The financial markets in Germany

Capital market and bank interest rates

Capital market rates climb sharply from previous low

In line with euro-area yields, German capital market rates first fell sharply during the period under review and then made a marked recovery. As in the other euro-area member states, the decline and successive rise in interest rates were not as sharp as in the United States. In mid-August, at just under 4.2%, the yield on ten-year Federal bonds was slightly up on early April, after having been ¾ percentage point below that level in mid-June. Compared with the average rate of other European government bonds, the interest rate discount on these bonds declined by a few basis points in early July and has since largely been below 1⁄10 percentage point. Given the tense budgetary situation in the public sector, the narrowing of the "yield advantage" of Federal bonds may also be related to the debate about how to counter-finance the early introduction of the third stage of the tax reform. The benchmark function of Federal bonds in the euro-area bond market is, however, unlikely to be contested. Given 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 still have a key role to play.

Low interest rate premium on bank bonds

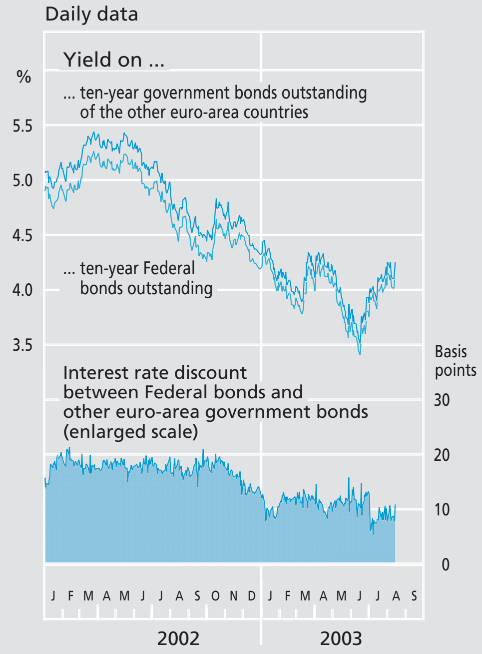
Probably first and foremost for the above-mentioned reasons relating to the precarious government budgetary situation, in the first half of July Federal bonds also lost something of their preferred status compared with debt securities issued by domestic credit institutions. However, the yields on these bank bonds increased sharply in the second half of

July, with the result that the interest rate premium on ten-year bank bonds over comparable government paper again rose by a few basis points at the end of the period under review and, at just under ¼ percentage point, reached roughly the level at the start of the second quarter. However, it was still moving well below the values observed in the second half of 2002.

Distinct decline in bank rates on deposits and longer-term loans

Paralleling the decline in capital market rates which continued until June, banks' lending and deposit rates also decreased in May and June and in some cases fell sharply.[1] In particular, there was a marked decrease in the terms for longer-term loans and deposits in this period: mortgage loans with interest rates locked in for ten years became cheaper between April and June, the rates charged on them falling by ½ percentage point to 4.8%. The decline in long-term fixed interest loans to enterprises was somewhat less marked at 0.4 percentage point. Depending on the amount of the loan, interest rates varied between 5.3% and 5.5%. Among longer-term deposits, it was mainly the rates of interest paid on savings bonds and savings deposits with interest rates locked in for correspondingly long periods which fell. In June they were between 0.3 and ½ percentage point down on April. However, against the backdrop of a ½ percentage point reduction in the key interest rate in early June, banks' short-term deposit rates also decreased considerably. Depending on the amount of the deposit, the interest paid on one-month time deposits, for instance, was between ⅓ and just under ½ percentage point down on April to between 1.4% and 1.9%.

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



Deutsche Bundesbank

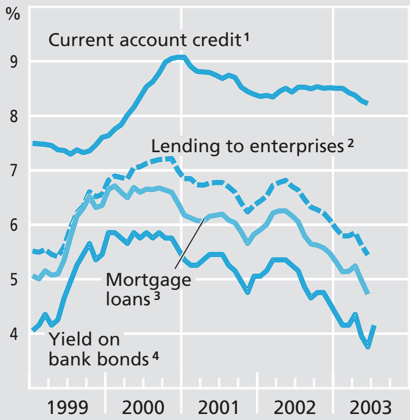
Slow adjustment of interest rates on short-term loans

Only specific interest rates on short-term or floating rate loans, however, showed a distinct decline. For instance, bills discounted and variable rate mortgage loans, both of which are well-collateralised, fell by 26 and 19 basis points respectively. Depending on the sum concerned, current account credit rates fell by between 12 and 15 basis points. By contrast, after adjusting by a few basis points, the terms on instalment credit and personal credit lines remained virtually unchanged. The delay in interest rate adjustments probably reflects the banks' efforts to adjust lending margins to take account of

1 The Deutsche Bundesbank collected statistics on lending and deposit rates for the last time in reporting month June 2003. These statistics are being replaced by euro-area interest rate statistics, which have been collected on a harmonised basis in the euro area since January 2003; the results are scheduled to be published for the first time in the September 2003 *Monthly Report*.

Bank interest rates
in Germany *

Monthly averages



* Owing to the discontinuation of the previous interest rate statistics, the lending rates shown in this chart end with the June figures. — **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.

Deutsche Bundesbank

higher default risks. Endeavours to further widen risk-differentiated margins were also apparent from the results of the quarterly survey on bank lending (see box entitled Bank Lending Survey on pages 28-29).

Share prices

Strong share price gains

German equity market prices rose sharply during the period under review. From April to mid-August German equity prices measured on the broad index for German equities (CDAX) went up by more than one-third. This increase far outstripped that of other European equities. Prices rose in two stages. The upward movement in April was followed by a moderate slide which lasted until the end of May, before a period of rising prices set in again. Whereas the prices of other European shares moved sideways from mid-June onwards, German equity prices continued to rise. When viewing this positive evolution of German share prices, it should, first, be borne in mind that the previous declines had been sharper in Germany. Second, estimated year-on-year profit expectations evolved more favourably for German blue chips in the period under review than for the other listed enterprises in the euro area. The positive signals which probably came from the progressive brightening of some sentiment indicators in Germany produced a similar directional response.

Borrowing in the securities markets

Bond sales

The amount of funds raised in the German bond market contracted in the second quarter of 2003. Calculated at market prices, gross sales of debt securities issued by domestic borrowers amounted to €275½ billion, compared with €316 billion in the previous quarter. After adjusting for redemptions and changes in issuers' holdings of their own shares, net sales came to €27½ billion, slightly less than half the figure for the previous quarter (€62 billion). At €19½ billion, sales of German bonds were more than three times as high as in the first quarter (€6 billion).

Almost two-thirds of the funds raised from the sale of domestic fixed interest securities accrued to the public sector, which raised €17 billion in the bond market. The Federal Government added €18 billion to its bonded debt in the second quarter, issuing primarily five-year Federal notes (Bobls) and ten-year Federal bonds (Bunds). The *Land* governments raised €11 billion in the bond market, slightly less than in the previous quarter (€13 billion). Two bonds issued by the former Treuhand agency were redeemed for €5 billion each. The latter borrower no longer issues paper on the bond market but acquires refinancing in conjunction with the Federal Government.

Issuance of corporate bonds

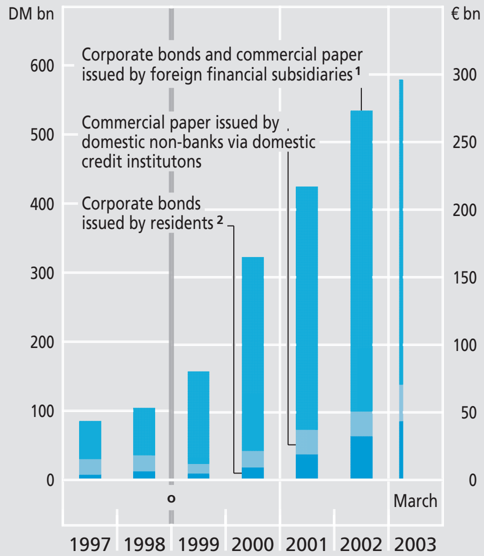
German enterprises again raised larger amounts of resources in the capital market in the second quarter of 2003. Overall, domestic corporate bonds were sold for €7 billion net and commercial paper issued by domestic non-banks for €½ billion net. The very low level of interest rates and the narrow yield spreads for corporate bonds are likely to have had a favourable impact. In addition to issuing domestic debt securities – amounting, on balance, to €22½ billion in the first half of 2003 – for refinancing purposes German industrial enterprises continued to use bonds issued in the international capital market by their foreign financial subsidiaries. At the end of March 2003, the last date for which figures are currently available, €225 billion worth of such bonds were outstanding, ie more than three times the amount of domestic corporate debt securities in circulation (see adjacent chart). German enterprises raise large amounts of funds in the international capital market via foreign subsidiaries primarily because of tax advantages.

Sales of bank bonds sluggish

Credit institutions raised considerably less (€2½ billion) than in the first quarter (€13 billion). As in the previous quarter, this can be explained by the German banks' limited need for refinancing as a result of weak lending. Despite the marked slump compared with the first quarter (€18½ billion), debt securities issued by specialised credit institutions, with net sales of €5 billion, again led the field, followed by mortgage Pfandbriefe with €4 billion. By contrast, the volume of other bank bonds outstanding fell by €6½ billion.

Securitised liabilities of German enterprises

Outstanding at year-end



1 Source: BIS. — **2** Excluding corporate bonds which are placed directly and reserved for the issuer's employees. — **o** From 1999, data in euro.

Deutsche Bundesbank

Funds raised in the equity market

As stock market prices rose, there was a sharp increase in issuing activity in the German equity market in the second quarter. Between April and June, domestic enterprises placed €5½ billion of new shares at market values, nearly twice as much as in the preceding quarter. In contrast to the preceding period, listed equities accounted for most of the issue volume.

Investment activity in the German securities markets

€ billion

Item	2003 Jan to Mar	2003 Apr to June	2002 Apr to June
Bonds and notes 1			
Residents	34.1	21.5	23.7
Credit institutions 2	20.0	3.2	15.9
of which Foreign bonds and notes 3	2.7	10.1	9.7
Non-banks 4	14.1	18.3	7.9
of which Domestic bonds and notes	10.8	9.0	– 3.1
Non-residents 3	34.0	25.2	31.9
Shares			
Residents	– 3.7	6.0	10.1
Credit institutions 2	– 6.2	5.5	– 9.1
of which Domestic shares	– 3.5	0.2	– 3.4
Non-banks 4	2.5	0.6	19.3
of which Domestic shares	8.9	2.9	– 4.2
Non-residents 3	– 2.5	2.5	10.1
Mutual fund shares			
Investment in specialised funds	7.9	6.8	11.1
Investment in funds open to the general public	10.9	7.0	4.6
of which: Share-based funds	– 0.8	2.0	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.

Deutsche Bundesbank

Investment activity in the securities markets

Bond purchases

Foreign investors were the main purchasers in the bond market, acquiring €25 billion worth of domestic debt securities. They added mainly government debt securities to their portfolios (€17 billion). Nonetheless, their purchases were well down on the first quarter (€34 billion). Investment by domestic non-banks was also on the decline; following €11 billion in the first quarter, they invested €9 billion worth of funds in domestic debt securities, most of which were issued by the public sector. By contrast, the credit institutions trimmed their domestic bond portfolio by €7 billion, having added €17½ billion in the previous quarter.

Share purchases

In the second quarter the main purchasers of German equities were domestic non-banks. They invested €3 billion in the German equity market, following €9 billion between January and March. On balance, foreign investors acquired €2½ billion of domestic shares. Domestic credit institutions barely featured in the equity market in the period under review.

Mutual fund shares

Sales of domestic and foreign mutual fund shares went down to €14 billion in the second quarter, compared with €22 billion in the first three months of the year. Virtually all the inflows accrued to domestic investment companies. Domestic funds open to the general public and specialised funds, which manage institutional customers' investment, each issued €7 billion net worth of fund shares in the second quarter. With regard to funds open to the general public, investors continued to focus on open-end real estate funds. These sold €5½ billion worth of shares, following €7 billion in the previous quarter. In line with the positive developments on the stock market, share-based funds recorded inflows of €2 billion in the second quarter, after €1 billion worth of shares had been redeemed in the previous three-month period. By contrast, the volume of money market funds outstanding shrank by €1½ billion (see chart on page 27).

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

As part of the deposit business of German MFIs with domestic customers, overnight

Further sharp increase in overnight deposits

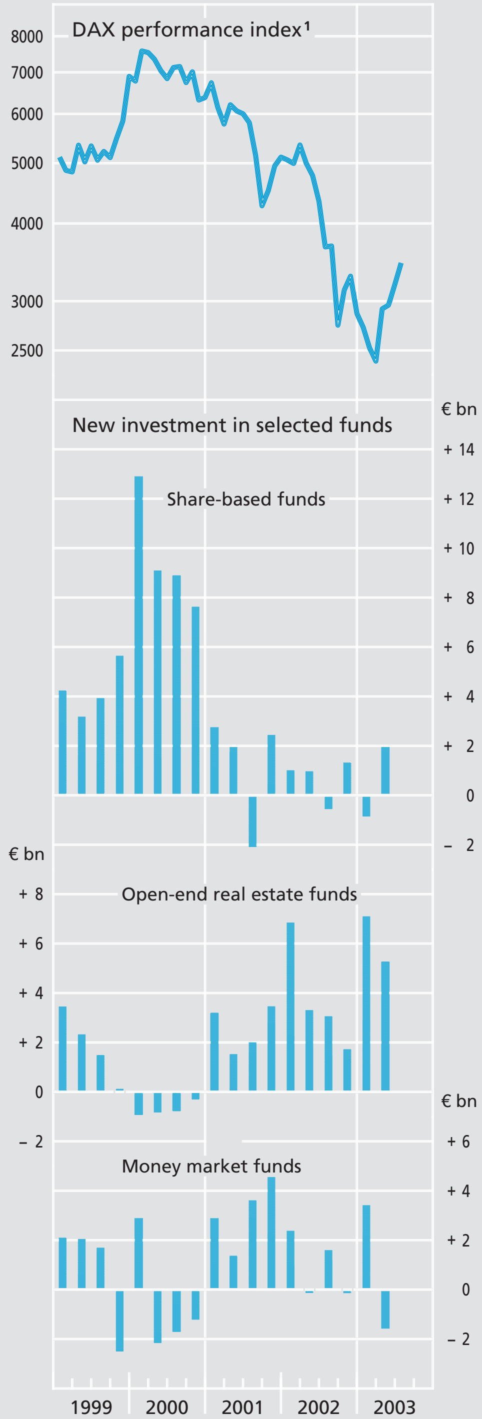
deposits again increased sharply in the second quarter of 2003, at a seasonally adjusted annualised rate of 15½%. However, the pace of the growth slowed somewhat compared with the first quarter, when annualised sight deposits had increased by just under 21%. In the period under review, non-financial enterprises and other financial institutions, in particular, expanded their overnight deposits more strongly in the period from April to June than is usual at that time of year. Given the subdued economic outlook and the persistently high degree of uncertainty in the financial markets, especially with regard to bond market price movements, these enterprises appear to consider it more appropriate to "park" their inflowing funds temporarily in overnight deposits rather than to invest them. The low interest rates certainly favoured that decision.

Sharp increase in short-term savings deposits, too…

Deposits with an agreed period of notice of three months again benefited from the interest rate situation. In seasonally adjusted terms, they were built up again distinctly in the second quarter. As in the previous quarter, the increase not only affected high-interest special savings facilities, which have been increasingly favoured since mid-2001, ie shortly after the start of the interest-lowering period in this market segment, but also savings deposits with a comparatively low minimum or basic rate of interest. In the period under review the decrease in deposits with an agreed maturity of up to two years is also likely to have contributed to the increase in short-term savings deposits. All in all, however, there was only a slight reduction in short-term time deposits between April and

… while only slight reduction in short-term time deposits

Share prices and selected fund investment



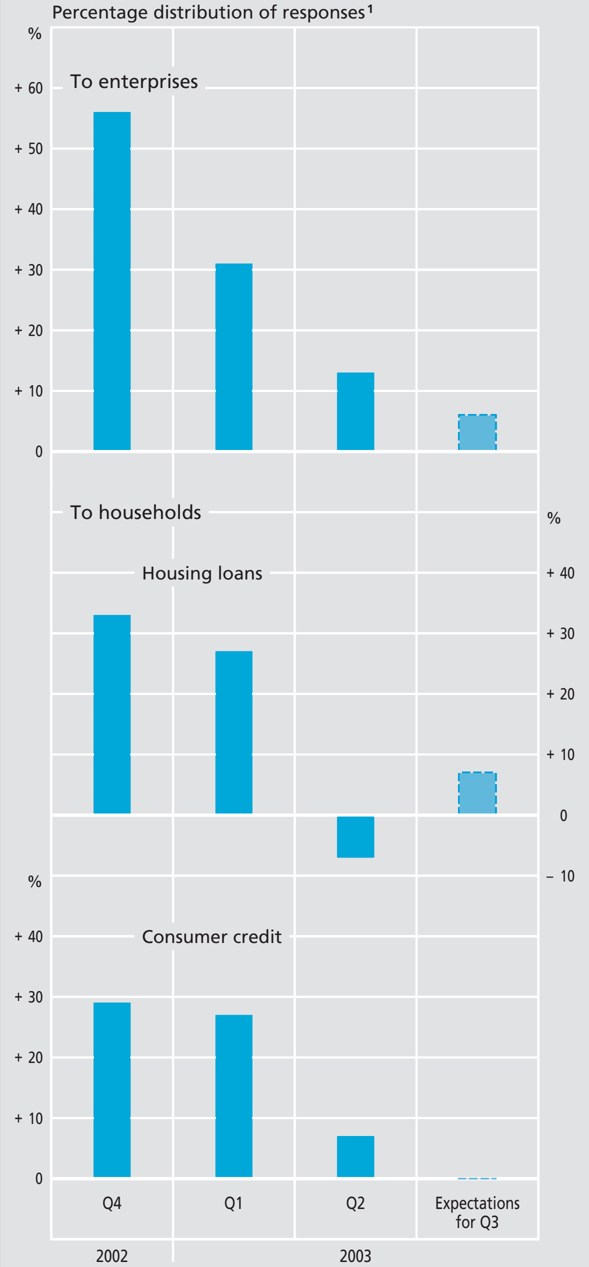
1 End of month; end-1987 = 1000. Source: Deutsche Börse AG.

Deutsche Bundesbank

Bank Lending Survey
Less stringent tightening of the credit standards

Changes in the credit standards applied to the approval of loans or credit lines

Percentage distribution of responses[1]



The results of the third Eurosystem Bank Lending Survey[2] published in July 2003 indicate that in the second quarter of 2003 there was a further slight tightening of the surveyed institutions' credit standards applied to loans or credit lines to enterprises in Germany. This tightening was again less stringent than in the previous quarter. This time small and medium-sized enterprises tended to be hit harder by the tightening, whereas the credit standards applied to lending to large enterprises had been the main target for tightening in the previous quarter. As the main overall reason for the tightening, the credit institutions pointed essentially to further estimations of higher risk; these were particularly related to the general economic outlook and sector-specific or firm-specific factors but also to the intrinsic value of collateral. Although market rates were declining, the data supplied by the survey respondents suggest that the tightening of the credit standards also reflected the fact that the refinancing terms in the money or bond markets were still slightly more restrictive. By contrast, credit standards applied to housing loans and household consumer credit remained virtually unchanged in the second quarter of 2003. The institutions do not expect any fundamental changes to their credit standards for enterprises or households in the third quarter of 2003 (see adjacent chart).

Despite the virtually negligeable change in credit standards, the respondent banks indicated that there had been a further widening of margins, especially for riskier loans. As far as corporate lending is concerned, the tightening also continued to be reflected, albeit to a lesser extent, in more restrictive loan covenants, volume reductions and stricter collateral requirements (see chart on page 29).

1 Difference between the sum of the percentages for "tightened considerably" and "tightened somewhat" and the sum of the percentages for "eased somewhat" and "eased considerably". — **2** See Deutsche Bundesbank, German results of euro-area bank

Deutsche Bundesbank

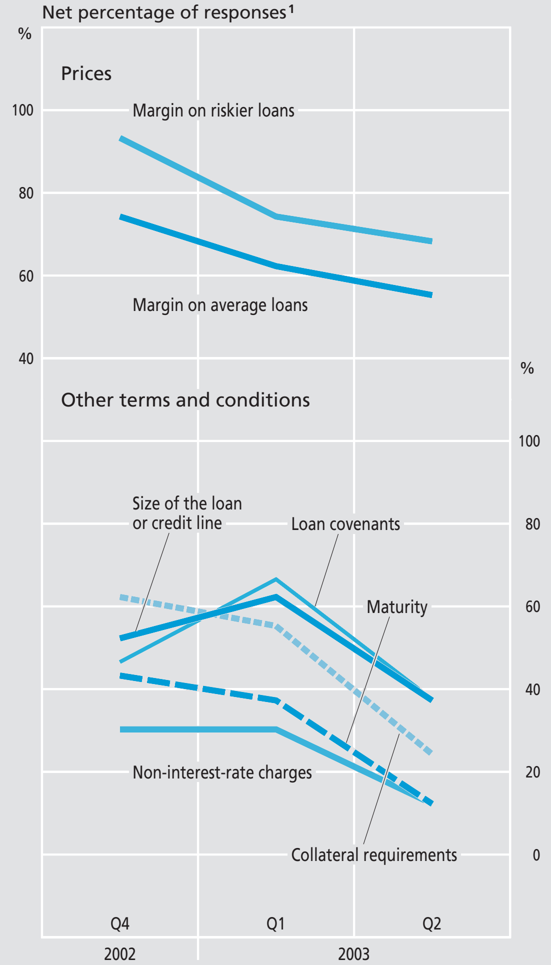
According to the survey, there was a further slight decrease in the demand for corporate credit, while for housing loans and household consumer credit the tendency was slightly upward. The banks' responses indicated that the shrinking demand for corporate loans was mainly affecting long-term loans. The main factor here was that less financing was needed for fixed investment, inventories and working capital; by contrast, positive demand effects came from debt restructuring, for example. With regard to lending to households, lower interest rates were the main positive factor affecting housing loans while weak consumer confidence continued to have a dampening effect. The institutions taking part in the survey expect little change in the overall demand for corporate credit in the third quarter; they anticipate a further slight decline in the demand from large enterprises only. Among households it is therefore assumed that demand for housing loans and consumer credit will remain more or less unchanged.

Taken together, these results show that German banks have continuously relaxed the tightening of credit standards over the past three quarters (see chart on page 28). This is true of both corporate lending and lending to households. By contrast, there is still a trend towards a persistent risk-differentiated widening of margins in the areas of credit business covered here. Even though the survey results can only provide data on the changes in the degree of restriction, a further easing of the overall situation regarding credit supply and demand can be expected in the third quarter of 2003.

In the second quarter of 2003 Germany's results were again below the aggregate figure for the euro area mainly in respect of tightening in the field of corporate lending. In Germany, however, there was a more frequent additional widening of margins in lending to households; in particular, the estimations of consumer credit risk were slightly up on the euro area. Overall, however, the German results broadly matched the aggregate results for the euro area.[3]

Changes in the credit terms and conditions applied to enterprises over the past three months

Net percentage of responses[1]



lending survey, *Monthly Report*, June 2003, pp 67-76. — **3** See European Central Bank, The results of the July 2003 bank lending survey for the euro area, *Monthly Bulletin*, August 2003, pp 10-12.

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

€ billion

Item	2003 Apr to June	2002 Apr to June
Deposits of domestic non-MFIs 1		
Overnight	+ 30.2	+ 28.1
With agreed maturities		
up to 2 years	– 5.9	+ 0.6
over 2 years	– 2.5	+ 0.8
At agreed notice 2		
up to 3 months	+ 2.8	– 8.7
over 3 months	– 5.4	– 3.2
Lending		
To domestic enterprises and resident individuals		
Unsecuritised	+ 4.6	+ 3.6
Securitised	+ 3.3	– 3.6
To domestic government		
Unsecuritised	– 9.4	– 14.2
Securitised	– 5.8	+ 9.4

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

Deutsche Bundesbank

June as, in addition to the other financial institutions, insurance companies added perceptibly to their short-term time deposits at German banks.

Marked reduction of longer-term bank deposits

In seasonally adjusted terms, however, longer-term bank deposits were reduced markedly in the period under review. In particular, the trend decline in savings deposits with an agreed period of notice of more than three months continued and gained momentum. In contrast to the previous quarters, between April and June deposits with an agreed maturity of more than two years were also reduced. It was primarily the insurance companies which allowed their longer-term time deposits to dwindle; with a share of around 60%, they represented the bulk of these deposits.

Lending to the private sector

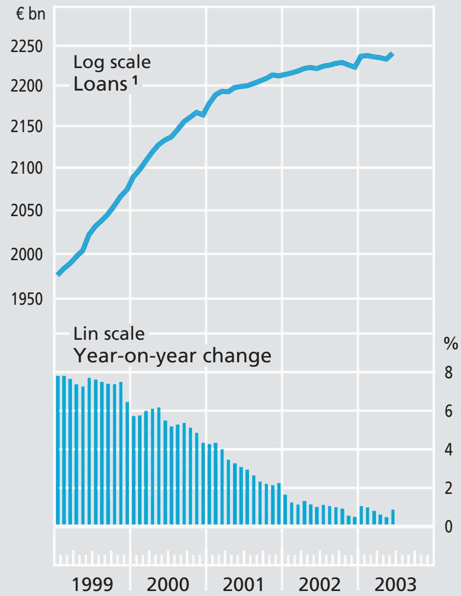
In seasonally adjusted terms, there was a moderate increase in loans by German MFIs to the domestic private sector between April and June. The low overall dynamism is probably still due primarily to the cyclically induced weak demand for credit. The results of the third Bank Lending Survey, however, also indicate that the banks tightened their terms of lending again slightly in the second quarter, albeit less than previously (see box entitled Bank Lending Survey on pages 28-29). This may have affected short-term loans to domestic enterprises in particular, as these were trimmed back in the period under review. By contrast, medium to long-term unsecuritised lending to the German private sector was expanded fairly strongly. In seasonally adjusted terms, domestic MFIs also increased their securitised lending to German enterprises. On balance, they added only shares and other equities to their portfolios, having reduced such holdings in the previous quarter.

Lending, by borrower

As the borrowers statistics show, on balance German banks granted only additional housing loans in the second quarter. As in the two previous quarters, this meant that medium and long-term housing loans increased perceptibly. This is likely to have been primarily due to the further clear reduction in mortgage rates between April and June. While consumer credit stagnated in the quarter under review, loans granted by German banks to domestic enterprises declined perceptibly. In particular, further net credit redemptions were made by the trade sector, manufacturing and construction, this pattern having been observed for nine quarters. However, on balance the services sector, financial institutions and insurance companies also decreased their lending at the end of the period under review, having expanded it between January and March, in some cases distinctly. By contrast, lending to transport and communications enterprises was expanded somewhat. However, the perceptible overall decline in lending by German banks to the domestic enterprise sector needs to be seen as closely bound up with the weak domestic economy. Although the banks also tightened their credit standards slightly in the second quarter, they did so to a far lesser extent than in the preceding quarters.

Loans to domestic enterprises and resident individuals

Seasonally adjusted



1 End of month; adjusted for statistical changes.

Deutsche Bundesbank

Lending to the public sector

Lending by domestic MFIs to the German public sector went down by €15.1 billion in the first quarter, after having increased by a similar amount in the previous quarter (€16.1 billion). In addition to unsecuritised lending by German banks to the domestic public sector (down by €9.4 billion), the banks also reduced their investment in government securities in the period under review (by €5.8 billion).