

## Monetary policy, banking business and the capital market

### Interest rate policy and the money markets

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Given the continuing favourable medium-term outlook for prices in the euro area, the Governing Council of the ECB has left the Eurosystem's key interest rates unchanged in recent months. The minimum bid rate for the main refinancing operations, now conducted as variable rate tenders, is still 2%. The interest rates on the marginal lending facility and the deposit facility are also unchanged at 3% and 1% respectively.

*Eurosystem  
interest rates  
unchanged  
given stable  
outlook for  
prices*

As market participants expected interest rate policy to hold steady, the overnight rate (Eonia) again kept close to the minimum bid rate for the main refinancing operations. There was a strong temporary increase in the overnight rate only in early April, when liquidity was scarce at the end of the March-April reserve maintenance period. The situation in the money market then relaxed again and towards the end of the subsequent reserve maintenance period the Eonia fell below 2% at times. In the quarter under review, interest rates on longer-term money market instruments were driven mainly by expectations of a rise in interest rates. In early April, for example, the rates on 12-month funds, in particular, showed a distinct increase. In June their average spread over the Eonia was nearly 40 basis points. In the ensuing period, however, the spread on longer-term money market instruments declined again somewhat. However, up to the end of the period under review, longer-term interest rate expectations on the money market continued to be upward-oriented.

*Money market  
rates*

## Money market management and liquidity needs

In the past three reserve maintenance periods, money market management by the Eurosystem had to make up for a considerable increase in credit institutions' demand for central bank money. Overall, this went smoothly. The demand arising from the factors determining liquidity went up by €32.1 billion or around 20%. This was especially due to the strong €23.8 billion growth in banknotes in circulation, although the pace of growth is continuing to slow. Owing to the Easter public holidays, the expansion was particularly marked in the April-May maintenance period. There was also a distinct net increase of €13.5 billion in liquidity needs arising from general government deposits. However, this was caused mainly by unusually large amounts being deposited in the week before the mid-year cut-off date (24 to 30 June). By contrast, changes in the net foreign reserves and other factors meant, on balance, that the market was provided with liquidity amounting to €5.2 billion. After adjusting for valuation effects, this was mainly due to increases in the Eurosystem's euro-denominated financial assets, which are included in "other factors". The €3.4 billion net increase in required reserves created additional demand for liquidity.

The greater demand for liquidity was covered primarily by €27.5 billion being added to the value of the main refinancing operations. However, the volume of longer-term refinancing operations was also further increased by €7.9 billion in the April-May maintenance period. This reflected the net €10 billion increase in allotment in the operation settled on 1 April, which concluded the increase in the volume of these operations from €45 to €75 billion that began on 29 January. On 11 May, the last day of the April-May reserve maintenance period, the Eurosystem conducted a fine-tuning operation by collecting fixed-term deposits amounting to €13 billion overnight at a fixed rate of 2.0%. It was the first fine-tuning operation for almost one year. The overhang caused by unexpectedly low demand for liquidity was thus absorbed, resulting in net recourse to the marginal lending facility amounting to a mere €84 million at the end of the period. In addition, this operation was successful in stabilising the overnight money rates in the interbank market. In the run-up to the fine-tuning operation the Eonia had declined to 1.83% on Friday, 7 May when the excess liquidity became apparent. Consequently, on Monday, 10 May the ECB announced the fine-tuning operation that was to take place on the following day. As a result, the overnight rates, which had been at 1.60% at the start of trading, increased immediately, taking the Eonia to 1.84% on the same day. After the operation conducted on 11 May, the Eonia was once again close to the minimum bid rate (2.07%).

Otherwise, the Eonia generally moved 2 to 4 basis points above the minimum bid rate, with slight upward movements at the end of the month. After a temporary increase at the end of the March-April reserve maintenance period, the Eonia again increased at the end of the June-July period, reaching 2.12% on 4 June when the market expected a liquidity shortage at the end of the period. This was, however, an incorrect assessment of the market. In fact, there was a slight liquidity surplus. The Eonia subsequently declined again temporarily to 1.72% by 8 June. By contrast, owing to a slight liquidity shortfall the Eonia went up for a short time to 2.53% by the end of the maintenance period on 6 July. For all that, the Eonia then swiftly increased again to a level close to the minimum bid rate.

## Factors determining bank liquidity <sup>1</sup>

€ billion; calculated on the basis of  
 daily averages of the reserve maintenance periods

Item	2004		
	7 April to 11 May	12 May to 8 June	9 June to 6 July
<b>I Provision (+) or absorption (-) of central bank balances by</b>			
1 Change in banknotes in circulation (increase: -)	- 11.1	- 6.1	- 6.6
2 Change in general government deposits with the Eurosystem (increase: -)	+ 5.5	- 6.2	- 12.8
3 Change in net foreign reserves <sup>2</sup>	+ 9.3	+ 0.6	- 3.1
4 Other factors <sup>2,3</sup>	- 6.8	+ 2.2	+ 3.0
<b>Total</b>	<b>- 3.1</b>	<b>- 9.5</b>	<b>- 19.5</b>
<b>II Monetary policy operations of the Eurosystem</b>			
1 Open market operations			
(a) Main refinancing operations	- 4.7	+ 11.5	+ 20.7
(b) Longer-term refinancing operations	+ 7.9	+ 0.0	- 0.0
(c) Other operations	- 0.4	+ 0.4	-
2 Standing facilities			
(a) Marginal lending facility	- 0.3	+ 0.1	+ 0.2
(b) Deposit facility (increase: -)	+ 0.3	- 0.4	+ 0.4
<b>Total</b>	<b>+ 2.8</b>	<b>+ 11.6</b>	<b>+ 21.3</b>
<b>III Change in credit institutions' current accounts (I + II)</b>	<b>- 0.3</b>	<b>+ 2.1</b>	<b>+ 1.7</b>
<b>IV Change in the minimum reserve requirement (increase: -)</b>	<b>+ 0.2</b>	<b>- 2.0</b>	<b>- 1.6</b>

<sup>1</sup> For longer-term trends and the contribution of the Deutsche Bundesbank, see pages 14\* and 15\* of the Statistical Section of this *Monthly Report*. — <sup>2</sup> Including end-of-quarter valuation adjustments with no impact on liquidity. — <sup>3</sup> Including monetary policy operations concluded in the second stage and still outstanding in the third stage of monetary union (outright transactions and the issuance of debt certificates) as well as financial assets not connected with monetary policy.

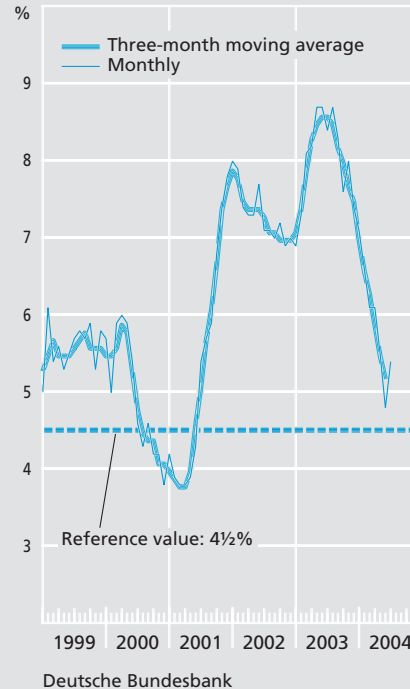
## Monetary developments in the euro area

### *Slowdown in monetary expansion*

The slowdown in monetary growth, which began one year ago, continued into the second quarter of this year. The growth of the euro-area money stock M3 was, in seasonally adjusted terms, again slightly weaker in the period from April to June than in the previous quarter. The three-month moving average of annual rates of change went down distinctly from 6.3% for the period from January to March to 5.2% for the period from April to June. The seasonally adjusted annualised three-month rate of change was 5% at the end of June. Again in the second quarter, private non-banks invested the increase in their claims on MFIs equally between liquid M3 components and longer-term monetary capital formation. Hence the annualised seasonally adjusted three-month rate of change in monetary capital formation (excluding the MFIs' capital and reserves) is higher than the corresponding monetary growth for the fourth consecutive quarter. In addition, capital market yields, which had risen again in the second quarter, are likely to have encouraged investment activity outside the banking sector. Despite the decline in investors' preference for liquidity, however, the present money stock is still far higher than experience suggests is required to finance inflation-free economic growth. Since the possibility of this liquidity surplus having an impact on demand in the commodities markets cannot be ruled out entirely, monetary developments must continue to be monitored carefully. In the present circumstances, however, there is no great risk for price stability.

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

Seasonally adjusted, annual percentage change

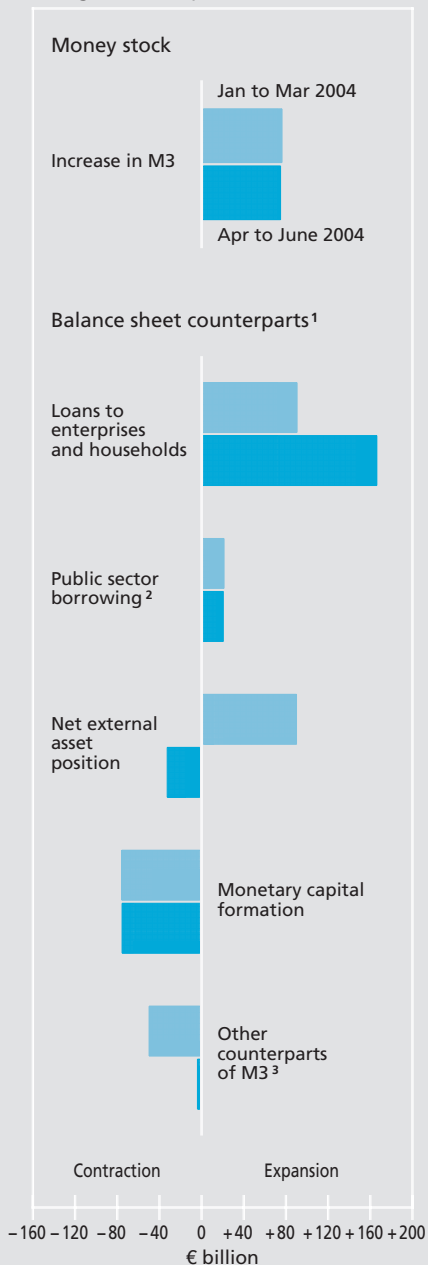


In the quarter under review, the growth of the money stock M3 was spread over almost all its components. However, in the second quarter there was a perceptibly smaller increase in cash holdings than in the preceding quarters, although the pace of expansion, at an annualised three-month rate of change of 15%, was still high. By contrast, there was hardly any increase in overnight deposits in the period from April to June, after they had risen strongly in the previous quarter. In the past three months they expanded at a seasonally adjusted annual rate of change of only 1½% (as opposed to 13½% between January and March). Overall, the money stock M1 climbed at an annualised rate of just under 3½% in the second quarter of 2004. Other short-term bank deposits (excluding overnight deposits) were also in-

*Components of  
the money  
stock*

### Euro-area M3 and its balance sheet counterparts

€ billion, seasonally adjusted,  
change over the period indicated



<sup>1</sup> Changes in balance sheet counterparts are shown in terms of whether they expand (+) or contract (-) the money stock. — <sup>2</sup> Bank loans to general government less euro-area general government deposits and holdings of securities issued by the MFI sector. — <sup>3</sup> Calculated as errors and omissions from the remaining items of the consolidated balance sheet of the MFI sector.

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creased in net terms in the quarter under review. However, the increase was concentrated on deposits redeemable at notice of up to three months. By contrast, short-term time deposits were reduced further in the period from April to June. Unlike what occurred in the previous quarter, the marketable instruments included in the money stock M3 also increased perceptibly in the second quarter. Money market fund shares were the main instruments sold outside the banking sector but bank liabilities arising from repo transactions and the sale of money market paper and short-term bank debt securities also increased.

The balance sheet counterparts indicate that, in the period under review, monetary growth was stimulated primarily by lending to domestic enterprises and households. There was a particular increase in loans to the private sector. They expanded in the period under review by an annualised three-month rate of 8%, which was far higher than the corresponding monetary growth (5%) for the first time since the end of 2000. This development continued to be driven mainly by the lively demand for housing loans in some euro-area countries.

*Balance sheet counterparts*

There was also a strong increase in lending to the euro-area public sector. In non-seasonally adjusted terms, it expanded by €43 billion in the April-June period. However, the increase affected securitised lending only (by €50 billion) while unsecuritised bank lending to the euro-area public sector was reduced by €7 billion. The greater expansion of central government bank deposits had a dampening

effect on monetary development – as did the outflows of non-banks' resources into the non-euro-area countries.

However, in the second quarter the continued strong increase in monetary capital formation provided the main effective counterbalance to monetary growth. Domestic MFIs were again able to place large volumes of bank debt securities with a maturity of over two years outside the domestic banking sector. Demand for longer-term time deposits was also heavy.

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

*Stagnating liquidity supply in Germany*

In contrast to figures for the euro area as a whole, short-term deposits in the German banking sector remained virtually unchanged in the period under review. However, there was a sharp increase in longer-term investment by domestic non-banks in German MFIs. In the second quarter institutional investors, in particular, shifted large amounts of liquid funds to longer-term time deposits. At the same time domestic households added far less to their short-term bank deposits than in the previous quarters. The capital market rates, which rose again in the second quarter, are likely to have favoured longer-term monetary capital formation and dampened the preference for liquidity.

*Overnight deposits reduced*

The decline in the preference for liquidity can be seen most clearly from overnight deposits, which, in seasonally adjusted annualised terms, were reduced by 3% in the past three

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

€ billion		
Item	2004	2003
	Apr to June	Apr to June
<b>Deposits of domestic non-MFIs 1</b>		
Overnight	+ 7.4	+ 30.2
With agreed maturities		
up to 2 years	- 6.2	- 5.9
over 2 years	+ 13.3	- 2.5
At agreed notice		
up to 3 months	+ 0.9	+ 2.8
over 3 months	- 2.3	- 5.4
<b>Lending</b>		
to domestic enterprises and households		
Unsecuritised	+ 1.7	+ 6.0
Securitised	- 9.1	+ 3.3
to domestic government		
Unsecuritised	- 18.7	- 9.4
Securitised	+ 14.9	- 5.8

\* 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.

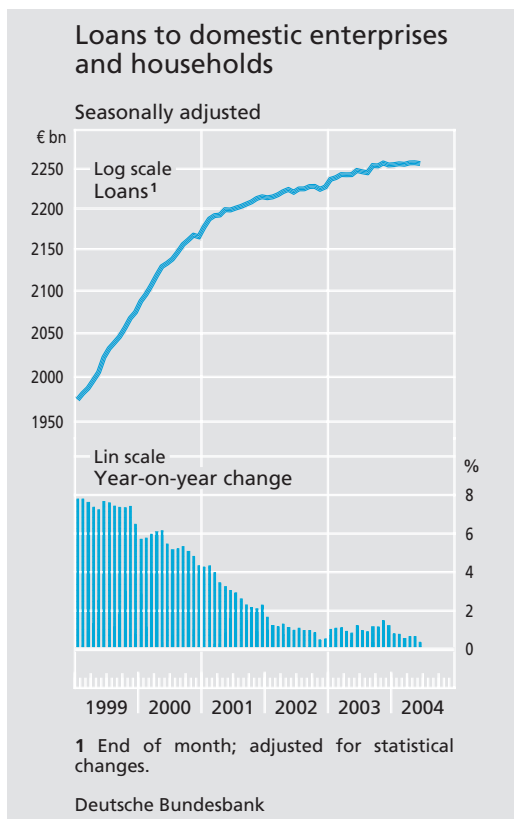
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months (April to June). In particular, insurance corporations and other financial intermediaries reduced their holdings of overnight money noticeably.

Short-term time deposits with an agreed maturity of up to two years have been declining since the end of 2001; this continued across a broad front in the quarter under review. In addition to households, which once again made a distinct reduction in their short-term time deposits, financial enterprises also perceptibly reduced their deposits with an agreed maturity of up to two years. By contrast, short-term savings deposits, which are traditionally held almost exclusively by households, were expanded strongly.

*Further decline in short-term time deposits ...*

*... but strong increase in short-term savings deposits*



*Overall increase in longer-term bank deposits*

Turning to the longer-term bank deposits, in the quarter under review strong investment was seen only in longer-term time deposits with a maturity of over two years. This was related, in particular, to portfolio shifts by insurance enterprises. However, longer-term savings deposits (with an agreed period of notice of more than three months) decreased further in the quarter under review.

*Loans to the private sector virtually unchanged*

As in the previous quarters, loans by German banks to their domestic non-bank customers stagnated in the period under review. This contrasts to a certain extent with the distinctly more lively demand for loans in the rest of the euro area, which, however, is being driven by the ongoing housing boom in some euro-area countries. Developments in Germany have been characterised mainly by the

fact that households and enterprises reduced their short-term loans more extensively in the period from April to June, taking up longer-term credit instead. Longer-term loans expanded in the second quarter at an annualised seasonally adjusted three-month rate of change of just over 2½%. A small reduction in banks' holdings of securities issued by domestic private residents accompanied what was overall only a slight increase in the volume of loans granted to private domestic non-banks. By contrast, the demand by banks for German government paper was very lively in the second quarter, after they had increased these investments unusually strongly in the period from January to March. Loans to the public sector were, however, sharply reduced in the second quarter, which means that, in net terms, the domestic banking sector provided the public sector in Germany with no additional funds in the period under review.

The ongoing weak credit development in Germany is still essentially a result of low credit demand. This is indicated by the July results of the Eurosystem's bank lending survey.<sup>1</sup> The German institutions taking part in the survey reported a further slight decrease in the demand for corporate loans and private housing loans and thus estimate the development of credit demand as somewhat weaker than for the euro area as a whole. However, the data on credit supply were largely in line with the survey results for the

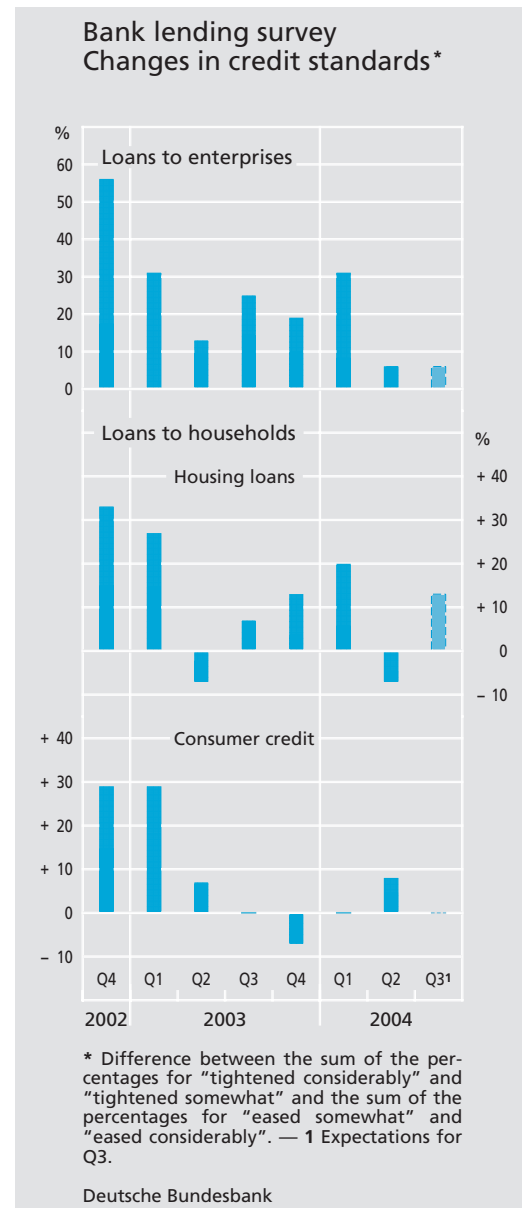
*No noteworthy changes in credit standards*

<sup>1</sup> See Deutsche Bundesbank, German results of euro-area bank lending survey, *Monthly Report*, June 2003, pp 67-76. The aggregate survey results for Germany can be found under [http://www.bundesbank.de/volkswirtschaft/vo\\_veroeffentlichungen.en.php](http://www.bundesbank.de/volkswirtschaft/vo_veroeffentlichungen.en.php).

euro area as a whole.<sup>2</sup> This means that in the second quarter of 2004 – for the first time since the survey was launched one and a half years ago – the respondent banks in Germany have not really tightened their credit standards for loans to enterprises. This was largely unrelated to the size of the borrower or the loan maturity. The credit standards applied to loans to households for house purchase (housing loans) also remained largely unchanged, following isolated tightening in the previous quarter. As in the previous quarters, there was also no noteworthy movement in consumer loans. In the third quarter of 2004 the respondent institutions expect the credit standards to remain more or less unchanged for corporate and consumer credit, while the data on housing loans signal a tendency towards a slight tightening (see adjacent chart).

*Persistent trend towards widening margin spreads for loans to households*

Despite the fact that the credit standards remained unchanged, the institutions participating in the survey reported that they had further widened their margins in the second quarter. For loans to households, however, this applies only to riskier lending (see chart on page 28). The German data on margin movements for average loans to enterprises were above the euro-area average for the third quarter in succession. At the same time, a further narrowing of margins on average private housing loans and consumer credit was recorded. The trend towards a risk-differentiated margin spread on loans to households was thus more strongly affirmed (see chart on page 28); it was thus more marked than in the euro area as a whole. Regarding the other lending terms – such as the bench-

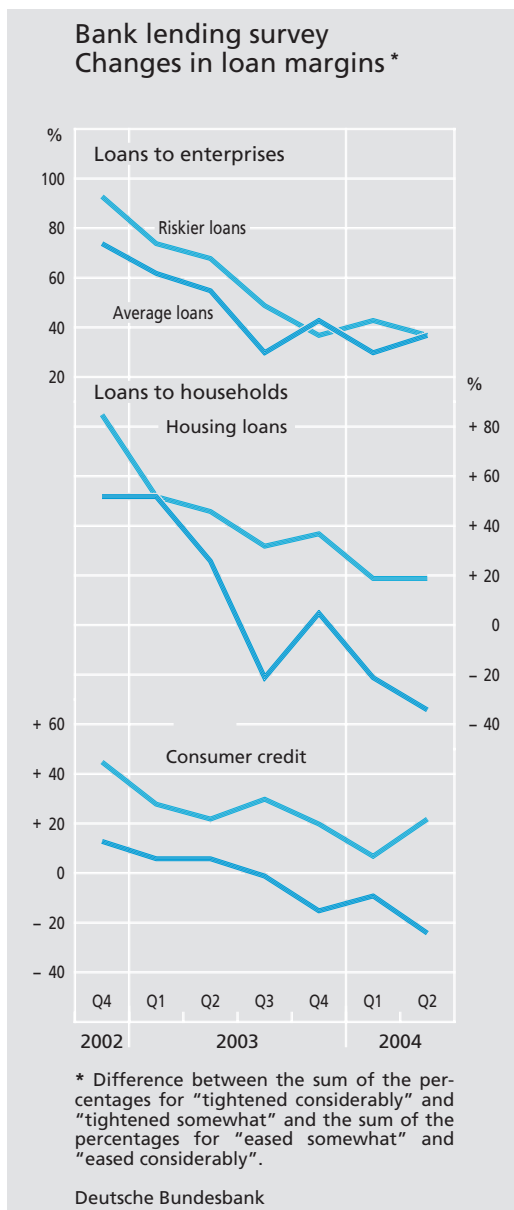


marks for the required collateral – the respondent institutions indicated no major changes.

There has been little change in banks' lending rates. For example, for new consumer credit and for housing loans with an initial interest rate fixation for up to one year the institu-

*Increase in lending rates, especially in the short-term maturity segment*

<sup>2</sup> See European Central Bank, *Monthly Bulletin*, August 2004, pp 15-19.



tions charged 5.3% and 4.5% respectively. The banks charged between 3.3% and 4.5% on short-term loans to enterprises, depending on the size of the loan. Their interest rates were between 3.9% and 5.2% on longer-term corporate loans, depending on the period of interest rate fixation. New housing loans with an interest rate fixed for more than ten years cost 5.1% on average.

As to liabilities, in some cases domestic banks paid somewhat higher rates of interest on private non-banks' deposits in the second quarter of 2004 than in the first, reflecting the development of long-term forward money market rates and interest rate movements in the capital market. In comparison with the previous quarter, the interest rates on time deposits of households and non-financial enterprises increased across almost the entire maturity range. The rates varied between 1.9% and 4.2% depending on the maturity category. By contrast, of savings deposits, only deposits with an agreed period of notice of up to three months were able to benefit from the slight upward movement in interest rates. On average, banks paid 2.1%; in the longer-term maturity range rates were 2.6%.

*Deposit rates tended to rise*

### Securities markets

Developments in the European capital markets were affected in recent months by the economic recovery that was gradually gaining strength in the euro area and the changes in sentiment in the US financial markets, which have been particularly frequent in recent months. As a result, from early April to around mid-June bond yields in the ten-year segment increased, with fluctuations, by ½ percentage point to 4½%. The yield rates have since fallen back somewhat. The bond markets in the United States and in the euro area benefited from the growing reticence of investors to invest in shares. The situation in the oil markets, which has escalated particularly of late, and the general geopolitical uncertainty were contributory factors. At the

*Capital market rates in the euro area ...*



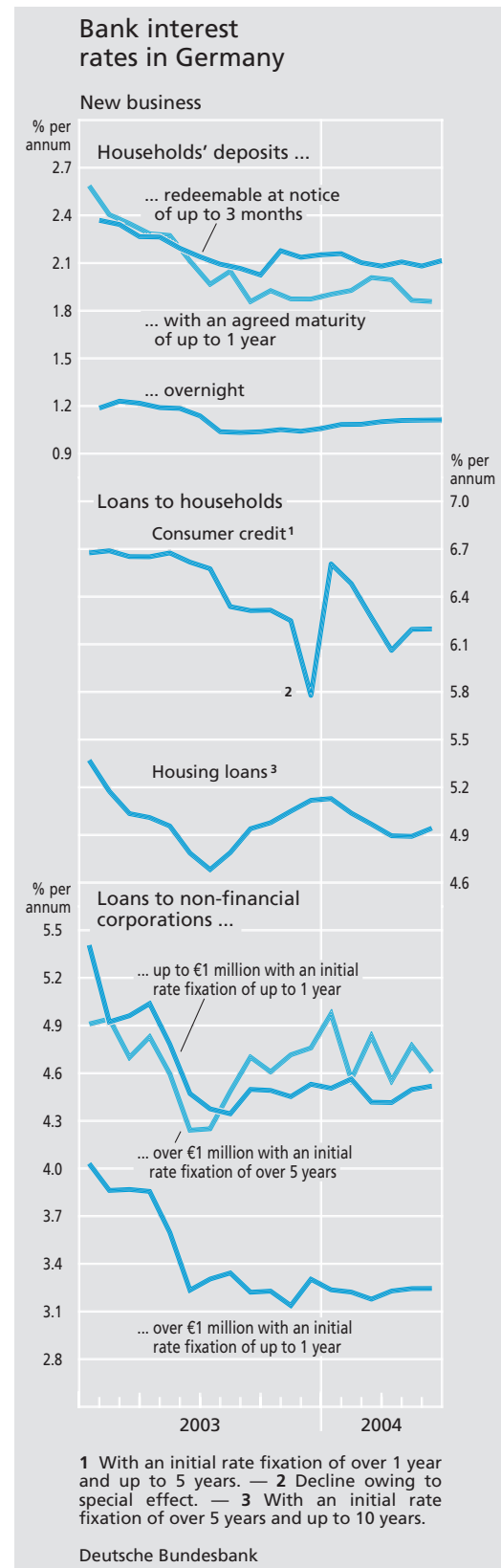
time of going to press, ten-year government bonds in the euro area were yielding, at just over 4%, only slightly more than in early April. As previously, yield fluctuation in the US bond market was more marked, with the result that the spread on US Treasuries over euro-area bonds increased from null in early April to roughly ½ percentage point in the second half of June, before shrinking to around ¼ point.

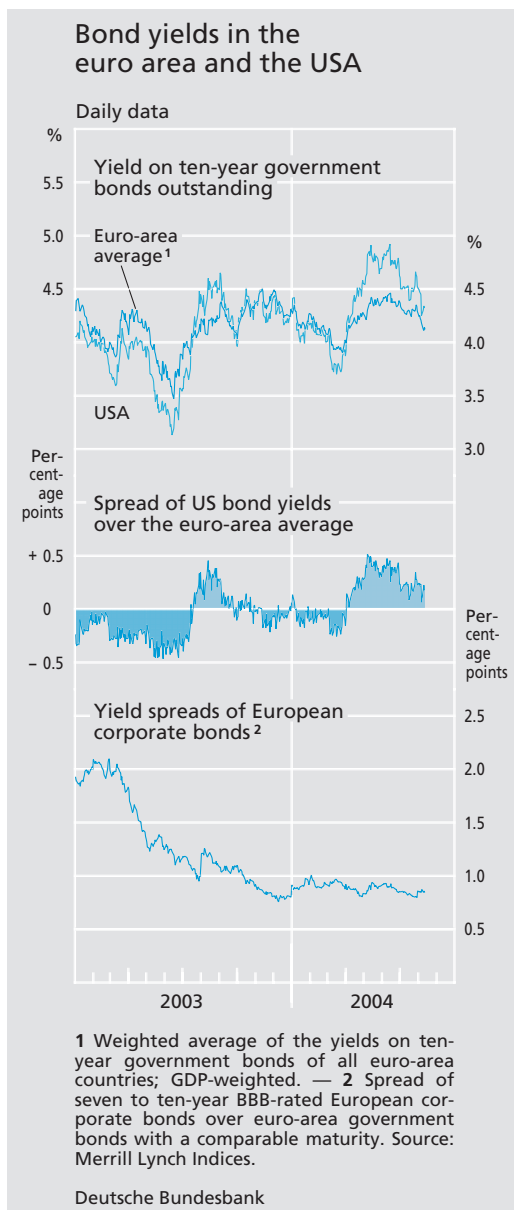
... and in  
Germany

Yields on German government bonds increased rather more strongly than capital market rates in other European countries. Owing to portfolio shifts into the highly liquid German bonds following the terrorist attacks in Madrid in March, the traditional yield spread on Federal bonds had risen by early April to almost 15 basis points; it then fell back to around 10 basis points in the following months. It can probably be assumed that this development was connected with the dissolution of the “safe haven” positions expanded in March. However, the tense situation in public finances may also have moved more strongly into investors’ sights again in recent months.

Losses in the  
equity market...

In spring, the cautious upward movement in the European equity markets continued at first, given greater confidence about the sustainability of the economic recovery in Europe and optimistic earnings expectations. Re-emerging doubts about the further continuation of the global economic upswing, together with growing tension in the oil market led to a further marked fall in share prices, especially in recent months. On balance, German equities lost roughly 8% of their value





on the CDAX price index and European equities lost some 6% on the Dow Jones EuroStoxx between early April and mid-August. Equities in the telecommunication, technology and media sectors recorded even greater losses.

... despite optimistic earnings expectations

This development contrasted to a certain extent with the analysts' optimistic earnings expectations. Between April and July they went

up by 8% for the equities in the DAX and by 6% for those in the Dow Jones EuroStoxx. At the same time, the already relatively low valuation level of German and European equities fell further. On the basis of expected year-on-year earnings, at 13.2x for the DAX and 13.6x for the Dow Jones EuroStoxx, the current price-earnings ratio is again well down on historical averages.

### Sales and purchases of securities

In the second quarter domestic issuers raised €290½ billion (nominal value) from sales of debt securities in the German bond market. After deducting redemptions and changes in issuers' holdings of their own bonds, net sales were €48 billion. In addition, sales of foreign bonds in the German market raised €30 billion net in the first quarter. Hence, total funds raised through the sale of domestic and foreign bonds and notes reached €78 billion in the period under review, compared with €87 billion in the previous quarter and only €51½ billion in the same quarter in 2003.

*Large sales receipts in the German bond market*

In the second quarter, more than one-third of the funds were raised through paper issued by credit institutions, to which €28 billion net accrued; in the same period in 2003, less than one-tenth of this figure was raised (€2.7 billion) in this segment of the banks' liability-side business. As in the previous months, other bank debt securities (€18½ billion) and debt securities issued by special purpose credit institutions (€17 billion) were still in demand in the period under review. These also include index certificates, more of which have

*Credit institutions expand their bonded debt*

been issued by banks recently (for details, see box on page 33). Mortgage Pfandbriefe outstanding were, by contrast, unchanged and, in net terms, public Pfandbriefe were redeemed (€8 billion).

*Fewer funds raised by the public sector*

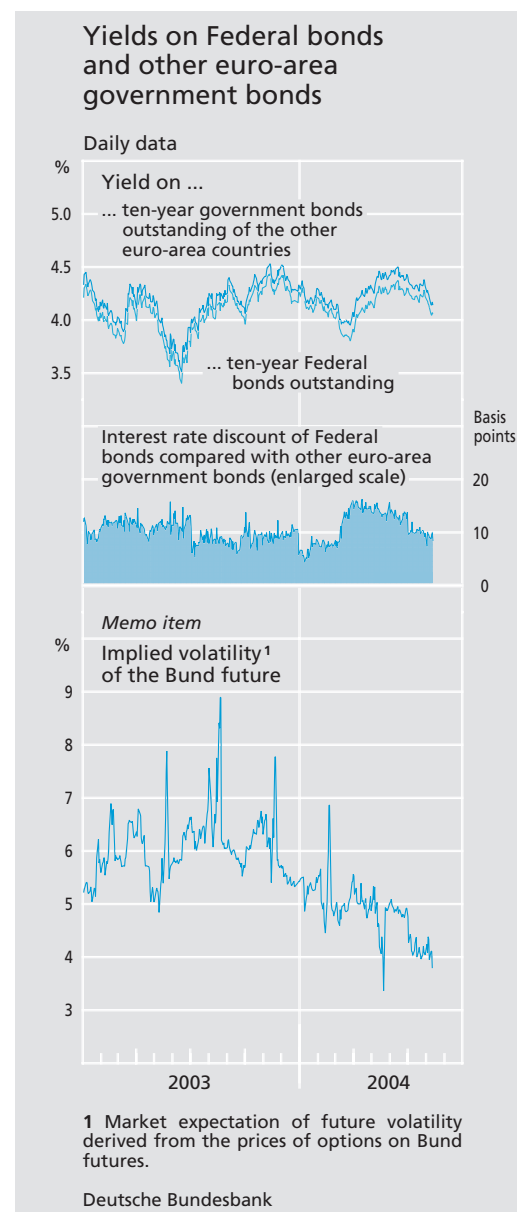
In the second quarter the public sector raised €15 billion in the bond market, compared with €17 billion in the same period in the previous year. Most of the funds were raised by Federal Government issues. Sales of ten-year Federal bonds raised €9 billion net, two-year Federal Treasury notes raised €4 billion and five-year Federal notes (Bobls) €3½ billion. By contrast, the volume of Federal savings notes outstanding decreased by €½ billion. Moreover, in April a bond issued by the former Bundespost was redeemed for €3 billion and in May a bond issued by the former Treuhand agency was redeemed for €4 billion.<sup>3</sup> State governments added €7 billion to their bonded debt.

*More funds raised by enterprises in the bond market*

The financing conditions in the capital market continued to be favourable and initial signs of an economic recovery resulted in enterprises raising €5 billion net worth of resources in the capital market in the second quarter (following €8 billion in the corresponding quarter in 2003). Money market paper raised roughly €1 billion.

*Domestic bonds and notes purchased mainly by credit institutions*

German credit institutions were again the principal purchasers in the German bond market in the second quarter. They added €38 billion to their bond portfolios, as opposed to €3 billion in the corresponding period in 2003. They invested almost equal amounts in domestic and foreign bonds and

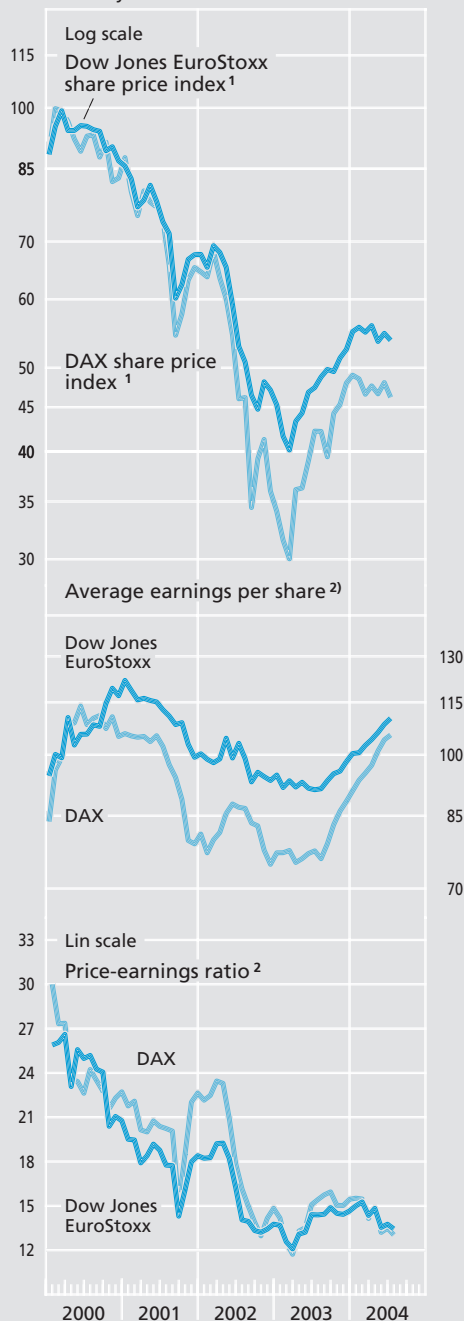


notes. Public debt securities accounted for most of the domestic bonds (€15 billion). Domestic non-banks invested €27½ billion (net) in the bond market. Of domestic paper (€16 billion), paper issued by private borrowers was most in demand. At the same time they

<sup>3</sup> In 1995 the debts of the Treuhand agency were transferred to the Redemption Fund for Inherited Liabilities. In 1999 responsibility was assumed by the Federal Government.

### Price movements and profit estimates for European and German public limited companies

Monthly data



<sup>1</sup> March 2000=100; source: Deutsche Börse AG. — <sup>2</sup> Based on year-on-year I/B/E/S analyst estimates. Source: Thomson Financial Datastream.

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invested (€11½ billion) in foreign debt securities, most of which, however, were denominated in euro. Foreign investors increased their holdings of domestic debt securities by €12½ billion net, on balance adding solely paper issued by private borrowers to their portfolios.

Issuing activity in the German equity market revived in the second quarter. Domestic enterprises placed new shares to a market value of €5 billion, following only €1½ billion in the previous quarter and €5½ billion in the second quarter of 2003. What was involved was an equity injection by a big bank in April and a few fairly small IPOs. By contrast, only a small volume of domestic equities were sold in the German market (€½ billion).

*More funds raised in the equity market*

Shares were purchased by domestic non-banks only. They topped up their share portfolios in the previous quarter by €23 billion, whereas they had been net sellers in the previous year. Banks, however, reduced their holdings by €5½ billion. Foreign investors reduced their portfolios of German equities more extensively (€12 billion).

*Shares purchased on balance only by non-banks*

Funds raised by the sale of mutual fund shares, at €1½ billion, were down on the previous quarter (€12½ billion). Investment interest in domestic funds focused primarily on open-end real estate funds (€1 billion). Furthermore, €2½ billion accrued to foreign funds. Domestic securities-based funds mainly experienced outflows. This applies particularly to mutual funds open to the general public.

*Far fewer funds raised by mutual fund shares*

## Index certificates – a new investment instrument

Banks and securities companies have been increasing their offerings of index certificates since the mid-1990s. Their share in the gross sales of debt securities by German banks has therefore increased perceptibly in recent months. However, their share in the total amount outstanding of securitised bank liabilities is estimated at less than 5%.

The value of index certificates – also known as participation certificates – is derived from an underlying instrument, generally key domestic and foreign share indices. Moreover, certificates also exist which are based on sector indices, baskets of indices or other financial products as well as “exotic” varieties with complex structures.

From a purely legal perspective, index certificates are debt securities on which no interim dividends are paid to the investor; a single repayment is merely made when the certificate matures. In the case of open-end certificates, however, once a year the investor has the right to exercise an option to redeem the certificates at the then index level in line with his/her subscription ratio. In the Bundesbank’s securities statistics, index certificates are recorded under “other bank debt securities” or “debt securities issued by special purpose credit institutions”. In banking statistics, they are reported as part of the “debt securities outstanding” and those with a correspondingly short maturity are allocated to paper with a maturity of up to two years

(their share in the volume outstanding of index certificates was roughly one-fifth in the period under review).

The importance of index certificates as a new investment instrument with a wide variety of characteristics has increased in recent years, following the equity market slump. The banks issuing these products, which are tailored to meet an extensive range of investment objectives, establish the bid/ask prices on each trading day. At least in the case of straightforward products, market participants cite the main advantages as being relatively low transaction costs, a comparatively high degree of transparency and liquidity, risk diversification and low minimum capital outlay. If the certificate is based on a performance index, on expiry of the speculation period, interim investment earnings on the underlying (eg dividends) can generally also be collected free of tax in the form of capital gains.<sup>1</sup> On the other hand, investors must bear in mind, *inter alia*, the issuer risk and the ranking of the certificate in relation to the issuer’s other liabilities. More complex, “exotic” certificates are less transparent and liquid; they also involve a more complicated pricing mechanism.

It is far simpler to issue a certificate than, for example, to launch a mutual fund, which is subject to strict investment guidelines and requires approval by the Federal Financial Supervision Authority (BaFin).

<sup>1</sup> This does not apply to capital guaranteed funds.

## Investment activity in the German securities markets

€ billion

Item	2004		2003
	Jan to Mar	Apr to June	Apr to June
<b>Bonds and notes</b>			
Residents	56.6	65.5	19.7
Credit institutions	55.3	38.2	3.2
<i>of which</i>			
Foreign bonds and notes	23.4	18.7	10.1
Non-banks	1.2	27.3	16.5
<i>of which</i>			
Domestic bonds and notes	4.4	16.0	2.4
Non-residents	30.4	12.6	31.9
<b>Shares</b>			
Residents	-0.9	17.8	3.7
Credit institutions	6.7	- 5.5	5.5
<i>of which</i>			
Domestic shares	7.4	- 6.3	0.2
Non-banks	-7.6	23.2	-1.8
<i>of which</i>			
Domestic shares	-9.2	23.3	1.0
Non-residents	3.1	-12.0	4.4
<b>Mutual fund shares</b>			
Investment in specialised funds	2.8	0.1	6.8
Investment in funds open to the general public	2.8	- 1.3	7.0
<i>of which: Share-based funds</i>	0.6	- 1.4	2.0

Deutsche Bundesbank