# Financial markets in Germany

## Capital market and bank interest rates

*Flatter yield curve*

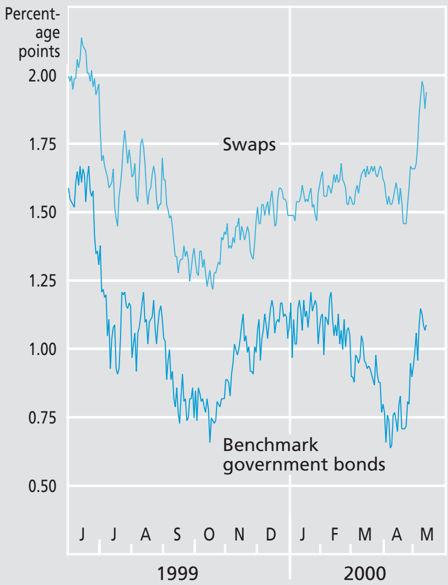
Interest rates in the German capital market during the spring continued to move closely in line with yields in the other euro area countries. The yield on ten-year Federal bonds – which act as the benchmark for the euro area on account of their liquidity advantage – was about 20 basis points lower than the euro area average (excluding Germany) throughout the period under review. In mid-May, following some marked fluctuations, the yield on ten-year Federal bonds outstanding was just under 5 ½ %, which was slightly higher than its end-1999 level. By contrast, the interest rates on Federal securities with shorter residual maturities rose distinctly over the same period, as a result of which the yield curve of the German bond market became considerably flatter. In mid-May the yield spread of ten-year Federal bonds over one-year paper observable in the market amounted to only ⅔ percentage point, compared with 1½ percentage points at the end of last year. In addition, the interest rate differential between ten-year debt securities issued by domestic banks and comparable Federal bonds widened somewhat during the spring months. The current gap of just over 50 basis points indicates that market players are still prepared to accept sizeable yield discounts on bonds and notes in return for higher liquidity.

*US yield spread narrowed by bond buy-backs*

The yield spread of long-term US government bonds over German Federal bonds narrowed appreciably for a time during the period under review. Thus ten-year US Treasury yields were only just over ½ percentage point higher than those of comparable German

US yield spread over Germany in the ten-year maturity segment

Daily values




Source: Primark-Datastream.

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paper at the beginning of April, as against 1 percentage point in December 1999 and again since early May 2000. This temporary narrowing of the interest rate differential was associated with a sharp fall in US government bond rates due to changes in macroeconomic fundamentals but also to the bond repurchase programme announced by the US Treasury. This structural factor is making it harder to undertake an economic interpretation of the yield spread vis-à-vis the US market with reference, say, to exchange rate expectations. The major impact of the structural factor is clearly discernible in a comparison with other segments of the US financial market. For example, the interest rate for ten-year US dollar swaps showed little change between January and April.[1] Consequently, the interest rate advantage of the United States over Germany in the swap market remained more or less unchanged during these months at approximately 1½ percentage points, although it lessened substantially in the case of government bonds.

*Further rise in bank interest rates*

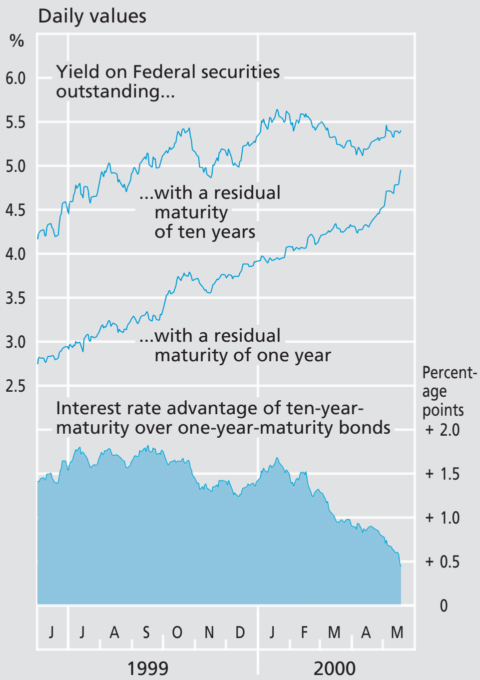
In contrast to capital market yields, long-term bank interest rates increased further in the spring on balance, although the rates weakened somewhat in April. In that month mortgage loans with interest rates locked in for ten years cost 6½% on average, which was around 0.1 percentage point more than in December 1999. The effective rates for long-term fixed-rate loans to enterprises increased by roughly ¼ percentage point. In April they averaged nearly 7% (credit volume of DM 200,000 to less than DM 1 million) and 6¾% (credit volume of DM 1 million to less than DM 10 million). Banks raised their short-term lending rates by a similar margin. For example, in April credit institutions charged an average of around 9¼% for current account credit (from DM 200,000 to less than DM 1 million) and 11½% on average for personal credit lines. The terms offered for short-term bank deposits were adjusted on a comparable scale. Thus the rates of interest paid on time deposits running for one month and three months (deposit amount from DM 100,000 to less than DM 1 million) in April – almost 3% and just over 3% – were both ¼ percentage point higher than at the end of 1999.

1 By means of interest rate swaps the counterparties exchange future interest rate payments. Swaps are mostly concluded between banks.

*Flatter yield curve reflects successful central bank policy*

The flattening-out of the yield curve in the market for Federal securities in the wake of a rise at the short end – which is largely shaped by current money market terms – reflects interest rate policy measures taken by the Eurosystem. At the same time, the fact that the term structure of interest rates continues to show a rising curve suggests that the market is expecting central bank interest rates in the euro area to be raised further. In this context the persistently low long-term interest rates indicate an assumption by market participants that the cyclical upturn in Germany and throughout the euro area will gather momentum without lastingly endangering the goal of price stability. This assessment is also supported by indicators of economic agents' long-term inflation expectations. For instance, the inflation expectations for Germany for the average of the next ten years culled from surveys in April 2000 (Consensus Forecast) amounted to no more than 1.6 %. In March, using this measuring concept, the expected real capital market rate in the ten-year maturity range was 3 ¾ %, compared with around 4 % on average during the nineties. Hence the financing conditions for the German economy remain comparatively favourable in both nominal and real terms.

Interest rate movements in the German bond market

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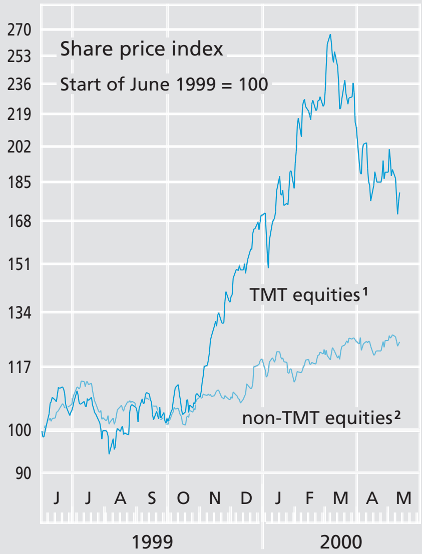
## Share prices

*Booming equity market*

The dynamic price surge seen on the German equity market in the autumn initially continued unabated at the beginning of this year. Measured by the broad CDAX share price index, equity prices increased by a further 20 % between the end of 1999 and the beginning of March 2000, albeit amid increasing price swings. At the same time the expected price volatility, which expresses market players' level of uncertainty about equity price developments, was exceptionally high. Thus the implied volatility of DAX share prices reflected by the VDAX index rose at the end of December by around 10 percentage points to over 30 %. German equities then fell by 10 % in the worldwide stock market correction in early March – which began with a dramatic fall on the US technology bourse Nasdaq. When this Report went to press in mid-May, prices on the German equity market were still almost 6 % up on the end of 1999. The consolidation concurrently lessened the price uncertainty; in mid-May the VDAX index stood at just over 24 %, although the

Price movements in the equity market

Daily values, log. scale




Source of data: Primark-Datastream. — **1** Shares of firms in the technology, media and telecommunications (TMT) industries. — **2** Total market excluding TMT shares.

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actual share price swings remained fairly large.

*Price movements driven by TMT equities*

In Germany equity price movements differed considerably in the individual market segments – as was the case on other major stock exchanges, too. The pronounced volatility in the market as a whole was caused by the fluctuating share prices of firms in the technology, media and telecommunications (TMT) industries, many of which are listed on the *Neuer Markt*. Thus German TMT equities climbed by 50 % between the end of December 1999 and the beginning of March 2000, whereas non-TMT share prices increased by a mere 2 % over the same period; the market as a whole rose in value by roughly 15 %.[2] Prices on the *Neuer Markt* soared by almost 90 % – measured by the NEMAX-All-Share price index, which comprises all equities traded on the *Neuer Markt*. Conversely, the subsequent fall in share prices was largely confined to enterprises in the high-tech sectors. Whereas TMT equities sustained losses of nearly 30 % up to mid-May, the prices of non-TMT equities rose by just over 2 %. The NEMAX-All-Share index plummeted by 27 %. This development shows that a fundamental valuation especially of start-up firms in very future-oriented industries is subject to considerable uncertainty. Moreover, the share prices of enterprises whose profit potential is dependent on market developments which lie quite a long way in the future, and which are correspondingly uncertain, react more frequently and more strongly to new information than the share prices of long-established firms.

## Borrowing in the securities markets

*Rise in bond sales at beginning of the year*

Issuing activity in the German bond market was stepped up noticeably at the beginning of the year. Gross sales of bonds issued by domestic borrowers, calculated at market prices, totalled € 180 billion in the first three months of this year (previous quarter: € 130 billion), which was similar to the issuance volume during the first quarter of 1999.[3] After subtracting redemptions and taking account of the changes in issuers' holdings of their own bonds, domestic bond sales yielded € 47

**2** Measured by Primark-Datastream's market-wide sectoral indices.
**3** As from the beginning of the year 2000, the figures discussed here also contain debt securities issued by non-banks with an original maturity of up to and including one year plus commercial paper.

billion net between January and March; this was nearly twice as much as in the preceding quarter (€ 27 billion). This sharp rise was probably due not least to catch-up effects in the issuance of bonds on the part of private-sector borrowers, in particular, who – following restrained issuance behaviour around the turn of the year – procured an increased amount of resources from the bond market. At € 34 billion, a distinctly larger amount of foreign bonds, too, were sold in Germany during the first three months of this year than in the previous quarter (€ 9½ billion); they were overwhelmingly denominated in euro.

*Brisk issuing activity by banks*

The higher level of borrowing in the bond market was predominantly attributable to increased issuing activity by credit institutions. They launched their own debt securities for € 37 billion net, compared with € 17 billion in the preceding quarter. Issues primarily took the form of communal bonds *(Öffentliche Pfandbriefe),* which accounted for € 19 billion, but larger amounts of other bank debt securities (€ 9½ billion) and debt securities issued by specialised credit institutions (€ 9 billion) were also sold. In contrast to the tendency towards shorter-dated paper that had been evident towards the end of 1999, the bonds sold in the first quarter of 2000 revealed an increasing preference for medium and longer maturities. At € 8 billion net, issuance of government debt securities remained virtually constant vis-à-vis the three preceding months. In this case, too, longer-term paper was favoured. Corporate bonds were sold in the net amount of € 2 billion, which represented a sharp rise both against the previous quarter and against the first three months of 1999.

## Investment activity in the German securities markets

€ billion

| Item | 1999 Oct. to Dec. | 2000 Jan. to Mar. | 1999 Jan. to Mar. |
|---|---|---|---|
| **Bonds and notes** 1 | | | |
| Residents | 7.2 | 66.0 | 64.8 |
| Credit institutions 2 | 0.2 | 37.9 | 16.6 |
| of which | | | |
| Foreign bonds and notes 3 | 7.3 | 15.2 | 7.8 |
| Non-banks 4 | 7.1 | 28.2 | 48.1 |
| of which | | | |
| Domestic bonds and notes | 5.0 | 9.3 | 19.7 |
| Non-residents 3 | 29.5 | 14.8 | 34.2 |
| **Shares** | | | |
| Residents | 25.9 | – 0.7 | 39.5 |
| Credit institutions 2 | 11.1 | 45.8 | 21.9 |
| of which | | | |
| Domestic shares | 6.5 | 43.0 | 22.4 |
| Non-banks 4 | 14.8 | – 46.6 | 17.6 |
| of which | | | |
| Domestic shares | – 36.8 | – 98.9 | – 1.9 |
| Non-residents 3 | 36.8 | 61.0 | – 17.4 |
| **Investment fund certificates** | | | |
| Investment in specialised funds | 22.7 | 9.5 | 14.7 |
| Investment in funds open to the general public | 4.7 | 16.3 | 13.9 |
| of which: Share-based funds | 5.6 | 12.9 | 4.2 |

**1** Since the beginning of 2000 including debt securities issued by non-banks with an original maturity of up to and including one year plus commercial paper. — **2** Book values, statistically adjusted. — **3** Transaction values. — **4** Residual.

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*Resources raised in the equity market*

In the first quarter of 2000 domestic enterprises sold new shares for € 5 billion, which was only slightly less than in the previous three months (€ 6½ billion). The beginning of the year was again marked by a large number of initial public offerings (IPOs) from domestic firms (40 altogether), of which more than three-quarters were launched via the *Neuer Markt.* Sales of foreign equities likewise remained high, raising € 55 billion net (after € 56 billion in the preceding quarter), mostly through portfolio investment.

## Investment activity in the securities markets

*Purchases of bonds*

Domestic credit institutions were the principal buyers in the bond market in the first quarter of 2000. They increased their bond portfolios by € 38 billion. Roughly half of this took the form of bank debt securities, while more than one-third was accounted for by foreign bonds. Domestic non-banks purchased debt securities worth € 28 billion net, in the main from foreign issuers (€ 19 billion); these were exclusively denominated in euro on balance. Hence the trend among domestic investors towards the international diversification of their bond portfolios continued in the first quarter of 2000. However, the diversification of currency risks played only a minor role for non-banks – unlike the credit institutions, which for the most part purchased bonds denominated in foreign currencies. Between January and March foreign buyers purchased German debt securities worth € 15 billion net, which was far less than in the preceding quarter (€ 29½ billion). This fall was solely due to a decline in demand for money market paper from German issuers; non-residents bought such paper for € 7 billion in the period under review, compared with a peak value of € 22½ billion in the fourth quarter of 1999.

*Shares*

Domestic credit institutions were the main purchasers in the German equity market in the first quarter of 2000; they bought shares worth € 46 billion net. The increase in the banks' holdings of equities issued by domestic enterprises (€ 43 billion net) was partly connected with forward transactions. The amount of domestic equities held by foreign investors rose by € 61 billion, compared with a rise of € 37 billion in the previous three months. The inflow of funds was exclusively attributable to direct investment – mostly in connection with one cross-border corporate take-over – whereas portfolio investment decreased steeply. The share portfolios of domestic non-banks declined by € 46½ billion.

*Investment fund certificates*

At € 26 billion, domestic investment funds raised almost the same amount of resources between January and March as they had done in the previous quarter (€ 27½ billion). One difference compared with the previous quarter, however, was that this time funds open to the general public were to the fore, selling investment fund certificates to the net value of € 16½ billion (previous quarter: € 4½ billion). The specialised funds raised € 9½ billion on balance, as against € 22½ billion in the final quarter of 1999. The sharp growth recorded by the funds open to the general public was largely achieved by share-based funds, which on their own recorded inflows of € 13 billion. Demand was evidently fuelled by the rise in equity prices and the growing popularity of shares as a form of financial asset acquisition. In contrast to the preceding quarter, the money market funds registered a net inflow of resources amounting to € 3 billion. Among the specialised funds, the mixed funds fared best, with net sales of € 6½ billion.

## Deposit and lending business of monetary financial institutions (MFIs) with domestic customers

*Sharp rise in overnight deposits*

In the deposit business of German MFIs with domestic customers overnight deposits grew unusually strongly in the first quarter of 2000, measured on a seasonally adjusted basis. Besides portfolio shifts at the expense of cash holdings accumulated in the run-up to the millennium date change – which appear to have played a role in January especially – another factor in the further course of the quarter seems to have been the expectation of rising interest rates. Employees and, above all, other financial institutions increased their overnight deposits.

*Decrease in shorter-term time deposits, ...*

Deposits with a maturity of up to two years decreased during the period under review. On a seasonally adjusted view, however, this decrease was confined to January, when shifts apparently took place in favour of overnight deposits. Shorter-term time deposits were increased again subsequently, thereby resuming the trend that had prevailed in the fourth quarter of 1999. They probably benefited from the rising interest rates; in March the rates for deposits redeemable at three months' notice – as mentioned earlier – were ¼ percentage point higher than their corresponding level in December 1999. Deposits with an agreed maturity of over two years likewise grew more slowly between January and March than they had done in the preceding three months. They increased by € 5.2 billion, compared with € 10.5 billion in the previous quarter and € 4.2 billion in the first three months of 1999. On balance it was only

*... slight increase in longer-term time deposits*

### Movement of the lending and deposits of monetary financial institutions (MFIs) in Germany *

€ billion

| Item | 2000 Jan. to Mar. | 1999 Jan. to Mar. |
|---|---|---|
| Deposits of domestic non-MFIs [1] | | |
| Overnight | + 6.1 | – 10.3 |
| With agreed maturities | | |
| up to 2 years | – 7.7 | + 4.8 |
| over 2 years [2] | + 5.2 | + 4.2 |
| At agreed notice [3] | | |
| up to 3 months | – 15.5 | + 4.2 |
| over 3 months [4] | + 0.9 | – 4.9 |
| Lending | | |
| Lending to domestic enterprises and individuals | | |
| Loans | + 20.7 | + 28.1 |
| Lending against securities | + 37.7 | + 18.3 |
| Lending to domestic public authorities | | |
| Loans | – 1.3 | + 6.4 |
| Lending against securities | + 3.9 | – 4.9 |

***** 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 this Report. — **1** Enterprises, individuals and public authorities. — **2** In 1998 excluding, in 1999 including, deposits under savings and loan contracts. — **3** Savings deposits. — **4** In 1998 including, in 1999 excluding, deposits under savings and loan contracts.

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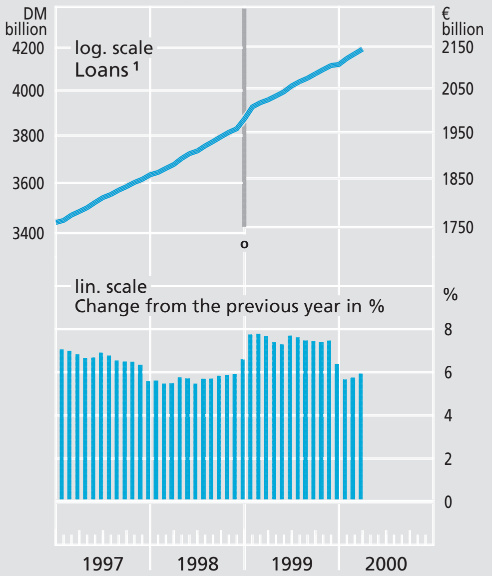
the domestic insurance enterprises which accumulated such deposits.

*Sharp fall in savings deposits at three months' notice*

Deposits with a period of notice of three months, which had already met with lacklustre interest at the end of 1999, fell sharply during the first quarter of 2000. The special saving facilities attracting a higher rate of interest, which in previous years had fuelled the growth of this particular component of the money stock, contracted noticeably. Part of the savings deposits were no doubt rechannelled into other short-term bank deposits. On the other hand, the decline in savings deposits with an agreed notice of over three months, which has been evident for a long time, came to a halt in seasonally adjusted terms. They were increased by € 0.9 billion – exclusively by households. Even

Loans 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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so, given the expectations of rising interest rates, the propensity to form longer-term savings and time deposits remained muted on the whole.

*Dynamic trend in lending to the private sector*

MFI lending to domestic enterprises and individuals showed a truly dynamic trend in the first three months of this year. With a seasonally adjusted annualised rate of nearly 11½ %, it grew virtually twice as fast as in the preceding quarter. A key factor in this growth was extensive securitised lending to the domestic business sector. In the first quarter of 2000 domestic MFIs increased their holdings of securities of German enterprises by a total of € 37.7 billion. The bulk of the securities was purchased in March; non-euro area residents were among the sellers. To the extent that these securities are purchased by banks in the secondary market, they do not entail any inflow of funds to the issuers. Loans to the domestic private sector likewise registered a steep rise. This applies especially to short-term loans, which expanded by 25 % in seasonally adjusted annualised terms. On balance the borrowers were exclusively domestic enterprises, especially the category of other financial institutions, which can be allocated neither to banks nor to insurance enterprises. By contrast, the pace of growth of medium and long-term loans accelerated only marginally.

*Slight rise in public sector debt*

The level of indebtedness of German public authorities to domestic MFIs increased by € 2.6 billion in the first quarter of 2000, compared with € 1.5 billion in the first three months of last year. On balance this increase was due solely to purchases of domestic government bonds by German MFIs in January. On the other hand, loans to the public sector fell by € 1.3 billion in the first quarter of the current year, following a rise in the preceding quarter.