

## Financial markets

### Financial market trends

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In the third quarter, events in the international financial markets were determined by factors which in some cases had mutually opposing effects. While the occasional cyclical scepticism which had emerged in the wake of high energy prices gave way to more positive expectations, inflationary risks increased significantly. Against this background, capital market rates rose from their temporary lows in the euro area and the United States, where market players had factored in a further tightening on the monetary policy side. In the period under review, the increase in the US interest rate spread was partly offset by reports on improved cyclical prospects in the euro area which supported the euro-dollar exchange rate, with the result that exchange rate movements in the currency markets were fairly moderate. It was not until November that the euro depreciated significantly against the US dollar. The generally benign environment in the European stock markets is likely to have buoyed foreign portfolio investment in the euro area. In the third quarter of 2005, net capital imports arising from German cross-border portfolio investment also increased, rising to €8 billion compared with €30½ billion in the previous quarter.

*Financial  
market  
environment*

### Exchange rates

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Against the backdrop of sharp increases in yields, events in the foreign exchange markets for much of the past few months have

*Euro exchange  
rate  
movements  
against the  
US dollar...*

been comparatively quiet.<sup>1</sup> The euro-US dollar exchange rate remained largely in a range of between US\$1.20 and US\$1.25 until the end of October. A spate of fairly positive economic indicators on the euro area and considerations on the part of several central banks to shift their reserve assets in favour of the euro initially boosted the euro, keeping it close to the ceiling of the exchange rate corridor. Moreover, the warning issued by the International Monetary Fund about the impact of a likely further rise in the US current account deficit and the economic effects of the hurricanes in the United States probably detrimentally affected the dollar. Uncertainty loomed in the markets for a time as to whether the US Federal Reserve would actually adhere to its policy of moderate interest rate increases in the light of these extraordinary pressures.

Following a clear statement by the Fed that it would react appropriately to existing inflationary risks, the mood in the markets again swayed in favour of the US dollar, especially as the US central bank raised the Federal Funds target rate at the end of September and in early November by an expected ¼ percentage point in each case. Furthermore, the robust economic performance in the USA and large capital inflows from abroad bolstered the US currency. Since mid-November, the euro-US dollar exchange rate fell for a time to its lowest level in two years. As this article went to press, €1 equalled US\$1.17, or around 14% below the level recorded at year-end 2004 and also lower than the level at the start of monetary union.<sup>2</sup>

Towards the end of the third quarter and in the fourth quarter of 2005, the exchange rate fluctuations of the euro against the pound sterling were less pronounced than they were against the US dollar. Once the Bank of England had reduced the central bank rate to 4½% in early August and further interest rate reductions appeared unlikely for the time being owing to rising inflation rates, the British currency initially recovered somewhat. In the ensuing period the euro-pound exchange rate displayed slight fluctuations but no readily apparent trend. As this article went to press, the pound was trading at £0.68 to the euro, which was around 4% lower than at the start of the year.

*... the pound sterling ...*

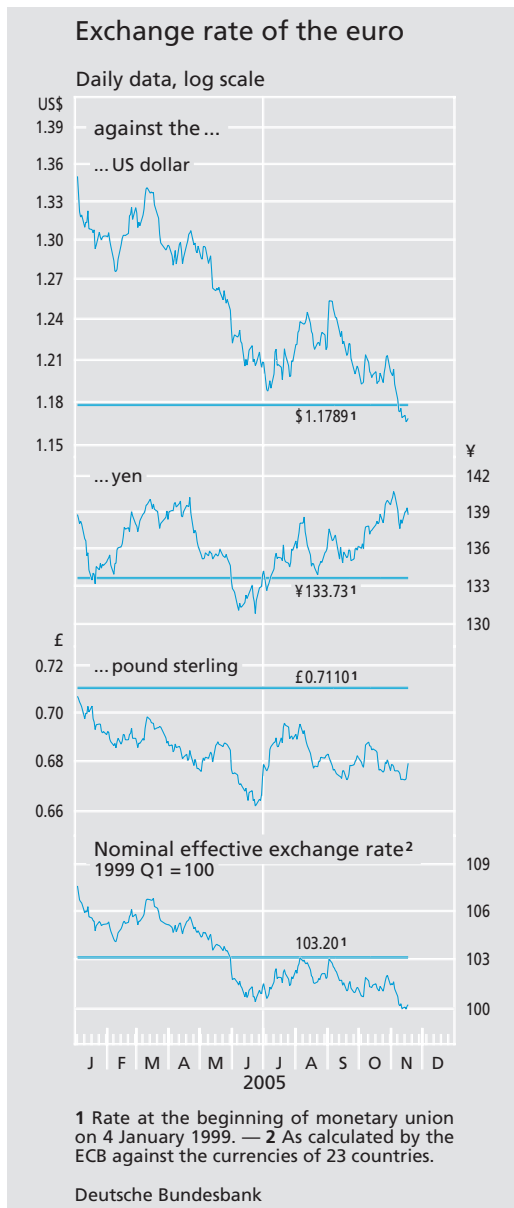
Despite Japan's improved economic outlook and the lively foreign demand for Japanese stocks, the euro has tended to strengthen perceptibly vis-à-vis the yen in the past few weeks. This is likely to have been determined mainly by the fact that Japanese bond yields did not entirely follow the rise in rates on US bonds and the fact that the yield differential on comparable European and US debt secur-

*... and the yen*

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1 As this Monthly Report went to press, the implied volatility of the euro-dollar exchange rate, at 9%, remained at a generally low level. This was also the case as regards the volatility of the euro against the yen (somewhat over 7%).

2 To what extent the Homeland Investment Act has helped bolster the US dollar so far this year can hardly be estimated reliably. The Act, which came into force in the fourth quarter of 2004, offers US companies a one-time tax break if they invest their profits made abroad in 2004 and 2005 in the US economy. According to estimates by the American Shareholders Association, companies have already exercised this rule to the amount of more than US\$200 billion. However, it is difficult to derive exact figures from the official statistics; see R M Sauer, K K Pierce, US International Transactions, First Quarter 2005, BEA, Survey of Current Business, July 2005, p 78 and K K Pierce and M J Argersinger, US International Transactions, Second Quarter 2005, BEA, Survey of Current Business, October 2005, p 84.



ities widened noticeably as a result. Consequently, the yen depreciated vis-à-vis the major currencies. In early November, the euro was trading at almost ¥141 and therefore nearly at the peak rate of late 2004. As this article went to press, the euro was trading only slightly lower at just under ¥139.

Effective euro exchange rate

On average, the euro weakened slightly vis-à-vis the currencies of 23 major trading part-

ners in the period under review. Hence, as this article went to press, the effective exchange rate stood at around 7% below the level recorded at the start of this year and 3% below the level recorded at the start of monetary union. In real terms, ie taking account of the simultaneously prevailing inflation differentials between the euro area and the major trading partners, the effective euro exchange rate, which is also a measurement of the price competitiveness of companies in the euro area, was fairly close to the level which had been recorded at the start of monetary union.

### Securities markets and portfolio transactions

In the third quarter, the international bond markets were influenced mainly by high oil prices, which at first were primarily perceived to be slowing down the global economy. As a result, the yield on ten-year Bunds outstanding fell, in line with the worldwide decline in bond yields, to below 3% by the end of September, thereby reaching a historical low. With hardly any changes in long-term inflationary expectations,<sup>3</sup> the corresponding German and European real rates of interest fell to 1½% and 1¼% respectively. However, following reports of higher inflation rates in the euro area and, particularly in the USA, the relevant central banks' publicly announced inflationary concerns and the robust economic expectations for the global economy increasingly focused bond market players' attention

Low bond market yields

<sup>3</sup> According to surveys by Consensus Economics.

on the risks to monetary stability arising from the increase in energy prices. Given the simultaneous upward interest rate pressure in the USA, German bond yields subsequently rose by around 50 basis points from their preceding low. With long-term inflationary expectations still virtually unchanged, the real interest rates also increased noticeably.

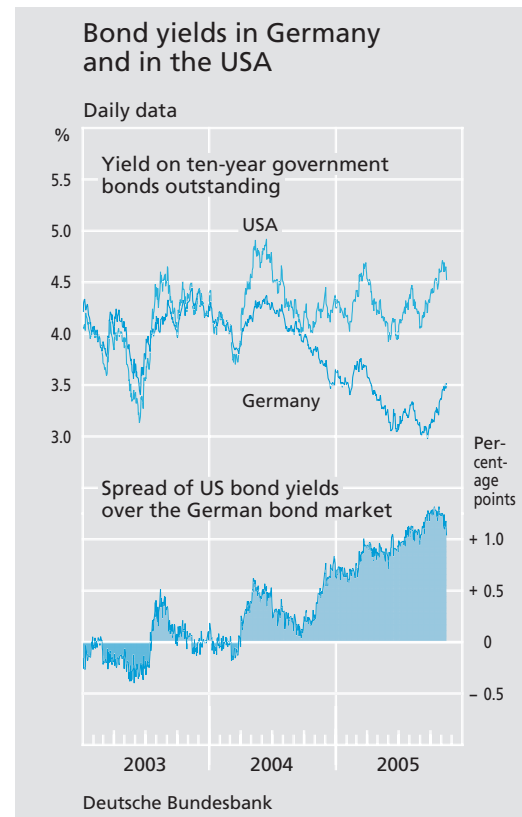
*Interest rate spreads on corporate bonds ...*

Interest rate spreads on BBB-rated corporate bonds, which in the previous quarter had still been suggesting larger default risk premiums and liquidity premiums, remained virtually unchanged in the third quarter despite negative factors such as the high price of oil and a temporary marked increase in implied volatility in the equity market; most stood at around 105 basis points. Hence, together with low capital market rates, the corporate sector continues to enjoy very favourable debt financing conditions. At the same time, rating agencies continued to assess companies' creditworthiness as sound and, as was the case in the two preceding quarters, again carried out more company upgrades than downgrades. For this reason, the slight widening in spreads since October suggests that the willingness on the part of market players to take on risks has waned somewhat of late, apparently in line with global developments in the corporate bond market.<sup>4</sup>

*... suggest smaller appetite for risk in bond markets*

*Markedly lower sales of bonds and notes*

Despite the low interest rate environment, issuance in the German bond market was relatively weak. At €282 billion, gross sales of domestic debt securities were much lower in the July to September period than in the previous quarter (€ 341½ billion). At €16½ billion, net sales were also clearly below the level seen in



the second quarter (€56½ billion). Non-resident issuers also tapped the German market. In the period under review, foreign bonds and notes were sold for €12½ billion; these consisted mainly of paper denominated in pounds sterling and US dollars. As a result, total funds raised through the sale of domestic and foreign bonds amounted to €29 billion compared with €104½ billion in the preceding quarter.

The subdued issuing activity in the German bond market primarily reflects the net redemptions of credit institutions which reduced their bonded debt by €10 billion after

*Credit institutions' net redemptions*

<sup>4</sup> A lower global propensity for risk is indicated by the development of the first common factor in a principal component analysis which included US and European corporate bonds of junk bond and investment grade status.

### Price movements and earnings estimates for European and German public limited companies

Monthly data



<sup>1</sup> January 2002 = 100; source: Deutsche Börse AG. — <sup>2</sup> Based on year-on-year I/B/E/S analyst estimates (earnings before goodwill). Source: Thomson Financial Datastream.

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selling €46 billion net in the previous quarter. On balance, they redeemed public sector Pfandbriefe and mortgage Pfandbriefe totalling €12 billion and €5 billion respectively, while debt securities issued by special-purpose banks and other bank debt securities were sold for €5 billion and €1½ billion respectively.

In contrast to the credit institutions, general government tapped the bond market to a greater extent at €27½ billion net in the period under review than in the previous quarter (€11½ billion). The bulk of these issues (€25½ billion) comprised paper issued by the Federal Government, which, in the light of the favourable interest rate, was active primarily in the longer maturity segment. It issued ten-year Bunds for €22½ billion (net) and 30-year Bunds for €7½ billion (net). At the short end of the market, it placed two-year Federal Treasury notes totalling €1½ billion (net). By contrast, five-year Federal notes were redeemed for €6 billion net. The Land governments sold debt securities worth €3 billion net.

*Public sector borrowing increases slightly*

Non-financial enterprises reduced their bonded debt by €1 billion despite low financing costs. For the second quarter in a row, this involved mainly the redemption of money market paper, although the level of debt in longer-dated securities increased. This generally indicates, as in other cases, that companies have a relatively favourable financial situation.

*Enterprises reduce bond market liabilities*

In the third quarter, foreign investors were the main purchasers in the German bond market,

*Purchases of debt securities*

investing €26 billion. In net terms, their interest focused on paper issued by general government (€17 billion). They also added €9 billion in paper issued by private borrowers to their portfolios. On balance, domestic non-banks topped up their bond market investments by €13½ billion. They increased investments in paper issued by general government and in foreign paper to the detriment of bonds and notes issued by private borrowers. The credit institutions reduced their bond holdings by €10 billion net.

*Robust equity market*

On the whole, the equity markets in Germany and in Europe have been performing well since July, not least as a result of further capital investment by non-residents. The dip in late August was just as quickly corrected as the short bout of weakness in October. In the period under review, US share prices again lagged behind those of European ones, having already performed more poorly in the first half of the year. Measured against the broad market indices CDAX and the Dow Jones EuroStoxx, the prices of German and European shares have risen by 10% and 6% respectively since early July, while the US S&P 500 has grown by a mere 3%. High energy prices and the hurricanes in the Gulf of Mexico had a negative impact on both sides of the Atlantic, resulting in production losses during various stages of petroleum processing. Above and beyond this, the debate over rising inflation rates, particularly in the United States, depressed share prices. Furthermore, the temporary dip in share prices in the European stock market was accompanied by a rise in real capital market rates.<sup>5</sup> This represents a higher discount factor and, conse-

### Investment activity in the German securities markets

€ billion			
Item	2004	2005	
	Q3	Q2	Q3
<b>Debt securities</b>			
Residents	23.8	46.2	3.2
Credit institutions	25.9	26.8	- 10.2
<i>of which</i>			
Foreign debt securities	13.4	26.0	- 0.9
Non-banks	- 2.1	19.4	13.4
<i>of which</i>			
Domestic debt securities	- 17.2	- 2.5	- 0.2
Non-residents	37.7	58.1	25.8
<b>Shares 1</b>			
Residents	- 15.4	- 26.1	- 4.0
Credit institutions	- 7.3	- 4.5	6.0
<i>of which</i>			
Domestic shares	- 3.5	- 6.9	4.5
Non-banks	- 8.1	- 21.6	- 10.0
<i>of which</i>			
Domestic shares	- 2.4	- 18.4	- 9.0
Non-residents	6.7	26.5	8.3
<b>Mutual fund shares</b>			
Investment in specialised funds	- 4.9	6.2	6.3
Investment in funds open to the general public	1.0	3.2	6.2
<i>of which: Share-based funds</i>	- 1.8	- 0.8	1.2

1 Includes shares acquired in the course of direct investment.

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quently, lowers the present value of future earnings and hence tends to lower share prices. However, European share prices have recently been buoyed by upward revisions in analysts' earnings estimates, particularly on a medium-term horizon.<sup>6</sup> Favourable economic indicators and the stable global economic environment also had a positive effect on share prices. Uncertainty about future share price developments again declined markedly whereas between July and October it had still been growing fast.<sup>7</sup>

<sup>5</sup> Measured against the yields of inflation-indexed French government bonds.

<sup>6</sup> I/B/E/S estimates on expected corporate earnings for three to five years included in the Dow Jones EuroStoxx index increased clearly from 9.4% to 10.2% per year.

<sup>7</sup> In terms of the VDAXnew or if calculated as the implicit volatility of options on the Dow Jones EuroStoxx 50 index.

## Major items of the balance of payments

€ billion

Position	2005		
	Q3	Q2	Q3
<b>I Current account 1,2</b>	+ 14.3	+ 23.7	+ 17.6
Foreign trade 1,3	+ 36.4	+ 41.5	+ 41.0
Services 1	- 11.4	- 5.6	- 13.4
Income 1	+ 1.5	- 2.3	+ 1.8
Current transfers 1	- 8.6	- 6.5	- 7.8
<b>II Capital transfers 1,4</b>	+ 0.2	+ 0.1	+ 0.0
<b>III Financial account 1</b> (Net capital exports: -)	- 31.8	- 21.5	- 25.6
1 Direct investment	- 7.3	- 9.4	- 3.1
German investment abroad	- 9.7	- 13.0	- 2.7
Foreign investment in Germany	+ 2.5	+ 3.6	- 0.5
2 Portfolio investment	+ 22.7	+ 30.7	+ 7.9
German investment abroad	- 25.6	- 54.6	- 28.0
Shares	+ 6.0	+ 1.0	- 3.6
Mutual fund shares	- 3.1	- 7.8	- 11.7
Debt securities	- 28.5	- 47.8	- 12.7
Bonds 5	- 21.0	- 45.8	- 8.7
of which:			
euro-denominated bonds	- 20.8	- 41.4	- 2.8
Money market paper	- 7.5	- 2.0	- 4.0
Foreign investment in Germany	+ 48.3	+ 85.3	+ 35.9
Shares	+ 6.6	+ 26.4	+ 8.3
Mutual fund shares	+ 4.0	+ 0.8	+ 1.8
Debt securities	+ 37.7	+ 58.1	+ 25.8
Bonds 5	+ 44.5	+ 58.9	+ 27.1
of which: public bonds	+ 21.2	+ 29.2	+ 16.5
Money market paper	- 6.8	- 0.8	- 1.3
3 Financial derivatives 6	+ 0.4	- 0.6	- 3.0
4 Credit transactions	- 47.0	- 41.2	- 26.4
Monetary financial institutions 7	- 5.1	- 64.7	- 15.9
of which: short-term	- 9.6	- 48.3	+ 6.1
Enterprises and individuals	- 12.2	+ 9.7	- 3.1
of which: short-term	- 10.7	+ 12.2	- 2.8
General government	+ 3.1	- 1.0	+ 0.4
of which: short-term	+ 1.8	- 1.3	- 5.0
Bundesbank	- 32.8	+ 14.8	- 7.9
5 Other investment	- 0.7	- 1.1	- 0.9
<b>IV Change in the reserve assets at transaction values</b> (increase: -) 8	+ 1.6	+ 1.2	- 0.8
<b>V Balance of unclassifiable transactions</b>	+ 15.7	- 3.5	+ 8.7

1 Balance. — 2 Including supplementary trade items. — 3 Special trade according to the official foreign trade statistics (source: Federal Statistical Office). — 4 Including the acquisition/disposal of non-produced non-financial assets. — 5 Original maturity of more than one year. — 6 Securitised and non-securitised options as well as financial futures contracts. — 7 Excluding the Bundesbank. — 8 Excluding allocation of SDRs and excluding changes due to value adjustments.

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Issuing activity in the German equity market revived perceptibly in the third quarter of 2005. Domestic listed enterprises took advantage of the favourable environment and issued new shares amounting to €3½ billion after issues worth only just over €1 billion in the previous quarter. A large share of the issuing volume was attributable to capital increases at two large public companies which partially financed foreign acquisitions by way of a capital increase.<sup>8</sup> In contrast to what happened in the second quarter of 2005, foreign equities were also sold again in Germany (€½ billion). A number of small-scale IPOs were also launched. There was an equal mix of IPOs which primarily consisted of capital increases and those which mainly consisted of a placement of shares by existing shareholders.

*More funds raised in equity market*

Net amounts of shares were purchased in the German market by domestic credit institutions (€6 billion), which bought mainly German shares, and by non-resident investors (€8½ billion). By contrast, domestic non-banks sold shares in the amount of €10 billion, the bulk of which was made up of domestic securities.

*Share purchases*

In the third quarter, sales of domestic mutual funds open to the general public were twice as high (at just over €6 billion) as in the previous quarter. The main driver behind this was the clear increase in the sale of share-based funds, which sold fund shares totalling just over €1 billion, after previously having to re-

*Sales of mutual fund shares*

<sup>8</sup> This acquisition of participating interests is not likely to be reflected in the balance of payments until the fourth quarter. For more information on direct investments during the period under review, see page 33.



deem shares to a similar extent in net terms. Sales of bond-based funds remained unchanged; on balance, these sales totalled just over €2 billion. New investments in money market funds rose slightly to just under €1 billion. In net terms, mixed security-based funds and open-end real estate funds each sold fund shares amounting to around €½ billion. The special funds, which are reserved for institutional investors, raised €6½ billion. Sales of foreign mutual funds remained unchanged at €11½ billion.

*Purchases of mutual fund shares*

Domestic non-banks were the main purchasers of mutual fund shares (€17 billion), predominantly those of foreign mutual funds. Domestic banks acquired mutual fund shares totalling €5 billion net, with most of this sum accruing to domestic mutual funds. Foreign investors purchased just under €2 billion in mutual fund shares in the German market.

*Total cross-border securities transactions*

Overall, the cross-border securities transactions, as shown in the balance of payments,<sup>9</sup> clearly lost momentum in the third quarter. Foreign investors, for instance, purchased German securities for a total of €36 billion (€85½ billion in the previous quarter), while domestic investors purchased debt securities, shares and mutual fund shares issued abroad in the amount of €28 billion (€54½ billion in the previous quarter). Net capital imports arising from securities transactions totalled €8 billion in the July to September period, compared with €30½ billion in the April to June period.

## Foreign direct investment

Net capital imports resulting from securities transactions were accompanied by net capital exports in the area of foreign direct investment. However, this figure (€3 billion) was lower than in the first and second quarters of this year, when it was still at €10½ billion and €9½ billion respectively. The net capital exports were due primarily to the international activities of German firms. In the period under review, these companies transferred capital totalling €2½ billion to their foreign branches. Repayment of loans which German parent companies had previously taken out with the subsidiaries abroad played a particularly important role. Furthermore, domestic companies increased their equity interests outside Germany, mainly in lending and insurance business, slightly by €1 billion. Foreign proprietors, by contrast, withdrew a small amount of capital from their branches and subsidiaries in Germany (€½ billion). In this context, as has been the case for some time now, intra-group loans played a decisive role. By comparison, non-resident firms, mainly from the euro area, increased their equity interests in Germany by €1 billion.

*Lower net capital exports through foreign direct investment*

<sup>9</sup> The balance of payment statistics divides cross-border equity transactions in line with the degree of participating interest into portfolio investment (participation below 10% of capital or voting rights) and direct investment (participation of 10% or more). Reinvested earnings and loans between affiliated companies are also considered as direct investments.