

Securities markets

Bond market

Interest rate movements

At the turn of the year German capital market rates continued to fall steeply. The yield on domestic bonds outstanding declined by $\frac{1}{2}$ percentage point to 5 % between mid-October and December 1997 and fell further to just over $4\frac{3}{4}$ % by mid-January 1998. When this Report went to press in mid-February, capital market rates, at less than $4\frac{3}{4}$ %, had reached a new all-time low. The decline in interest rates was particularly pronounced in the long-term maturity categories. The yields on ten-year Federal bonds fell by almost $\frac{3}{4}$ percentage point to barely 5 % between October 1997 and mid-February 1998. Federal securities with residual maturities of one year declined in the same period by about $\frac{1}{2}$ percentage point. The yield curve in the bond market thus continued to flatten out. In mid-February the yield spread between ten-year and one-year bonds observable in the market came to about $1\frac{1}{4}$ percentage points.

*Interest rate
movements*

The decline in capital market rates in the winter largely reflects the direct and indirect implications of the financial crises in East Asia. In their wake there were sizeable shifts of investment funds worldwide into "safe havens" in the last two months of the year. At present investors seem prepared to accept low yields for low-risk investments in terms of credit rating, liquidity and exchange rates. US bonds, in particular, benefited from these inflows of funds, but so did the European bond markets. Against this background the interest

*Determinants
of interest rate
movements*

rate advantage of ten-year US Treasuries against comparable German Federal bonds has decreased to about ½ percentage point on average in the past few months. The restraining influences on prices and business activity emanating from the crises in East Asia have likewise contributed to lower capital market rates. The danger of an acceleration of price trends on the goods markets, which prevailed well into the autumn in view of a strongly expanding world economy, is now seen by market players to have all but disappeared. The improved price outlook also affected interest rates at the “short end” of the German capital market, where rates had been rising since late summer.

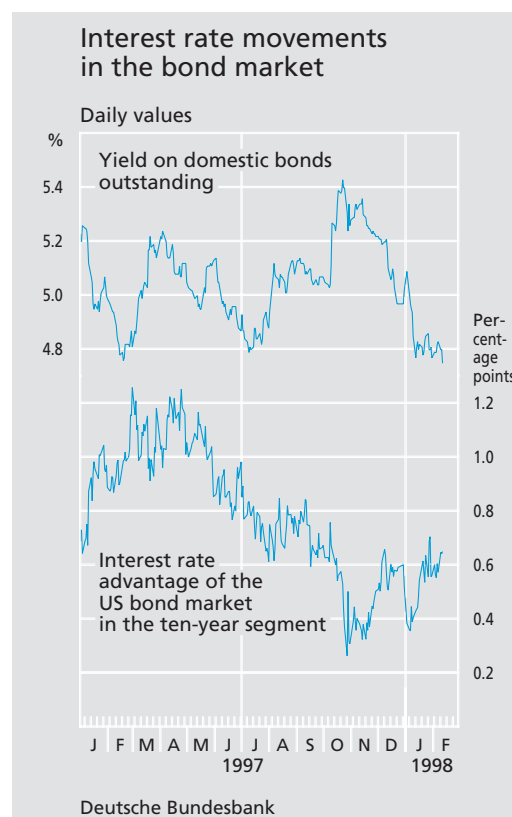
*Favourable
financing terms*

The underlying monetary conditions, which in many countries were favourable in any case, have improved further thanks to the decline in capital market rates. Interest rates in Germany – and thus financing terms for business activity – are low over the entire maturity range. This is true not only in nominal terms but also in real terms. Adjusted for the current rate of price increases at the consumer level, capital market rates are now about 3½% and thus almost 1 percentage point below the average of the past 20 years.

Sales of bonds

Amount raised

Between October and December 1997 gross sales of domestic bonds, at DM 193.1 billion (market value), were slightly lower than in the preceding quarter (DM 200.9 billion) but higher than in the last quarter of 1996 (DM 182.4 billion). Net sales, after deducting redemptions and after taking due account of



changes in issuers' holdings of their own bonds, were considerably down on the results of the comparable previous periods, however, owing to the fact that a sizeable volume of securities matured at the end of the year; between October and December net sales totalled only DM 32.6 billion, compared with DM 45.9 billion in the three preceding months and DM 58.8 billion a year before.¹ In the fourth quarter of 1997 foreign bonds were sold to the extent of only DM 7.7 billion in the German market, compared with the peak figure of DM 30.3 billion between July and September. In particular, sales of foreign currency bonds in Germany declined sharply

¹ The actual amount raised in the bond market in the period under review was even lower, at DM 26.5 billion, because the allotment of bonds issued by the Currency Conversion Equalisation Fund amounting to DM 6.1 billion entailed no direct recourse to the market.

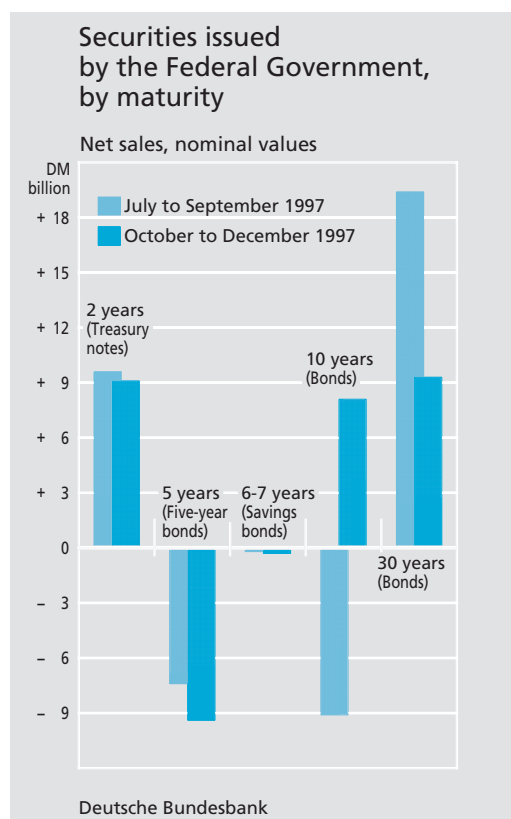
(to DM 5.0 billion net, compared with DM 25.5 billion between July and September). Domestic investors purchased Deutsche Mark-denominated debt instruments issued by non-residents to the tune of DM 2.7 billion. Combined net sales of domestic and foreign bonds came to DM 40.3 billion between October and December 1997, compared with DM 76.2 billion in the three preceding months and DM 62.7 billion in the corresponding period of 1996.

Bank bonds

The decline in the amount raised by sales of domestic bonds was due entirely to a decrease in credit institutions' issuing activity. At DM 19.0 billion, they issued distinctly less bank bonds on balance in the last quarter of 1997 than between July and September, when banks had raised DM 51.3 billion in the bond market. This decline partly reflects a fall in direct lending to the public sector, but also to private non-banks, towards the end of the year. Sales of communal bonds (*Öffentliche Pfandbriefe*) yielded DM 9.0 billion, while mortgage bonds (*Hypothekendarlehenbriefe*) were placed to the extent of DM 6.4 billion. The outstanding amount of other bank bonds rose by DM 6.0 billion. Bonds issued by specialised credit institutions were redeemed to the tune of DM 2.4 billion on balance.

Public bonds

In contrast to banks, the public sector drew on the bond market more heavily in the fourth quarter of 1997 than in the third quarter. Public issuers' bonded debt increased by DM 7.1 billion, after having declined by DM 3.8 billion between July and September (both figures excluding debt securities of the Cur-



rency Conversion Equalisation Fund). The amount raised by the Federal Government in the bond market in the final quarter of last year came to DM 11.5 billion.² In view of the very low capital market rates, it reduced the level of its money market loans and increased its capital market debt. In particular, the Federal Government resorted to long-term bond issues for its credit financing. The outstanding amount of 30-year and ten-year Federal bonds rose by DM 9.3 billion and DM 8.1 billion, respectively. Two-year Treasury

² As a rule, there is a mathematical discrepancy between the amounts raised by the Federal Government as a whole and the changes cited here in the outstanding amount of individual categories of Federal securities. This discrepancy is due to the fact that the total amount raised is calculated at market values and takes due account of the changes in the Federal Government's own holdings, whereas the changes in the outstanding amounts are recorded at nominal values and exclude changes in own holdings.

notes were sold to the tune of DM 9.1 billion on balance (nominal value). The outstanding amount of Federal savings bonds and five-year special Federal bonds, by contrast, declined (by DM 0.3 billion and DM 9.4 billion, respectively). Four-year Treasury notes, which have not been issued since the middle of 1995, were redeemed in the amount of DM 4.0 billion. The Länder Governments tapped the bond market for DM 1.3 billion. Debt securities issued by the former Federal Post Office Fund and Federal Railways Fund were redeemed to the tune of DM 4.5 billion and DM 1.1 billion, respectively; the outstanding amount of bonds issued by the Treuhand agency declined by DM 0.3 billion. The bonded debt of other public borrowers remained virtually unchanged.

*Foreign
Deutsche Mark
bonds*

Between October and December 1997 foreign borrowers issued bonds denominated in Deutsche Mark to the nominal value of DM 27.8 billion. About DM 6½ billion of this amount was accounted for by debt securities of foreign public authorities and a further DM 3½ billion by securities issued by international organisations. Net sales of foreign Deutsche Mark bonds came to only DM 7.9 billion in the period under review, compared with DM 21.8 billion between July and September 1997 and DM 18.6 billion in the corresponding period of 1996. The bulk of these securities were sold to non-residents (DM 5.3 billion).

*Short-dated
bonds issued
by domestic
non-banks*

The outstanding amount of short-dated bonds issued by domestic non-banks (with an agreed maturity of up to and including one year, which are not included in the figures

Sales and purchases of bonds

Item	1997		Oct. to Dec. 1996
	July to Sep.	Oct. to Dec.	
DM billion			
Sales			
Domestic bonds ¹	45.9	32.6	58.8
of which			
Bank bonds	51.3	19.0	46.2
Foreign bonds ²	30.3	7.7	3.9
of which			
Foreign currency bonds	25.5	5.0	2.3
Purchases			
Residents	41.1	8.8	33.3
Credit institutions ³	38.4	- 10.2	20.6
Non-banks ⁴	2.7	19.0	12.8
of which			
Foreign bonds ²	17.4	2.8	- 1.7
Non-residents ²	35.1	31.5	29.3
Total sales/purchases	76.2	40.3	62.7

¹ Net sales at market values plus/less changes in issuers' holdings of their own bonds. — ² Transaction values. — ³ Book values, statistically adjusted. — ⁴ Residual.

Deutsche Bundesbank

analysed here) declined slightly between October and December; at the end of 1997 it came to DM 31.0 billion, compared with DM 34.4 billion at the end of September. As usual, domestic enterprises markedly reduced their short-term external funding through Deutsche Mark-denominated commercial paper towards the end of the year (outstanding volume at the end of December: DM 8.1 billion, compared with DM 12.4 billion at the end of September). The outstanding amount of public sector securities running for less than one year increased marginally; at the end of December it came to DM 22.9 billion.

Purchases of bonds

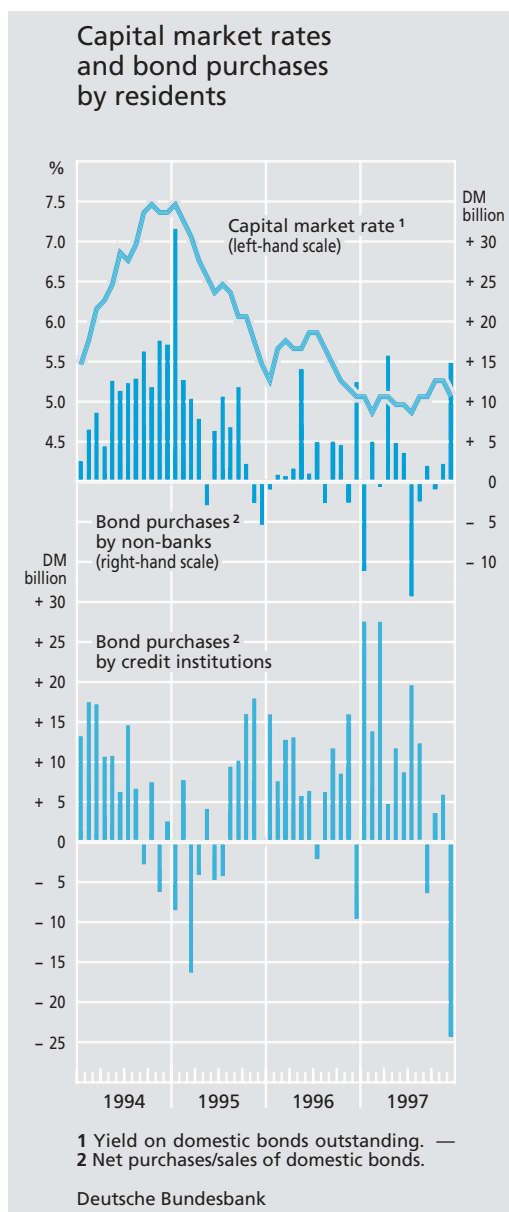
The demand on the German bond market in the last quarter of 1997 was marked by for-

Brisk foreign demand in November and December

foreign investors' sizeable bond purchases. Overall, non-residents purchased German bonds to the tune of DM 31.5 billion in the period under review, compared with DM 35.1 billion between July and September 1997. Their purchases were concentrated on November (DM 18.7 billion) and December (DM 13.9 billion), when the crises in East Asia escalated. Three-quarters of the securities consisted of public bonds. By contrast, non-residents' purchases of domestic bank bonds (which, as a rule, consist largely of foreign currency bonds) declined in the fourth quarter (DM 8.1 billion, compared with DM 17.0 billion between July and September).

Non-banks' growing propensity to buy

Between October and December 1997 domestic non-banks' propensity to buy bonds was again distinctly greater than in the three preceding months (DM 19.0 billion, compared with DM 2.7 billion). This applied, however, only to domestic bonds, which experienced a marked trend reversal. Non-banks purchased such bonds to the value of DM 16.2 billion in the period under review, after having sold such paper to the tune of DM 14.7 billion (net) in the third quarter. By contrast, there was a large fall in purchases of foreign bonds which, at DM 2.8 billion between October and December, came to less than one-fifth of the amount recorded in the previous quarter (DM 17.4 billion). One factor that probably also contributed to this change in investment behaviour – besides the narrow scope now existing for "convergence trading" within Europe – was that, given the escalating crises in East Asia, investing in German bonds seemed a more attractive prop-



osition, despite the low interest rates, than purchasing foreign currency bonds.

Domestic credit institutions reduced their bond holdings by DM 10.2 billion in the last quarter of 1997; in the previous period they had augmented their bond portfolios by DM 38.4 billion. This change was due entirely to the trend in December, when banks' holdings of bonds and notes declined by DM 29.9 bil-

Banks' bond sales

lion. The decrease in that month was concentrated on domestic public bonds (DM 20.1 billion less on balance). On the one hand, banks appear to have met foreign demand, which was very buoyant in that month, partly from their own holdings; on the other hand, securities lending transactions were curtailed substantially at the turn of the year. On balance, banks sold domestic bonds worth DM 15.1 billion in the period under review, whereas they purchased debt securities of foreign issuers in the amount of DM 4.9 billion (net).

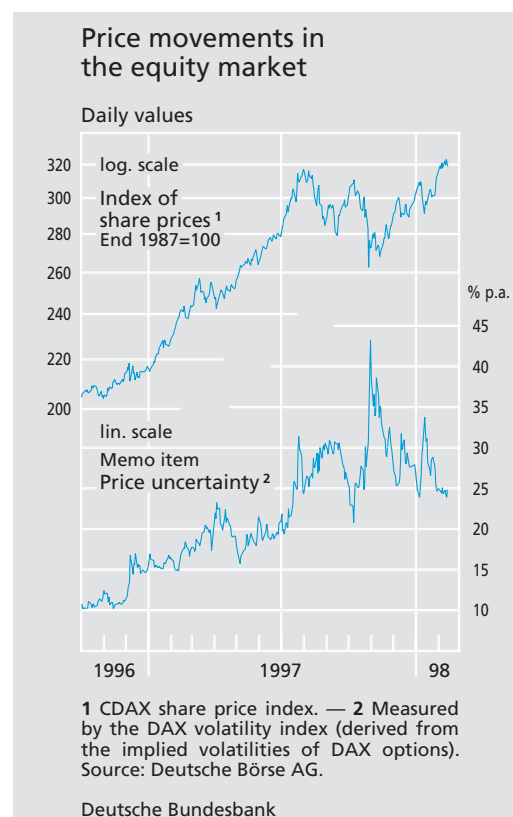
Equity market

Share price movements

Following the sharp decline at the end of October in the wake of the worldwide stock market turbulence, share price movements in the German equity market tilted upwards again from the middle of November. At the end of 1997 German stocks (measured in terms of the comprehensive CDAX share price index) were trading 15% higher than after the slump in prices in October and only 5% lower than at the peak level reached at the end of July. Compared with the previous year, the CDAX was ahead by almost 39%; this is the third-largest increase in equity prices within a year since 1970. Share prices have continued to strengthen since the start of the year, and at the beginning of February 1998 they even reached new peaks. However, price uncertainty remained high right up to the end of the period under review.

Share sales

In the fourth quarter of 1997 domestic enterprises issued new shares to the market value



of DM 8.4 billion in the German equity market; this was distinctly more than in the third quarter (DM 6.2 billion), but considerably less than in the last quarter of 1996, when Deutsche Telekom's flotation had led to a record issue volume of DM 22.4 billion. Almost two-thirds of the new issues consisted of capital increases by credit institutions, a development which is to be seen against the background of the continuing restructuring efforts in the banking sector. Foreign equities were sold in the German market between October and December to the extent of DM 19.6 billion, with about one-half consisting of portfolio investments. Overall, DM 28.0 billion was raised in the German equity market in the fourth quarter of 1997, compared with DM 17.2 billion between July and September

Sales and purchases of shares

DM billion			
Item	1997		Oct. to Dec. 1996
	July to Sep.	Oct. to Dec.	
Sales			
Domestic shares ¹	6.2	8.4	22.4
Listed	5.5	7.5	21.9
Unlisted	0.7	0.9	0.5
Foreign shares ²	11.1	19.6	11.9
Portfolio purchases	4.1	10.3	10.1
Direct investment	7.0	9.3	1.8
Purchases			
Residents			
Credit institutions ³	- 9.1	1.3	7.5
Non-banks ⁴	1.8	33.2	20.2
Non-residents ²	24.6	- 6.5	6.5
Total sales/purchases	17.2	28.0	34.2

¹ Market values. — ² Transaction values. — ³ Book values, statistically adjusted. — ⁴ Residual.

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and DM 34.2 billion in the corresponding period of 1996.

Share purchases

Domestic non-banks predominated on the buyers' side of the German equity market in the final quarter of last year; they purchased equities totalling DM 33.2 billion, split roughly between shares of foreign and domestic enterprises (DM 17.7 billion and DM 15.5 billion, respectively). Particularly non-banks' interest in buying domestic shares thus increased distinctly; in the previous quarter they had sold such securities to the tune of DM 10.4 billion. Non-banks apparently made use of the lower price level compared with the summer months to make new purchases. Credit institutions' share portfolios rose by DM 1.3 billion between October and December. Foreign investors sold German

equities worth DM 6.5 billion (net) in the same period.

Investment funds

Sales of certificates of domestic investment funds yielded DM 36.5 billion in the period under review, compared with DM 30.4 billion between July and September and DM 25.5 billion in the last quarter of 1996. Between October and December foreign investment fund units were sold in the German market to the tune of DM 0.9 billion. The combined amount raised by sales of domestic and foreign investment fund certificates thus came to DM 37.3 billion.

Amount raised

In the fourth quarter of 1997 specialised funds recorded inflows of resources in the record amount of DM 33.8 billion, which was mainly due to inflows in December (DM 23.1 billion). The sales proceeds of specialised funds typically increase towards the end of the year owing to the large investment demand of institutional investors. The intermediation of specialised funds offers them the opportunity to handle investment operations – for example in derivatives – more flexibly. Almost two-thirds of the amount raised accrued to mixed funds (DM 22.0 billion). Share-based funds and bond-based funds sold certificates worth DM 7.2 billion and DM 4.4 billion net, respectively. Open-end real estate funds received DM 0.2 billion.

Specialised funds

By contrast, the funds open to the general public sold certificates worth only DM 2.6 billion (net) in the period under review (previous

Funds open to the general public

quarter: DM 6.2 billion). A key factor in this, besides outflows of resources from money market funds and open-end real estate funds (– DM 1.9 billion and – DM 0.3 billion, respectively), was the reduced interest in share-based funds (DM 3.3 billion). Against the background of the worldwide stock market turbulence, share-based funds with an international focus of investment activity appear to have suffered the largest losses of business. The bond-based and mixed funds raised DM 0.8 billion and DM 0.7 billion, respectively, which was slightly more than in the three preceding months.

Between October and December investment fund certificates were purchased exclusively by residents on balance. Non-banks purchased certificates of domestic and foreign funds to the tune of DM 31.0 billion. Non-banks sold money market fund certificates to the value of DM 3.1 billion (net). Domestic credit institutions' holdings of investment fund certificates rose by DM 9.2 billion. Foreign investors sold certificates of domestic mutual funds in the amount of DM 2.9 billion.

*Purchases of
investment
fund certificates*