Financial markets in Germany

Capital market and bank interest rates

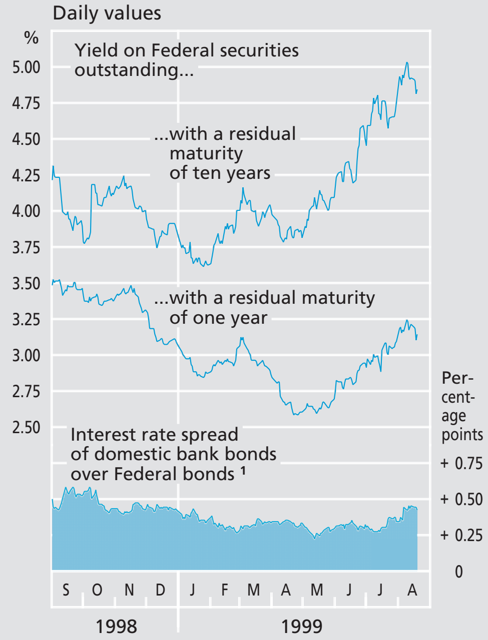
Rising capital market rates and steeper yield curve

During the summer German capital market rates increased at broadly the same pace as yields in the other EMU countries. At over 4¾%, the yield on ten-year Federal bonds outstanding was more than ¾ percentage point higher in mid-August 1999 than at the end of March. This was still almost ¼ percentage point below the EMU average; the maximum yield spread of individual EMU countries over German yields increased to just under ½ percentage point. Yields on Federal securities with shorter residual maturities were affected to a much lesser extent by the rise in interest rates than those of paper with medium and long maturities. The yield on securities with a residual maturity of one year, for example, was only about ¼ percentage point higher recently than at the end of March. As a result, the yield curve of Federal securities steepened further. In mid-August, the interest rate spread observable in the market between ten-year Federal securities and instruments with a residual maturity of one year was 1¾ percentage points, compared with less than 1¼ percentage points at the end of March.

Bank bonds showing higher interest rate spread of late

The yield gap between ten-year bonds issued by domestic banks and comparable Federal bonds remained at a virtually constant level of around 30 basis points until July. At the end of July, as the yields on Federal bonds fell temporarily, the interest rate differential broadened to around 40 basis points. Whereas yields on the relatively large-volume and liquid communal bonds *(Öffentliche Pfandbriefe)* largely matched the downward trend exhibited by Federal bonds, the yields on other bank bonds remained broadly unchanged. Such a yield pattern usually indicates an increased demand on the part of institutional investors, who prefer liquid investment vehicles. It is possible that many internationally active market players regarded the strengthening of the euro vis-à-vis the US dollar as evidence of a turnaround and thus as a good time to enter the market. In August, the yield spread of ten-year bank bonds increased to almost ½ percentage point amid growing interest rate uncertainty. This may have been partly induced by the fact that the existence of a highly liquid futures market for Federal bonds gains importance as a "quality advantage" whenever markets are unsettled.

Interest rate movements in the bond market



1 With a residual maturity of ten years.

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Slight rise in long-term bank interest rates, but fall in short-term interest rates

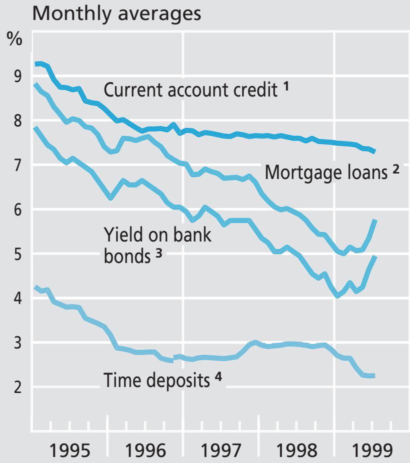
The yield rise in the capital market during the summer was accompanied by an increase in long-term bank interest rates. In July 1999, ten-year fixed mortgage rates averaged slightly over 5¾ %, compared with just under 5¼ % in March 1999. The rates for long-term fixed-interest loans to enterprises were similar; in July the effective interest rate payable averaged 6 % (for loans of DM 200,000 to less than DM 1 million) and 5¾ % (for loans of DM 1 million to less than DM 10 million). The interest rates for short-term deposit and lending business, on the other hand, continued to decline following the Eurosystem's interest rate cut at the beginning of April. Thus, at 7 ⅓ %, the cost of current account credit in the range of DM 1 million to less than DM 5 million was almost 0.2 percentage point lower in July than in March. The rate of remuneration of short-term time deposits declined by about 0.4 percentage point over the same period. In July the average interest rate earned by time deposits with an agreed maturity of one month and investment amounts of DM 100,000 to less than DM 1 million was 2 ¼ %.

Interest rate level continues to bolster economic recovery

Despite the rise in capital market rates, long-term borrowing rates are continuing to buttress the incipient upswing in economic activity. In nominal terms, capital market and bank interest rates are still close to their all-time lows and are distinctly lower than the levels reached in the trough of the previous interest rate cycle. In real terms, too, the interest rate level is comparatively low. In July the anticipated ten-year real interest rate level in the capital market (calculated on the basis of nominal yields less the inflation expectations ascertained by surveys) – which is of key im-

Bank interest rates in Germany

Monthly averages



1 DM 1 million and more but less than DM 5 million. — 2 On residential property; effective interest rate, fixed rate over ten years. — 3 With a mean residual maturity of over nine to ten years. — 4 Time deposits with an agreed maturity of three months (up to and including October 1996: maturity of between one and three months), for amounts of DM 100,000 and more but less than DM 1 million.

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portance for investment decisions – was just under 3 ¼ %, compared with the average rate during the nineties of around 4 %.

Share prices

German equity market gaining ground

Following the decline in share prices in the first quarter of this year, the German equity market moved upwards until July. From the end of March to mid-July, share prices – as measured by the comprehensive CDAX index – increased by 13 %; this was still around 9 % below the record high of July 1998. In addition to the favourable international setting, the improved internal outlook also helped domestic equities to regain lost ground in comparison with other European countries. This momentum was presumably buoyed by the German Government's announced package of fiscal policy measures. The share prices of construction firms, in particular, clearly outperformed the market as a whole, surging by 34 %. However, German equities, too, were dragged down by the sharp international slide in share prices from the middle of July on. Between mid-July and the beginning of August, German share prices fell by 10 %; subsequently they edged upwards. On balance, the share prices of the blue-chips contained in the DAX and of the broad cross-section of firms comprising the CDAX index increased alike by around 5 % between the end of March and mid-August, whereas the Dow Jones Euro Stoxx index rose by about 2 %.

Borrowing via the securities markets

Declining sales of bonds and notes

Borrowing via the issuing of bonds declined in the second quarter. At € 133 ½ billion (market value), gross sales of bonds of domestic issuers remained clearly below the peak of € 163 ½ billion reached in the previous quarter. In terms of the amount, around three-quarters of the newly issued paper was denominated in euro. After deducting redemptions and taking into account the changes in issuers' holdings of their own bonds, the sale of domestic fixed-interest securities generated € 50 billion in the second quarter. The outstanding amount of domestic bonds thereby exceeded a volume of € 2 trillion for the first time. Sales of foreign bonds and notes amounted to € 29 billion; on balance they were accounted for exclusively by paper denominated in euro or currency units of other EMU participants.

Muted issuing activity of the public sector

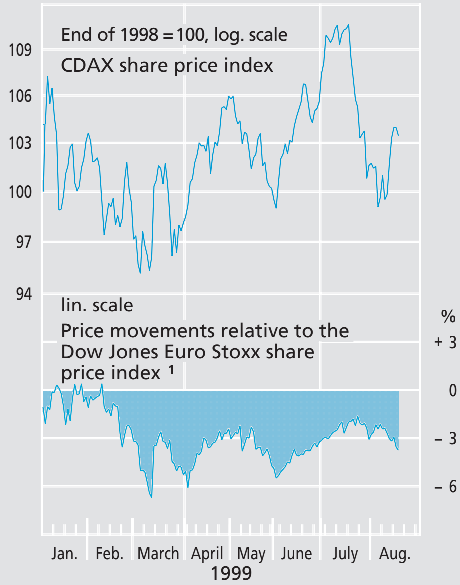
The decline in net sales of domestic bonds can be attributed to the muted issuing activity of the public sector. It raised only € 3 ½ billion net in the bond market in the second quarter, compared with € 14 ½ billion in the first quarter of the year. The Federal Government increased its bonded debt by just under € 7 billion, mainly in the form of five-year special Federal bonds and ten-year bonds (amounting to € 5 billion and € 3 billion net, respectively). Bonded debt of the Treuhand agency and the former Federal Post Office was redeemed on a large scale (for € 2 ½ billion and € 1 billion, respectively). The Länder Governments raised € 1 billion in the bond market. From April to June, domestic credit institutions obtained a net sum of € 46 billion by selling their own debt securities, i.e. roughly the same amount as in the previous quarter. Issuing activity weakened perceptibly in the course of the period under review, however, owing to the rapidly increasing capital market rates; in June net sales of bank bonds came to merely € 7 billion, compared with € 25 billion in April and € 13 ½ billion in May.

Large amount of funds raised in the share market

In the second quarter of 1999, domestic enterprises launched new shares amounting to about € 18 billion (market value), compared with only € 3 billion in the first three months of the year. This high issue volume was largely due to Deutsche Telekom's capital increase in June, although the general trend towards going public also remained strong between April and June. In the second quarter of 1999, a total of 81 enterprises raised funds

Price movements in the equity market

Daily values



1 Change in the CDAX share price index relative to the Dow Jones Euro Stoxx share price index in % since end-1998.

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via the German stock exchanges for the first time. The new record number of 109 initial public offerings launched in the first half of the year was more than the total recorded during the whole of 1998. Demand for foreign equities remained high, on an overall view. Between April and June 1999, € 17 billion worth of foreign shares were sold in Germany (compared with just under € 16 ½ billion in the previous quarter), of which half each was accounted for by direct investment and by portfolio investment.

Investment activity in the securities markets

In the second quarter of 1999 domestic credit institutions were to the fore on the buyers'

Purchases of bonds and notes

side of the bond market. They expanded their bond portfolios by € 37½ billion, which was twice as much as in the previous quarter. The banks purchased foreign bonds and domestic bank bonds in roughly equal amounts. During the period under review, foreign investors purchased bonds issued by German borrowers to the tune of € 26 billion net. There was a strong demand for domestic bank bonds, which were purchased by non-residents in the net amount of € 23 billion. A marked preference was again shown for large-volume communal bonds, which evidently offer foreign institutional investors an attractive risk-return profile. Short-dated bank debt securities also accounted for a major part of the acquisitions by non-residents. At € 16 billion, domestic non-banks' net purchases of bonds and notes were much lower than the corresponding first-quarter total (€ 46½ billion), which had benefited from a fairly high pent-up investment need that had built up over the turn of the year.

Shares

Foreign investors showed a lively interest in German equities in the second quarter. They increased their holdings of domestic shares by € 21½ billion, after having sold such securities amounting to € 15 billion in the first quarter. This development was boosted by the successful placement of new Deutsche Telekom shares with private investors in other EMU countries. Domestic non-banks likewise continued to purchase German equities to the tune of € 12½ billion on balance. At the same time, they added € 14½ billion worth of foreign shares to their portfolios. The sellers' side of the equity market during the period under review consisted solely of credit institutions, which reduced their holdings of shares by € 13½ billion – partly in the context of forward transactions. They sold exclusively domestic equities on balance; by contrast, they bought foreign shares for € 2½ billion.

Investment activity in the German securities markets

€ billion

Item	1999 Apr. to June	1999 Jan. to March
Bonds and notes		
Residents	53.3	63.3
Credit institutions 1	37.4	16.6
of which Foreign bonds and notes 2	19.2	7.8
Non-banks 3	15.9	46.7
of which Foreign bonds and notes 2	10.1	27.9
Non-residents 2	25.9	34.8
Shares		
Residents	13.6	34.6
Credit institutions 1	– 13.7	21.9
of which Domestic shares	– 16.0	22.4
Non-banks 3	27.3	12.7
of which Domestic shares	12.7	– 4.1
Non-residents 2	21.6	– 15.2
Investment fund certificates		
Investment in specialised funds	14.3	14.7
Investment in funds open to the general public	9.6	13.9
of which: Share-based funds	3.2	4.2

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

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Investment fund certificates

At € 24 billion, the amount of resources that flowed into domestic investment funds from April to June was somewhat lower than in the first quarter of the year (€ 28½ billion). The greater part of the inflows (just under € 14½ billion net) accrued to the specialised funds, which are reserved for institutional investors. Investment funds open to the general public attracted resources totalling € 9½ billion. Whereas mixed funds continued to predominate among the category of specialised funds, share-based funds were the favourite choice among the investment funds open to the general public; they sold certificates worth a net total of more than € 3 billion, followed once again by open-end real estate funds (just under € 2 ½ billion). The popularity among private investors of purchasing equities through investment funds is now also beginning to shape the asset structure of the investment funds open to the general public. On account of the surge in share prices in the past few years plus the sustained high inflow of capital into share-based investment funds, the latter have now become the largest group of funds in terms of the volume invested; at the end of 1996 the assets of bond-based funds, which were previously the favourite fund vehicle, had been more than twice as great as those of share-based funds.

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

€ billion

Item	Apr. to June 1999	Apr. to June 1998
Deposits of domestic non-MFIs 1		
Overnight	+ 27.2	+ 14.6
With an agreed maturity		
of up to two years	– 12.0	– 2.0
of more than two years 2	+ 1.0	+ 3.1
Redeemable at notice 3		
of up to three months	+ 2.2	– 1.2
of more than three months 4	– 7.1	– 4.7
Lending		
Lending to domestic enterprises and individuals		
Advances	+ 35.1	+ 31.9
Lending against securities	– 5.1	+ 0.8
Lending to domestic public authorities		
Advances	– 3.3	– 3.8
Lending against securities	– 0.5	+ 7.1

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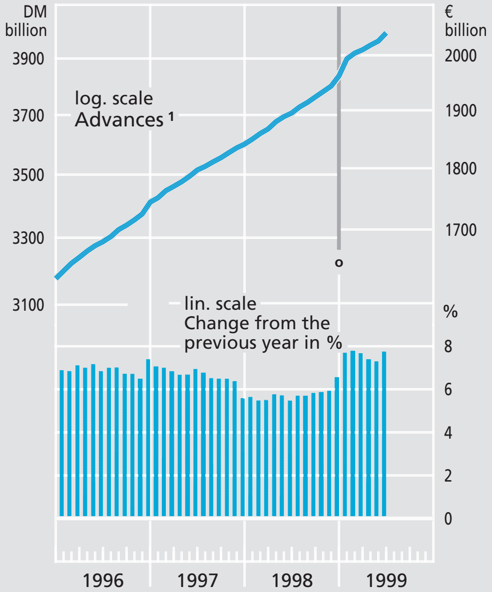
Deposit and lending business of Monetary Financial Institutions (MFIs) with domestic customers

Continuing marked liquidity preference

In the second quarter of 1999 domestic MFIs' deposit business was again characterised by a persistently high liquidity preference shown by domestic investors. From April to June their overnight deposits rose at a seasonally adjusted annual rate of 23 %. This robust growth was probably fuelled not least by the further decline in deposit rates. Following the ECB Governing Council's decision to cut interest rates on April 8, credit institutions lowered their interest rates payable on time deposits by an average of around 0.4 percentage point, i.e. by a greater margin than their rates for sight deposits. As a result, the opportunity cost of holding overnight deposits fell further. This development is consistent with the fact that holdings of shorter-running time deposits decreased at an annual rate of 13 ½ % in the period under review, whereas they had risen substantially in the previous three months. The growing interest rate uncertainty in the bond markets was probably an additional reason that induced many investors to temporarily lodge their funds in liquid form in sight deposit accounts. Finally, the growth of sight deposits was doubtless also boosted by the ongoing repatriation to Germany of money hitherto invested in the Euro-market. Thus German investors' short-term deposits with the foreign subsidiaries and branches of domestic credit institutions were 28 % lower of late than a year before. The main reason for this was presumably that Euro-deposits became less attractive, compared with domestic deposits, following the

Advances to domestic enterprises and individuals

Seasonally adjusted



1 End-of-month level; excluding statistical changes. — o Figures in euro from 1999.

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introduction of interest payments on minimum reserve holdings.

Stronger growth of savings deposits at three months' notice

Deposits with an agreed period of notice of up to three months, which tend to be held primarily by households, increased substantially between April and June (by € 2.2 billion). This corresponds to a seasonally adjusted annual growth rate of 8 %. Deposits at over three months' notice bearing unattractive rates of interest were apparently shifted into short-term savings deposits in the period under review. Deposits with an agreed maturity of more than two years increased only marginally in the second quarter of 1999 (by € 1.0 billion, compared with € 3.1 billion a year earlier). This can probably be attributed to the fact that insurance companies, which traditionally are the main investors in the registered bank bonds carrying no price risk that are contained in this item, currently consider the yield on these securities to be too low. This seems to imply a continuation of the trend already witnessed last year for insurance enterprises to shift their asset acquisition out of this type of investment in favour of other vehicles such as specialised investment funds.

Little demand for longer-term bank deposits

Slowdown in lending to the private sector

Lending by MFIs to domestic enterprises and individuals weakened during the second quarter of the year. In total, private sector borrowing from MFIs rose by € 30.0 billion between April and June, as opposed to € 32.7 billion during the same period last year. This corresponds to a seasonally adjusted annualised rate of increase of 6 ½ %. This was far lower than during the three preceding months (11%), when lending to the private sector had been exceptionally high owing to the expiry of special depreciation facilities in eastern Germany. Regarded in this context, the decline, especially in advances, now evident can be seen as a return to a more normal state of affairs. In seasonally adjusted terms, advances grew at an annual rate of 6 ½ % between April and June, as opposed to 10 ½ % in the first three months of the year. Longer-term loans, in particular, increased at a slower pace. Given the rather muted economic momentum at the present time, however, the demand for advances should not be considered weak. Moreover, this demand has no doubt also been boosted recently by the fact that borrowers have started to bring forward planned capital expenditure measures, particularly housing construction projects, in view of the rising longer-term interest rates. It may well be additionally reinforced by the lowering from the year 2000 of the assessment basis for qualifying for a government grant towards the cost of buying an owner-occupied dwelling, which the Federal Government announced in its package of savings measures. The MFIs reduced their holdings of corporate securities, especially of shares, by € 5.1 billion in the period under review. However, this was attributable entirely to a very high level of disposals in June (– € 17.1 billion) owing to the maturing of forward contracts concluded in the previous quarter – presumably largely with counterparties abroad.

Lower level of public sector debt to MFIs

German public authorities' indebtedness to domestic MFIs declined during the period under review. The public sector reduced its credits by € 3.7 billion, compared with a rise of € 3.3 billion in the second quarter of 1998. This decline can be attributed above all to a decrease in advances (– € 3.3 billion). In addition, the MFIs decreased their portfolios of domestic government bonds slightly between April and June (– € 0.5 billion). When assessing the level of borrowing by the domestic public sector, it should be remembered that in April the Federal Government received its share of the Bundesbank's profit distribution for the year 1998 (€ 8.3 billion) and was already able to draw on those funds in that month.[1] All in all, public sector cash transactions had only a minor expansionary impact on monetary growth in the second quarter. This was due not least to the public sector's fiscal consolidation efforts.

1 In the statistics pertaining to monetary analysis, the expansionary effect of the profit distribution – considered in isolation – is reflected in a decline in "other factors".