

The financial markets in Germany

Capital market and bank interest rates

In line with European yields, German capital market rates have fallen sharply on balance since the mid-year point. In mid-November the yield on ten-year Federal bonds outstanding was 4.4%, which was a good ½ percentage point down on early July. Compared with the average rate of other European government bonds, the interest rate discount on these bonds moved within a narrow band of between 15 and 20 basis points in the period under review. The interest-rate advantage of ten-year bonds issued by domestic banks over similar government bonds has hardly changed since the summer months. When this article went to press in mid-November, the spread was just under 30 basis points, well down on the average of previous years. The poor performance of German bank shares (see page 21) has therefore not resulted in higher risk premia for bank bonds.

*Decline in
capital market
rates*

Whereas short-term bank interest rates, which are more strongly influenced by money market conditions, showed little change between July and October, the longer-term debit interest rates fell sharply, albeit somewhat less than capital market rates. The cost of mortgage loans at a rate of interest locked in for ten years decreased on average by just under ½ percentage point to 5.7%. The decline in effective interest rates on long-term fixed-rate corporate loans was somewhat smaller. In October the rates were 6.3% (for a credit volume of €100,000 to less than €500,000) and 6.1% (for a credit volume of €500,000 to less than €5 million). By contrast, the rates charged for current account

*Little change
in short-term
bank rates but
lower long-
term rates*

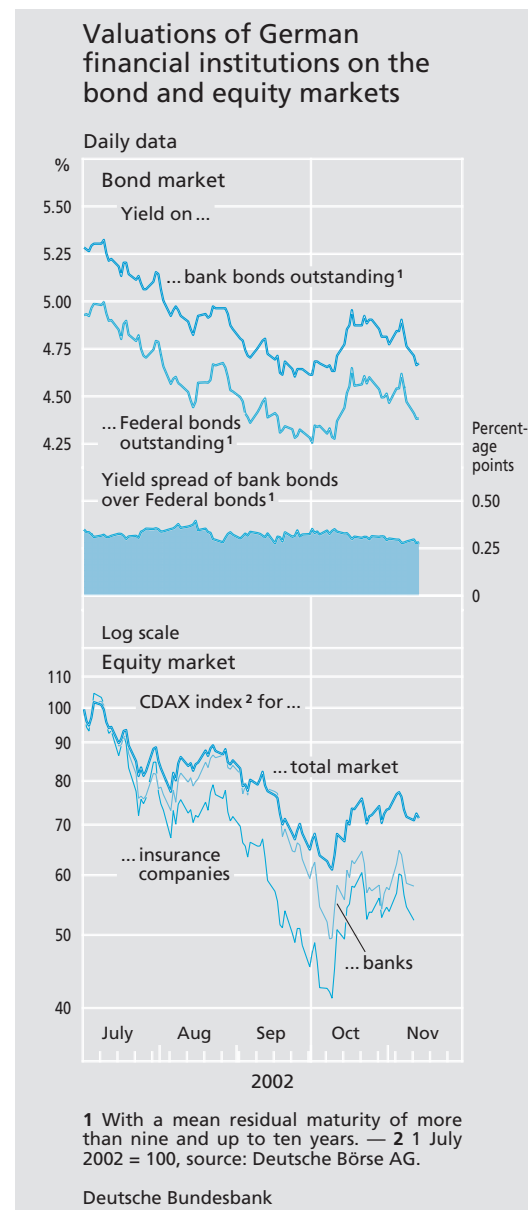
credit (for a credit volume of €500,000 to less than €2.5 million) and for personal credit lines hardly changed at all; they were, on average, 8.6% and 12.5% respectively in October. On the liabilities side of the balance sheet, the interest rate paid in October on fixed-term deposits with a maturity of one month was 2.6% and on those with a maturity of three months 2.7% (for an investment amount of €50,000 to less than €500,000), ie a few basis points lower than in July.

Share prices

Major price slump on the equity market

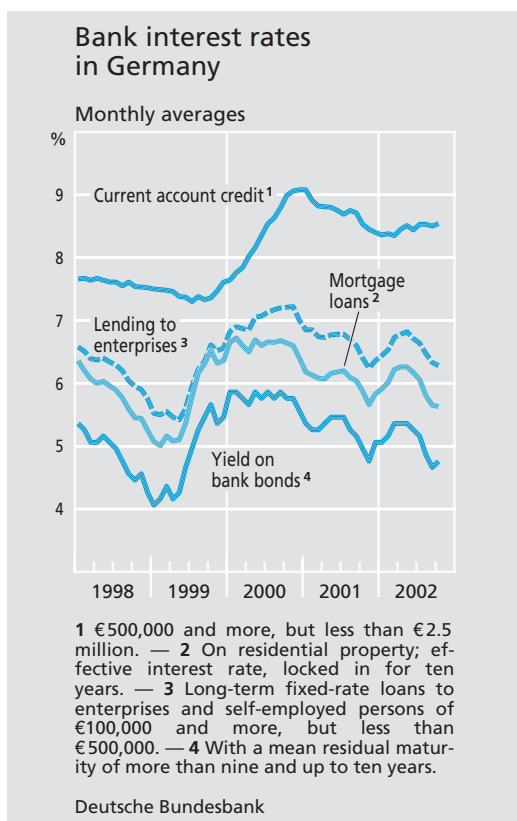
Against the background of falling prices in the international financial markets, quotations in the German share markets have also declined considerably in recent months. In the first half of October, the broad index for German equities (CDAX) was at times nearly 40% down on its mid-year position, thus falling to its lowest level since 1995. Prices have since recovered slightly but at the end of the period under review they were still 26% down on their mid-year level. Prices were thus still almost two-thirds down on the historical peak reached in May 2000.

In particular, the prices of financial assets have fallen dramatically. For example, compared with early July, insurance companies recorded, on balance, a loss of 46% of their stock market capitalisation, with banks losing 37%. Given the economic imponderables, the expectation that banks would expand their loan risk provisions became stronger. In addition, concern grew about further write-downs on bank loans granted to “New Econ-



omy” enterprises in the late 1990s. Furthermore, the slide in prices of financial assets is also likely to have been affected by the decline in valuation reserves. This applies, in particular, to financial institutions which had topped up their equity portfolios during the boom period.

As a result of falling prices and virtually unchanged profit expectations, the valuation



level of German blue chips (ratio of price to year-on-year expected profits) moved into line with the level of European enterprises in October. The price/earnings ratio of DAX enterprises is now well below its long-term average. The estimated profits which it includes are, however, based on the assumption that the performance of German blue chips will make a noticeable recovery.

Borrowing in the securities markets

Bond sales

Issuing activity in the German bond market overcame the slight weakness of spring 2002 and picked up again in the summer. Calculated at market prices, gross sales of debt securities issued by domestic borrowers amounted to €232 billion in the third quarter,

compared with €212 billion in the previous three-month period. With only a minor increase in redemptions and in issuers' holdings of their own bonds and notes, net sales of domestic fixed-interest securities raised €53 billion, compared with €36½ billion in the preceding period. Thus, far more bonds issued by German enterprises (€137½ billion) were sold in the first three quarters of 2002 than in the whole of 2001 (€86½ billion). However, there was a slight decline in foreign bonds and notes; at €14 billion in the third quarter of 2002, net sales were somewhat down on the second quarter (€18½ billion). Between July and September €67 billion (net) of domestic and foreign debt securities were sold, as opposed to €55 billion in the preceding three months.

Just under half of the borrowing on the German bond market in the summer was by the public sector, which expanded its bonded debt by €24 billion (previous quarter: €21½ billion). Of this amount, the Federal Government accounted for €22 billion and the *Land* governments for €10 billion. By contrast, €8 billion worth of bonds issued by special funds such as the Federal Railways Fund, the Currency Conversion Equalisation Fund and the Treuhand agency were redeemed. These special funds are no longer involved in the bond market as issuers. They refinance their liabilities by issuing Federal securities.

Slight increase in the public sector

The German Finance Agency continued to pursue its strategy of shortening the residual maturity of government debt in order to reduce the Federal Government's current interest burden. In the third quarter the Federal

Major issue of short-term Federal securities

Government issued €9½ billion (net) of Treasury discount paper ("Bubills") with a six-month maturity and €7 billion of two-year Federal Treasury notes ("Schätze"). Issues of five-year Federal notes ("Bobs") were up by €3½ billion, those of ten-year Federal bonds by €2½ billion and those of thirty-year Federal bonds by €1 billion. Federal savings notes worth €1 billion net were repurchased.

More funds raised by the banks

After a poor spring, there was a sharp increase in the issue of bank bonds in the third quarter. Net sales of this kind of paper went up from only €9 billion in April to €21 billion in June. This increase was accounted for primarily by sales of other bank bonds, which raised €24½ billion, followed by those of debt securities issued by other specialised credit institutions, which raised €5 billion. By contrast, the volume of public Pfandbriefe outstanding shrank by €8½ billion. Sales of corporate bonds also increased in the third quarter (€8 billion, following €5½ billion in the second quarter).

Few funds raised on the equity market

Against a backdrop of plummeting prices on the stock exchanges, issuing activity in the German equity market was again weaker in the third quarter than in previous quarters. Between July and September domestic enterprises placed only €1½ billion worth of new shares, compared with just under €2½ billion in the previous three months. Sales had last been at a similarly low level in the third quarter of 1996. On balance, the outstanding volume of equities issued by foreign enterprises was slightly down, by €½ billion, after increasing by €15½ billion between April and June. Total borrowing in the equity market

Investment activity in the German securities markets

Item	2002		2001
	Apr to June	July to Sep	July to Sep
€ bn			
Bonds and notes			
Residents	34.6	30.7	23.5
Credit institutions	15.9	- 5.0	- 8.2
of which			
Foreign bonds and notes	8.1	6.5	2.9
Non-banks	18.7	35.7	31.6
of which			
Domestic bonds and notes	8.2	28.0	27.3
Non-residents	20.5	36.1	20.3
Shares			
Residents	6.3	2.3	- 9.6
Credit institutions	- 9.1	- 5.6	- 16.3
of which			
Domestic shares	- 3.4	- 4.2	- 14.3
Non-banks	15.4	7.9	6.6
of which			
Domestic shares	- 5.6	7.1	8.3
Non-residents	11.6	- 1.2	10.5
Investment fund certificates			
Investment in specialised funds	11.1	7.4	5.9
Investment in funds open to the general public	4.6	4.6	4.5
of which: Share-based funds	1.0	- 0.5	- 2.1
Deutsche Bundesbank			

declined from €18 billion in the second quarter to only €1 billion in the third.

Investment activity in the securities markets

In the third quarter foreign investors and domestic non-banks were the main buyers in the bond market. Foreign investors purchased €36 billion worth of domestic bonds, far more than in the second quarter (€20½ billion). Domestic non-banks added €35½ billion to their bond portfolios, most of which (€28 billion) was domestic paper. By contrast, German credit institutions reduced their bond holdings by €5 billion. This includes portfolio shifts from domestic paper (-€11½ billion) to foreign paper (€6½ billion).

Bond purchases

The impact of the decline in share prices on economic activity

Since spring 2002 global share prices have again been tumbling from what was still a very high level; in Germany alone they have fallen by nearly 40%. Along with accounting scandals in the United States, this was mainly due to the worsening of the global economic outlook. The experience of various countries reveals that what occurs in the financial system can have a profound impact on the real economy. Especially in economic regions such as the USA, where shares are of relatively major importance as investment and financing instruments, share prices may affect the development of the economy and reinforce current trends.

Although credit institutions continue to play a dominant role in Germany in terms of financial flows, elements based on the financial markets have also become increasingly important in this respect in recent years. Events in the financial markets are therefore likely to have a greater effect on cyclical developments than in the past. However, it is difficult to find empirically significant links between the two because the time-frame for measuring share price effects in Germany is still very short and shares continue to play a relatively minor role. Moreover, equity investment is concentrated on certain categories of households and the funds raised focus on certain types of enterprises or financing purposes.

Even so, owing to households stepping up their direct investment and their indirect investment via mutual funds, consumer demand is likely to have become more dependent on share price movements. Estimations over lengthy periods show that a 30% to 40% decline in the value of households' equity holdings since April 2002 is likely to lead to a private-consumption-induced slowing of GDP growth in Germany by $\frac{1}{10}$ to $\frac{2}{10}$ percentage point, assuming that asset losses due to price developments are persistent. In the vast majority of cases, this wealth effect sets in within one year. At the same time, however, it should also be noted that major portfolio shifts in the international capital markets have boosted the prices of fixed-interest securities by nearly 4% on average since early April. Households with mixed securities portfolios have thus also achieved gains in some areas.

For enterprises, the price slump has meant that the equity market has practically dried up as a source of financing. Any directly related adverse impacts on investment activity are likely, if anything, to be limited as, even in the boom years of 1996 to 2000, no more than around 7% of corporate financing was raised through share issuance and only a fairly small part of this was linked to fixed capital formation. However, in certain sectors, such as technology, the

¹ This corresponds, by and large, to James Tobin's q theory, which postulates a connection between the equity market and the demand for investment goods. Investment occurs if the resultant additional

capitalisation value of a listed company is higher than the costs of the required capital outlay. If the cost of capital remains constant, falling share prices lead to enterprises curtailing their investment activity. In

percentage was considerably larger. If the bear market continues, it is likely to discourage investment projects in these sectors, which might otherwise provide a valuable stimulus to long-term growth.

In the corporate balance sheets, a marked fall in the prices of listed shares leads, pursuant to the provisions of the German Commercial Code, to the need for value adjustments to be made if book values are undershot. Those firms which are facing growing balance sheet risks are precisely those which had sharply increased their equity holdings in listed companies during the boom period. Lower profits or a poorer outlook for profitability are, in turn, putting the brake on corporate willingness to invest or restricting the range of financing options. Moreover, perhaps as a result of their significantly lower market capitalisation, public limited companies are coming under pressure from their shareholders or facing the threat of hostile takeovers. In order to effect a rapid increase in the value of a firm on the stock market, the next step is often to take radical business policy measures to improve performance, such as a restructuring of business units and cutbacks in investment plans.¹

The recent dramatic falls in prices have also worsened the balance sheet and performance situ-

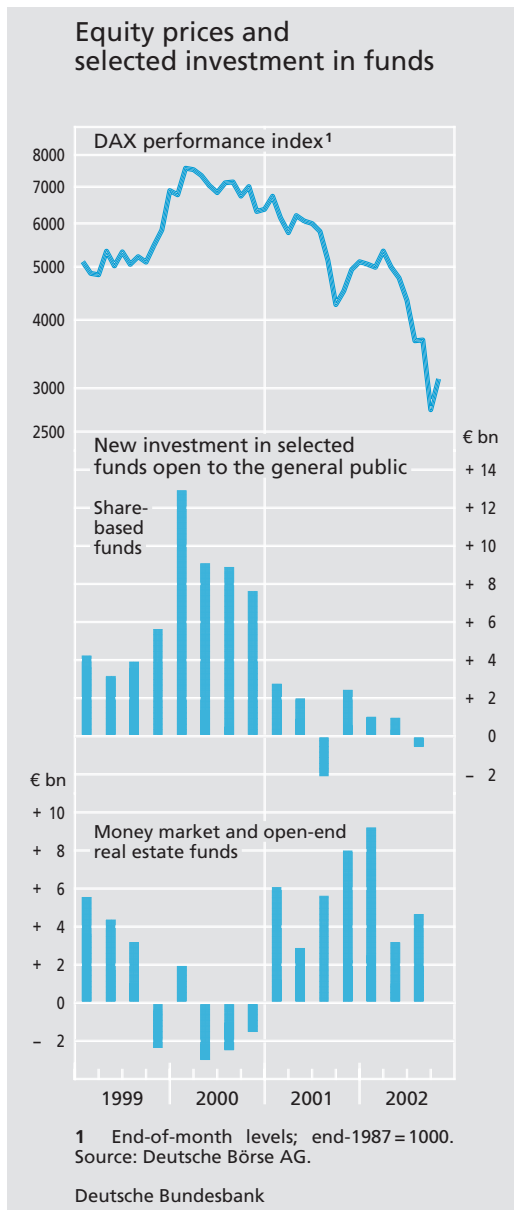
some cases it may even be wise for an enterprise to buy back its own capital on the stock market. Share repurchasing has since become legally permissible to an extent in Germany, too, but most adjustments

ation of banks and insurance companies and have thus led to the introduction of a more cautious business policy. This also makes it more difficult to raise business loan financing. Moreover, in the bond markets, higher risk premia are being required of certain categories of borrowers. Overall, financial market developments have therefore contributed to a deterioration in the environment for the financing of investment plans.

Feedback effects of share prices on enterprises and households are the result of "soft" factors such as consumer confidence and enterprises' business expectations, which are directly connected to market developments. However, it is not entirely clear how this operates. The accelerated slump in prices occurred concurrently with the marked decline in the Ifo business expectations index. Consumer sentiment, however, remained subdued until September and did not worsen to any major extent until October.

Finally, it is important not to overlook the risks associated with the international integration of enterprises' capital and trade. The fact that the equity market tends to play a more important role in the main non-euro-area economies and that share prices have fallen worldwide is placing an additional strain on economic recovery in Germany.

are still made by reducing loan capital, which may mean by selling equity holdings.



Share purchases

On balance, domestic non-banks were the only purchasers of equities in the third quarter. They invested €7 billion in the German equity market and just under €1 billion in foreign shares (previous quarter: -€5½ billion and €21 billion respectively). Foreign investors, however, reduced their portfolios of German shares by €1 billion net. In the period under review, domestic credit institutions raised €4 billion from the sale of domestic

shares and just under €1½ billion from sales of foreign shares. Credit institutions thus reduced their equity portfolios by slightly less than in the previous three months (-€9 billion).

Sales of shares in domestic and non-resident mutual funds went down to €15 billion in the third quarter, compared with a figure of €18½ billion for the period from April to June. The bulk of funds raised once again flowed to domestic mutual funds, which issued shares worth €12 billion net (previous quarter: €15½ billion); as in the previous quarter, foreign mutual fund shares accounted for €3 billion.

Mutual fund shares

Between July and September the inflow of resources to domestic special funds, which manage monies invested by institutional customers, was, at €7½ billion, well down on the preceding three months. Mixed securities funds were still in the forefront, with inflows of €3½ billion net, but fewer resources accrued to them than in the previous quarter (€7½ billion). By contrast, bond-based funds and open-end real estate funds attracted slightly more investment. At €4½ billion net, domestic investment funds open to the general public sold as many certificates in the third quarter as in the preceding three months. Savers with mutual funds continued to favour open-end real estate funds, to which they channelled €3 billion. With fund assets of €72½ billion, these kinds of special funds open to the general public became even more popular. Between July and September new resources amounting to €1½ billion were channelled to money market funds

Cautious investment behaviour by savers with mutual funds

and €1 billion to bond-based funds, after they had had to repurchase their own bonds in the previous quarter. The recent appeal of these kinds of funds is likely to have been boosted by the dramatic collapse of prices on the equity markets. By contrast, investors showed less interest in share-based funds. Following inflows in the second quarter, €½ billion was withdrawn in the second quarter. Mixed funds and pension mutual funds also experienced a small volume of repurchases.

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

*Perceptible
increase in
overnight
deposits*

As part of the deposit business of German MFIs with domestic customers, overnight deposits again increased sharply in the third quarter of 2002, at a seasonally adjusted annual rate of 11½%. Domestic enterprises were almost alone in building up sight deposits; around half of these deposits were built up by non-financial enterprises. Other financing institutions and insurance companies also increased their overnight deposits sharply in the third quarter, especially in September. The marked uncertainty on the financial markets about future interest rate and equity market developments is likely to have been the main determining factor.

*Perceptible
decline in short-
term time
deposits...*

By contrast, domestic investors made a perceptible seasonally adjusted reduction in their deposits with agreed periods of notice of up to two years, after having expanded them in the previous quarter. Deposits with an agreed maturity of more than two years were only

Lending and deposits of monetary financial institutions (MFIs) in Germany *

Item	€ bn	
	2002 July to Sep	2001 July to Sep
Deposits of domestic non-MFIs ¹		
Overnight	+ 4.8	+ 17.7
With agreed maturities		
up to 2 years	- 6.2	+ 5.5
over 2 years	- 0.6	- 0.1
At agreed notice ²		
up to 3 months	- 0.4	- 0.1
over 3 months	- 0.2	- 3.2
Lending		
To domestic enterprises and resident individuals		
Unsecuritised	+ 9.4	+ 7.7
Securitised	+ 3.9	- 7.9
To domestic public authorities		
Unsecuritised	- 4.7	- 2.4
Securitised	+ 7.5	- 8.2

* 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 the *Monthly Report*. — 1 Enterprises, individuals and public authorities. — 2 Savings deposits.

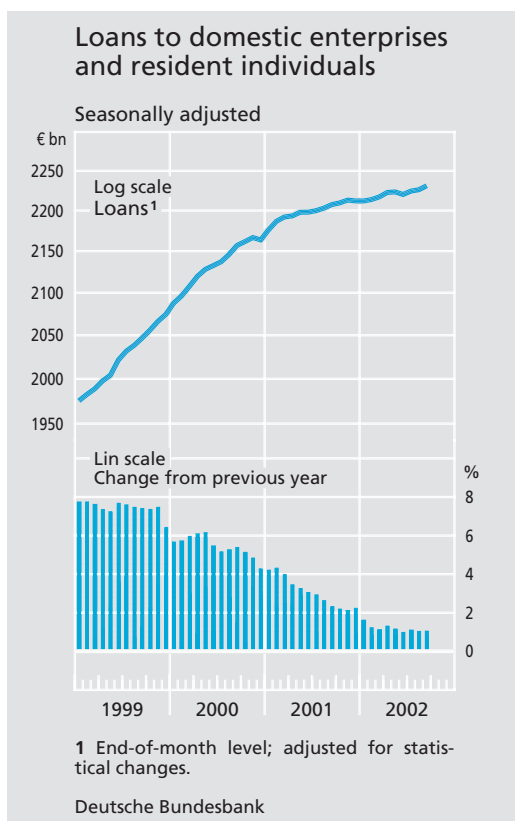
Deutsche Bundesbank

slightly reduced in the period under review. On balance, only domestic non-financial enterprises reduced their longer-term time deposits at German MFIs.

*... and a
moderate
decrease in
long-term time
deposits*

In the third quarter, there was a seasonally adjusted increase in deposits with an agreed period of notice of three months, after a special effect had caused them to decline noticeably in the second quarter. This is probably due to both the present marked preference for liquidity and the fact that remuneration of short-term savings deposits has shrunk less than returns on the capital market. The contraction of deposits with an agreed period of notice of over three months continued during the period under review, albeit at a slower pace.

*Overall increase
in savings
deposits*



Lending to the private sector restrained

Between July and September loans by German MFIs to the domestic private sector continued to expand very moderately in seasonally adjusted terms. While there was a sharp increase in short-term loans after a decline in the preceding quarters, medium to long-term loans to German enterprises and households increased only slightly. In the third quarter of 2002 the MFIs again made a marked expansion of their holdings of securities issued by German enterprises.

Lending, by borrower

The development of lending to the domestic corporate sector, as one of the most import-

ant categories of borrower, continued to be very subdued in the third quarter. The increase in lending to other financing institutions and insurance companies and the slightly positive impulses in lending to the services sector were offset primarily by a further reduction in loans to manufacturing companies. In seasonally adjusted terms, lending to this economic sector has now been contracting for one and a half years. Much the same applies to lending to enterprises in the trade and construction sectors. Housing loans showed no more than a slight increase in the third quarter, their year-on-year rate thus falling further to just over 1½%. By contrast, consumer lending was, for the first time for a while, stepped up again very distinctly. In addition to a perceptibly sharper increase in medium and long-term lending, short-term lending has now also picked up again somewhat, having previously been reduced over a period of almost two years.

Lending by German MFIs to domestic public authorities went up by €2.7 billion in the third quarter of 2002. The increase can be traced back solely to the purchase of government securities (€7.5 billion). By contrast, loans were reduced by €4.7 billion in the period under review as both Federal and *Land* governments cut their debt to German banks.

Increase in lending to the public sector