The financial markets in Germany

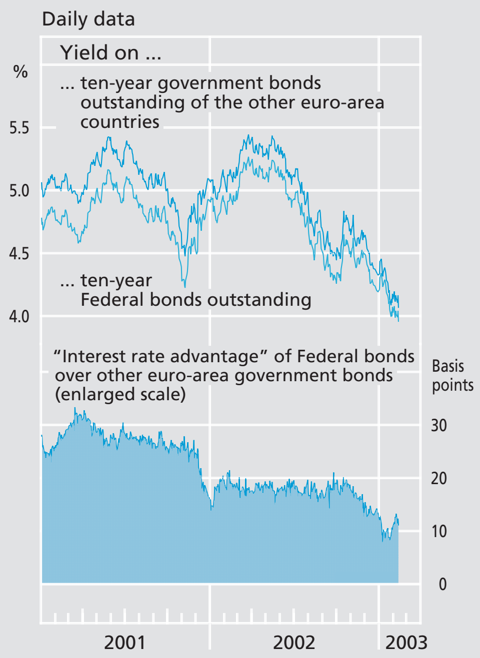
Capital market and bank interest rates

Less attention paid to benchmark function of Federal bonds

In line with European yields, German capital market rates have fallen by around ¼ percentage point since early October 2002. When this *Monthly Report* went to press in mid-February, the yield on ten-year Federal bonds outstanding was around 4%, the lowest level since the start of 1999. Compared with the average rate of other European government bonds, the interest rate discount on these bonds was halved from just under 20 basis points in the first three quarters of 2002 to just over 10 basis points in February 2003. However, this does not mean that Federal bonds are about to lose their benchmark function in the euro-area bond market, a function which gives the Federal Government, as the issuer of these bonds, an "interest rate advantage" over the other public sector borrowers in the euro area. Owing to the liquid secondary market and the status of the Bund future as the most important instrument for hedging against long-term interest rate risks in the euro area, Federal bonds continue to play a key role. The Federal Government's reduced interest rate advantage in the euro-area bond market is therefore better seen as linked to its very tight budgetary situation.

Decrease in interest rate premiums of bank bonds

For this reason, Federal bonds also lost something of their preferred status among borrowers compared with bonds issued by banks. In any case, the interest rate premium of ten-year debt securities issued by domestic credit institutions over comparable Federal bonds declined to less than 20 basis points by January. It subsequently recovered slightly. Overall, “Interest rate advantages” of Federal bonds in the euro-area bond market



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interest rate premiums on bank bonds are at much the same level as in spring 2002 before the increase in risk premia in the summer months, ie at a historical low.

Decline in bank rates, especially on deposits and longer-term loans

In parallel with developments in the German capital market, longer-term bank interest rates on lending and deposits have shown a further decline in recent months. Between October 2002 and January 2003 the interest rate charged on mortgage loans with a rate of interest locked in for ten years went down by an average of 0.3 percentage point to 5.4%. Effective interest rates on long-term fixed-rate corporate loans decreased somewhat more sharply, ranging between 5.8% and 6% depending on the size of the loan. Among longer-term deposits, it was mainly the rates of interest paid on savings bonds and savings deposits with interest rates fixed for correspondingly long periods which fell considerably. In January they averaged around 3%, which was 0.3 to 0.4 percentage point lower than in October last year.

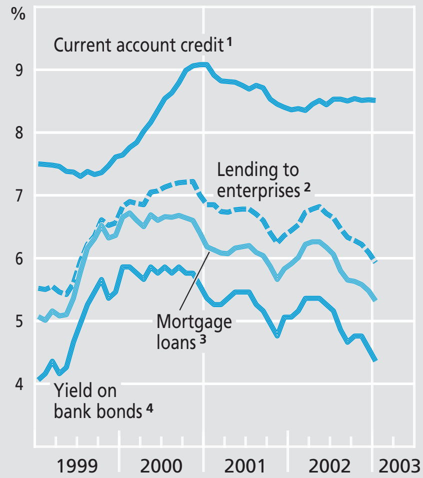
In this connection, the decline in the interest rates on banks’ short-term deposits is also noteworthy; it was already under way before the key interest rate was reduced in December, in line with the development of the corresponding money market rates. In January, for instance, the interest rate on fixed-term deposits with maturities of one month and three months (€50,000 to less than €500,000) was, at 2.3%, also just under 0.4 percentage point down on October. It was only for some types of short-term variable-yield loans and only after the ECB’s most recent interest rate move that a further downward movement in rates occurred. Above all, the rates on bills discounted, which are generally relatively well collateralised, declined by an average of around 0.2 percentage point to 6.1%, with the variable rates on mortgage loans falling by the same amount to 5.7%. They thus hit their lowest levels for around three years.

Slight fall in interest rates charged for current account credit

By contrast, there has so far been only a slight reduction in the rates charged for current account credit as well as for instalment credit and personal credit lines for private customers. In fact, for smaller loans in this category, various upward adjustments were made. In January the average rate charged for larger current account loans (€100,000 to €500,000) was 9.7%, with 10.7% being charged for instalment credit and 12.5% for personal credit lines, ie only a few basis points below the rates charged in the preceding months. As was evident from earlier interest rate reductions, the banks are endeavouring to improve their interest rate margin, at least for a time, by making somewhat lagged interest rate adjustments in their lending business. A further factor is likely to have been that the banks are now evidently taking greater account of credit risks in their interest rate charges. The existing very narrow interest rate margins were, in many cases, felt to be no longer sufficient. Owing to the marked rise in insolvencies, the increased default risks in short-term lending are likely, in the current situation, to have been a prime factor in determining how the banks set their terms. Given higher risks, it also seems appropriate to adjust the relevant terms in order to make more efficient use of national savings. Whether the attempt to improve margins will meet with success, however, will be decided by inter-bank competition. There is still likely to be major pressure on banks to pass the lower refinancing costs on to their customers.

Bank interest rates in Germany

Monthly averages



1 €500,000 and more, but less than €2.5 million. — 2 Long-term fixed-rate loans to enterprises and self-employed persons of €100,000 and more, but less than €500,000. — 3 On residential property; effective interest rate, locked in for ten years. — 4 With a mean residual maturity of more than nine and up to ten years.

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Share prices

Ups and downs on the equity market

Share issuing had been on a downward slide since the summer and continued to fall in early October. Prices then rose by a around one-quarter towards the middle of the month, before going back down again with wide fluctuations. Only the prices of telecommunications and utilities shares managed to avoid the downward trend and improve. Since November renewed scepticism about opportunities for further growth have, however, set in across a broad front. As the risk of war has increased, uncertainties have grown, putting greater pressure on share prices, especially in recent weeks. In mid-February the broad market index for German equities (CDAX) was at times beneath its low level recorded in the first half of October. Compared with the historical peak in March 2000, this means a loss of more than two-thirds. German equity market capitalisation also declined strongly and, at the end of 2002, was more than 60% down on its spring 2000 level.

Although prices have hardly shown any overall change, the valuation level of German blue chips (ratio of price to expected year-on-year profits) has gone up again slightly since October 2002. In keeping with the downward revision of economic expectations and

Investment activity in the German securities markets

€ billion

Item	2002 July to Sep	2002 Oct to Dec	2001 Oct to Dec
Bonds and notes			
Residents	27.1	– 2.6	21.8
Credit institutions 1	– 5.0	– 19.7	– 1.9
of which Foreign bonds and notes 2	6.5	– 7.0	3.2
Non-banks 3	32.1	17.1	23.7
of which Domestic bonds and notes	25.2	5.5	3.6
Non-residents 2	39.0	– 6.3	21.6
Shares			
Residents	3.9	5.7	13.2
Credit institutions 1	– 5.6	0.0	– 2.2
of which Domestic shares	– 4.2	– 1.3	2.2
Non-banks 3	9.5	5.6	15.3
of which Domestic shares	6.0	– 1.0	4.9
Non-residents 2	– 0.1	3.7	– 1.1
Mutual fund shares			
Investment in specialised funds	7.4	23.2	20.3
Investment in funds open to the general public	4.6	3.2	13.4
of which: Share-based funds	– 0.5	1.4	2.4

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

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given the marked slump in profits in 2002, analysts are now expecting a later recovery in corporate profits than they did some months ago.

Borrowing in the securities markets

Bond sales

Despite buoyant issuing activity, net redemptions were recorded in the German bond market in the final quarter of 2002. Calculated at market prices, gross sales of debt securities issued by domestic borrowers amounted to €250 billion, compared with €232 billion in the preceding three-month period. However, these were offset by exceptionally high redemptions and increases in issuers' holdings of their own bonds and notes amounting to nearly €264 billion. The volume of domestic bonds outstanding thus fell in the fourth quarter by more than €13 billion after a rise of almost €53 billion in the third quarter. All in all, the outstanding volume of fixed interest securities issued by domestic borrowers was €2,481 billion at the end of 2002, thus exceeding its previous year's value by 5.6%. At €5 billion, net sales of foreign paper in the German market were also well down on the quarter (€13 billion) and thus offset only some of the net redemptions of bonds issued by domestic borrowers. Overall, between October and December 2002 around €9 billion net worth of domestic and foreign debt securities were redeemed, compared with €66 billion raised in the previous three months.

High net redemptions of bank bonds

Net redemptions on the German bond market were mostly of bank bonds (-€18 billion), which accounted for nearly two-thirds of the total domestic bonds outstanding. At the end of 2002, the value of this paper outstanding was only 3.7% up on the year. Net redemptions were of all types of bank bonds except debt securities issued by specialised credit institutions, which were sold for €5 billion (net) in the fourth quarter. Public Pfandbriefe outstanding were down by €13 billion, other bank bonds by €8 billion and mortgage Pfandbriefe by €1 billion.

Few issues of public sector bonds

Between October and December 2002 the public sector added €4 billion to its bond market debt. By contrast, €24 billion of new funds were raised on the capital market in the third quarter of 2002. Up to the end of 2002, the volume of public sector bonds outstanding was 7.5% up on the year. The Federal Government issued €11 billion (net) worth of debt securities in the autumn quarter, most of which were two-year Treasury notes (€6 billion) and ten-year Federal bonds (€4 billion). The *Land* governments issued €6 billion (net) worth of new bonds. Debt securities issued by public sector issuers, especially the Treuhand agency and the former Federal Post Office, were redeemed for €13 billion.

Funds raised in the equity market

Issuing activity in the German equity market was still very subdued in the fourth quarter of 2002. As in the preceding three months, domestic enterprises raised only €1½ billion by placing new shares. In the same period, foreign shares were sold in the German market for €8 billion (previous quarter: €2 billion). The total funds raised in the equity market thus went up from €4 billion in the third quarter to €9½ billion in the fourth.

Investment activity in the securities markets

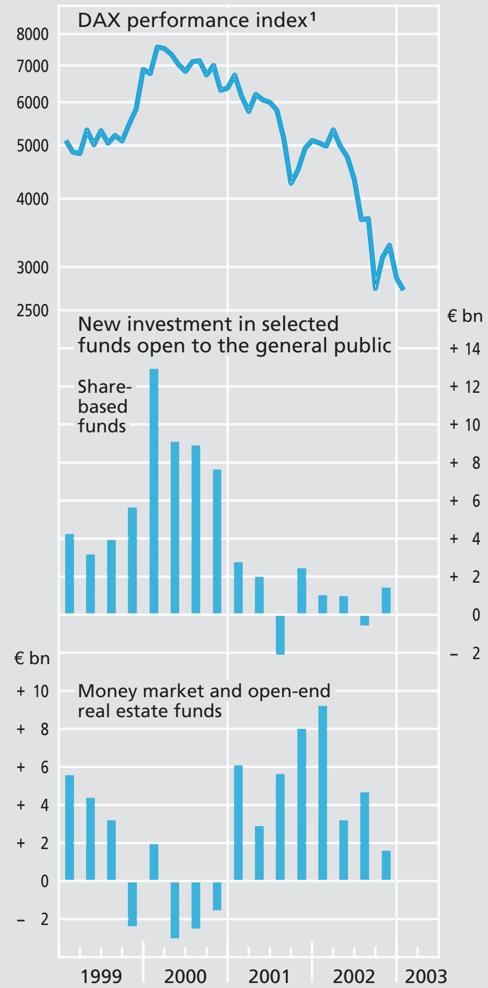
Bond purchases

Domestic non-banks were the sole purchasers in the bond market in the fourth quarter (€17 billion), buying mainly foreign paper (€12 billion). Domestic banks and foreign investors reduced their bond portfolios by €20 billion and €6 billion respectively. The latter primarily sold bonds issued by private borrowers (-€11 billion) and purchased public sector bonds (€5 billion).

Share purchases

The tendency towards international diversification of equity portfolios, which has been going on for some years, continued in the last quarter of 2002. In that period, resident investors purchased €8 billion worth of foreign shares and sold €2½ billion of domestic paper. While credit institutions made hardly any change to their equity portfolios, domestic non-banks upped their equity holdings by €5½ billion. Non-resident investors purchased €3½ billion of German equities.

Equity prices and selected investment in funds



1 End-of-month levels; end-1987 = 1000. Source: Deutsche Börse AG.

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Mutual fund shares

Sales of mutual fund shares picked up again in the final quarter of 2002. Domestic funds

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

€ billion

Item	2002 Oct to Dec	2001 Oct to Dec
Deposits of domestic non-MFIs 1		
Overnight	+ 34.6	+ 45.6
With agreed maturities		
up to 2 years	+ 7.2	+ 1.6
over 2 years	+ 9.4	+ 1.0
At agreed notice 2		
up to 3 months	+ 18.1	+ 21.8
over 3 months	− 1.2	− 2.7
Lending		
To domestic enterprises and resident individuals		
Unsecuritised	+ 0.8	+ 16.8
Securitised	+ 17.1	+ 8.6
To domestic public authorities		
Unsecuritised	+ 2.7	+ 1.9
Securitised	− 1.0	+ 1.8

* 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.

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raised €26 billion from the sale of shares, which was more than twice as much as in the preceding quarter. However, the increase concerned only the specialised funds preferred by institutional investors (€23 billion, following €7 billion in the third quarter), which usually record marked inflows towards the end of the year. Mutual funds open to the general public raised only €3 billion from the sale of shares (previous quarter: €5 billion). Foreign funds also raised less (€2 billion) than in the previous period (€3 billion).

Private investors continued to invest primarily in open-end real estate funds (€1.7 billion), which are considered safe. However, the temporary price rises in the equity market also revived interest in share-based funds (€1.4 billion). Particularly after the price recovery in mid-October, such funds again sold more shares, after sustaining outflows of €0.5 billion in the summer months.

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

Moderate increase in overnight deposits

In the final quarter of 2002 there was a seasonally adjusted relatively moderate increase in domestic customers' overnight deposits with German MFIs. These deposits expanded by a seasonally adjusted annual rate of 4½% compared with 11% in the previous quarter. A sharp increase in November was followed by a distinct decline in December. This also reflected the investment behaviour of the other financial institutions. They had made noticeable additions to their sight deposits at domestic banks between September and November but reduced them again in December. On balance, they thus curbed the increase in overnight deposits in the fourth quarter. By contrast, the volume of sight deposits built up by both non-financial enterprises and individuals in the quarter under review was more or less normal for the time of year.

Short-term time deposits stagnated...

In seasonally adjusted terms, deposits with an agreed maturity of up to two years remained virtually unchanged in the fourth quarter, having been reduced perceptibly between July and September. In contrast to their usual behaviour, both resident individuals and the public sector (excluding the Federal Government) did not add to their holdings of short-term time deposits in the last quarter of 2002; they even reduced them. Only domestic enterprises made a marked increase in their short-term time deposits. At the same time, deposits with an agreed maturity of over two years increased sharply. Resident individuals and German insurance companies again both added considerably to their longer-term time deposits in the period under review. In the preceding quarters, insurance companies – traditionally the largest group of investors in this particular type of deposits – had shown considerable restraint.

... but longer-term time deposits increased sharply

Marked increase in short-term savings deposits

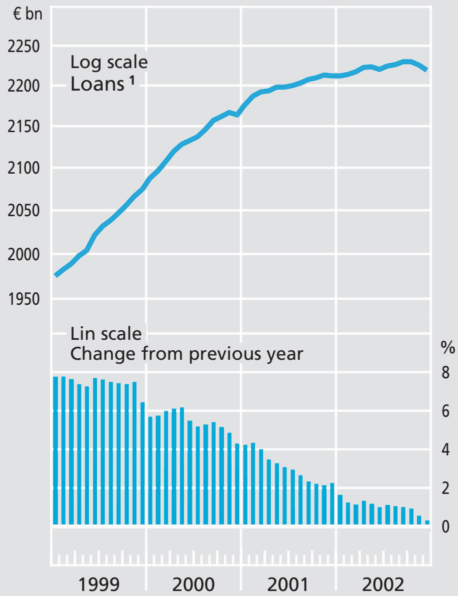
Deposits with an agreed period of notice of three months again increased considerably between October and December. All in all, the trend in favour of short-term savings deposits (which has been observed since the beginning of the interest rate reduction phase at the start of 2001) continued in the last quarter of 2002. The currently rather low rate of interest is accompanied by comparatively low opportunity costs of money holdings. This means that the appeal of short-term savings deposits is probably mainly determined at present by the fact that they are fairly readily available. By contrast, deposits with an agreed period of notice of more than three months were continuously reduced. The decline accelerated again in the fourth quarter, after a relatively small reduction in the fourth quarter.

Lending to the private sector

In seasonally adjusted terms, lending by German MFIs to the domestic private sector stagnated in the fourth quarter. Loans to enterprises and individuals were, in fact, reduced considerably. In particular, banks' short-term loans were decreased markedly while medium to long-term bank loans to the domestic private sector were expanded slightly between October and December. Given the difficult economic situation, enterprises, in particular, reduced their short-term liabilities to German MFIs considerably or they used the favourable interest rate situation to consolidate their indebtedness over the longer term. The greater reluctance of banks to enter into new business seems to have contributed in some cases to the weak development of short-term lending, given the fact that the pressure of low returns in the German banking industry has led to a keener awareness of risk. By contrast, in recent months the banks expanded their securitised lending to domestic enterprises. In this connection, only German credit institutions' holdings of shares and other equities increased on balance, which suggests, in part, that related restruc-

Loans to domestic enterprises and resident individuals

Seasonally adjusted



1 End-of-month level; adjusted for statistical changes.

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turing processes are taking place in the corporate sector.

Lending, by borrower

According to the borrower statistics, all economic sectors contributed to the marked decline in lending by German banks to the domestic corporate sector in the fourth quarter of 2002. In addition to manufacturing, which has been reducing its debt steadily since spring 2001, the other financial institutions and insurance companies also cut back their borrowing from German banks; in the previous quarter they had still raised considerable amounts of funds. Moreover, the services sector and commercial enterprises also reduced their liabilities to the credit institutions. By contrast, the German banks increased their lending to resident individuals and housing construction somewhat. However, commensurate with the weak development of the economy and the associated income uncertainty, borrowers demonstrated little propensity to take up such loans.

Lending to the public sector

Lending by domestic MFIs to the German public sector went up in the final quarter by €1.7 billion; in the previous year the increase was €3.7 billion. On balance, only unsecuritised lending was increased in the period under review. In addition to the *Land* governments, the municipalities also borrowed additional funds from German banks, while the Federal Government reduced its bank debt. Domestic MFIs reduced their holdings of securities issued by the German public sector by €1 billion in the fourth quarter.