

## Financial markets in Germany

### Capital market and bank interest rates

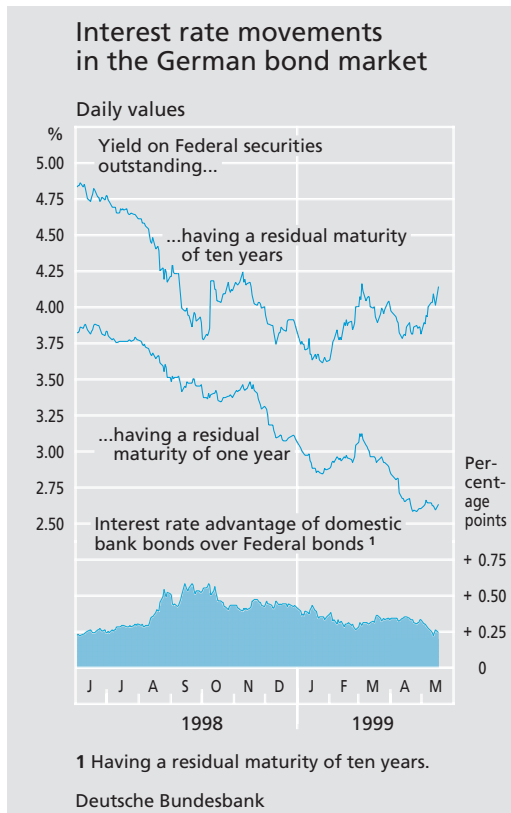
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In the spring, developments in the German capital markets were still marked by all-time low interest rates, corresponding to trends throughout the European monetary union. In January 1999, the yield on ten-year Federal bonds outstanding, which marks the lower end of the European interest rate corridor in this maturity range, went down to a record low of less than 3¾%. As an average of the years between 1990 and 1999, the yield was around 6¾%. In mid-May, ten-year Federal bonds had a yield of slightly more than 4%. If one looks at the different maturities, the interest rate range for Federal securities once again fanned out widely in the spring. By the end of 1998 the interest rate advantage observable in the market of ten-year Federal securities over paper having a residual maturity of one year had shrunk to three-quarters of a percentage point; by mid-May, this advantage had gone back up to 1½ percentage points. The yield on Federal securities having a residual maturity of one year, at just over 2½%, was virtually at the same level as the three-month EURIBOR.

*Level of interest rates still very low*

The interest rate advantage of bonds issued by domestic banks vis-à-vis Federal bonds, following a sharp decline in the last quarter of 1998, has changed little since that time. For paper with a maturity of ten years it was ¼ percentage point, as opposed to over ½ percentage point during the financial market turmoil in the autumn of 1998. Thus, the interest rate advantage of bank bonds has now reached a level corresponding to ratios that have been observable for quite some

*Interest rate advantage of bank bonds has changed little*



time now. Apparently the liquidity differences, which in autumn had been an important factor behind widening discrepancies of yields, have diminished in importance along with the easing of tensions in the international financial markets.

*Bank interest rates continuing their declining trend*

The fall in the cost of funds to the banks in the bond market is reflected by the rates of interest on long-term loans. In April 1999, the rate for mortgage lending with interest rates locked in for ten years averaged slightly over 5%, as opposed to just over 5¼% at the end of 1998. The rates for long-term fixed-interest loans to enterprises were somewhat higher; in April the effective interest to be paid averaged 5½% (for loans of DM 200,000 to less than DM 1 million) and 5¼% (for loans of DM 1 million to less than

DM 10 million). The interest rates for short-term deposit and lending business tended to show an uneven trend as of late. In April, at 7½%, the cost of current account credit of DM 1 million and more but less than DM 5 million was only slightly lower than at the end of 1998. By contrast, the interest on short-term time deposits went down distinctly, in line with the declining money market rates after the end of the year and the ECB's interest rate cut in April. In that month, time deposits having an agreed maturity of one month and investment amounts of DM 100,000 and more bore an interest rate of around 2½%.

On the whole, borrowing from external sources, both directly from the capital market and from credit institutions, has remained extremely "low-priced". The cost of borrowing has remained well below its long-term average in real terms, too. The expected real capital market rate (calculated on the basis of nominal yields excluding the inflation expectations ascertained by surveys), which is relevant to investment decisions, was around 2¼% in April for a maturity of ten years, compared to around 4% as an average of the nineties.

*Borrowing from external sources inexpensive*

## Share prices

Following a sharp rise in share prices at the beginning of the year, the German equity market tended to command minor investor interest. Initially, German equities, too, benefited from inflows of funds as a consequence of the smooth start of monetary union.

*Equity market burdened by "home-grown" uncertainty*



Throughout the course of the spring, though, "home-grown" uncertainty started to become an ever-increasing burden, which meant that German shares, particularly in March, lost considerable ground against the European average. Whereas the Euro STOXX increased by more than 3% up to the end of March, the prices of internationally traded shares contained in the DAX and the comprehensive CDAX index each went down by around 2%.<sup>1</sup> The continuing debate on economic and tax policy in Germany probably played a particular role. The shares of insurance companies, for example, the future tax status of which was the subject of controversy, lost quite a lot of ground. In April, prices recovered somewhat, but they went back down distinctly in May. As of late, the CDAX was less than 2% higher than its level

at the end of 1998. Export-sensitive industries, such as the mechanical engineering and chemical industries (at + 11% each) showed disproportionately high share price gains against the background of the strengthening of the US dollar.

### Borrowing in the securities markets

The majority of borrowing in the securities markets took place in the first quarter of 1999, as usual, by the issuing of bank and public bonds. Gross sales of bonds of domestic issuers hit a new all-time high, at € 163½ billion. Half of this paper was denominated in euro, including all listed bonds issued by the Federal Government and a series of large-volume debt securities issued by credit institutions. Paper denominated in Deutsche Mark most likely continue to be more important in credit institutions' smaller-scale issues which are tailored primarily to private clients. After deducting redemptions, and taking into account the changes in issuers' holdings of their own bonds, the sale of domestic fixed-interest securities generated € 62½ billion in the first quarter, compared with just under € 23 billion in the previous three-month period. Another € 36 billion was raised by sales of foreign bonds and notes, of which € 31½ billion was denominated in either euro or other EMU currency units.

*Record sales of bonds and notes*

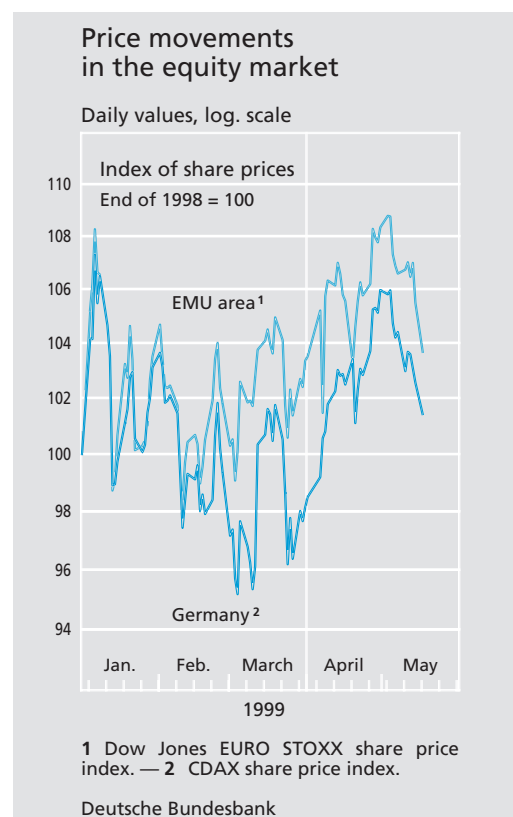
<sup>1</sup> The Euro STOXX share price index includes quotations of around 320 equities from EMU countries; the CDAX share price index contains all German shares traded on the Frankfurt securities exchange in the first segment (*Amtlicher Handel*), the Regulated Market (*Geregelter Markt*) and the New Market (*Neuer Markt*); the DAX comprises 30 major German public limited companies.

*Bank bonds  
continue to  
predominate*

Among domestic borrowers, credit institutions predominated between January and March, selling bonds to the tune of € 48 billion (net). At nearly DM 37 billion, communal bonds occupied a particularly prominent position. This paper, covered by claims on the public sector, were apparently used not only to refinance new borrowing but also to fund non-securitised liabilities. The public sector took recourse to the bond market by issuing bonds totalling € 14½ billion. On balance, this was accounted for exclusively by the Federal Government, which obtained a net sum of around € 18 billion by selling debt securities. The Federal Government particularly used ten-year and 30-year bonds for its borrowing (€ 11 billion and € 6 billion, respectively) owing to the low capital market rates. By contrast, the value of debt securities in circulation issued by the Länder (–€ 1 billion) and public debtors, who – such as the Treuhand agency or the former Federal Post Office – are no longer active as issuers, went down by a total of € 3 billion.

*Growing width  
of the equity  
market*

In the domestic equity market, German enterprises borrowed some € 3 billion in the first quarter of 1999, compared with € 4½ billion in the last quarter of 1998. This decline went along with a sharp rise in the number of capital increases. That indicates that, in particular, small and medium-sized enterprises have replenished their equity. The number of public limited companies has risen by one-quarter since mid-1998, i.e. by around 1,000, to just under 5,700. Taken all together, these factors seem to indicate that the use of equity as a financing instrument in Germany is gradually becoming more widespread. Between Janu-



ary and March 1999, € 16 billion worth of foreign equity was sold in Germany; on balance, this was accounted for exclusively by portfolio investment. Apparently the trend towards international diversification of equity portfolios is continuing.

### Investment in the securities markets

In the domestic bond market, domestic non-banks were the most important group of investors between January and March. They expanded their holdings of bonds by € 47½ billion after having been reluctant to enter into new investments up until the end of 1998 (€ 8 billion net between October and December). This may have been due in part to the fact that institutional investors, in par-

*Debt securities*

Investment of funds in German securities markets		
€ billion		
Item	1998 Sep. to Dec.	1999 Jan. to March
<b>Bonds and notes</b>		
Residents	27.6	64.2
Credit institutions <sup>1</sup>	19.4	16.5
of which		
Foreign bonds and notes <sup>2</sup>	20.0	7.8
Non-banks <sup>3</sup>	8.1	47.7
of which		
Foreign bonds and notes <sup>2</sup>	- 1.4	28.2
Non-residents <sup>2</sup>	13.9	34.2
<b>Shares</b>		
Residents	25.3	34.6
Credit institutions <sup>1</sup>	1.7	21.9
of which		
Domestic shares	3.6	22.4
Non-banks <sup>3</sup>	23.6	12.7
of which		
Domestic shares	- 18.7	- 4.0
Non-residents <sup>2</sup>	19.5	- 15.3
<b>Investment fund certificates</b>		
Investment in specialised funds	20.0	14.7
Investment in investment funds open to the general public	4.2	13.9
of which: Share-based funds	2.8	4.2

<sup>1</sup> Book values, statistically adjusted. — <sup>2</sup> Transaction values. — <sup>3</sup> Residual.

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ticular, had a pent-up need to invest over the turn of the year, a demand which was relieved gradually with the help of the successful launching of the euro. Non-banks mainly purchased debt securities issued by non-residents (around € 28 billion), primarily from the euro area. The domestic banks' holdings of bonds rose by DM 16½ billion. A major part of this total was accounted for by government bonds issued by other euro area countries. During the period under review, foreign investors purchased domestic bonds for a net total of € 34 billion. Particularly in January, where there was once again a considerable amount of shifting of funds to "safe havens" against the backdrop of the currency crisis in Brazil, non-residents were very active in the German bond market.

By contrast, foreign investors divested themselves of German equities quite heavily, selling German shares for a total of € 15½ billion. Domestic non-banks shifted their portfolios at the expense of domestic paper. The buyers therefore consisted exclusively of credit institutions, on balance; they purchased a wide range of equities for € 22 billion. It is possible that banks, owing to the restraint of other groups of investors in the equity market, performed a certain buffer function.

Shares

Indirect participation in the capital markets using investment funds as a vehicle has stabilised at a high level. In the first quarter of the year, € 28½ billion flowed into domestic funds, compared with € 24 billion in the last quarter of 1998. Around half of the inflows were accounted for each by the specialised funds reserved for institutional investors and by the investment funds open to the general public. Whereas the mixed funds predominated among the specialised funds, share-based funds continued to gain ground among the investment funds open to the general public; they sold certificates for a net total of around € 4 billion. At € 3½ billion, open-end real estate funds, too, were in a healthy state, which is not unusual in times of very low capital market rates.

Investment certificates

### Deposit and lending business of Monetary Financial Institutions (MFIs) with domestic customers

Domestic MFIs' deposit business was characterised in the first quarter of 1999 by a con-

*High liquidity  
preference of  
domestic  
investors*

tinued rise in the liquidity preference of domestic investors. Their overnight deposits rose at an annual rate of 30 % between January and March after eliminating seasonal influences, compared with just under 16 % between October and December. Generally speaking, a high liquidity preference is not unusual in times of low interest rates and low rates of inflation. In addition, more and more banks are offering rather attractive rates for sight deposits. Moreover, overnight deposits probably grew somewhat, particularly in January in connection with the start of monetary union. Deposits having an agreed maturity of up to two years also rose considerably as of late, after having been decreased almost continuously from 1994 until the middle of last year. This trend is probably linked to the simultaneous reduction of short-term deposits at the foreign branches and subsidiaries of German credit institutions, particularly in Luxembourg and London (see page 25). The usual seasonal reduction of such funds at the end of the year was extremely steep in December and, unlike in most cases, was not reversed at the beginning of this year.

*Weak growth  
of savings  
deposits at  
three months'  
notice*

Deposits having an agreed notice of up to three months, held primarily by individuals, increased only weakly in the first three months of the year, the growth taking place exclusively among so-called special savings facilities. Owing to the continuous decline in interest rates, these savings deposits are apparently not very attractive at present, particularly as the interest exceeding the basic savings rate is often paid only if the funds are held over a relatively long period of time.

### Trends in lending and deposits of Monetary Financial Institutions (MFIs) in Germany \*

€ billion		
Item	Jan. to March 1999	Jan. to March 1998
Deposits of domestic non-MFIs 1		
Overnight	- 9.8	- 14.2
Having an agreed maturity		
of up to two years	+ 5.1	- 6.1
of more than two years 2	+ 3.8	+ 5.7
Redeemable at notice 3		
of up to three months	+ 4.2	+ 4.8
of more than three months 4	- 4.4	- 2.8
Lending		
Lending to domestic enterprises and individuals		
Advances	+ 28.6	+ 7.6
Lending against securities	+ 18.3	+ 28.0
Lending to domestic public authorities		
Advances	+ 6.4	+ 7.5
Lending against securities	- 4.9	+ 12.0

\* Besides banks (including building and loan associations), the Monetary Financial Institutions (MFIs) also include money market funds; see also Table IV.1 in the Statistical Section of the Monthly Report. — 1 Enterprises, individuals and public authorities. — 2 In 1998 excluding deposits with building and loan associations, in 1999 including such deposits. — 3 Savings deposits. — 4 In 1998 including deposits with building and loan associations, in 1999 excluding such deposits.

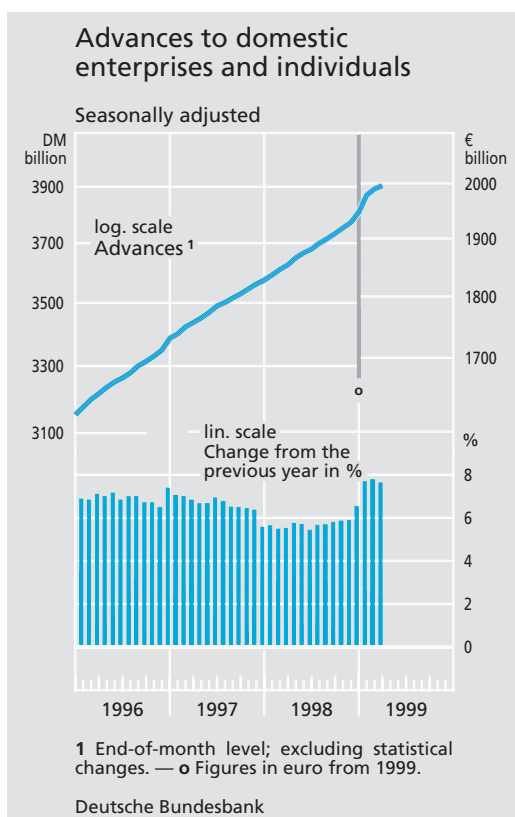
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In line with the general hesitancy regarding longer-term accumulation of financial assets, due in particular to low interest rates, domestic investors boosted their deposits having an agreed maturity of over two years by only a small margin in the first three months of this year (€ 3.8 billion, as opposed to € 5.7 billion a year earlier). The decline in deposits at over three months' notice that has been taking place since 1996 has continued.

*Longer-term  
deposits are not  
much in  
demand*

Lending by MFIs to domestic enterprises and individuals continued to be strong during the period under review. In total, private sector borrowing from MFIs rose by € 46.9 billion between January and March, as opposed to € 35.6 billion during the same period last year. Seasonally adjusted and extrapolated to yield an annual rate, this corresponds to a rise

*Continued  
strong lending  
to the private  
sector*



of 10 ½ %, which is virtually as high as in the last quarter of 1998, when lending to enterprises and individuals rose sharply owing to the expiration of special depreciation facilities in eastern Germany at the turn of the year. In the first quarter of 1999, lending was strong

across the board. Advances rose by € 28.6 billion, or much more sharply than a year ago (€ 7.6 billion), when the private sector's demand for loans was rather muted. Seasonally adjusted, the lively demand for longer-term loans was the key factor behind this trend. At € 18.3 billion, securitised lending was also distinctly expanded, if less than a year before. Particularly in March, when foreign investors sold a large volume of German equities, banks were on the buying side of the market.

Lending to the domestic public sector was low in the first quarter of the year. This is due less to an overall decrease in the propensity to incur debt than to a shift in the structure of creditors in public sector indebtedness. Between January and March, the public sector met its financing needs to a large extent by issuing debt securities, which, on balance, were placed outside the banking sector. By contrast, the banks reduced their portfolios of domestic government bonds, whereas they purchased a large volume of public bonds issued by other EMU countries, as mentioned earlier.

*Weak lending  
by MFIs to the  
public sector*