Financial markets in Germany

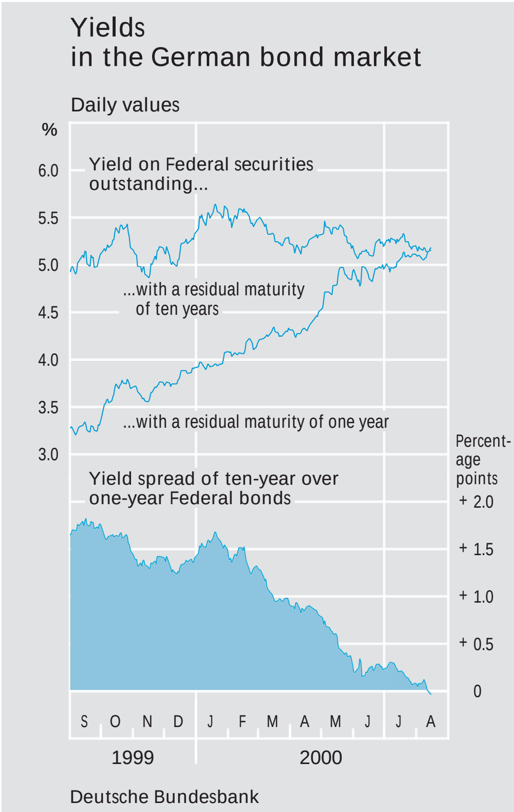
Capital market and bank interest rates

Capital market rates stable and yield curve even flatter

Long-term interest rates in the German capital market fell slightly in the second quarter of 2000 amid minor fluctuations. The yield on ten-year Federal bonds outstanding in mid-August stood at just under 5 ¼ %. The very close convergence between rates in the German bond market and yields in the other euro-area countries persisted. Thanks to their benchmark position within the euro area, however, ten-year Federal bonds were priced just over ¼ percentage point lower than the euro-area average (excluding Germany). Unlike the yields on long-term Federal bonds, interest rates on Federal securities with shorter residual maturities again rose distinctly in the summer months. Consequently, the bond market yield curve has been virtually flat since the end of July. In mid-August yields on ten-year Federal bonds observable in the market actually fell slightly below those on one-year paper, whereas they had showed a yield spread of just under ⅔ percentage point three months earlier and almost 1½ percentage points at the end of 1999. In fact, ten-year Federal bonds – owing to their benchmark status and associated liquidity advantage – have recently tended to attract a slightly lower interest rate than Federal bonds with medium-term residual maturities.

Wider spread of Federal bonds due to special factors

However, the interest rate movement of the most liquid Federal bonds was influenced by special factors which render it hard to make a reliable assessment of the general interest rate trend in the German bond market. The chief factor was the expectation on the part of market participants that the government



Yields in the German bond market

would significantly reduce its borrowing in the bond market in the course of this year as a result of the anticipated substantial additional receipts from the auction of mobile phone licences and from further privatisation proceeds. Assuming that Federal bond issues would thus be in relatively short supply, market players hastened to buy long-term public-sector bonds, in particular, thereby driving down the yield. As yields on private-sector debt securities did not match this downward trend but instead rose somewhat compared with their levels at the end of April, the interest rate differential between many private-sector debt securities and Federal bonds widened considerably. For instance, the spread between ten-year debt securities issued by domestic banks and comparable Federal bonds increased by about 20 basis points between the end of April and the beginning of June. In mid-August it amounted to about ⅔ percentage point; this gap is almost twice as great as the average for the nineties. As rates for ten-year interest rate swaps largely track the yield on bank debt securities outstanding, the spread between swaps and Federal bonds likewise widened distinctly during the past few months.[1] Besides leading to a flatter yield curve, the widening of interest rate differentials resulted in the fact that – for the first time since the early nineties – the average yield on all domestic bonds outstanding was significantly higher than the yield on ten-year Federal bonds

Flat yield curve reflects low inflation expectations

The emergence of a virtually flat yield curve in the market for Federal securities coupled with only slightly changed long-term interest rates indicates that market participants' inflation expectations are very subdued, despite the improved economic outlook for both Germany and the whole euro area. This estimation is borne out by direct indicators of economic agents' long-term inflation expectations. Thus the expected inflation rate for Germany for the average of the next ten years, as culled from surveys (Consensus Forecast) in the first half of 2000, was no more than 1.6 %. If this measure is subtracted from the yield on domestic debt securities outstanding, the real capital market rate in the ten-year maturity range in June was 3 ¾ %, compared with just over 4 % on average during the nineties. Therefore, the financing

1 By means of interest rate swaps the counterparties exchange future interest payments (fixed coupons against floating rates linked to a money market rate). Such swaps are mostly concluded between banks. Hence swap rates and yields on bank debt securities are very similar.

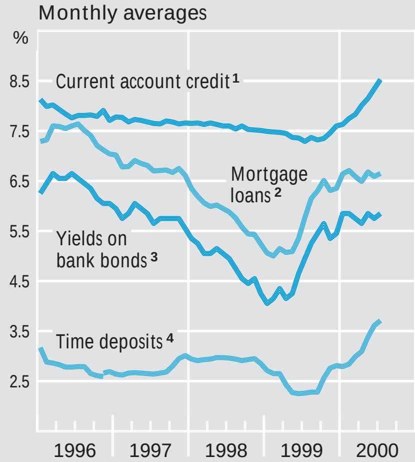
terms for the German economy remain comparatively favourable in both nominal and real terms.

Further rise in bank interest rates

Bank interest rates were raised further across the board during the summer months. In particular, banks increased their short-term lending and deposit rates noticeably. For example, in July banks charged more than 8½% on average for current account credit (from DM 1 million to less than DM 5 million) and 12% on average for personal credit lines, which in both cases corresponds to an increase of more than 50 basis points compared with April. The terms offered for short-term time deposits were adjusted on a comparable scale. Thus the rates of interest paid in July on time deposits running for one month and three months (deposit amount from DM 100,000 to less than DM 1 million) – just over 3½% and 3¾% – were both more than 60 basis points higher than they had been three months earlier. By contrast, the increase in long-term bank rates was more moderate. Thus mortgage loans with interest rates locked in for ten years cost just under 6¾% on average in July, which was around 15 basis points more than in April. The interest charged on long-term fixed-rate loans to enterprises increased by roughly ¼ percentage point. In July their effective rates averaged around 7¼% (credit volume of DM 200,000 to less than DM 1 million) and 7% (credit volume of DM 1 million to less than DM 10 million).

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 one month (up to and including October 1996: a 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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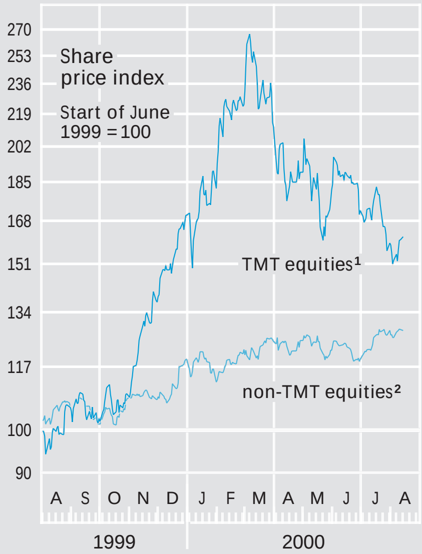
Share prices

Equity market stable following correction

Following their record high in March, equity prices in the German share market fell by 13% up to mid-August, as measured by the broad CDAX share price index. At the same time the advantage over average European share prices which they had enjoyed during the first few months of 2000, and which at times had amounted to almost 10%, was all but wiped out. German equities nevertheless remained approximately 5% ahead of their end-1999 level. The stock price correction during the past few months also caused uncertainty on the German stock exchanges to abate considerably. Thus the implied volatility of German blue-chip share prices captured by the VDAX index has fallen continuously by more than one-third from the beginning of

Price movements in the equity market

Daily values, log. scale



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

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this year to below 20%. Since the end of May, actual price volatility has also decreased.

Contrasting trends in individual market segments

However, the development of the overall market continues to mask significant differences in the price movements of individual equity market segments. While the "growth stocks" in the technology, media and telecommunications (TMT) industries, following their earlier dynamic price surge, plummeted from spring onwards, quotations in the more traditional sectors rose steadily. By the time this Report went to press, high-tech stocks had lost nearly 40% of their market value compared with their peak at the beginning of March and were down by more than 5% compared with their level at the end of last year; by contrast, non-TMT equities rose to new all-time highs and in mid-August were 7% up on end-December.[2]

Equities which are listed on the *Neuer Markt* are mainly issued by very young and innovative companies from high-tech sectors whose profit potential is dependent on market developments which lie quite a long way in the future. Attempts to assess the underlying value of such shares is therefore subject to major uncertainty; moreover, their prices generally react more strongly to new information or even to mere market rumours. This not only leads to a greater degree of price volatility compared with the shares of firms in established economic sectors, it also means that the valuation level of such growth stock is more dependent on changes in investors' risk propensity. For example, fears expressed in the United States and then Germany about the possibly insufficient solvency of some high-tech companies triggered dramatic price falls across the entire market segment. The NEMAX-All-Share price index, which comprises all equities traded on the *Neuer Markt*, was latterly more than 40% below its peak recorded in mid-March. Nevertheless, share prices in that market were still 12% above their level at the end of 1999.

Borrowing in the securities markets

Sales of bonds

Borrowing via the issuance of domestic debt securities increased slightly in the second quarter. Gross sales of bonds and notes issued by domestic borrowers, calculated at

2 Measured by Primark-Datastream's market-wide sectoral indices.

market prices, totalled € 183 billion, which was roughly the same as between January and March 2000. However, after subtracting the lower redemptions and taking account of the changes in issuers' holdings of their own bonds, net domestic bond sales raised € 52½ billion between April and June and thus more than in the preceding quarter (€ 47 billion).[3] By contrast, sales of foreign bonds, at € 10½ billion, were considerably lower than in the first quarter (€ 34 billion). For one thing, German investors bought foreign debt securities denominated in euro or one of its national currency units only to the amount of € 14 billion (after € 29½ billion in the previous quarter and € 28½ billion in the second quarter of 1999). Most of these issues were launched by residents of other euro-area countries. For another thing, residents sold debt securities denominated in foreign currencies in the amount of € 3½ billion net between April and June, after having bought such securities to the value of € 4½ billion in the previous quarter.

Investment activity in the German securities markets

€ billion

Item	2000 Jan. to March	2000 April to June	1999 April to June
Bonds and notes [1]			
Residents	75.8	27.8	51.9
Credit institutions [2]	37.9	22.2	37.4
of which			
Foreign bonds and notes [3]	15.2	5.6	19.2
Non-banks [4]	37.9	5.7	14.5
of which			
Domestic bonds and notes	19.1	0.8	4.8
Non-residents [3]	5.0	34.9	26.9
Shares			
Residents	– 2.5	– 4.8	11.6
Credit institutions [2]	45.8	– 28.1	– 13.7
of which			
Domestic shares	43.0	– 31.7	– 16.0
Non-banks [4]	– 48.3	23.3	25.3
of which			
Domestic shares	– 100.0	– 0.6	12.2
Non-residents [3]	62.0	40.2	22.0
Investment fund certificates			
Investment in specialised funds	9.5	8.5	14.3
Investment in funds open to the general public	16.3	8.0	9.6
of which: Share-based funds	12.9	9.1	3.2

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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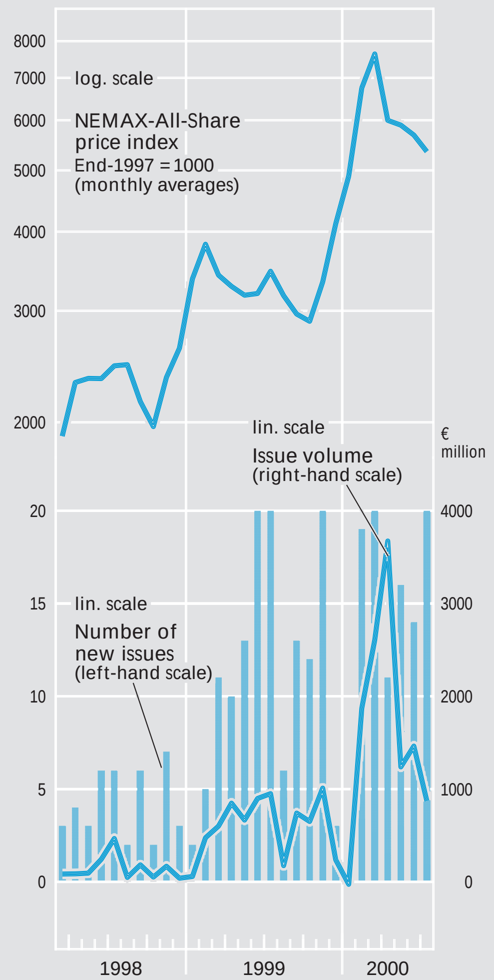
Sharp increase in sales of bank debt securities

Credit institutions were the principal beneficiaries of the higher amount of resources raised from sales of domestic debt securities. Between April and June they sold their own debt securities for € 45½ billion net, compared with € 36½ billion in the first quarter. For the first time in two quarters, longer-dated debt securities (with maturities of more than four years) were predominant. The bank debt securities sold again primarily took the form of communal bonds (*Öffentliche Pfandbriefe*), which once more accounted for € 19 billion. However, sales of other bank debt securities, designed to refinance lending to the private sector, rose considerably from € 9½ billion to € 16 billion. At € 9½ billion, the amount raised from bond sales by specialised credit institutions remained virtually unchanged. The net proceeds raised by government debt securities between April and June was distinctly lower than in the previous quarter (€ 8 billion) and amounted to € 3½ billion. The main reason for this was the subdued issuing activity of the Federal Government (€ 3 billion), whose cash situation is rather favourable. Corporate bonds were sold in the net amount of € 3 billion, which was half as much again as in the first quarter.

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.

Price movements and issuing activity in the *Neuer Markt*



Source: Daily data of Deutsche Börse.

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Persistently buoyant issuing activity in the equity market

Between April and June, domestic enterprises placed new shares in the German equity market to the market value of € 8 billion, compared with € 5 billion in the preceding quarter. Foreign enterprises accommodated equities worth € 27½ billion net in the domestic market, as against € 54½ billion in the first quarter, which had been bloated by a large cross-border takeover. The *Neuer Markt* was again the main conduit for new issues in Germany, launching 39 and 41 initial public offerings (IPOs) in the first and second quarter, even though the climate for stock market flotations deteriorated perceptibly from mid-March in the wake of growing investor restraint caused by the sharp drop in share prices and greater uncertainty. More and more enterprises that went public were unable to maintain their issuing price, with the result that a number of planned IPOs were postponed. Nevertheless, the total number of enterprises listed on the *Neuer Markt* has increased to 300 since the end of July. Just under one-sixth of them are foreign firms. The share of foreign investors, too, rose significantly compared with last year to around 20 %.

Investment activity in the securities markets

Purchases of bonds

Foreign investors were the principal buyers in the bond market in the second quarter. On balance, they bought domestic debt securities for € 35 billion, compared with € 5 billion between January and March. They were mainly interested in short-term bank debt securities; they also purchased public debt securities totalling € 12½ billion net. Domestic credit institutions increased their bond portfolios by € 22 billion, compared with € 38 billion in the previous quarter. Whereas they bought bank debt securities to the value of € 23 billion and foreign bonds totalling € 5½ billion, they sold public paper in the amount of € 6½ billion. While domestic non-banks had acquired a fairly large amount of bonded debt in the first quarter (€ 38 billion), they reduced their investment in the bond market considerably between April and June to just € 5½ billion. Their interest in domestic and foreign debt securities alike waned noticeably.

Purchases of shares

On balance, foreign investors were the main purchasers of domestic shares in the second quarter. They bought German equities to the net value of € 40 billion, compared with € 62 billion between January and March. Domestic non-banks increased their stock portfolios by € 23½ billion on balance, buying exclusively foreign shares. Credit institutions sold German shares worth € 31½ billion and purchased foreign equities for € 3½ billion, thus reducing their total stock holdings by € 28 billion. However, the related shift in the ownership of German shares away from domestic banks and towards foreign investors was mainly due to maturing forward transactions.

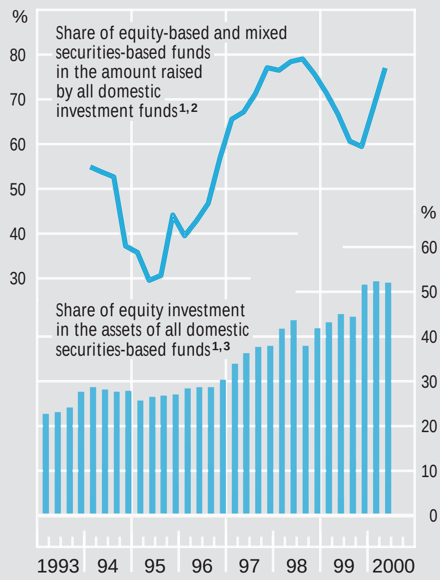
Investment fund certificates

Sales of investment fund certificates fell between April and June, just as they had done in the first quarter of 2000. Domestic investment funds sold certificates to the net value of € 16½ billion, compared with € 26 billion in the first quarter. Net sales of foreign mutual fund units in the period under review, at € 10 billion, were likewise well down on the previous quarter (€ 17½ billion).

Ongoing growth of share-based funds

Domestic specialised funds, which are open only to institutional investors, raised new resources amounting to € 8½ billion between April and June, compared with € 9½ billion in the previous quarter. At € 4 billion, almost half of this sum accrued to share-based funds. Domestic funds open to the general

Equity investment through investment funds



1 Funds open to the general public and specialised funds. — **2** Average of the last four quarters. — **3** End-of-quarter levels.

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public sold certificates for € 8 billion net during the period under review, after having attracted significantly larger inflows of capital in the first quarter of 2000 (€ 16½ billion net). In this segment, too, investors predominantly favoured share-based funds, which recorded inflows of € 9 billion. This means that in the first six months of this year retail investors invested far more in share-based funds on balance (€ 22 billion) than they had done in the whole of 1999 (€ 17 billion). Neither the muted share price trend in the second quarter nor the greater uncertainty in some market segments have evidently dented the growing popularity of share-based fund certificates. Retail investors perhaps regard this type of investment vehicle as an appropriate means of diversifying their portfolios, because they show a clear preference, on the one hand, for

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

€ billion

Item	2000 April to June	1999 April to June
Deposits of domestic non-MFIs 1		
Overnight	+ 0.6	+ 26.2
With agreed maturities		
up to 2 years	+ 4.3	– 12.0
over 2 years	+ 2.6	+ 1.0
At agreed notice		
up to 3 months	– 20.1	+ 2.2
over 3 months 2	+ 2.3	– 7.1
Lending		
Lending to domestic enterprises and individuals		
Loans	+ 25.3	+ 34.2
Lending against securities	– 22.1	– 5.2
Lending to domestic public authorities		
Loans	– 1.7	– 3.3
Lending against securities	– 6.6	– 0.4

* 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 Savings deposits.

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investment funds with a European or international investment profile and, on the other hand, for investment funds focused on "new economy" growth stocks. Such securities are likely to be subject to comparatively high price volatility. In contrast to their growing appetite for share-based funds, private investors reduced their involvement in bond-based funds and money market funds by € 2 billion each on balance during the period under review.

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

Weak demand for overnight deposits

In the deposit business of German MFIs, the overnight deposits of domestic customers declined considerably on balance in the second quarter of 2000, measured on a seasonally adjusted basis. While these deposits had increased significantly during the first four months of this year against the background of expectations of rising interest rates, a change in investment behaviour occurred in May and June. Rising short-term interest rates pushed up the opportunity cost of liquid cash holding, as a result of which savings were switched from sight deposits to better remunerated forms of investment.

Marked rise in shorter-term time deposits, ...

This switch primarily benefited deposits with an agreed maturity of up to two years, whose attractiveness was appreciably enhanced by the quite steep increase in interest rates on shorter-term time deposits during the second quarter amounting to more than ½ percentage point. They grew by € 4.3 billion in the second quarter after having contracted by € 7.7 billion in the previous three months.

... moderate increase in longer-term time deposits

Deposits with an agreed maturity of more than two years rose by € 2.6 billion between April and June, thereby growing faster than they had done in the second quarter of last year (€ 1.0 billion). While domestic insurance companies continued to invest in longer-term deposits, employed and other individuals notably decreased their holdings of longer-dated fixed-term deposits.

Marked fall in savings deposits at three months' notice

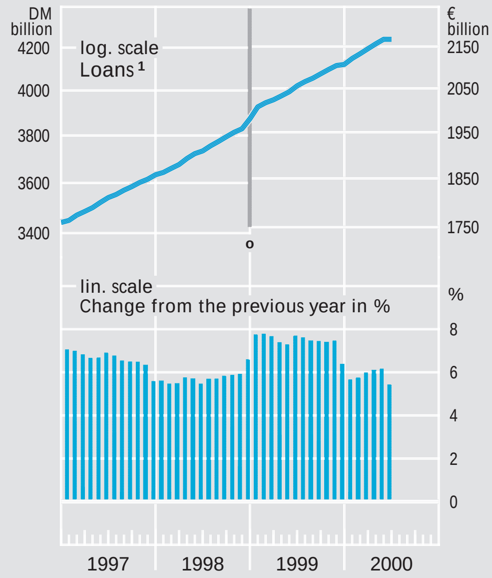
The fall in deposits with an agreed period of notice of three months, which has been apparent for some time, persisted in the second quarter. For almost a year now this decline has affected not only traditional savings deposits but also special savings facilities attracting a higher rate of interest, whose negative interest rate gap vis-à-vis comparable fixed-term deposits with a maturity of three months has widened noticeably of late. To some extent domestic households appear to have switched their short-term savings deposits not only into fixed-term deposits but also into deposits redeemable at a period of notice of more than three months; in the period under review the latter increased substantially in seasonally adjusted terms.

Lower lending to the private sector

MFI lending to domestic enterprises and individuals was noticeably lower in the second quarter than in the first. However, this was mainly a consequence of extensive disposals of securities by German MFIs in June in connection with large-scale forward transactions concluded in March 2000 with non-residents both inside and outside the euro area. Altogether, German MFIs ran down their holdings of securities issued by domestic enterprises by € 22.1 billion between April and June. Loans grew somewhat less rapidly in the second quarter. They expanded at a seasonally adjusted annual rate of 4½%, following 7½% in the first quarter. A slightly stronger demand was recorded for medium and long-term borrowing in the second quarter on a seasonally adjusted basis; in particular, employees and other individuals increased their indebtedness to German MFIs. By contrast, short-term loans, which had increased considerably in the preceding quarter, grew far more slowly in the period under review. With regard to the different categories of borrowers, credit utilisation by enterprises and households decreased in the second quarter while lending to the housing sector rose marginally. Within the enterprise sector,

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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credit demand weakened especially in wholesale/retail trade, transport, communication and other financial mediation services. By contrast, it showed a surge in the manufacturing sector.

Fall in public sector debt

The level of indebtedness of German public authorities to domestic MFIs decreased by € 8.4 billion in the second quarter of 2000, compared with a decline of € 3.7 billion one year earlier. This owed much to the government sector's markedly improved budgetary situation. On balance banks' holdings of securities issued by public authorities decreased by € 6.6 billion in the second quarter, while loans were curtailed by € 1.7 billion. In addition, the government increased its deposits with German MFIs in the period under review by the unusually substantial amount of € 5.1

billion. For the most part this increase occurred in June in the context of the issuance of a further tranche of shares in *Deutsche Telekom* in that month.