

Securities markets

Bond market

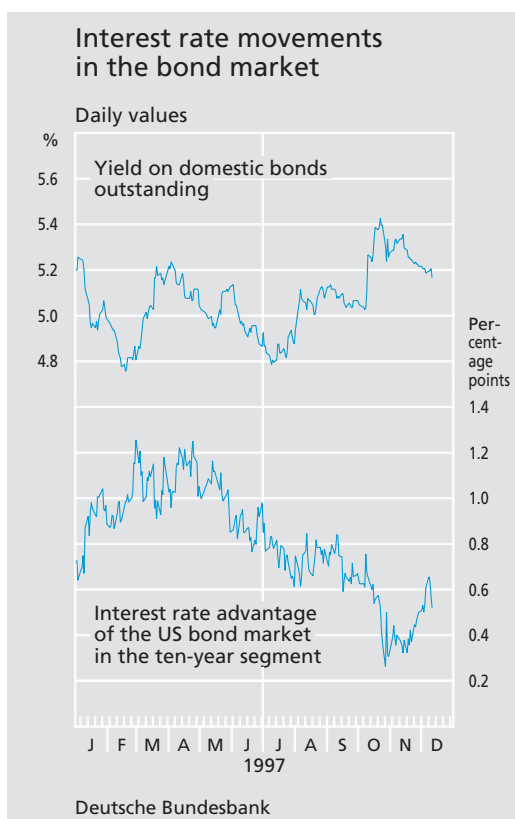
Interest rate movements

The yield on domestic bonds outstanding rose slightly in the autumn. After having fallen short of the 5% mark for several weeks in June and July, it increased to about 5% in August and to 5¼% in October. Yields fluctuated considerably for a short while at the end of October in the wake of the crisis in the east Asian financial markets, but these fluctuations soon abated. When this Report went to press in mid-December, the yield on bonds outstanding again stood at just over 5%. However, interest rates increased in the autumn months only at the shorter end of the capital market, which had been showing a slight upward trend in interest rate movements ever since the beginning of July. Long-term capital market rates, by contrast, have even fallen beneath the low of February 1997 of late. Consequently, the interest rate differential between the individual maturity categories in the bond market narrowed further in the autumn. The yield spread between ten-year and one-year Federal bonds observable in the market came to slightly more than 1¼ percentage points in mid-December, compared with 2 percentage points at the end of July 1997.

*Marginal rise
in the yield
on bonds
outstanding*

The rise in interest rates in the shorter-term maturity segments of the capital market was primarily a reflection of the slight tightening of monetary policy which the Bundesbank felt obliged to undertake in October in view of the higher inflation risk. International influences were predominant in the longer-term

*Determinants
of interest rate
movements*



maturity segments in particular. Following a temporary increase in yields in August, a tendency towards the downward movement of interest rates spread from the US capital market. This trend was probably attributable, on the one hand, to receding fears of inflation in the United States and, on the other, to shifts into bonds in response to the turbulence on the international stock exchanges. In the aggregate, the yield advantage of the US bond market contracted further in autumn. In mid-December it came to about $\frac{1}{2}$ percentage point, compared with $\frac{3}{4}$ percentage point in July.

Sales of bonds

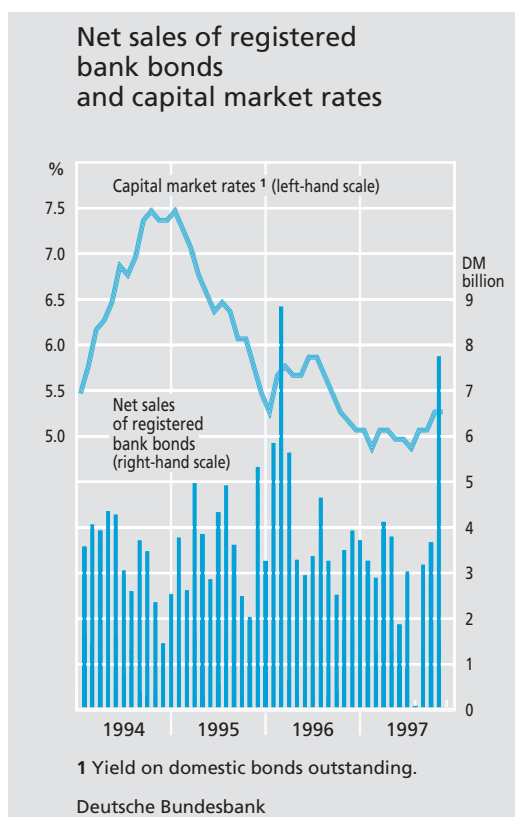
Amount raised

Gross sales of domestic bonds were lower between August and October, at DM 182.6 bil-

lion (market value), than in the preceding three months, when domestic borrowers had issued bonds worth DM 202.7 billion; between August and October 1996 bonds were sold to the extent of DM 173.6 billion gross. Net of the sizeable redemptions and after taking due account of changes in issuers' holdings of their own bonds, the amount raised came to only DM 27.1 billion in the period under review, compared with DM 65.3 billion between May and July and DM 54.0 billion a year before. Sales of foreign bonds in Germany also declined distinctly; between August and October they amounted to DM 19.0 billion (net), compared with the record volume of DM 39.2 billion in the preceding three months. In particular, there was a drop in domestic investors' demand for foreign currency bonds, which accounted for only DM 13.9 billion (May to July: DM 32.5 billion). The scope for convergence trade within Europe was possibly considered narrower, while interest in US dollar bonds waned for exchange rate reasons. Debt securities denominated in Deutsche Mark and issued by non-residents were sold in the domestic market to the tune of DM 5.0 billion on balance. The total amount raised by sales of domestic and foreign bonds between August and October 1997 came to DM 46.0 billion, compared with DM 104.5 billion in the preceding three months and DM 55.8 billion in the corresponding period of 1996.

Credit institutions received the total amount raised by sales of domestic bonds between August and October (DM 31.4 billion net). More than one-third of this sum was accounted for by other bank bonds (DM 12.6 billion).

Bank bonds



This trend is probably a reflection of the quite sharp expansion of banks' longer-term lending. Issuing activity was also brisk in the market for communal bonds (*Öffentliche Pfandbriefe*), which were sold to the tune of DM 11.7 billion net. The outstanding amount of bonds issued by specialised credit institutions rose by DM 5.5 billion. DM 1.6 billion (net) was generated by sales of mortgage bonds (*Hypothekendarlehenbriefe*) in the period under review. The banks also made increasing use of registered bank bonds (which are not included in the figures analysed here) for funding purposes; between August and October their net sales came to DM 14.6 billion, compared with DM 5.0 billion in the three preceding months. Registered bank bonds, which carry no price risks, are attractive for institutional investors at times of rising

capital market rates as they can be shown in the balance sheet at their purchase price and need not be written down to a lower market value – as is the case for marketable securities.

Between August and October the public sector reduced its liabilities in the bond market by DM 4.4 billion; in the three preceding months public authorities had launched bond issues in the amount of DM 10.9 billion (net). This decline was due, firstly, to redemptions made by the Federal Railways Fund and the Federal post office; their bonded debt decreased by DM 2.1 billion and DM 2.0 billion, respectively. Secondly, the Federal Government and its special funds increasingly covered their financial requirements, particularly in September and October, by raising loans against borrowers' notes. The outstanding amount of bonds issued by the Federal Government declined by DM 1.4 billion between August and October. As in the previous three-month period, the Federal Government's issuing activity focused on the short and very long ends of the maturity range. Thus, the outstanding amount of two-year Treasury notes rose by DM 9.7 billion (nominal value) and that of thirty-year bond issues by DM 9.4 billion. By contrast, five-year special Federal bonds (–DM 9.3 billion), ten-year bond issues (–DM 5.7 billion) and Federal savings bonds (–DM 0.3 billion) were redeemed on balance. The Länder Governments tapped the bond market for DM 1.0 billion. The bonded debt of the other public sector issuers changed only marginally.

Public bonds

Sales and purchases of bonds

DM billion

Item	1997		Aug. to Oct. 1996
	May to July	Aug. to Oct.	
Sales			
Domestic bonds ¹	65.3	27.1	54.0
of which			
Bank bonds	53.4	31.4	50.4
Foreign bonds ²	39.2	19.0	1.8
of which			
Foreign currency bonds	32.5	13.9	2.5
Purchases			
Residents	73.3	28.1	35.2
Credit institutions ³	54.9	23.2	31.8
Non-banks ⁴	18.3	4.9	3.4
of which			
Foreign bonds	24.2	5.4	- 3.6
Non-residents ²	31.2	18.0	20.5
Total sales/purchases	104.5	46.0	55.8

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

Deutsche Bundesbank

*Change in the
procedure for
issuing Federal
securities*

The Federal Ministry of Finance and the Deutsche Bundesbank have agreed to modify the procedure for issuing Federal securities. From January 1998 Federal bonds ("Bunds") will no longer be issued through the Federal Bond Consortium. Bunds – as well as Federal Treasury notes ("Schätze"), five-year special Federal bonds ("Bobl's") and Federal Treasury discount paper ("Bubills") will then be auctioned by tender using a uniform procedure through a newly formed "Bund Issues Auction Group". Resident credit institutions and domestic branches of foreign institutions will be eligible to join this "Auction Group" if they are confident of being able to buy at least 0.05 % of the total allocated issue volume on average. A ranking of bidders classified by their shares (but not disclosing their actual percentage) will be published annually.

Amounts intended for market management purposes (except "Bubills") will continue to be set aside for placement through the stock exchange in the open market, and the initial tap issue of five-year special Federal bonds will be retained.

The new issuance procedure will end a tradition going back more than 130 years of issuing Federal bonds in Germany through a bank syndicate. The Prussia Bond Issue Consortium was formed in 1835 and was superseded in 1890 by the Reich Bond Issue Consortium; in 1952 the Federal Bond Consortium revived this tradition. In the past 45 years the Federal Bond Consortium has launched 370 bond issues of the Federal Government, Federal railways, Federal post office, ERP Special Fund, Treuhand agency and the German Unity Fund. The Consortium is now being dissolved because its importance has increasingly declined compared with the auction procedure, which takes place under competitive conditions.

Between August and October foreign borrowers issued bonds denominated in Deutsche Mark worth DM 32.1 billion (nominal value). About half of this volume consisted of drawings under medium-term note programmes. Approximately DM 5 billion and DM 3 billion, respectively, was accounted for by foreign public authorities and international organisations. Debtors with less favourable credit standing showed less interest in Deutsche Mark issues of late; in the course of autumn the loan risk premiums, which had previously been unusually low, rose markedly in the bond markets. Net sales of foreign

*Foreign
Deutsche Mark
bonds*

Deutsche Mark bonds in the period under review, at DM 17.6 billion, were on a par with the corresponding period of 1996; between May and July they had totalled DM 23.0 billion. Just under three-quarters of the debt securities were sold to non-residents (DM 12.6 billion).

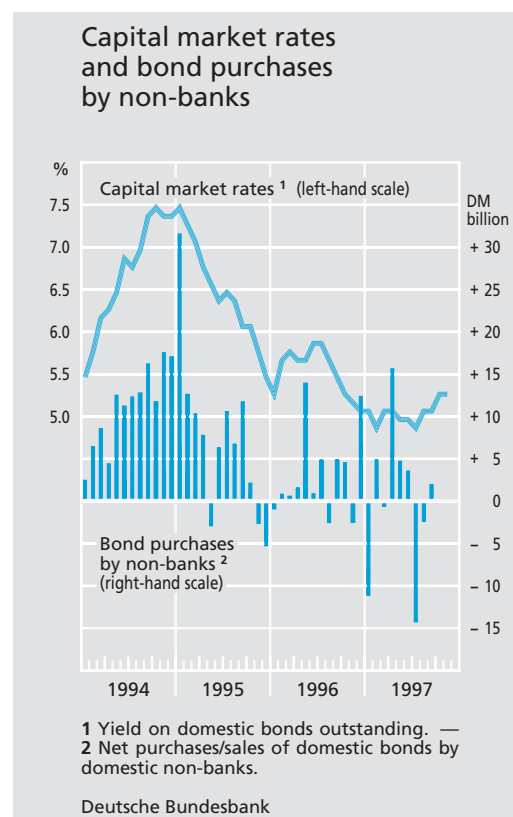
*Short-dated
bonds issued
by domestic
non-banks*

The outstanding amount of short-dated bonds issued by domestic non-banks (with an agreed maturity of up to and including one year, which are generally not included in the figures analysed here) went up slightly between August and October; at the end of October it reached DM 35.9 billion, compared with DM 33.6 billion at the end of July. Domestic enterprises drew more heavily on Deutsche Mark-denominated commercial paper for short-term external funding (outstanding volume at the end of October: DM 13.0 billion). The public sector's outstanding amount of debt securities running for less than one year also expanded a little; at the end of October this item totalled DM 22.7 billion.

Purchases of bonds

*Credit
institutions'
brisk demand*

Credit institutions' bond portfolios increased by DM 23.2 billion between August and October, compared with DM 54.9 billion in the three preceding months. While banks continued to purchase foreign bonds on a large scale (DM 13.6 billion in the period under review, compared with DM 15.0 billion between May and July), they stepped up their holdings of debt securities issued by resident borrowers by only DM 9.6 billion. As in the previous three months, the foreign debt securities consisted mainly of foreign currency



bonds (DM 10.1 billion). In respect of domestic issues, sales of public bonds (–DM 9.2 billion net) were outstripped by purchases of bank bonds (DM 18.4 billion).

On an overall view, domestic non-banks' interest in buying bonds continued to decline in the period under review. They purchased debt securities to the extent of only DM 4.9 billion (net), compared with DM 18.3 billion between May and July. However, this decline was due entirely to smaller purchases of bonds issued by non-residents (DM 5.4 billion between August and October, compared with DM 24.2 billion in the preceding three months). Besides the stabilisation of the exchange rate trend of the Deutsche Mark against the US dollar, a contributory factor may have been that the potential for price

*Non-banks'
demand*

gains within Europe has meanwhile dwindled markedly in view of the extensive convergence of capital market interest rates. Non-banks' holdings of domestic debt securities changed only marginally in the period under review (– DM 0.5 billion) in the context of persistently very low capital market rates; in the previous three months their holdings had shrunk by DM 5.9 billion.

*Volatile
interest of
non-residents*

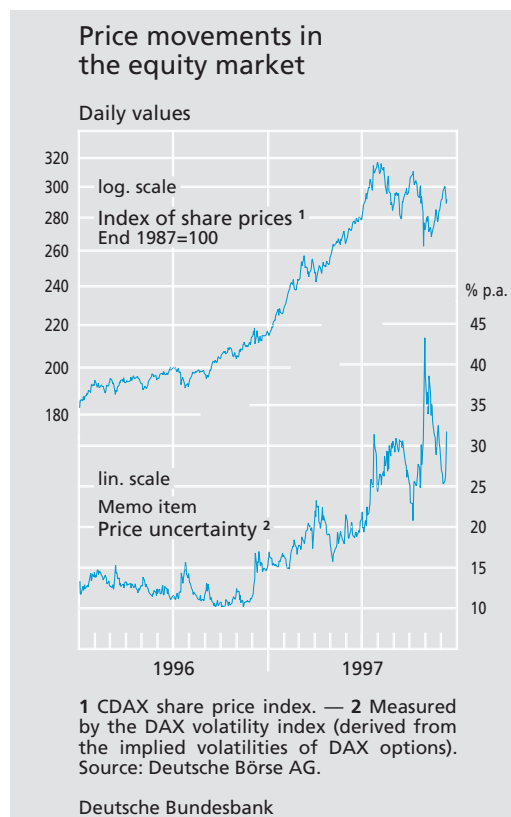
Non-residents' purchases in the German bond market were subject to sharp fluctuations in the period under review. It is not clear to what extent the recent turbulence in the financial markets contributed to this volatility. In September foreign investors purchased domestic bonds to the tune of DM 16.3 billion net, DM 11.1 billion of this sum being public bonds; in the ensuing month, however, they sold domestic bonds amounting to DM 2.0 billion. Taking the three-month period as a whole, net purchases of domestic bonds by foreign investors totalled DM 18.0 billion, DM 15.5 billion of which was accounted for by bank bonds.

Equity market

Share price movements

*Equity market
affected
by the shock
waves of the
international
turbulence*

In the autumn months, the course of development of the German equity market was adversely affected by the global financial market turbulence. Up to mid-September share prices fell by 12% compared with the peak of end-July (measured in terms of the comprehensive CDAX share price index) under the impact of sharp share price move-



ments in the US equity market. From mid-October share prices – which had recovered markedly in the meantime – were caught up in the wake of the crisis in the east Asian financial markets. At the end of October the domestic equity market lost more than 7% of its value in one day, measured by the CDAX index, which was the steepest drop since summer 1991. At the same time uncertainty about the future trend in share prices – measured by their implied volatility – increased sharply. In November – amid continuing pronounced fluctuations – share prices were about at the same level that had prevailed prior to the bull market peak in July; latterly, they were on average about 9% lower than at the end of July but still 33% higher than at the beginning of the year.

*Repercussions
of the
turbulence in
the equity
markets*

The macroeconomic repercussions of the turbulence in the equity market are likely to be relatively modest in Germany. In this country the significance of equities, both for financing and investment purposes, is not great enough for major fluctuations in share prices to have a substantial direct negative impact on firms' funding ability or investors' level of wealth and thus, in the end, on overall economic demand. In addition, volatile share prices affect the German banking system to a much lesser extent than is the case in countries in which shares play a major role as loan collateral or where banks' capital backing depends in part directly on share price movements and associated changes in their undisclosed reserves. But notwithstanding the relative impact of these direct shock waves, excessively high or excessively low equity quotations are problematical from Germany's point of view, too. They hamper the efficient use of the equity market and its longer-term development.

*Implications for
monetary policy*

In a situation in which equity markets are extremely nervous it is all the more important for monetary policy makers to give market players a clear orientation, and thus to help them to find a fundamentally correct level of prices for shares, by adhering steadfastly to a policy geared to stability. Such a policy concurrently provides the best protection against exaggerations and the build-up of speculative bubbles in the financial markets, which in individual cases may entail massive macroeconomic costs.

Sales and purchases of shares

DM billion			
Item	1997		Aug. to Oct. 1996
	May to July	Aug. to Oct.	
Sales			
Domestic shares ¹	4.0	9.0	2.5
Listed	3.2	8.0	0.8
Unlisted	0.8	1.0	1.6
Foreign shares ²	10.9	9.5	4.7
Portfolio purchases	8.5	2.1	1.3
Direct investment	2.4	7.4	3.4
Purchases			
Residents			
Credit institutions ³	- 11.9	- 13.6	2.7
Non-banks ⁴	- 4.4	21.7	2.9
of which			
Domestic shares	- 16.4	11.2	- 1.5
Non-residents ²	31.2	10.3	1.5
Total sales/purchases	14.9	18.4	7.1

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

Deutsche Bundesbank

Sales and purchases of shares

Issuing activity in the German equity market picked up substantially between August and October. Domestic enterprises issued new shares to the market value of DM 9.0 billion, compared with DM 4.0 billion between May and July.¹ Prominent among these offerings were some issues of credit institutions which must be seen not least against the background of increased merger and acquisition activity in the financial sector. Foreign equities were sold in Germany to the extent of DM 9.5 billion (net) between August and October, after residents had purchased foreign shares worth DM 10.9 billion in the preceding three

Share sales

¹ These figures do not include the privatisation of one particular public shareholding carried out in autumn as it was not a new issue.

months. The total amount raised by sales of both domestic and foreign equities came to DM 18.4 billion between August and October, compared with DM 14.9 billion in the previous three months.

Share purchases

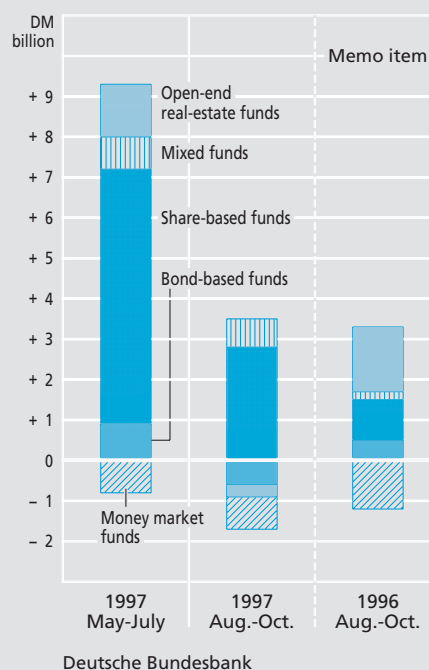
Domestic non-banks predominated on the buyers' side of the German share market in the period under review. On balance, they purchased equities worth DM 21.7 billion. Just over half (DM 11.2 billion) of this sum consisted of equities of domestic companies. Domestic credit institutions ran down their share portfolios by DM 13.6 billion, selling almost exclusively domestic stocks. Non-residents purchased German shares in the amount of DM 10.3 billion. They showed particular interest in September (+DM 7.8 billion), whereas in October, as the mood on the stock market deteriorated increasingly, foreign investors bought virtually no German shares on balance.

Investment funds

Amount raised

The amount raised from sales of domestic investment fund certificates between August and October was a little lower, at DM 25.8 billion, than in the preceding three months (DM 32.2 billion). DM 7.8 billion was invested in foreign investment fund certificates in the period under review. Combined sales of domestic and foreign investment fund certificates yielded DM 33.5 billion between August and October, compared with DM 36.4 billion between May and July and DM 12.3 billion a year before.

Amount raised by domestic funds open to the general public



The amount raised by specialised funds between August and October (DM 24.0 billion) roughly matched that in the previous three months (DM 23.8 billion). Of the specialised funds, the mixed funds again recorded the largest inflows of resources (DM 16.4 billion). The share-based funds received DM 8.3 billion. DM 0.1 billion was invested in money market funds. Certificates of bond-based funds were returned to the extent of DM 0.8 billion (net).

Specialised funds

Between August and October certificates of domestic funds open to the general public attracted only minor interest. On balance, the funds open to the general public sold certificates to the extent of only DM 1.8 billion, compared with DM 8.4 billion in the previous three-month period. Share-based funds again recorded the largest inflows of capital (DM

Funds open to the general public

2.8 billion). Mixed funds sold certificates to the tune of DM 0.7 billion. Open-end real estate funds, however, had to repurchase certificates (for DM 0.3 billion on balance) for the first time in a long while. Bond-based funds and money market funds likewise recorded outflows of capital (– DM 0.6 billion and – DM 0.8 billion, respectively).

*Purchases of
investment
fund
certificates*

As usual, investment fund certificates were purchased predominantly by domestic non-banks. Between August and October they

purchased mutual fund shares worth DM 31.2 billion, compared with DM 25.0 billion in the preceding three months. Three-quarters of this sum consisted of certificates of domestic funds (DM 24.1 billion). Non-banks sold certificates of domestic and foreign money market funds to the value of DM 1.4 billion. Domestic credit institutions expanded their holdings of investment fund certificates by DM 8.5 billion. Foreign investors resold certificates of German funds totaling DM 6.2 billion (net).