The financial markets in Germany

Capital market and bank interest rates

Continued pressure on the "benchmark" premium of Federal bonds

In line with euro-area interest rates, there has been a marked decline in the yields on German Federal bonds since the start of the year. In mid-May the yield on ten-year Federal bonds was, at 3.8%, more than ⅓ percentage point down on the start of the year. The interest rate discount on Federal bonds over government bonds of other euro-area countries, which was just under ⅕ percentage point one year before, reached new lows of less than 10 basis points in the period under review. The decline in the "interest rate advantage" of Federal bonds is also likely to have been responsible for the currently low interest rate premium of bank bonds with the same maturity. Besides the strained government budgetary position, the debate about Germany's future classification by leading rating agencies is also likely to have had a negative impact on the "benchmark" premium of German bonds.

Decline in bank interest rates, especially for deposits and longer-term lending

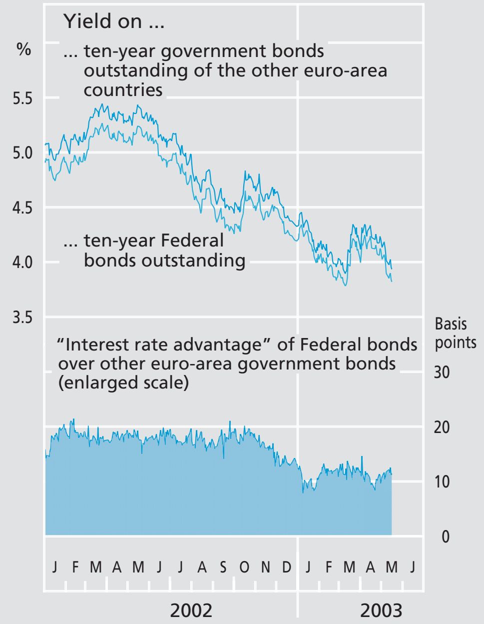
Paralleling developments in the German capital market, longer-term bank interest rates on lending and deposits also showed a further decline between January and March before being raised again somewhat in April. During that period the interest rate charged on mortgage loans at a rate of interest locked in for ten years decreased by an average of just under ⅕ percentage point to 5.2%. In April, however, it went back up to 5.3%. Effective interest rates on long-term fixed-rate corporate loans developed along similar lines. Depending on the amount of the loan, they were in the order of 5.7% to 5.9% at the end of the period under review. With regard to longer-term deposits, a marked decline was recorded primarily in the rates of interest paid on savings bonds with rates locked in for long periods. In March these interest rates were 2.7%, just under ⅓ percentage point down on January; in April they went up again slightly to around 2.8%. The banks made further downward adjustments to their interest rates on short-term deposits. After the most recent reduction of the key interest rate in March, fixed-term deposits with one and three month maturities were remunerated, on average, at just over 2% in April, more than ¼ percentage point down on January.

Lagged interest rate reduction on short-term lending

Just as when previous interest rate cuts were made, the banks endeavoured to use lagged interest rate reductions on short-term lending to bring about a temporary improvement in their interest rate margin and to adjust rates to take account of the increase in default risk. For instance, after the ECB's most recent interest rate move, the terms applying to short-term current account credit and personal credit lines for private customers have become only slightly more favourable than those for short-term fixed-term deposits. On average, the April interest rates on larger amounts of current account lending (8.4%) and on personal credit lines (12.4%) were, respectively, 13 basis points and 14 basis points down on the start of the year. The rates on bills discounted, which tend to be relatively well collateralised, have declined since the start of the year by an average of between 7 and 16 basis points to 6.0% and those on variable-rate mortgage loans have fallen by the same amount to 5.6%.

"Interest rate advantages" of Federal bonds in the euro-area bond market

Daily data



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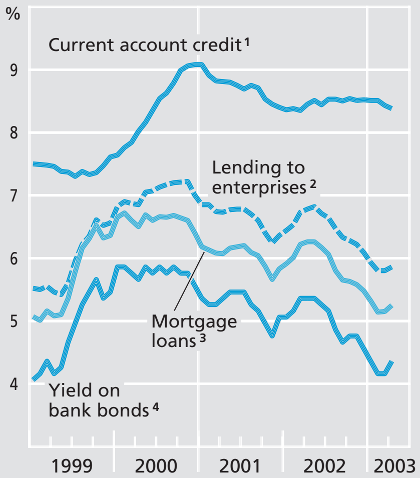
Share prices

German shares very volatile by international standards

Between the start of the year and mid-March, German shares lost just under one-quarter of their value when measured on the CDAX, the broad market index for German equities. The decline in German equity prices was thus sharper than that of other European share prices. However, the recovery of German share prices which set in just before the start of the Iraq war was also more marked than that in the other euro-area equity markets: since mid-March the CDAX has risen by more than one-quarter compared with a growth in value of 20% for the European shares included in the Dow Jones EuroStoxx index. The development of German share prices since the start of the year can be partly explained by the impact of the Iraq war on the

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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German economy, which, at first, market players evidently expected to be particularly negative. This is indicated by a study of the effects of the war on the financial markets as revealed by the prices of relevant futures contracts.[1] The study concludes that before the start of the war, expectations were that the German equity market would be quite badly affected, while the negative consequences for the share markets of other euro-area countries and the USA would be limited.

Borrowing in the securities markets

Buoyant bond sales

In the first quarter of 2003 sales in the German bond market showed a distinct improvement over the previous quarter. Domestic borrowers issued debt securities to a market value of €316 billion, compared with €250 billion in the final quarter of 2002. After adjusting for redemptions and changes in issuers' holdings of their own bonds, net sales amounted to €62 billion, compared with net redemptions of €13 billion in the preceding period. The volume outstanding of fixed interest securities issued by German borrowers was thus 5.8% up on the year. In the first quarter €6 billion was raised from sales of foreign bonds.

Large issues of public sector bonds

Half the funds raised at the start of the year accrued to the public sector, which increased its bonded debt by €35 billion. The volume of public sector bonds outstanding was thus 9.6% up on the year. In the first three months of the year the Federal Government issued €29 billion (net) worth of debt securities. Most of these were ten-year Federal bonds (€15 billion), followed by five-year Federal notes (Bobls) and 30-year bonds (€6 billion each). The *Land* governments issued €13 billion worth of new bonds. By contrast, a debt security issued by the Treuhand agency was redeemed for €7 billion. This borrower no longer issues debt securities under its own name but in conjunction with the Federal Government.

Despite upturn, weak sales of bank bonds

Market sales of bank bonds picked up in the first quarter of 2003. Following net redemptions of €18 billion in the previous quarter, German credit institutions raised €13 billion in the bond market. The still comparatively low level of recourse to the bond market is a

1 Andrew Leigh, Justin Wolfers and Eric Zitzewitz (2003): *What Do Financial Markets Think of War in Iraq?*, NBER Working Paper No 9587.

result of German banks' low refinancing needs connected with the low level of lending activity. However, there was a continuation of the trend, which has been under way for some years, away from public Pfandbriefe (-€18 billion) and mortgage Pfandbriefe (-€2 billion) towards debt securities issued by specialised credit institutions (€19 billion) and other bank bonds (€13 billion).

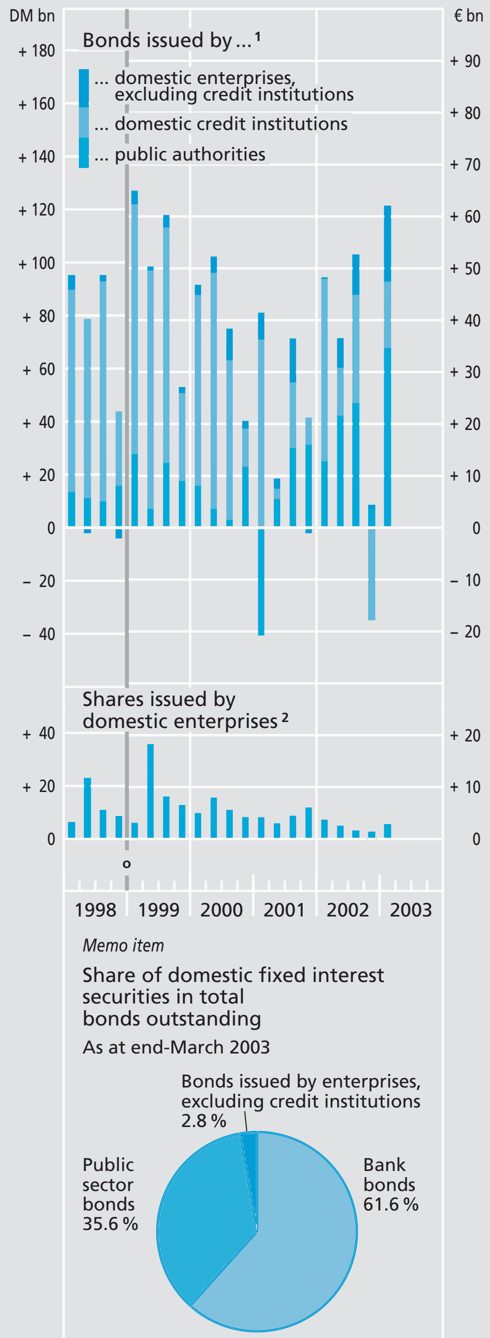
Buoyant issuance of corporate bonds

Sales of corporate bonds achieved a new record high of €15 billion between January and March. Roughly half of these funds were raised as part of commercial paper programmes. All in all, just under one-quarter of new borrowing in the German bond market was accounted for by debt securities issued by non-financial enterprises. Despite very high growth rates – their volume outstanding was more than two-thirds up on the previous year – their share in the volume outstanding of all domestic debt securities (2.8%) nevertheless remains very small. While paper issued abroad by German enterprises also needs to be added, no precise figures on its volume are available.

Weak borrowing in the equity market

Although issuing activity in the German equity market in the first three months of 2003, at €3 billion (market value), was double that of the previous quarter, it was well below the figures for the bullish period at the end of the 1990s. Most of the volume of issues was accounted for by unlisted shares (€2 billion).

Net borrowing in the German capital markets



1 At market prices less redemptions and changes in issuers' holdings of their own bonds; including money market paper. — 2 Sales at market prices. — o From 1999, in euro.

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Investment activity in the German securities markets

€ bn

Item	2002 Oct to Dec	2003 Jan to Mar	2002 Jan to Mar
Bonds and notes 1			
Residents	– 4.7	32.7	47.5
Credit institutions 2	– 19.7	20.0	22.3
of which			
Foreign bonds and notes 3	– 7.0	2.7	9.1
Non-banks 4	15.0	12.7	25.1
of which			
Domestic bonds and notes	3.4	9.4	14.4
Non-residents 3	– 4.2	35.4	20.7
Shares			
Residents	5.7	– 3.9	10.7
Credit institutions 2	0.0	– 6.2	– 8.6
of which			
Domestic shares	– 1.3	– 3.5	– 5.4
Non-banks 4	5.6	2.2	19.3
of which			
Domestic shares	– 1.0	8.9	1.1
Non-residents 3	3.7	– 2.5	8.0
Mutual fund shares			
Investment in specialised funds	23.2	21.4	5.0
Investment in funds open to the general public	3.2	11.1	13.7
of which: Share-based funds	1.4	– 0.8	1.0

1 From the start of 2000, including debt securities with maturities of up to one year issued by non-banks and commercial paper. — **2** Book values, statistically adjusted. — **3** Transaction values. — **4** Residual.

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Investment activity in the securities markets

Bond purchases

Foreign investors were the principal purchasers in the German bond market in the first quarter of 2003. They expanded their portfolios of German debt securities by €35 billion. Their demand for private sector bonds (€19 billion) and for public sector bonds (€16 billion) was broadly similar. Domestic credit institutions purchased €20 billion worth of fixed interest securities. Their main interest was in public sector paper (€21 billion). By contrast, purchases of foreign bonds and sales of private sector bonds were, at around €3 billion, roughly in balance. Domestic non-banks, however, showed greater preference for private sector issues (€12 billion). They also bought €3 billion worth of foreign bonds and notes, while reducing their holdings of domestic public sector bonds by €2 billion.

Share purchases

In the equity market, only domestic non-banks increased their holdings of German equities (€9 billion). By contrast, they sold €7 billion worth of foreign equities. The credit institutions shed both domestic (-€4 billion) and foreign (-€3 billion) paper. Foreign investors reduced their portfolios of German shares by €2 billion.

Mutual fund shares

Sales of mutual fund shares picked up again in the first quarter of 2003. Domestic funds sold more shares (€32 billion) than in the previous three months, when sales had been quite strong in any case (€26 billion). The increase was solely in mutual funds open to the general public, which sold €11 billion worth of shares. By contrast, somewhat fewer resources (€21 billion) than in the previous quarter accrued to specialised funds, which are tailored to the requirements of institutional investors. Foreign funds (€2 billion) played a minor role.

Private investors continued to focus on open-end real estate funds (€7 billion), which are considered particularly safe; their next preference was for money market funds (€4 billion). By contrast, share-based funds, whose inflow of resources tends to be used as a yardstick by which to assess the situation on the stock exchanges, recorded outflows amounting to €1 billion. However, it should be noted that the data on the sale of mutual fund shares cover only the first quarter of the year and therefore reflect the reversal of sentiment in the equity market from mid-March to a limited extent only.

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

Sharp increase in overnight deposits

With regard to the deposit business of German MFIs with resident customers, in the first quarter of 2003 investment was mainly in the liquid types of deposits, thus showing a continuation of the trend already observed last year. In addition to the high level of uncertainty among investors, the currently low opportunity costs of short-term bank deposits are likely to have encouraged liquidity-holding. Consequently, in seasonally adjusted terms, the predominant expansion from January to March was in overnight deposits. In the period under review, they were stepped up extremely sharply, at a seasonally adjusted annualised year-on-year rate of 21½%. Individuals, in particular, increased their overnight deposits in the first quarter far more strongly than in previous years. Moreover, the usual seasonal decrease in sight deposits held by enterprises was weaker in the period under review than in previous years; this was due to the clear increase in holdings of overnight deposits by financial enterprises.

Heavy investment in short-term savings deposits, too, …

In seasonally adjusted terms, deposits with an agreed period of notice of three months also showed a sharp increase between January and March. There were probably further marked shifts away from short-term time deposits (with an agreed maturity of up to two years), these having undergone a marked reduction in the first quarter of 2003. Given the, at present, comparatively minor interest rate advantage of short-term time deposits over savings deposits with a three-month period of notice, individuals, insurance companies and other financial institutions reduced their short-term time deposits.

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

€ billion

Item	2003 Jan to Mar	2002 Jan to Mar
Deposits of domestic non-MFIs 1		
Overnight	+ 3.9	– 17.1
With agreed maturities		
up to 2 years	– 13.8	– 12.3
over 2 years	+ 3.4	+ 7.3
At agreed notice 2		
up to 3 months	+ 8.8	+ 1.9
over 3 months	– 4.7	– 5.7
Lending		
To domestic enterprises and resident individuals		
Unsecuritised	+ 2.1	– 6.0
Securitised	– 1.3	– 12.3
To domestic public authorities		
Unsecuritised	– 4.4	– 4.4
Securitised	+ 20.5	+ 3.5

* 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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… but with further reduction in short-term time deposits

Overall decrease in longer-term bank deposits

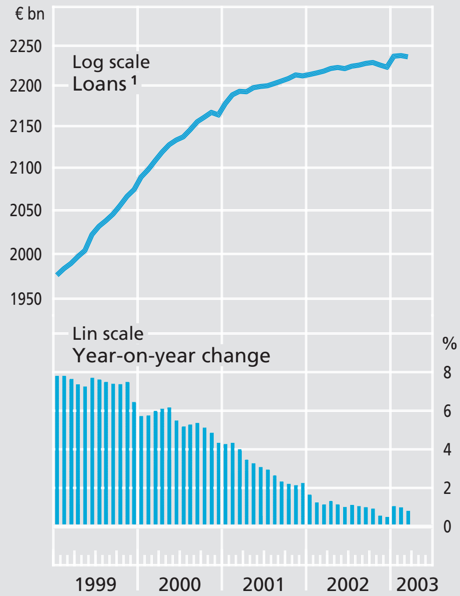
In seasonally adjusted terms, longer-term bank deposits were reduced on balance in the period under review. In particular, there was a decrease in holdings of savings deposits with an agreed period of notice of more than three months, while there was a moderate expansion in longer-term time deposits in the quarter under review. It was mainly German insurance companies, traditionally the dominant group of investors in this type of deposits, which formed longer-term time deposits in the first quarter of 2003.

Lending to the private sector

Seasonally adjusted lending by German MFIs to the domestic private sector fell slightly in

Loans to domestic enterprises and resident individuals

Seasonally adjusted



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

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the first three months of the year. In seasonally adjusted terms, however, the only reduction was in securitised lending by domestic banks to German enterprises. By contrast, there was a perceptible increase in loans to the domestic private sector; growth in this area had been very weak for some time and there was even a reduction in such loans towards the end of last year. In particular, there was a marked increase in medium to long-term loans. Unsecuritised short-term lending, however, showed little increase.

Lending by borrower

According to the borrowers statistics, in the first quarter of the year additional loans granted by German banks were, on balance, mainly for housing construction. In particular, the increase in medium to long-term housing loans was perceptibly stronger than in the two preceding quarters. This was possibly due to the lower interest rates for mortgage loans, which, in average quarterly terms, were up to ½ percentage point lower than in the previous quarter, depending on the interest-rate lock-in period. While consumer lending likewise increased somewhat more strongly than in the final quarter of 2002, growth in loans and advances to the domestic corporate sector continued to be weak. Ultimately, only the financial institutions and insurance companies expanded their borrowing to any sizeable extent. This contrasted with a decrease in lending to the other economic sectors. In particular, manufacturing made further perceptible reductions in its debt, but more strongly consumer-oriented sectors such as trade and services also paid off their debt on balance. In addition to the slow pace of economic growth in Germany, this is likely to be due to greater restraint in lending on the part of the banks.

Lending to public authorities

Lending by domestic MFIs to the German public sector went up by €16.1 billion in the first quarter; in the same period of 2002 it had declined by €0.9 billion. On balance, this was the outcome solely of investment in securities issued by the public sector, with domestic MFIs increasing their holdings of such securities by €20.5 billion in the first quarter. By contrast, German banks' unsecuritised lending to the domestic public sector was reduced.