Monetary policy and banking business

Interest rate policy and the money market

Interest rates rise in October

In raising interest rates by ¼ percentage point in early October, the Governing Council of the ECB further reined back its monetary policy. With effect from 11 October, main refinancing operations have been conducted as fixed-rate tenders with a minimum bid rate of 3¼%, and the interest rates on the marginal lending facility and the deposit facility have been 4¼% and 2¼% respectively.

The renewed interest rate rise had become necessary as risks to price stability remained on the upside. While the decline in crude oil prices since August, coupled with a favourable baseline effect, has triggered a temporary marked fall in the current inflation rate, this has not significantly affected the somewhat longer-term risks to price stability. Hence, the favourable economic developments in the euro area could result in price and cost increases, such as the recent increase in oil prices or the planned VAT increase in Germany in 2007, being passed through to a greater degree. There is also the persistent danger of second-round effects on wage developments, which may undermine stability. More importantly, however, the continued strong monetary expansion in the euro area – which increased still further in the third quarter owing to robust credit growth – heralds longer-term inflation risks.

Money market rates

Like the four previous interest rate rises, the latest monetary policy measures, which market participants had been expecting, were mainly implemented smoothly in the money

Money market management and liquidity needs

During the three reserve maintenance periods between 12 July and 10 October 2006, euro-area credit institutions' need for central bank liquidity determined by autonomous liquidity factors fell by €7.6 billion in net terms. The increase in the volume of banknotes in circulation was similar to that of the corresponding reserve maintenance periods last year and absorbed €9.7 billion, the main rise being in the July-August period. However, the remaining autonomous factors more than offset this need. The decline in general government deposits with the Eurosystem, which should be seen in connection with the fairly high levels of the preceding periods, led to a net €7.9 billion fall in liquidity needs. If the net foreign reserves and the other factors are taken together, a move which eliminates liquidity-neutral valuation effects, there is a €9.4 billion decline in the banks' liquidity needs over the three periods. This was caused by Eurosystem purchases of financial assets which were unrelated to monetary policy.

The Eurosystem took account of the changes in the liquidity needs arising from autonomous factors by adjusting the volumes of its main refinancing operations (MROs). These were initially expanded during the July-August period by €13.2 billion but the average allotment amount was reduced by €15.7 billion and €5.3 billion, respectively, in the following two periods. After a marked increase in the minimum reserve requirements in the preceding three periods, the reserve requirement in the period under review increased only slightly (by €0.7 billion) and was met by the credit institutions without difficulty.

The money market rate (EONIA) stood mostly at between 2.80 % and 2.83 % until the key interest rate rise took effect on 9 August. With the new minimum bid rate of 3.00 %, EONIA stood mostly at between 3.04 % and 3.07 % until the Governing Council of the ECB raised the main refinancing rate to 3.25 % with effect from 11 October.

The ECB continued its generous allotment policy in the July-August and August-September periods, allotting €2.0 billion above the benchmark in each of the MROs. Hence, the spread between the EONIA and the minimum bid rate (EONIA spread) was reduced from being mostly 8 basis points to being mostly between 6 and 7 basis points. Owing to the declining EONIA spread in the course of the period under review, the ECB reduced the allotment to €1.0 billion above the benchmark in the first three MROs of the September-October reserve maintenance period. As the EONIA spread fell further, the ECB decided to allocate only the benchmark amount in the final two MROs of the September-October period and informed the market accordingly.

The outcome of the ECB's generally loose allotment approach was that the overnight rates declined slightly for a time towards the end of the July-August and August-September reserve maintenance periods. Liquidity-absorbing fine-tuning operations ensured that the EONIA rate was very close to the minimum bid rate at the end of the reserve maintenance period. In the September-October reserve maintenance period, the end of the increased allotment led to a rise in the rates in the last few days of the period. A liquidity-providing fine-tuning operation resulted in EONIA standing at 3.09 % on the last day of the reserve maintenance period.

The liquidity-absorbing fine-tuning operations amounted to €18.0 billion and €11.5 billion, and the liquidity-providing operation €9.5 billion. In all three operations, the desired volume was fully achieved.

Factors determining bank liquidity [1]

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

Item	2006: 12 July to 8 Aug	9 Aug to 5 Sep	6 Sep to 10 Oct
I Provision (+) or absorption (–) of central bank balances due to changes in autonomous factors			
1 Banknotes in circulation (increase: –)	– 9.4	– 0.5	+ 0.2
2 General government deposits with the Eurosystem (increase: –)	– 6.0	+ 11.6	+ 2.3
3 Net foreign reserves [2]	– 6.7	– 0.3	– 0.6
4 Other factors [2]	+ 9.4	+ 4.1	+ 3.5
Total	– 12.7	+ 14.9	+ 5.4
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	+ 13.2	– 15.7	– 5.3
(b) Longer-term refinancing operations	± 0.0	+ 0.0	± 0.0
(c) Other operations	– 0.3	+ 0.2	+ 0.7
2 Standing facilities			
(a) Marginal lending facility	+ 0.0	– 0.1	+ 0.0
(b) Deposit facility (increase: –)	+ 0.5	+ 0.0	– 0.1
Total	+ 13.4	– 15.6	– 4.7
III Change in credit institutions' current accounts (I + II)	+ 0.8	– 0.7	+ 0.6
IV Change in the minimum reserve requirement (increase: –)	– 0.9	+ 0.7	– 0.5

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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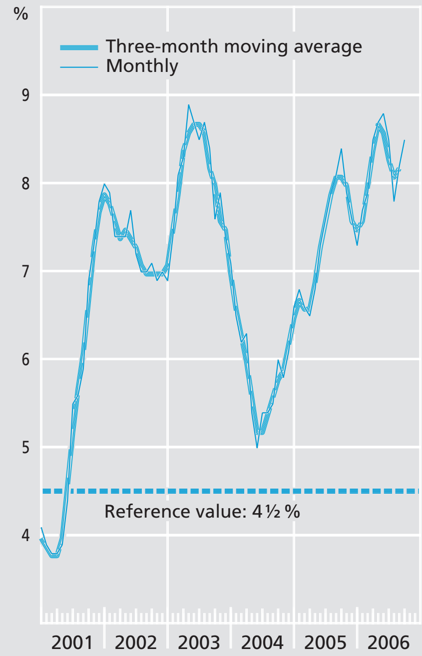
market. For the most part, the EONIA overnight rate between the start of August and the beginning of November was slightly above the marginal allotment rate which, in turn, was only a few basis points higher than the minimum bid rate. The remaining money market rates also tended to go up somewhat in the period under review. After the key interest rate hike in October, they rose across the board by up to 10 basis points until mid-November, although the money market yield curve has recently steepened somewhat. The recent remuneration for 12-month funds was around ½ percentage point higher than for overnight money. The three-month forward rates, which also express interest rate expectations, rose slightly, too. The market has priced in at least one further increase in the overnight rate of ¼ percentage point over a six-month time horizon.

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

Steep rise in money stock continues

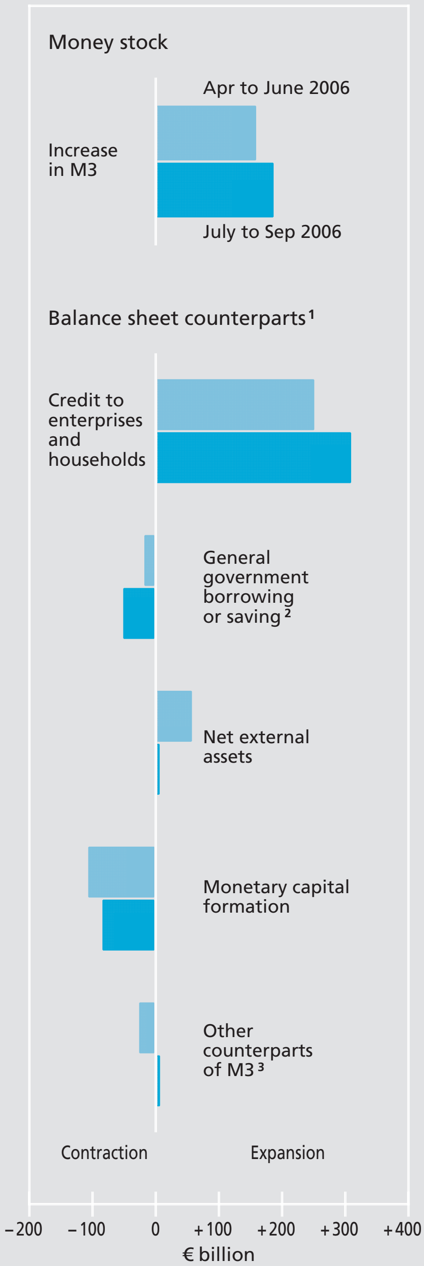
The broad monetary aggregate M3 continued to grow very strongly in the euro area in the third quarter of 2006. With an annualised seasonally-adjusted growth rate of 10½%, the pace of M3 expansion even slightly exceeded the very rapid rate seen in the second quarter (9%). Given that interest rates remain low, growth was driven mainly by the prolonged heavy demand for credit in the private sector. Although this was offset by continuing strong monetary capital formation, the latter lost some momentum in the period under review. General government borrowing or saving has also exerted a dampening effect on monetary growth of late.

Strong growth in M3 components remunerated at market rates

Of the components of M3, the short-term time deposits remunerated at market rates and marketable instruments were increased very sharply in the third quarter. The former attracted much attention, especially from households. By contrast, there was very little demand for the traditional low-yield deposit components of M3 in view of the higher opportunity costs. Hence, short-term savings deposits (with an agreed period of notice of up to three months) increased only slightly. Overnight deposits did not expand much either: their annualised, seasonally-adjusted growth rate from July to September was 1½%, down from 8% in the second quarter. Only cash holdings continued to increase rapidly. Overall, the especially liquid components of the monetary aggregate M1 rose in the third quarter at a seasonally-adjusted annual

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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rate of only 3%, the smallest rise since early 2001.

Heavy lending to private sector continues

In the third quarter, lending to the private sector in the euro area continued to generate strong stimuli for monetary developments. Credit growth has accelerated noticeably of late, picking up to a seasonally-adjusted annual rate of just over 12½% after tapering off somewhat for a period in the second quarter. Alongside housing loans, there was also increased demand for loans to enterprises. As in the preceding quarters, short and medium-term loans were also topped up heavily despite the continuing rise in bank interest rates. In addition, banks acquired a considerable amount of securities issued by enterprises resident in the euro area. In so doing, they indirectly provided funds to the corporate sector.

Credit to general government declines

In contrast to the domestic private sector, the euro-area public sector scaled back their loans from domestic banks in the third quarter. In addition, the banks further reduced their stocks of public sector securities, continuing their net sales of such paper in both of the preceding two quarters. At the same time, central government deposits (which are not part of M3) increased sharply, considerably accentuating the dampening effect of general government borrowing or saving on M3.

Strong monetary capital formation

Moreover, continuing strong monetary capital formation again had a dampening effect on monetary growth of late. However, the volume of additional longer-term investment with banks in the euro area was somewhat smaller in the third quarter than in the first and second quarters. The seasonally adjusted annual growth rate stood at 6½% at the end of the period under review, as against 8½% in the two preceding quarters. In addition, the flattening of the yield curve in the capital market evidently reduced the appeal of longer-term time deposits and bank debt securities remunerated at market rates. Although both of these components remained robust in the third quarter, overall they attracted a noticeably lower level of investment than they had in the preceding two quarters. There was muted demand, especially from households, for deposits with an agreed maturity of over two years. They indicated a preference not only for short-term time deposits, but also for longer-term savings deposits, which are likely to be more liquid at a similar remuneration, even if the period of notice is more than three months.

Deposit and lending business of German banks with domestic customers

Moderate rise in bank deposits

In contrast to the strong monetary expansion throughout the euro area, bank deposits in Germany grew only moderately in the third quarter. The seasonally adjusted annualised growth rate of these deposits slipped from 6½% in the second quarter to just under 4% in the third quarter. In this context, the relatively moderate growth in domestic private demand for credit continued. At the same time, domestic non-banks received considerable inflows of funds from abroad. Unlike the situation in the euro area, however, it was mainly longer-term bank deposits that experienced stronger growth, while investment in shorter-term deposits was only moderate.

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

€ billion

Item	2006 July to Sep	2005 July to Sep
Deposits of domestic non-MFIs 1		
Overnight	– 13.0	+ 11.4
With agreed maturities		
of up to 2 years	+ 24.0	+ 3.2
of over 2 years	+ 5.7	+ 1.7
Redeemable at agreed notice		
of up to 3 months	– 12.2	– 0.5
of over 3 months	+ 3.8	– 3.2
Lending		
to domestic enterprises and households		
Unsecuritised	+ 17.3	+ 16.8
Securitised	– 2.1	+ 7.6
to domestic government		
Unsecuritised	– 3.0	– 5.4
Securitised	– 8.7	– 0.7

* 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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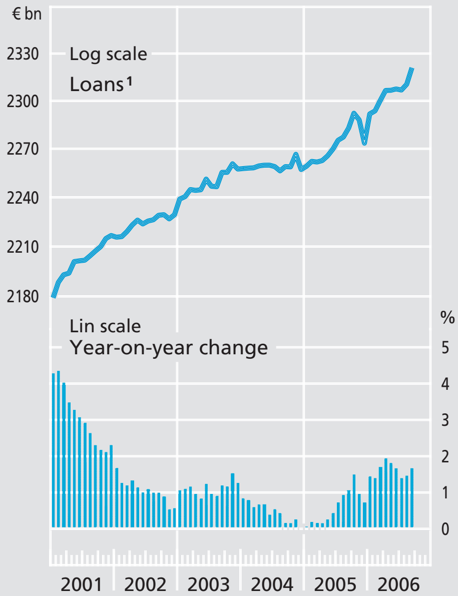
Portfolio shifts behind sharp rise in short-term time deposits

As in the whole of the euro area, short-term time deposits remunerated at market rates were topped up particularly heavily between July and September. However, the rise was largely fuelled by shifts away from overnight deposits and short-term savings deposits. Households, in particular, evidently attempted to benefit from the rise in money market rates in this manner. The reason was that retail banking interest rates for new deposits with an agreed maturity of up to two years recently rose considerably faster than rates for overnight money or short-term savings deposits (see page 28–29). As a corollary of these shifts, domestic non-banks' overnight balances (excluding Federal Government de-

Loans to domestic enterprises and households

Seasonally adjusted



1 End of month; adjusted for statistical changes.

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posits) fell by an annualised and seasonally adjusted rate of 1½% in the third quarter. On an annual basis, short-term savings deposits actually shrank by just under 8%.

Renewed demand for longer-term bank deposits

In addition to short-term time deposits, domestic bank customers again built up longer-term balances in the period under review. There was renewed demand, in particular, for deposits redeemable at a period of notice over three months. Large-scale shifts away from short-term savings deposits evidently occurred here as well. As in the preceding quarter, domestic insurance corporations (which traditionally constitute the most important group of depositors) were alone in increasing their time deposits with an agreed maturity of over two years.

Lending almost unchanged overall

Lending by German banks to domestic non-banks remained almost unchanged in the period under review. However, this picture masks very heterogeneous developments. Whereas lending to domestic enterprises and households (including securitised lending) expanded by a seasonally adjusted annualised rate of 2% in the third quarter, lending to the public sector in Germany fell by just under 7½% over the same period. The decline affected both lending and, even more so, banks' holdings of public sector securities.

Slight increase in lending to private sector …

Once more, a sharp rise in short-term lending to other financial intermediaries contributed to the increase in lending to enterprises and households in the period under review. Securities transactions with banks (reverse repos) accounted for the majority of the loans, which do not entail a flow of funds to the non-bank sector. The increase in lending to domestic enterprises and households is lower still if one excludes these interbank transactions settled with the aid of other financial intermediaries (especially securities trading houses).

… in face of further increase in lending to domestic enterprises

Other financial intermediaries aside, non-financial corporations also recently increased their loans from German banks. By contrast, lending to households increased only marginally. For example, housing loans, which are particularly prevalent, increased only fractionally more than usual in the third quarter. This somewhat heterogeneous lending pattern in the private sector is in line with observations made by German credit institutions participating in the Eurosystem's Bank

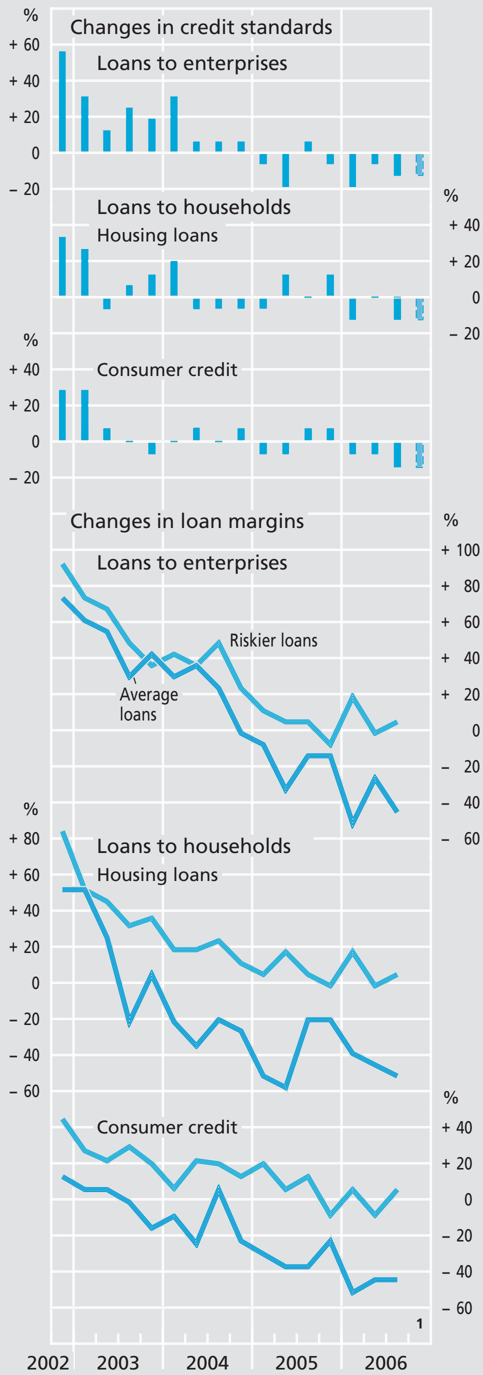
Lending Survey.[1] Whereas according to these data lending to enterprises picked up again slightly, household demand for housing loans in the third quarter was slightly down on the preceding quarter. By contrast, the banks surveyed reported an increase in demand for consumer loans, a development which they attributed to a rise in consumer confidence and signs of anticipatory effects ahead of the increase in VAT. The banks expect demand to increase further in the fourth quarter across all the lending categories reviewed here, although housing loans are expected to be somewhat less buoyant than the rest.

Easing of credit standards

In terms of loan supply, enterprises benefited from an easing of credit standards in the third quarter of 2006, as did households for their housing and consumer financing.[2] According to the Bank Lending Survey data, the respondent banks ascribed this to a brightening of the general economic outlook and increasing competition. At the same time, participating institutions also reduced their margins for average exposures across all credit categories, leaving those for riskier loans largely unchanged. Hence, the margin spread, observable for some time, continued to widen in the reporting period. On balance, respond-

1 All the aggregate survey results for Germany are available at http://www.bundesbank.de/volkswirtschaft/vo_veroeffentlichungen.en.php.
2 In respect of loans to enterprises in particular, the German results point to supply conditions that are slightly more expansionary than indicated by the results for the euro area as a whole. At the same time, the assessment of demand for loans to enterprises was somewhat less positive in Germany than the euro-area average. Conversely, developments with regard to retail customers broadly matched those indicated in the euro-area survey results. See European Central Bank, Monthly Bulletin, November 2006, p 22.

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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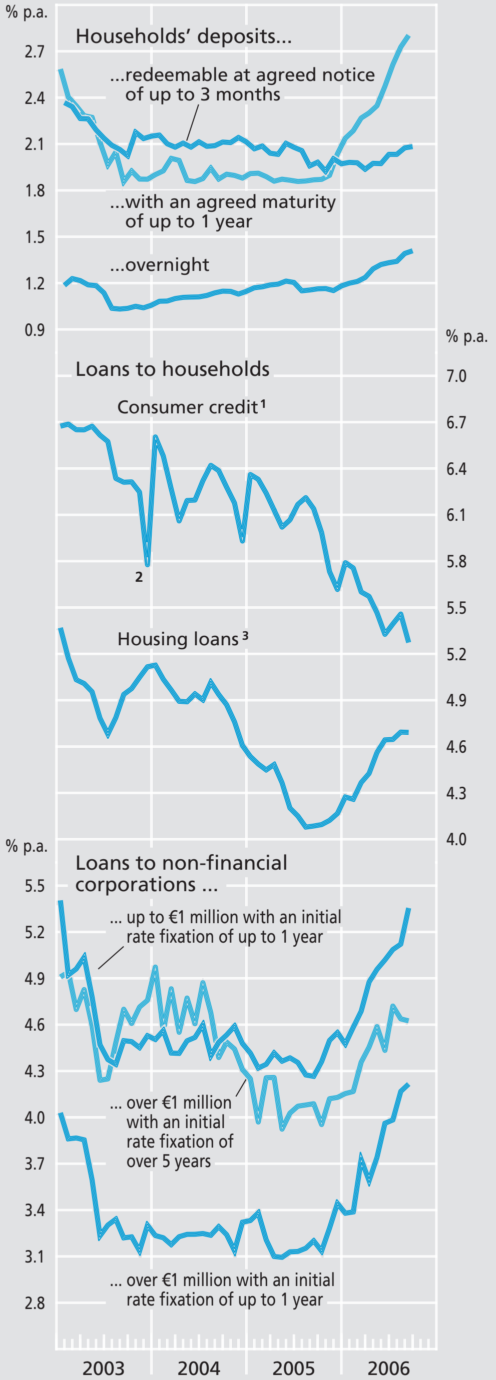
Bank interest rates in Germany

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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ents expect the moderate easing of credit standards across all lending categories to continue in the final quarter of 2006.

Lending rates continue to rise

The trend towards a reduction in margins for average-risk loans runs counter to the general increase in banks' lending rates, through which the institutions pass on the gradual tightening in Eurosystem monetary policy to their customers. However, interest rates on new loans from German institutions were still higher across virtually all product categories and maturities than at the end of the preceding quarter; only on mid-term consumer loans were banks charging somewhat less than they had three months earlier. Moreover, the short-term lending rates were revised upwards more strongly than rates for longer-term loans. It is likely that developments in the capital markets also played a part here; they saw a sharp decline in long-term yields in the reporting period, and this caused the yield curve to flatten further. Overall, the German banks' rates for long-term loans to enterprises recently stood at between 4.6% and 4.9% depending on the loan amount, while banks charged 4.7% and 8.9% for long-term housing and consumer loans respectively.

Deposit rates mainly increasing

There was also an increase in the remuneration for households' deposits in the quarter under review. Depending on the maturity, the rate of interest paid on households' time deposits ranged between 2.5% and 3.4%, though here, too, the discernible upward trend was stronger for shorter maturities than for longer ones; the remuneration rate for overnight deposits was 1.4%. The rate of interest on savings deposits with a notice period of up to three months did not change, at 2.1%, while German banks were recently offering 2.7% for longer notice periods.