the third quarter. For loans to corporations, banks charged between 4.8% and 5.0% according to credit volume, which was slightly more than three months previously.