

Financial markets in Germany

Capital market and bank interest rates

Since mid-May the yield on ten-year Federal bonds outstanding has fallen somewhat on balance and, when this Report went to press in mid-August, it was just over 4¾%. This development masked an uneven upward and downward movement, as was also evident in foreign bond markets. However, German capital market rates fluctuated very little by international comparison. The implied volatility of the Bund future, which measures the extent of the price swings in the futures market in the period ahead expected by market players, likewise indicates low interest rate uncertainty. At the time of going to press, the yield on ten-year Federal bonds was more than ¼ percentage point below the euro-area average. The interest rate spread between ten-year debt securities issued by domestic banks and comparable Federal bonds has scarcely changed since mid-May. At the end of the review period it was less than ½ percentage point. The yield spread of domestic corporate bonds over long-term government bonds likewise remained largely constant and is currently around 80 basis points. Overall, the market for German bonds is therefore comparatively stable.

*Slight decrease
in capital
market rates*

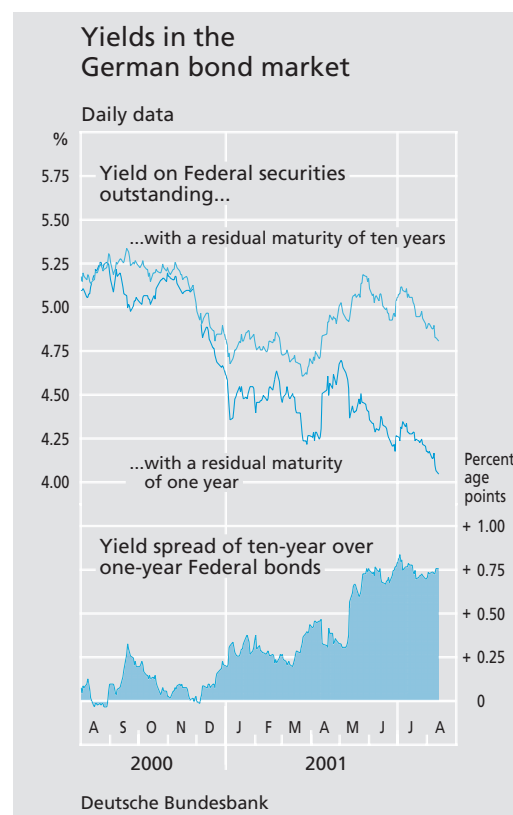
The yields on Federal securities with a shorter residual maturity fell rather more markedly of late, with the result that the estimated yield curve became slightly steeper. In mid-August the interest rate spread of ten-year Federal bonds over one-year paper observable on the market was just over ¾ percentage point, compared with around ⅔ percentage point in mid-May. The yield curve for one to two-year

*Slightly steeper
yield curve*

bonds is, however, still slightly inverse. By historical comparison, the overall yield curve may be considered flat. The medium to long-term inflation expectations prevailing in the bond market thus seem to be very restrained. The expected real capital market rate for ten-year bonds (calculated on the basis of nominal yields less inflation expectations derived from surveys) remains relatively low, at around 3 %.

Slight rise in long-term bank interest rates

Short and long-term bank interest rates developed in opposite directions in the period under review. While the rates for long-term loans and deposits rose slightly, the short-term interest rates on banks' asset and deposit business fell slightly. For instance, in July banks charged an average of just under 8¾ % for current account credit (for a credit volume of between DM 1 million and less than DM 5 million), 15 basis points less than in April. In comparison, the rates for personal credit lines fell only slightly to an average of 12⅔ %. Similarly, in July the interest rate on one-month time deposits (for an investment volume of DM 100,000 to less than DM 1 million) was, at just under 3¾ %, around 15 basis points lower than three months previously. By contrast, a moderate increase was recorded in long-term bank rates. For instance, the interest rate charged on mortgage loans with interest locked in for ten years averaged just under 6½ % in July, this being around 10 basis points more than in April. The cost of long-term fixed-rate loans to enterprises rose even less. The effective rates were on average around 6¾ % (for a credit volume of between DM 200,000 and less than DM 1 million) and just over 6½ %

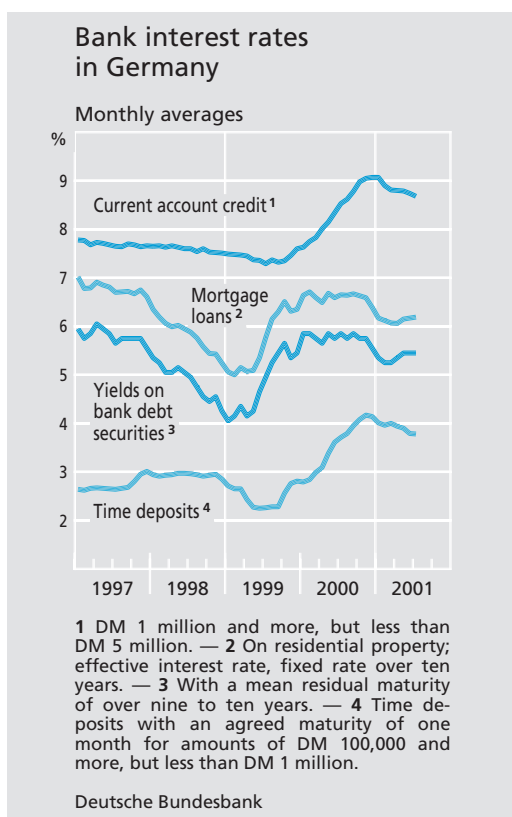


(for a credit volume of between DM 1 million and less than DM 10 million). In July interest rates on savings deposits with an agreed contract period of more than four years were only slightly up on April and were on average 4½ % (for deposits with an agreed notice period of three months).

Share prices

After a temporary recovery in prices at the start of the second quarter, the downward slide on the German equity market resumed from mid-May onwards. Measured on the broad CDAX share price index, equity prices fell by 9 % up to the time when this Report went to press in mid-August. Compared with their historical peak in March 2000, the price

Continued slump on the equity market



of German shares fell by more than one-third, compared with a loss of slightly more than one-quarter for the Dow Jones Euro STOXX index. With the recent slump, equity market uncertainty also increased for a time. The VDAX, which uses option prices to measure the expected share price volatility of the German blue-chip companies which make up the DAX, rose quite steeply for a time. However, not all market segments were affected to the same extent by the gloomy market sentiment. For instance, the prices of what are known as secondary stocks remained largely stable in the review period.

However, the mood on the *Neuer Markt* was still particularly jittery. In June and July alone the NEMAX-All-Share price index lost almost one-third of its value. Compared with its

peak in March 2000, the market for primarily technology-related “growth stocks” fell by more than 85%. At the end of the period under review, prices were on average only just above the level at which the whole stock market segment was introduced in March 1997. In the meantime, 14 companies have declared themselves insolvent. The high yield expectations of many investors in the often very young enterprises – with the profitability of some of them being very difficult to predict – have, for the moment, mostly met with disappointment. In addition to marked speculative phases, the heavy dependence on changes in the investors’ risk propensity has so far made such stocks extremely susceptible to wide fluctuations in price. As the euphoria and the unprecedented surge in prices gradually gave way, from March 2000, to doubts and disillusionment, the awareness of flaws in this market segment grew. The operator of the *Deutsche Börse* reacted to the crisis of confidence on the *Neuer Markt* at the start of the year by setting stricter criteria for the quarterly reports of the listed enterprises and, at the end of the period under review, by amending the regulations aimed at excluding “penny-stock” issues and insolvent enterprises from this trading segment from autumn onwards.

Borrowing in the securities markets

There was very little issuing activity in the German bond market in the second quarter. Gross sales of debt securities issued by borrowers domiciled in Germany, calculated at their market value, amounted to € 178 billion

Sales of bonds and notes

(previous quarter: € 216 billion). Although redemptions of and additions to issuers' holdings of their own bonds were also down, the funds raised by sales of domestic fixed-interest securities fell very strongly from € 20 ½ billion in the first three months of the year to € 9 ½ billion. In particular, domestic issuers reduced their liabilities arising from short-term paper with maturities of up to one year; the outstanding stock of such securities fell by € 14 billion. By contrast, net sales of foreign bonds and notes, at € 29 billion, remained virtually constant compared with the first quarter (€ 31 ½ billion). Foreign bonds were – as in the previous months – mostly denominated in euro (€ 26 billion). Total net sales of debt securities in the German bond market in the second quarter of 2001 therefore amounted to € 38 ½ billion.

Sharp decline in sales of bank debt securities

The lower amount of funds raised is essentially attributable to severe cutbacks in the issuing activity of credit institutions. From April to June they issued no more than € 2 billion net worth of their own bonds, compared with € 36 ½ billion in the first quarter. As at that time, the banks massively reduced their outstanding stocks of short-dated bonds. Credit institutions concentrated on issuing other bank debt securities (€ 6 ½ billion net), which are used mainly to refinance lending to trade and industry. Sales of mortgage bonds (*Hypothekendarlehenbriefe*) were only just over € ½ billion. Communal bonds (*Öffentliche Pfandbriefe*) and debt securities issued by specialised credit institutions were redeemed for € 4 billion and € 1 ½ billion on balance. From April to June public authorities again raised € 5 ½ billion net in the bond market,

after having reduced their bonded debt by € 21 billion in the first quarter in connection with the redemption of bonds of the Currency Conversion Equalisation Fund. The Federal Government issued € 5 ½ billion net worth of debt securities, while the Länder Governments sold fixed-interest securities in the amount of € 2 ½ billion. Corporate bonds were sold for € 2 billion net, somewhat less than in the first quarter (€ 5 billion).

The slowdown in issuing activity in the German equity market continued in the second quarter. From April to June domestic enterprises placed new shares to a market value of € 3 billion, compared with just over € 4 billion in the first three months of the year. At nine, the number of initial public offerings (IPOs) was the same as in the previous quarter, but compared with the preceding two record years it was very low. Foreign enterprises placed € 44 ½ billion worth of equities on the domestic market. This was mainly due, however, to the takeover of a US stock corporation by a major German telecommunications company.

Borrowing in the equity market

Investment activity in the securities markets

Domestic investors were again the principal buyers in the bond market in the second quarter of 2001, increasing their bond holdings by a total of just under € 41 billion after € 60 billion in the first quarter. This time the credit institutions were predominant, adding € 23 billion to their bond portfolios. They continued to focus on foreign bonds (€ 14

Purchases of bonds

Investment activity in the German securities markets

€ billion

Item	2001		2000
	Jan. to Mar.	Apr. to June	Apr. to June
Bonds and notes 1			
Residents	59.6	40.9	19.0
Credit institutions 2	22.8	23.1	22.2
of which			
Foreign bonds and notes 3	17.5	14.1	5.6
Non-banks 4	36.8	17.8	- 3.1
of which			
Domestic bonds and notes	22.8	3.1	- 5.0
Non-residents 3	- 7.4	- 2.7	40.7
Shares			
Residents	4.3	- 23.6	- 5.8
Credit institutions 2	29.8	- 26.1	- 28.1
of which			
Domestic shares	23.3	- 28.4	- 31.7
Non-banks 4	- 25.5	2.4	22.3
of which			
Domestic shares	- 28.1	- 39.6	- 3.3
Non-residents 3	8.9	70.9	42.9
Investment fund certificates			
Investment in specialised funds	12.2	2.9	8.5
Investment in funds open to the general public	12.1	5.6	8.0
of which: Share-based funds	2.8	2.0	9.1

1 Since the start of 2000, including non-bank debt securities with an original maturity of up to and including one year and commercial paper. — 2 Book values, statistically adjusted. — 3 Transaction values. — 4 Residual.

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billion), while buying around € 7 billion net of domestic bank debt securities. By contrast, the activity of domestic non-banks in the bond market declined; their investments fell from € 37 billion in the first quarter to less than € 18 billion between April and June. The decline affected almost exclusively bonds of domestic private debtors, € ½ billion of which were re-sold by non-banks in the second quarter. By contrast, they purchased € 14½ billion worth of foreign securities, virtually the same amount as in the previous three months. Foreign investors were once again sellers of bonds; their holdings of domestic bonds fell by € 2½ billion.

On the other hand, non-residents invested € 71 billion in German equities in the second quarter, compared with € 9 billion from Janu-

ary to March. By contrast, domestic non-banks sold German equities in the amount of € 39½ billion net and bought shares in foreign companies in the amount of € 42 billion – the vast majority of which as direct investment. Similarly, domestic credit institutions sold a total of € 28½ billion worth of shares in German companies during the period under review and purchased € 2½ billion worth of foreign equities. The high net sales of German stocks by residents and the high net purchases by non-residents were due to a large extent to the aforementioned takeover of a US enterprise by a large German concern and the associated ownership transfer to foreign investors. In addition, considerable portfolio reallocations from residents to non-residents occurred as a result of commitments related to derivative transactions.

In the second quarter, sales of domestic investment fund certificates fell to their lowest level for five years. From April to June German investment companies issued € 8½ billion net worth of certificates, compared with € 24½ billion in the first three months of 2001. Net sales of foreign investment fund certificates also fell, from € 6 billion in the first quarter to € 4½ billion in the second.

Domestic funds open to the general public issued share certificates in the amount of € 5½ billion net, after recording inflows of funds of more than € 12 billion in the first quarter of 2001. Savers in investment funds continued to prefer share-based funds but allocated only € 2 billion to them. In the first half of the year the total amount raised by domestic share-based funds, at less than € 5 billion,

Investment fund certificates

Investors hesitant and cautious

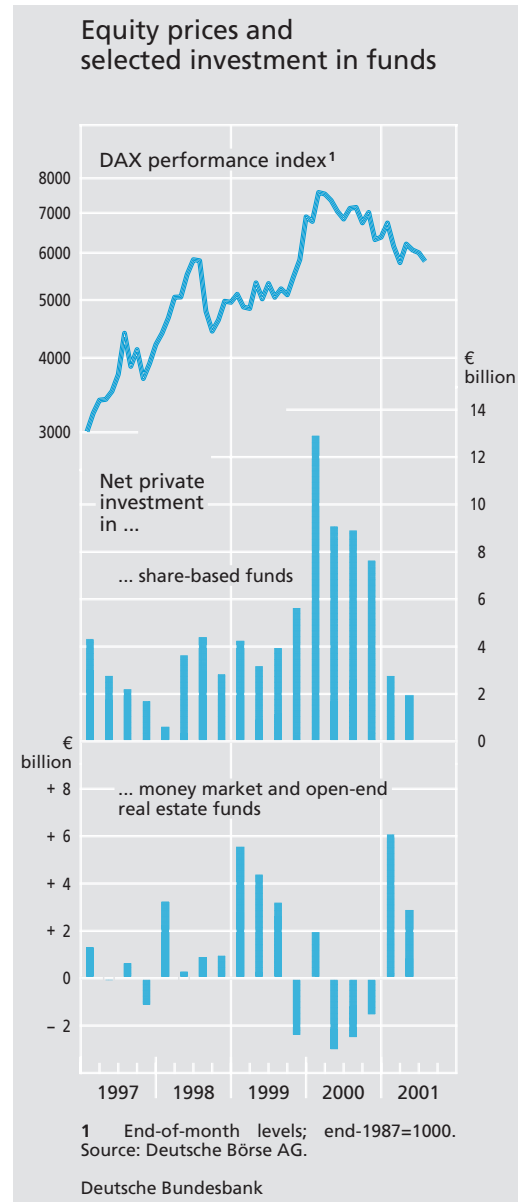
Purchases of shares

was only a fraction of the record amount of € 22 billion raised in the first half of 2000. Following the general stock market euphoria at the start of last year, the disappointment of many private investors at the developments on the stock market is clearly affecting new investment. This can be seen, *inter alia*, from the fact that the less risk-prone open-end real estate funds and money market funds, which had attracted little interest for a long time, found increased favour among investors in the period under review. Around € 1½ billion worth of units in both types of fund were sold in the second quarter, with each selling € 4½ billion worth in the first half of 2001. In 2000, shares in money market funds and open-end real estate funds had been returned in the amount of € 2 billion and € 3 billion respectively. From April to June the amount raised by domestic specialised investment funds, which manage the assets of institutional customers, was, at just under € 3 billion, lower than in the previous quarters. On balance, these funds were invested almost exclusively, and in roughly equal proportions, in share-based funds and mixed funds.

Deposit and lending business of monetary financial institutions (MFIs) with domestic customers

Clear increase in overnight deposits

In seasonally adjusted terms, the overnight deposits of domestic customers with German MFIs increased markedly in the second quarter of 2001. Although at the start of the quarter non-financial enterprises also increased their sight deposits, the overall upsurge was due, in particular, to the increase in individ-



uals' overnight deposits. As in the previous quarter, this trend was prompted by the persistent decline in short-term interest rates and the continued great uncertainty in the equity markets.

The preference for liquid forms of investment was also reflected in a perceptible seasonally adjusted increase in deposits with an agreed maturity of up to two years, al-

Perceptible increase in short-term time deposits...

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

€ billion

Item	2001	2000
	Apr. to June	Apr. to June
Deposits of domestic non-MFIs 1		
Overnight	+ 21.0	+ 0.6
With agreed maturities		
up to 2 years	+ 1.8	+ 4.3
over 2 years	+ 2.3	+ 2.6
At agreed notice 2		
up to 3 months	- 2.9	- 20.1
over 3 months	- 4.0	+ 2.3
Lending		
To domestic enterprises and individuals		
Unsecured	+ 5.8	+ 25.6
Securitized	- 22.7	- 22.1
To domestic public authorities		
Unsecured	- 13.2	- 2.1
Securitized	+ 2.6	- 6.6

* 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 this Report. — 1 Enterprises, individuals and public authorities (excluding Federal Government). — 2 Savings deposits.

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though on balance this was due solely to the large transfers to this investment vehicle in June. Even if the increase in the second quarter of 2001, at € 1.8 billion, was less than in the same quarter last year (€ 4.3 billion), it clearly exceeded the increase in earlier years. In particular, households accumulated extensive short-term time deposits in the second quarter of 2001. Deposits with an agreed maturity of over two years rose by € 2.3 billion from April to June, compared with € 2.6 billion in the same period of last year. Mainly insurance companies – which traditionally represent the largest category of investors having recourse to this type of deposit – increased their holdings in longer-term time deposits.

... and moderate increase in longer-term time deposits

Deposits with an agreed period of notice were reduced further during the period under review. From April to June 2001 domestic non-banks reduced their short-term savings deposits by € 2.9 billion and their long-term deposits by € 4.0 billion. However, the decrease in savings deposits with an agreed period of notice of three months was, for the first time since the third quarter of 1999, less than usual at this time of year.

Further reduction in savings deposits

After a marked increase in the previous period, lending by German MFIs to domestic enterprises and individuals was perceptibly down in the second quarter of 2001. This is due to extensive sales of securities of German enterprises by domestic MFIs in connection with futures transactions. Overall, German MFIs reduced their holdings of securities issued by German enterprises by € 22.7 billion in the second quarter. However, banks also granted fewer loans to domestic enterprises and households in the second quarter of 2001 than in the first quarter. The seasonally adjusted annual growth rate fell from just under 6% in the first quarter of 2001 to less than 1%. As in the previous quarter, medium and long-term lending increased moderately, but short-term loans decreased.

Marked decrease in lending to the private sector...

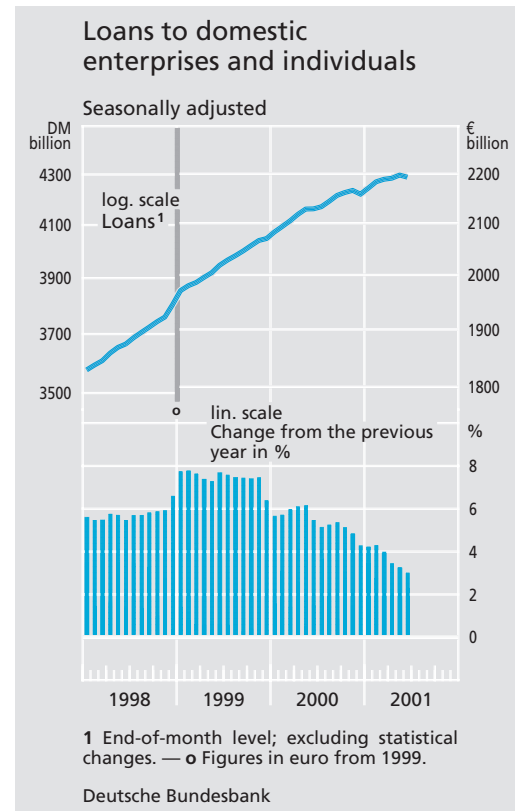
Among the most important categories of borrowers, loans to the housing sector continued to expand at the moderate pace of the previous quarter. Outstanding borrowing from domestic MFIs by employees remained virtually unchanged in the second quarter of 2001. By contrast, enterprises, which had strongly increased their demand for credit in the previ-

... and especially to enterprises

ous quarter, reduced their indebtedness markedly in seasonally adjusted terms. This was mainly attributable to a perceptible decline in borrowing by financing institutions, whose pattern of debt incurrence is very volatile over the short run. However, the other enterprise sectors, too, with the exception of transport and communications and service industries, reduced their borrowing from domestic MFIs.

*Further
reduction in
public sector
debt*

The level of indebtedness of German public authorities to domestic MFIs declined by € 10.6 billion in the second quarter of 2001, compared with a reduction of € 8.7 billion year on year. This was caused solely by a reduction of € 13.2 billion in unsecured loans. The Federal Government alone reduced its borrowing from German MFIs in the period under review by € 11.6 billion; at the same time it ran down its deposits at German MFIs by € 1.0 billion. Securitised lending by domes-



tic banks to German public authorities increased, by contrast, by € 2.6 billion.