

Monetary policy, banking business and the capital market

Interest rate policy and the money market

The Governing Council of the European Central Bank did not change the Eurosystem's historically low key interest rates in the past few months. The main refinancing operations continued to be conducted as variable rate tenders with a minimum bid rate of 2% while the interest rates on the marginal refinancing facility and the deposit facility remained at 3% and 1% respectively. The interest rate policy decisions were based on the Governing Council's position that there are currently no clear signs of increasing inflationary pressure in the euro area. Owing to the high price of oil, however, second-round effects in the wage and price setting process cannot be entirely ruled out. In addition, the ample liquidity in the euro area, which is already reflected in an increase of some asset prices, could also lead to price effects in the product markets in the medium term. Hence, there are still upward risks to price stability. Some of these have become more acute in the period under review.

*Eurosystem
interest rates
unchanged*

As market participants had expected interest rate policy to hold steady, the overnight rate (EONIA), with the exception of short-term fluctuations at the end of the reserve maintenance period and at the end of the year, remained virtually unchanged in the period under review. The overnight interest rate (EONIA) was mostly close to the marginal lending rate, which was only a few basis points above the minimum bid rate. The other money market rates also remained fairly steady. At just over 20 basis points, the

*Money market
rates*

Money market management and liquidity needs

During the three reserve maintenance periods from 12 October 2004 to 18 January 2005, euro-area credit institutions' need for central bank money arising from the autonomous factors determining liquidity increased by €16.7 billion in net terms. This was mainly due to the further seasonally-induced increase in banknote circulation of €30.9 billion, which rose sharply in the pre-Christmas period, in particular, although the rise was lower than in the same year-earlier period. On 22 December, the volume of banknotes in circulation exceeded €500 billion for the first time. By contrast, seasonally-induced liquidity needs arising from general government deposits declined markedly by €12.9 billion net. If, in order to eliminate valuation effects, the changes in net reserve assets and other factors are taken together, these two items resulted in a slightly lower liquidity provision of €1.3 billion. The required level of minimum reserves went down by €0.4 billion, resulting in waning demand for central bank liquidity.

The greater need for liquidity was covered primarily by the main refinancing operations (MROs) being topped up by €16.5 billion. The volume of longer-term refinancing operations remained unchanged. In the period under review, the ECB carried out a fine-tuning operation on the last day of each reserve maintenance period.

In the period under review, the EONIA rate was mostly at a slightly higher level, following to a large extent the same trend as the slightly higher marginal rates of allotment until the end of the year. The EONIA rates rose from 2.05%/2.06% to 2.08%/2.09%. The period was characterised by rises in the EONIA rate at the end of each month and deviations following the allotment of the last MRO in each reserve period.

During the reserve maintenance period starting on 12 October, the market apparently assumed greater liquidity scarcity following the allotment of the last MRO. Following the rise in the EONIA rate to 2.24% on 4 November, the ECB carried out a liquidity providing fine-tuning operation on the last day of the reserve maintenance period totalling €6.5 billion. On 8 November, the EONIA rate was set at 2.02%.

During the reserve maintenance period starting on 9 November, the ECB began allotting liquidity above the benchmark. The EONIA rate remained, however, at a slightly higher level. The days following the allotment of the last MRO were the exception, when the market had anticipated excess liquidity. After a liquidity absorbing fine-tuning operation was carried out with a volume of €15 billion on the last day of the reserve period, the EONIA rate stood at 1.98%.

8 December was the start of an extended (by 42 days) reserve maintenance period, during which the ECB also allotted liquidity above the benchmark in each MRO. The deviation from the benchmark was the greatest during the MRO of 30 December, when it amounted to €5 billion. Owing to the generous allocation policy and the extended reserve period, things went relatively smoothly at the turn of the year. At the end of the year, the EONIA rate stood at 2.21%. The ECB conducted a liquidity-providing fine-tuning operation on the last day of the reserve period, after a small liquidity deficit had become apparent on the preceding day. Nevertheless, on 18 January, the EONIA rate stood at 2.14%; this was due to a temporary interruption in the RTGSplus payment system and an unexpected outflow caused by an increase in the autonomous factors on this day. At the start of the new January/February reserve period, the EONIA rate fell to a still somewhat higher level of 2.08%.

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Factors determining bank liquidity ¹

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

Item	2004/2005		
	12 Oct to 8 Nov	9 Nov to 7 Dec	8 Dec to 18 Jan
I Provision (+) or absorption (-) of central bank balances by			
1 Change in banknotes in circulation (increase: -)	- 4.6	- 5.7	- 20.6
2 Change in general govern- ment deposits with the Eurosystem (increase: -)	+ 3.1	- 5.1	+ 14.9
3 Change in net foreign reserves ²	- 0.5	- 0.3	- 7.7
4 Other factors ^{2,3}	+ 0.0	+ 3.9	+ 5.9
Total	- 2.0	- 7.2	- 7.5
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	+ 1.5	+ 7.8	+ 7.2
(b) Longer-term refinancing operations	+ 0.0	± 0.0	± 0.0
(c) Other operations	+ 0.2	- 0.7	+ 0.7
2 Standing facilities			
(a) Marginal lending facility	- 0.2	± 0.0	+ 1.0
(b) Deposit facility (increase: -)	- 0.3	+ 0.2	+ 0.0
Total	+ 1.2	+ 7.3	+ 8.0
III Change in credit institutions' current accounts (I + II)	- 0.9	+ 0.1	+ 0.6
IV Change in the minimum reserve requirement (increase: -)	+ 0.9	- 0.1	- 0.4

¹ For longer-term trends and the contribution of the Deutsche Bundesbank, 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. — ³ 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.

yield spread between twelve-month funds and EONIA, for example, changed very little over the period under review. Similarly, the three-month forward rate, which also expresses interest rate expectations, hardly changed on balance in the period under review. A $\frac{1}{4}$ percentage point increase in interest rates is currently not expected until the fourth quarter of 2005.

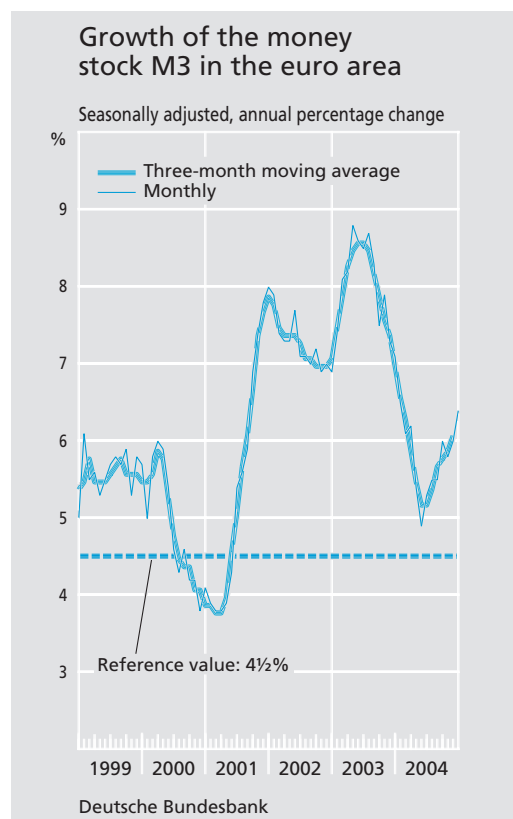
Monetary developments in the euro area

Monetary expansion accelerates

The money stock M3 grew strongly again in the fourth quarter of 2004. In seasonally adjusted terms, this aggregate grew by just under 7½% from October to December, quite similar to the development in the previous quarter (8½%) when monetary expansion, following a phase of gradual weakening, had picked up the pace considerably. The three-month moving average of annual rates of change for the period from October to December was 6.1%. Hence, this figure was again nearly a percentage point higher than the figure for the period from May to July 2004 when this rate (5.2%) had dropped to the lowest level since June 2001.

Components of the money stock

Among the components of the money stock, cash holdings grew very strongly at a seasonally adjusted annual rate of 13% in the period under review; this was, however, markedly slower than in the previous quarters. Stagnation in December was the sole cause for the lower increase in currency in circulation. Since seasonally adjusted overnight deposits at the same time grew relatively slowly in the period

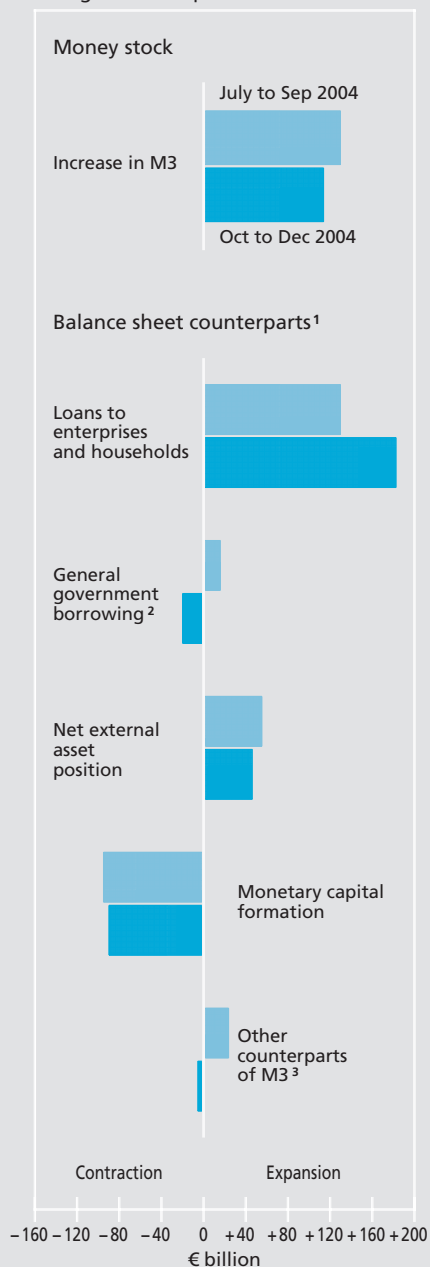


from October to December, the money stock M1 also grew only moderately in this period at an annualised rate of just under 4½%.

Moreover, the increase in deposits with a three-month period of notice, which in the preceding quarters had grown strongly, weakened considerably in the last quarter of 2004. These may have been invested in short-term time deposits, which were particularly in demand from domestic investors at the end of the period under review. In the period from October to December 2004, deposits with an agreed maturity of up to two years grew by an annualised rate of over 17%. This was the strongest growth since late 2000, when short-term interest rates reached their highest level (5%) since the mid-1990s and the interest rate disadvantage vis-à-vis long-

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 errors and omissions from the remaining items of the consolidated balance sheet of the MFI sector.

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term fixed-interest securities was particularly low at ¼ percentage point. True, the quarterly average of this interest rate discount was around 1¾ percentage points. However, in the light of low capital market rates, which declined further over the quarter, liquid and safe short-term time deposits were apparently viewed as being an attractive investment alternative. This is also evidenced by a large increase in repo transactions, which in economic terms represent time deposits backed by securities. Over and above that, among the marketable financial instruments, short-term bank debt securities were also in heavy demand. By contrast, money market fund shares experienced only moderate growth in the fourth quarter.

The sharp increase in M3 in the quarter under review was again accompanied by a marked increase in credit to the domestic private sector. First, banks added large amounts of securities issued by domestic private borrowers to their portfolios. Second, they provided a large volume of loans – as in the preceding quarter – to enterprises and households. In the period from October to December, these loans increased at an annualised rate of 8½%. Continuing the development witnessed in the first half of 2004, these loans again grew faster than M3 in the period under review. Above all, housing loans expanded sharply again, contributing around ¾ percentage points to the 7.0% year-on-year rate of loans to the private sector in December 2004. The demand for consumer and corporate loans also appears to be intensifying.

Balance sheet counterparts

Furthermore, extensive inflows of funds from foreign payment transactions stimulated monetary growth in the euro area in the fourth quarter. The net external assets of the MFI sector, which reflects payment transactions between domestic non-banks and non-euro-area residents, rose by €56½ billion in the fourth quarter. Inflows of merely €20½ billion were recorded in the same year-earlier period.

By contrast, the decline in credit to government in the euro area itself dampened monetary expansion in the quarter under review. In net terms, this was due exclusively to the decline in securitised lending. This contrasted with a reduction in central government deposits at domestic banks, meaning that the repeated strong growth of monetary capital formation represented an essential counterbalance to the increase in banks' asset-side business. Alongside the marked increase in longer-term time deposits, bank debt securities with a maturity of over two years made strong gains for the second quarter in a row. By contrast, savings deposits redeemable at notice of over three months rose negligibly.

Deposit and lending business of German banks with domestic customers

Liquidity holding in German rises only slightly

In contrast to the euro area, private non-banks' liquid bank deposits rose only slightly in the fourth quarter in Germany. In the previous quarter, short-term deposits of domestic enterprises and households were topped up strongly on a broad front. The reasons for the low preference for liquidity in the quarter

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

€ billion		
Item	2004	2003
	Oct to Dec	Oct to Dec
Deposits of domestic non-MFIs 1		
Overnight	+ 1.8	+ 15.5
With agreed maturities		
of up to 2 years	+ 14.6	+ 0.0
of over 2 years	+ 8.4	+ 2.8
Redeemable at agreed notice		
of up to 3 months	+ 9.7	+ 10.6
of over 3 months	+ 2.6	+ 1.4
Lending		
to domestic enterprises and households		
Unsecuritised	- 0.6	+ 4.2
Securitised	+ 7.3	- 3.2
to domestic government		
Unsecuritised	- 3.2	+ 4.5
Securitised	- 5.8	- 2.1

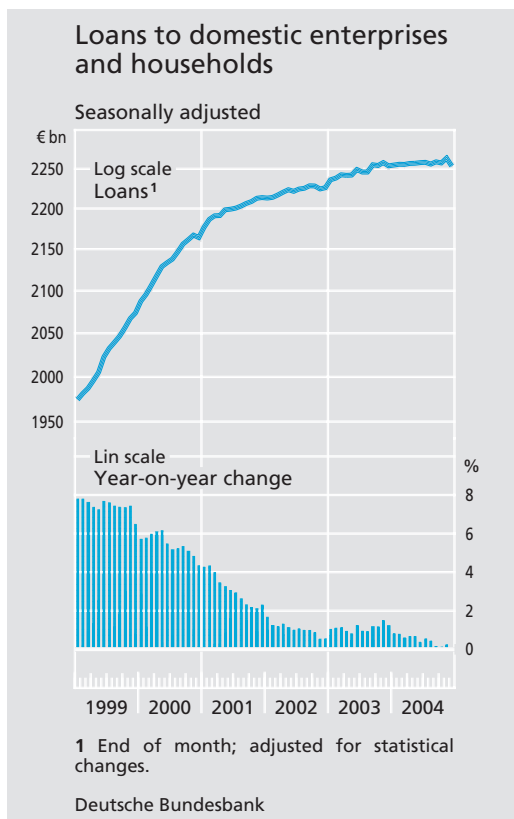
* As well as banks (including building and loan associations, but excluding the Bundesbank), monetary financial institutions (MFIs) here also include money market funds; see also Table IV.1 in the Statistical Section of the *Monthly Report*. — 1 Enterprises, households and government excluding central government.

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under review are to be found mainly in the corporate sector. Whereas households invested their funds in the domestic banking sector across the whole range of maturities to an extent which is typical for that time of the year, enterprises began to shift their liquidity holdings in the fourth quarter to higher-yielding bank deposits with longer maturities or to use them to repay their outstanding loans.

Turning to short-term bank deposits, overnight deposits declined slightly in the period under review. In the period from July to September 2004, by contrast, these deposits rose sharply by an annualised rate of 8½%. Apart from insurance corporations, which normally top up their liquid bank deposits towards the end of the year, especially other financial institutions, such as investment companies or

Slight decrease in overnight deposits...



...but a sharp rise in short-term time deposits

Sharp increase in longer-term bank deposits

financing subsidiaries of larger enterprises, reduced their overnight money to a larger extent than usual in the fourth quarter. Conversely, the short-term time deposits of this group of investors and non-financial corporations increased strongly. By contrast, households again preferred to invest their cash in overnight money, a fact which is seen in a reduction in their short-term savings deposits.

Unlike the short-term deposits, the longer-term bank deposits of domestic households and enterprises rose sharply in the quarter under review. Time deposits with a maturity of over two years increased considerably again. Besides insurance corporations, wage and salary earners, in particular, topped up their longer-term time deposits. Furthermore, in the period from October to December, the

longer-term savings deposits (with an agreed maturity of over three months) rose slightly for the first time since the first quarter of 2001.

Lending by German banks to domestic non-banks declined substantially in the fourth quarter. The decline was attributed solely to loans; domestic banks' holdings of securities issued by public and private domestic borrowers remained practically unchanged. In particular, unsecured lending by German banks to general government in Germany declined markedly. In the period from October to December, these loans decreased at an annualised rate of over 8%. Over and above that, loans to domestic enterprises and households fell, after rising somewhat in the previous quarter. The decline in unsecured lending to domestic private non-banks in the quarter under review was not limited to only shorter-term maturities. Medium to long-term loans to domestic enterprises and households also declined perceptibly in the period from October to December. In contrast to the development in the rest of the euro area, the subdued increase in housing loans to households was not strong enough to offset the noticeable reduction in other loans to households and unsecured lending to enterprises.

Credit declines substantially

According to the January results of the Euro-system's bank lending survey¹, the reason behind the low volume of lending continues to

Reason for low volume of lending more on the demand side

¹ 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 viewed under http://www.bundesbank.de/volkswirtschaft/vo_veroeffentlichungen.en.php.

be more on the demand side. According to the survey, participating banks did not fundamentally tighten their lending standards any further. For the third quarter in a row, credit institutions left their credit standards for corporate loans, housing loans and household consumer credit largely unchanged in the fourth quarter of 2004.

Spreads continue to rise on riskier loans

For the first time since the launch of the Bank Lending Survey, margins on corporate loans with average risk remained steady, while margins on loans to households with average risk exposure actually declined somewhat. Further, albeit weaker widening of the margins persisted only in the case of riskier loans across all credit categories. At the same time, the respondent banks also recorded a fairly marked decline in demand for both corporate loans and loans to households. According to credit institutions participating in the survey, this was mainly due to a repeated decline in the financing needs for fixed investment and the low level of consumer confidence.

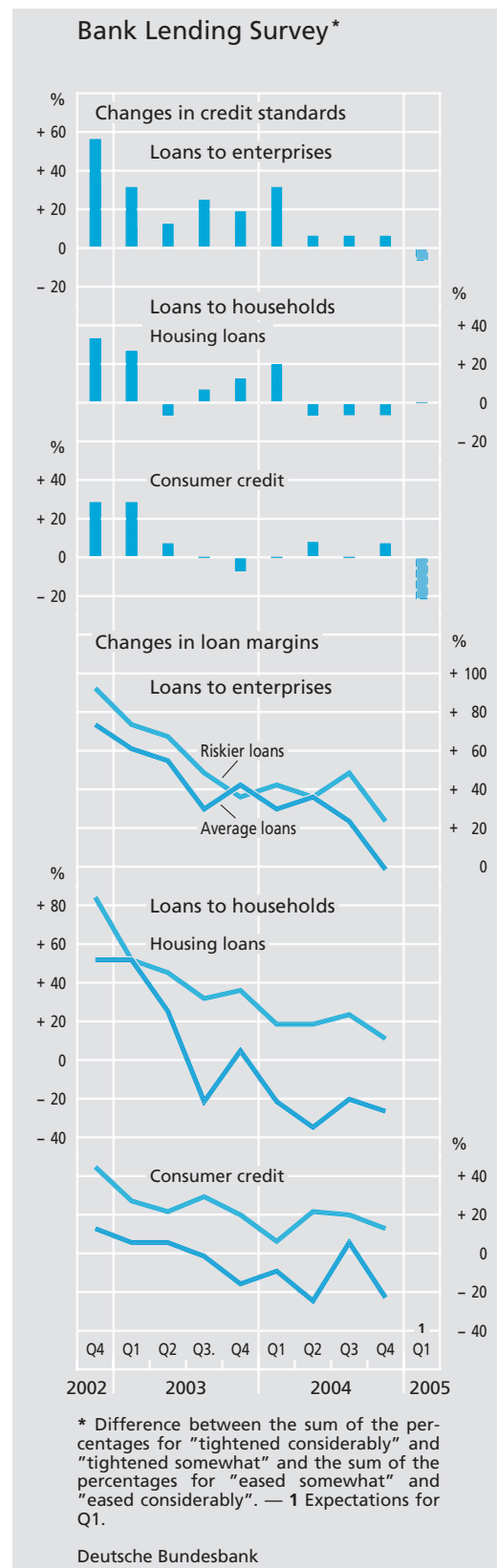
Demand for credit again weaker than in the euro area as a whole

As in the preceding quarters, the results for Germany largely match those for Europe.² However, credit demand remained weaker in Germany than in the euro area.

Long-term lending rates declining

With regard to new business, German banks, in line with the declining interest rates in the capital market, offered long-term loans at cheaper rates in the fourth quarter of 2004. For example, in the period under review, German banks charged non-financial enterprises between 4.3% and 4.6% for new long-term

² See European Central Bank, *Monthly Bulletin*, February 2005, pp 16 ff.





lending depending on the loan amount. They charged 4.7% for loans for house purchase with an interest rate fixation of over ten years and 8.0% for long-term consumer loans in the period under review. Developments in short-term lending were, by contrast, mixed in the fourth quarter of 2004. Whereas banks changed their interest rates very little in the area of short-term corporate lending in the period from October to December, the corresponding rates for housing loans and consumer credit dropped.

The interest rates on deposits at domestic credit institutions remained virtually unchanged in the fourth quarter. At the end of the quarter, banks were paying 2.1% for savings deposits with a notice period of up to three months and 2.5% for longer maturities. Only interest rates on time deposits of households and non-financial enterprises dropped somewhat in the longer maturity range. Towards the end of the period – depending on the maturity – the rates on households' time deposits were between 1.9% and 2.6%, while those for enterprises were between 2.0% and 3.8%.

Again little change in deposit rates

Securities markets

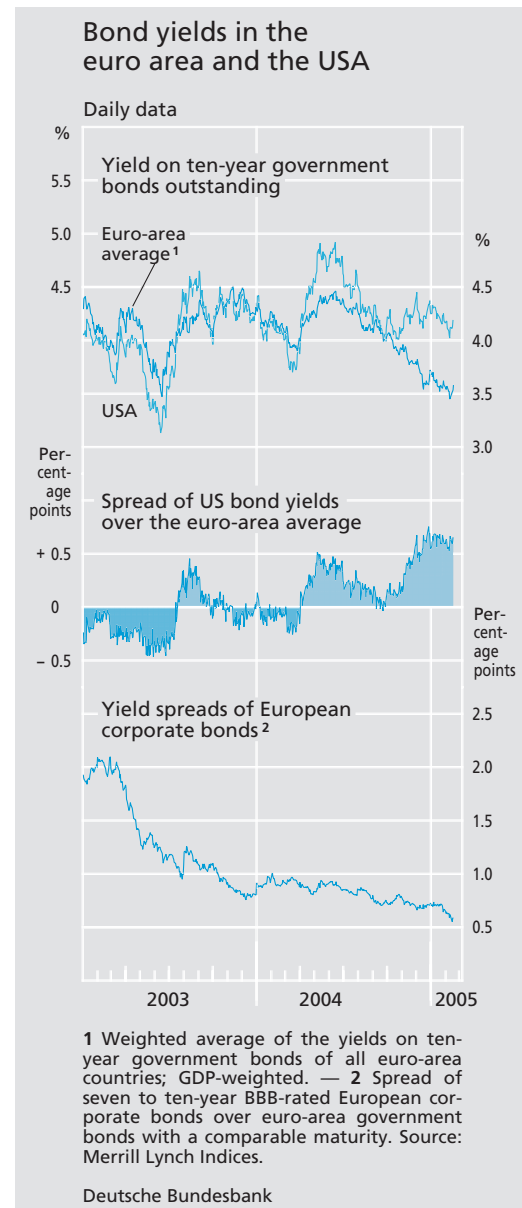
The tendency towards relaxation in the capital markets which began last summer has, with only a few interruptions, continued. Against this backdrop, European bond yields clearly decoupled from the dollar interest rate trend in the fourth quarter of 2004. Whereas yields on ten-year euro-area bonds declined by a half a percentage point to just under

Capital market rates near historical low

3.5% since last October, comparable dollar yields increased temporarily by approximately ¼ percentage point. The long-term interest rates in the euro area are thus at the lowest level in over a hundred years. A number of determinants contributed to this development, such as large excess liquidity in the euro area and the associated investment pressure. A certain strategic shift on the part of internationally operating investors in favour of euro-denominated investments may have also had an influence. This was compounded by the fact that economic growth in the euro area in the fourth quarter of 2004 was weaker than had been originally expected and, subsequently, the assessment of the outlook for domestic economic growth in the markets was also somewhat more subdued.

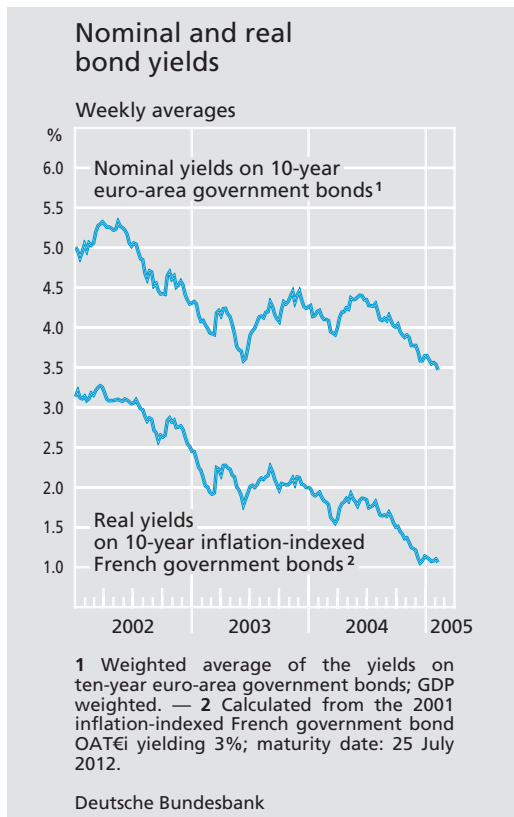
Subdued economic expectations depress real rate of interest

The importance of economic expectations is also reflected in the fact that the decline in the nominal yields in the euro area has been accompanied by lower real interest rates. Ten-year French inflation-linked bonds are currently yielding just over 1%, the lowest amount since they were introduced in the late 1990s. Other measures of real interest rates have also fallen to their lowest level in years. By contrast, euro-area market participants' long-term inflation expectations have persisted around the 2% mark for several months, ie the figure which the Eurosystem has defined as the upper ceiling for price stability.³ This feature also differentiates the scenario of the fourth quarter of 2004 and the summer of 2003, when market participants had been expecting lower interest rates. In the light of unchanged price expectations, the lower growth expectations led to



falling longer-term nominal rates of interest. This – together with the widely steady short-

³ According to the results of a survey conducted by Consensus Economics, bank economists expect inflation to rise by an average of just under 2% annually over the next ten years. The corresponding break-even inflation rate – approximately the difference between the nominal yield of French government bonds and the real rate of interest on index-linked bonds of the same issuer – is somewhat higher at just under 2¼% per annum. However, owing to the inflation risk premium component of the yield on nominal bonds, it is likely to overstate somewhat the expected rate of inflation.



term rates of interest – contributed to a flattening of the yield curve.

Rising equity prices in Germany and Europe...

Given the overall favourable earnings outlook for many enterprises, share prices in the European equity markets have risen in line with those in the US and Japan. In the fourth quarter of 2004 German equity prices – as measured by the broad CDAX index – rose by just under 10%, comparable to a rise in the equity prices of the enterprises listed in the Dow Jones EuroStoxx index. Since the beginning of the year, the shares of European enterprises have continued to rise by 5%. The share prices of German enterprises rose somewhat slower. As was the case in the spring of 2003, in the fourth quarter of 2004, the sharp reduction in the real interest rate probably exerted a positive influence on

equity prices. One indicator of this influence is the fact that equity prices rose in all sectors represented in the EuroStoxx index, even in those sectors which are susceptible to cyclical swings, such as the chemical and capital goods industry. In contrast to 2003, the equity markets now appear to be rewarding the intensified rationalisation and consolidation efforts of many enterprises, which are reflected in another rise in expected earnings for the year 2005.⁴

... against the backdrop of lower real interest rates and more favourable earnings forecasts

Analysts now expect corporate earnings to be higher than during the equity boom five years ago, and the range of their forecasts is at a rather average level by historical standards. Despite recent share price gains, the underlying price-to-earnings ratio of German and European equities increased only marginally to around 13 in the fourth quarter. This suggests a comparatively large risk premium implicit in the current market prices, as investors demand compensation for the risks associated with investing in equities. This stands in contrast to the low interest rate premia on corporate bonds and to the low share price uncertainty in the equity market, which is reflected in a reduction in the implied volatility of DAX future options. Investors are apparently expecting more of a tendency towards less share price fluctuations than in the previous years. It is also possible that they do not assess the earnings outlook of enterprises quite as positively as equity analysts do.

Continued low equity valuations...

... reflect low appetite for risk in the equity markets

Despite the favourable financing conditions, more bonds were repaid in the German bond

Fewer funds raised in the German bond market

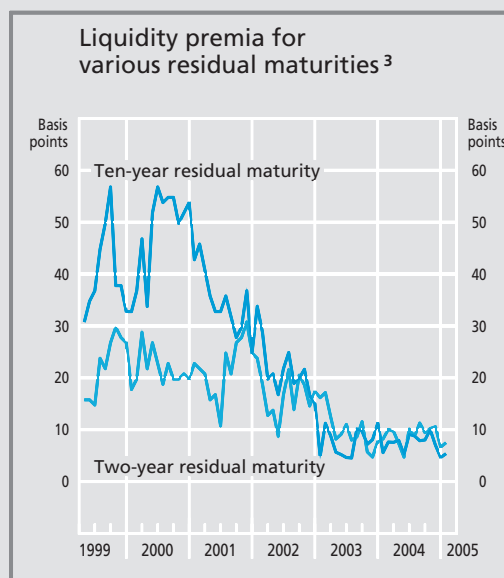
⁴ I/B/E/S forecasts.

An indicator to measure the liquidity premium in the bond market

Bond yields consist of a benchmark rate corresponding to usual market rates, a default risk premium and usually a liquidity premium. The latter compensates the investor for the risk that a purchase or sale at any time is either not possible or is possible only with considerable price effects. Bond investors are therefore generally willing to pay a premium for bonds which have a large trading volume and hence, high liquidity. The premium on such bonds, which include German Federal Bonds, is reflected in lower yields. However, the size of the liquidity premium is not directly observable, but must be estimated. Longstaff (2004) presented a method for doing this in the case of the United States.¹ He compares the yields on US Treasuries with bonds of a government agency whose repayments are explicitly guaranteed by the US government and hence have an identical default risk. The difference in the yields of these two bonds should thus be merely a result of liquidity differences and can therefore be interpreted as the price of liquidity.

This analysis can also be applied to German Federal bonds. For instance, a comparison with bonds issued by the Kreditanstalt für Wiederaufbau (KfW) makes it possible to estimate the liquidity bonus contained in the prices of Federal bonds.² The higher the yield spread is on KfW bonds vis-à-vis Bunds, the higher the value is which investors place on the liquidity of Bunds in the form of higher prices and lower yields. The adjacent chart shows the liquidity premium calculated this way for bonds with various maturities. The size of the premium rises commensurate with the residual maturity; the average premium has been 17 basis points for two-year securities and 26 basis points for ten-year securities (since 1999). There has been a clearly recognisable fluctuation in the liquidity premium over time. The higher figures in 2000 —

particularly in the case of ten-year bonds — might be a result of the large proceeds from the auction of the UMTS licenses. In this vein, in the expectation that the supply of Bunds, and hence, their liquidity could drop in future, investors were apparently prepared to temporarily pay a higher price for liquidity. Since that time, however, the premium has fallen steadily. For several months now, it has been very low compared with the long-term average. An empirical determination of possible explanatory factors shows that fluctuations in the liquidity premium show a positive correlation in particular with changes in the implied volatility in the equity market (measured by the VDAX). This indicates that investors prefer liquid forms of investment especially in times of heightened uncertainty in the equity market. Therefore, in the current environment of low uncertainty, the price which market participants are willing to pay for liquidity is accordingly small.



1 F Longstaff (2004): The Flight-to-Liquidity Premium in U.S. Treasury Bond Prices, *Journal of Business*, vol 77, no 3, pp 511-526. — 2 Owing to the Federal government's explicit liability for the bonds issued by the KfW (section 1 (a) "Guarantee of the Federal Republic", Law Concerning KfW), the default risk of both bonds should be virtually identical. The volume of ten-year Bunds outstanding is €52 billion, compared with €10 billion at the KfW. Bunds and KfW bonds are both traded on the bonds trading system MTS, meaning that

a constant minimum amount of liquidity is ensured. It is therefore assumed that the relative liquidity of KfW bonds and Bunds is fairly stable over time. — 3 Liquidity premia are calculated as the difference between the constant maturity curves for different maturities provided by Bloomberg for Bunds and KfW bonds. To calculate the yield curve for KfW bonds, Bloomberg also uses a number of bonds issued by the Rentenbank, for which the Federal government has assumed a guarantee for ensuring solvency.

Price movements and earnings estimates for European and German public limited companies

Monthly data



¹ March 2000 = 100; source: Deutsche Börse AG. — ² Based on I/B/E/S forecasts of 12-month forward earnings per share. Source: Thomson Financial Datastream.

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market in the fourth quarter of 2004 than were issued. Although gross issuance of domestic debt securities amounted to €279½ billion, redemptions and changes in issuers' holdings were even higher, totalling €293 billion. Hence, the amount outstanding of domestic bonds fell by €14 billion between October and December, having grown by €33 billion in the preceding quarter. In the period under review, foreign bonds raised €15½ billion in Germany. As a result, total funds raised through the sale of domestic and foreign bonds amounted to €1½ billion compared with €56½ billion in the preceding quarter.

The drop in funds raised in the German bond market is essentially due to net redemptions by domestic credit institutions, which reduced their bonded debt by 20½ billion in the fourth quarter. In the third quarter they had issued €23 billion (net) worth of own bonds. In particular, public Pfandbriefe were redeemed on balance (-€24½ billion), whereas other bank debt securities and debt securities issued by specialised credit institutions recorded net sales of €2½ billion and 1½ billion respectively.

Credit institutions reduced bonded debt

In the fourth quarter, general government tapped the bond market to a lesser extent (€3½ billion) than was the case in the preceding quarter (€5 billion). The decline was mainly the result of lower net issuance of Federal securities (€3½ billion; third quarter: €11½ billion). Central government was mainly active in the longer-term maturity range in the fourth quarter. It sold ten-year Federal bonds (Bund) worth €3 billion and five-year Federal notes (Bobl) worth €2½ billion (net). This con-

Fewer funds raised by the public sector

trusted with redemptions of Federal Treasury notes ("Schätze") amounting to €1½ billion. In addition, a bond issued by the former Federal Post Office was redeemed for €3½ billion. Consequently, the volume outstanding of bonds issued by the various special funds dropped to €2½ billion. Five years ago the volume outstanding of this kind of paper was €163 billion. However, the special funds have ceased using their own debt securities to generate resources but, owing to the more favourable financing terms, are now issuing debt jointly with the Federal Government. At €4 billion, state government borrowed more funds than in the preceding period (€2½ billion).

Enterprises

Compared with the third quarter of 2004, falling long-term interest rates, continued low interest rate premia on corporate bonds⁵ and rising equity prices have further improved the financing conditions for those enterprises which are able to tap the capital markets. At the same time, the more favourable earnings situation has also improved the possibilities of internal financing. Altogether, at €3 billion, German enterprises tapped the bond market to a lesser extent than in the previous period (€4½ billion). As in the past quarter, they used the low long-term interest rates to issue paper with longer maturities in particular and reduced the outstanding volume of money market paper.

Purchases of domestic bonds

In the fourth quarter of 2004, foreign investors were the main purchasers in the German bond market, topping up their holdings of German bonds by €16 billion. By contrast, domestic investors sold domestic bonds

Investment activity in the German securities markets

€ billion			
Item	2004		2003
	July to Sep	Oct to Dec	Oct to Dec
Bonds and notes			
Residents	28.5	- 14.5	18.6
Credit institutions	25.9	2.5	8.6
of which			
Foreign bonds and notes	13.4	17.3	13.4
Non-banks	2.7	- 17.0	10.0
of which			
Domestic bonds and notes	- 7.2	- 15.2	19.2
Non-residents	27.8	15.9	10.5
Shares			
Residents	- 16.1	4.3	- 9.4
Credit institutions	- 7.3	11.0	9.2
of which			
Domestic shares	- 3.5	8.8	7.0
Non-banks	- 8.9	- 6.7	- 18.6
of which			
Domestic shares	- 2.5	- 6.6	- 21.9
Non-residents	6.8	0.7	21.2
Mutual fund shares			
Investment in specialised funds	- 4.9	7.4	5.2
Investment in funds open to the general public	1.0	- 6.5	- 0.4
of which: Share-based funds	- 1.8	1.1	0.9

worth €30 billion (net), buying foreign bonds instead worth €15½ billion.

Although issuing activity in the German equity market increased somewhat the fourth quarter of 2004, it was still subdued. German enterprises placed new shares to a market value of €3 billion, having placed only €1 billion in the third quarter. A capital injection of a large enterprise in the retail industry in December contributed to this result. In addition, sales of foreign equities in the German market raised €2 billion. On the buy side, between October and December there were major portfolio shifts between credit institu-

Few funds raised in the equity market

⁵ At the time this article went to press, the spreads on corporate bonds with a BBB rating (the lowest investment grade rating) over government bonds with the same maturities was at 60 basis points and therefore close to the long-standing lows.

tions which topped up their holdings of domestic equities by €9 billion, and non-banks, which sold domestic equities worth €6½ billion. Foreign investors invested €½ billion in German equities.

*Mutual fund
shares*

The demand for mutual fund shares recovered only slightly in the fourth quarter. After experiencing outflows of funds in the third quarter, German investment companies were able to again attract new funds in the October to December period (€1 billion), although on balance, these accrued solely to the special funds which manage institutional investors' monies (€7½ billion). By comparison, investment funds open to the general public were redeemed for €6½ billion, which

was primarily due to strong withdrawals from money market funds (-€7 billion). Among the other categories of funds, mainly open-end real estate funds recorded outflows (-€½ billion), while share-based funds recorded inflows of €1 billion, in line with positive share price movements. For the first time in a while, foreign funds redeemed shares in net terms (-€1 billion). Both credit institutions and foreign investors topped up their holdings of German funds shares by €3 billion and €1 billion respectively. In addition, banks purchased foreign mutual funds shares for €2 billion. By contrast, domestic non-banks reduced their holdings in domestic and foreign investment funds by €3½ billion and €3 billion respectively.