Financial markets

Financial market environment

Financial market trends

At the beginning of 2006, the international financial markets were characterised by improved expectations for the global economy. Despite a further significant increase in energy prices, growth prospects, particularly for Europe and Japan, were revised upwards in line with the largely positive leading economic indicators. Against this backdrop, capital market rates rose worldwide. Influenced by the positive economic indicators, which were also reflected in favourable quarterly results and improved profit expectations of enterprises, the increase in share prices in the international stock markets continued into the second quarter. A downward movement occurred in mid-May, however, and this partly offset the share price gains achieved hitherto.

Exchange rates

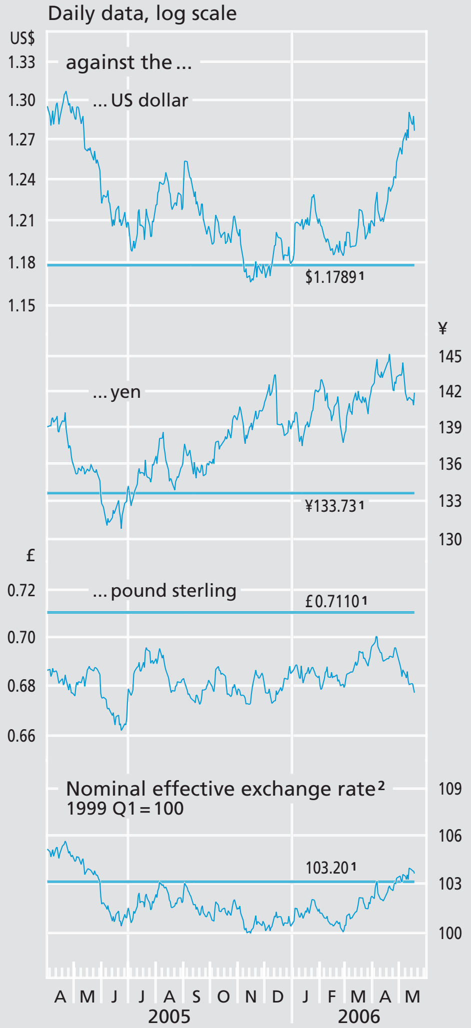
Euro exchange rate movements against the US dollar ...

The sustained improvement in economic activity in the euro area and the consequently growing expectation of rising interest rates led to an appreciation of the euro in the spring. Reports of shifts in the foreign currency portfolios of some central banks in favour of a greater euro share may also have played a role in this.

In February, however, the euro-dollar exchange rate had still been hovering persistently within a narrow band at just under US\$1.20 per euro. Then in mid-March the euro appreciated sharply when, in rapid succession, it was reported that the US trade deficit for January had reached a record high and

Exchange rate of the euro

Daily data, log scale



1 Rate at the beginning of monetary union on 4 January 1999. — 2 As calculated by the ECB against the currencies of 23 countries.

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the US current account had shown a surprisingly large deterioration for the fourth quarter of 2005. Worries about the financing of the US current account deficit were refuelled by the fact that the investment income component was now showing a deficit for the first time in recent years while the long-term net capital inflows into the United States were smaller than expected.

When the positive reports about economic developments in the euro area then started to accumulate at the beginning of April and the prospects for the US economy also started to appear less certain, the impression intensified in the market that interest rates in the euro area would rise again in the next few months and that the interest rate differential between the United States and the euro area would possibly not increase any further. This caused the euro to appreciate for a second time, and the currency temporarily reached US$1.23.

In mid-April the euro underwent a prolonged appreciation when the anticipated interest rate increases of the US Federal Reserve became ever more doubtful, particularly after the publication of the minutes from its most recent meeting. The burgeoning expectations of a narrowing interest rate differential between the United States and the euro area benefited the euro, which was being quoted at US$1.28 at the end of the period under review and thus 8% higher than at the beginning of the year.

... the yen ...

The euro depreciated against the yen at the beginning of the period under review as expectations that the zero interest rate policy in Japan would soon come to an end temporarily prevailed in the markets. This followed an announcement of an increase in consumer prices in Japan together with statements from the Japanese government that it would cease to resist an early change in monetary policy. Furthermore, the yen may also have been supported by speculation that the Chinese government might allow a further appreciation of the renmimbi, which would consequently strengthen Japan's competitive position.

As early as the beginning of March the euro made up its losses against the yen after talk in the market about further interest rate increases for the euro area following the widely anticipated change in key ECB interest rates. The statement made by the Bank of Japan that, even though there would be a change in its monetary policy strategy, Japanese key interest rates would be increased in the medium term only and thus later than previously anticipated had a similar effect. Speculation that there would be an increase in the interest rate advantage of European assets over Japanese assets drove the euro-yen exchange rate up to ¥145 by mid-April, thereby reaching an all-time high. The euro then became somewhat weaker again. At ¥142 at the end of the period under review, the euro was around 2% up on its level at the beginning of the year.

... and the pound sterling

On balance, the change in the value of the euro against the pound sterling was comparatively small during the period under review. The euro has been under a slight amount of pressure since the beginning of April when it became apparent after the publication of the minutes of the Bank of England's meeting that the majority of the Policy Board members were optimistic about the future progress of the UK economy and did not see any need to relax its monetary policy. As this report went to press, the euro was trading at £0.68, ie 1% below its value recorded at the turn of 2005-06.

Effective euro exchange rate

On an average against the currencies of the 23 most important trading partners, the euro was quoted 3% higher than at the beginning of the year, which means that it was approximately at its level at the start of monetary union. Owing to the low inflation differentials between the euro area and the major trading partners, the euro appreciated by approximately the same amount in real terms.

Securities markets and portfolio transactions

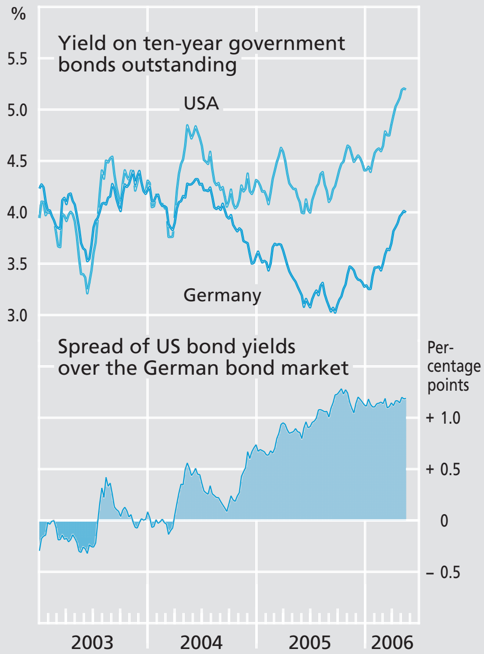
Sharp rise in capital market rates in euro area ...

There was a sharp rise in yields in the international bond markets in the first few months of 2006. Since the beginning of the year, the rise in interest rates in the three major currency areas amounted to between 47 and 73 basis points. This large degree of parallel movement is quite remarkable as there have been a recurring number of extensive shifts in the yield differentials over the past few years. First, the expectation of further monetary policy action in key economies is reflected in the upward trend in long-term interest rates. Second, the higher level of interest rates was driven by a positive economic environment and predominantly favourable leading indicators. This could be seen not only from surveys among market participants who were more optimistic about growth prospects, particularly in the euro area.

... driven by rising real interest rates

Real interest rates, which are often used as a simple indicator of market participants' perceptions about expected economic growth, also rose sharply. Owing to the rise in energy prices and the weaker US dollar, markets in the United States also expected a further rise in inflation. On balance, Bond yields in Germany and the USA

Weekly average



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yields on ten-year Treasuries had reached 5.1% by the end of the period under review and were therefore only slightly below the long-term nominal growth expectations for the USA, which were estimated at 5½% by the Consensus Forecast in April.

In Germany, the yield on ten-year Bunds outstanding rose in line with the international trends between the beginning of 2006 and mid-May by approximately ⅔ percentage point to just over 4%, thereby reaching the level last recorded in the final quarter of 2004. Given the virtually unchanged long-term inflation expectations, the yield moved closely in parallel with the real yield on comparable inflation-linked bonds throughout the reporting period – as in the preceding quarter – which was at around 1.8% at the end of the period under review.[1] At just over ½ percentage point, however, the real interest rate increase in the euro area since the beginning of the year was almost twice as high as in the USA. This is fully in line with the economic expectations of market participants, which have increased relatively sharply for the euro area since the beginning of the year.

Yield curve has steepened

These expectations have also been reflected in a clear upward shift in the yield curve.[2] This happened in two stages. Up until the rise in interest rates by the Eurosystem at the beginning of March, the yields across all maturity ranges rose by just under ¼ percentage point; since then, there has been a further rise in interest rates, which has affected the long-term end of the market almost twice as much as the short end. On the whole, the interest rate spread between (estimated) yields on bonds with a maturity of ten years and those with a maturity of one year increased from 63 basis points (30 December 2005) to 1 percentage point (18 May 2006), a development which would primarily explain the greater optimism on the part of market participants.

Unchanged interest rate spreads on corporate bonds ...

The yields on corporate bonds largely followed the increase in government bonds with a similar maturity. As a result, interest rate spreads of BBB-rated corporate bonds over government bonds remained virtually unchanged in the second quarter both in the

1 This is based on a French government bond maturing in 2015. Like the inflation-indexed Bund, which was reissued in March, the French bond is linked to the euro area consumer price index (excluding tobacco).
2 This is based on the German yield curve which is recalculated on a daily basis by the Bundesbank.

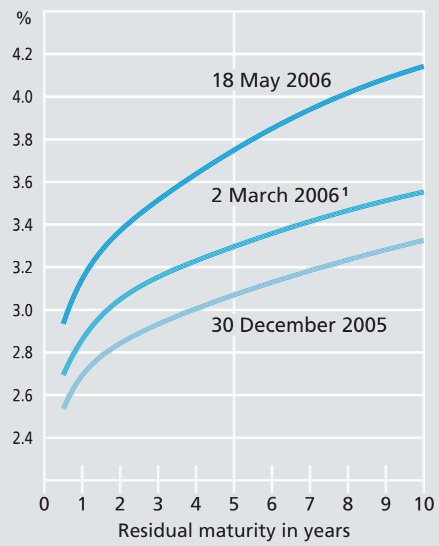
euro area and in the United States. Although, at 118 and 87 basis points respectively at the end of the period under review, spreads for seven to ten-year bonds were ½ and ¼ percentage point respectively above their lows reached in the second quarter of 2005, financing conditions for the corporate sector remained favourable on a longer-term comparison. The good credit rating of many enterprises active in the capital market is likely to have contributed to the prolonged period of low spreads. This is supported by the fact that, although the number of rating upgrades remained virtually unchanged, fewer West European and US companies were downgraded in the first quarter of 2006 than in the final quarter of 2005.

... continue to reflect favourable financing conditions in bond market

Buoyant issuing activity in bond market ...

At €328½ billion, the gross issue volume of domestic debt securities in the first quarter of 2006 was approximately the same as in the corresponding period a year earlier and was therefore clearly greater than the seasonally depressed gross issues in the fourth quarter of 2005 (€247½ billion). After taking account of redemptions and changes in issuers' holdings of their own bonds, domestic debt securities were sold for €69½ billion net, compared with net redemptions of €23 billion in the fourth quarter of 2005. Net sales of foreign bonds in Germany reached €42 billion in the period under review. Just over three-quarters of these were euro-denominated bonds, which – at least where ten-year government bonds were concerned – offered, on an average of the quarter, a yield spread of around 10 basis points over comparable Bunds. As a result, the total funds raised through the sales of German and foreign debt securities amounted to €111½ billion compared with €11 billion in the preceding quarter.

Yield curve
in the German bond market*



* Interest rates for (hypothetical) zero-coupon bonds (Svensson method), based on listed Federal securities. — **1** Interest rate increase of 25 basis points by the Governing Council of the ECB.

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... with high level of funds raised by credit institutions ...

Of the German borrowers, credit institutions were the main borrowers in the bond market in the first quarter. The credit institutions sold their own securities to the net value of €36 billion after reducing their capital market debt in the preceding two quarters. In the first quarter, debt securities issued by specialised credit institutions (€26 billion) and other bank debt securities (€14 billion) accounted for almost all of the funds raised. Issues of mortgage Pfandbriefe were issued for just under €1 billion. By contrast, public Pfandbriefe were redeemed for €4½ billion.

... the public sector ...

In the period under review, the public sector issued own debt securities worth around €24

Interest rate level
and expectations
for inflation and growth

1 GDP-weighted average. — **2** Expectations for the next ten years. Own calculations on the basis of half-yearly surveys on short and long-term expectations for the development of the consumer price index and gross domestic product. Source: Consensus Forecast.

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billion net. The Federal Government, which primarily sold 10 and 30-year bonds in the capital market (€8½ billion and €7 billion respectively), reaped the benefits of just over half of these debt securities. In March, the Federal Government issued an inflation-indexed bond among its ten-year paper for the first time. With the issuance of this debt security linked to the euro-area consumer price index (excluding tobacco), the Federal Government enhanced its range of debt instruments. Furthermore, it issued two-year Federal Treasury notes (Schätze) for €3½ billion on balance. The Federal Government redeemed €4½ billion (net) of its liabilities arising from five-year Federal notes. The state governments raised €6½ billion in the German bond market.

... and non-financial enterprises

Given the sustained favourable financing costs in the German bond market, non-financial enterprises raised €9½ billion in the first quarter of 2006 after they had reduced their bond market debt in Germany in each of the preceding three quarters. Money market paper (commercial paper) accounted for almost two-thirds of the funds raised, and longer-term corporate bonds for one-third.

Purchases of debt securities

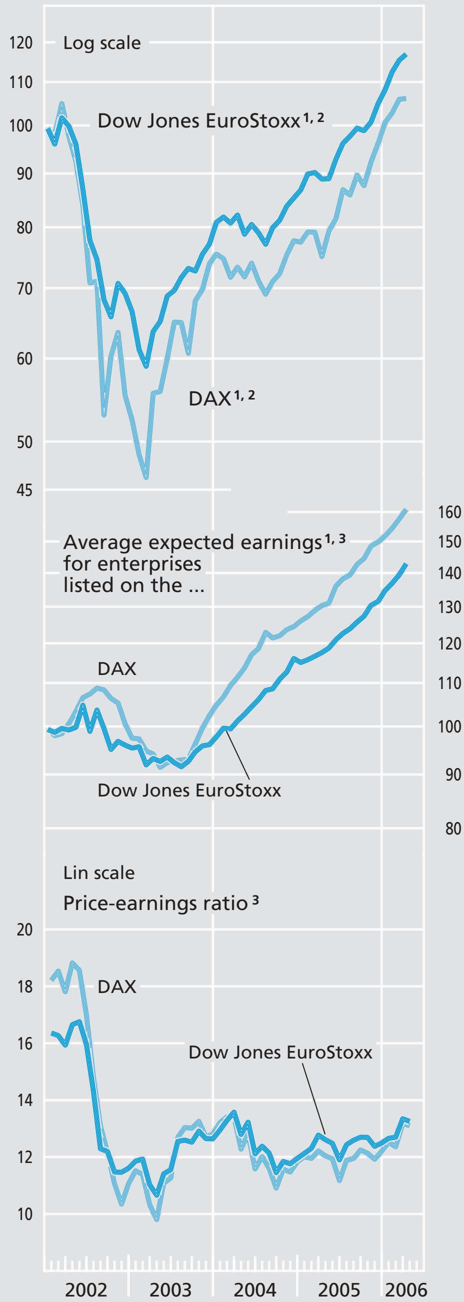
As in the preceding two quarters, foreign investors were the most important group of buyers of German debt securities with net purchases of €55½ billion. They purchased securities issued by both private borrowers (€34 billion) and the public sector (€21 billion). Next came German non-banks, which, after making net sales in the previous quarter, added German debt securities issued by the private sector to the value of €13½ billion and debt securities issued by the public sector to the value of €5½ billion net to their portfolios. By contrast, German credit institutions sold domestic bond holdings for €4½ billion. Public sector bonds and bank debt securities accounted for around half of this paper. At the same time, credit institutions invested €29 billion net in foreign debt instruments during the period under review; non-banks purchased paper issued by foreign borrowers for €13 billion.

Share price gains in the stock markets

The stock markets in Germany and in Europe generally developed extremely favourably well into May and therefore continued the strong upward trend of the previous year. At the same time, the price increases in the US stock markets were more modest, as in preceding quarters. Towards the end of the period under review, however, stock markets worldwide underwent a substantial correction. According to the broad market indices CDAX and the Dow Jones EuroStoxx, prices at the end of the period under review were just under 4% and 3% respectively up on the prices at the beginning of January and were thus consistent with the favourable economic data. The upsurge was due, first, to signs of increasing dynamism in mergers and acquisitions, which, according to market participants, were encouraged by the still relatively low capital market rates in a multi-year comparison and enterprises' ample liquidity supply. Second, the higher-than-expected corporate profits are also likely to have played a part in the increased stock prices. Inflation concerns, particularly in the United States, and the consequent expectation of a further increase in key interest rates were among the negative factors which became more significant in May. There was a decline in prices recently, and market participants' uncertainty about further price developments – as measured by the VDAXnew volatility index or calculated as the implied volatility of options on the Dow Jones EuroStoxx 50 index – increased somewhat at the end of the period

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

Monthly data



1 January 2002 = 100. — **2** Source: Deutsche Börse AG. — **3** Based on year-on-year I/B/E/S analyst estimates ("earnings before goodwill"). Source: Thomson Financial Datastream.

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Investment activity in the German securities markets

€ billion

Item	2005 Q1	2005 Q4	2006 Q1
Debt securities			
Residents	61.7	– 5.9	56.3
Credit institutions	46.4	– 1.3	24.6
of which			
Foreign debt securities	34.6	24.3	29.0
Non-banks	15.2	– 4.6	31.8
of which			
Domestic debt securities	– 2.3	– 14.3	18.8
Non-residents	51.4	16.8	55.3
Shares			
Residents	– 3.6	5.3	5.2
Credit institutions	1.5	7.2	6.1
of which			
Domestic shares	2.3	1.6	7.4
Non-banks	– 5.1	– 1.9	– 0.9
of which			
Domestic shares	– 5.8	– 14.0	– 7.4
Non-residents	5.6	19.2	0.6
Mutual fund shares			
Investment in specialised funds	8.9	13.9	11.5
Investment in funds open to the general public	0.4	– 3.4	– 6.3
of which: Share-based funds	– 1.8	1.7	– 0.5

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under review although it remained at a fairly low level on a longer-term comparison.

Modest amount of funds raised in stock market

Despite the favourable price developments, issuing activity in the German stock market remained subdued in the first quarter. Given a market value of just €½ billion, significantly fewer new shares were placed by German enterprises than in the previous quarter (€7 billion); around half of these were listed shares. With a value of €5 billion, significantly fewer foreign shares were also sold in Germany than in the preceding quarter (€18 billion). However, the high value achieved in the previous quarter was due primarily to a large cross-border corporate acquisition. German shares were primarily purchased by domestic credit institutions (€7½ billion), which sold foreign shares worth €1½ billion at the same time. Non-resident investors increased their equity holdings in Germany – solely through portfolio investments – by €½ billion. By contrast, German non-banks reduced their investment in German shares by €7½ billion net and purchased foreign shares with a net value of €6½ billion instead.

Sales and purchases of mutual fund shares

At a net value of €5 billion, the inflows recorded by German investment companies were roughly half as large as in the first quarter (€10½ billion). The resources were channelled solely into specialised funds which are open only to institutional investors (€11½ billion), whereas mutual funds open to the general public redeemed shares to the value of €6½ billion net. The outflows from funds open to the public were primarily from open-end real estate funds, which had to redeem mutual fund shares to the value of €9 billion. By contrast, mixed funds and funds of funds sold mutual fund shares for €1 billion net and €½ billion respectively. At €18 billion, sales of foreign mutual fund shares clearly exceeded the value recorded in the previous quarter (€5½ billion). Share certificates were mostly purchased by non-banks (€11 billion), which invested exclusively in foreign mutual funds. By contrast, the purchases of credit institutions, which acquired certificates worth €7½ billion, were primarily German mutual fund shares (€6½ billion). Non-residents invested €5 billion in the German fund market.

Total cross-border securities transactions

Overall, cross-border securities transactions, as shown in the balance of payments, clearly gained momentum at the beginning of the year. Investments in foreign securities by German investors and purchases of German paper by foreign investors largely cancelled each other out (€61 billion each).

Direct investment

Net capital exports through direct investment

In contrast to what occurred in portfolio investment, there were net outflows of funds in the area of direct investment in the first quarter of this year, whereas – in connection with several large transactions – capital had been imported into Germany in the preceding quarter. Between January and March 2006, net capital exports at just over €17 billion were at approximately the same level as in the same period of 2005. Cross-border direct investment of German enterprises worth just over €17 billion was the main reason for this. The main target countries were EU member states (particularly Belgium, France and Hungary) and the United States.

On balance, foreign proprietors did not inject any additional funds into their German affiliates during the first quarter of 2006. Reinvested earnings were offset by outflows in equity capital and intra-group credits.

Major items of the balance of payments

€ billion

Item	2005 Q1	2005 Q4	2006 Q1
I Current account 1,2	+ 29.1	+ 20.6	+ 26.2
Foreign trade 1,3	+ 43.2	+ 34.7	+ 39.8
Services 1	– 5.5	– 4.2	– 6.2
Income 1	+ 3.1	+ 3.5	+ 3.1
Current transfers 1	– 7.3	– 7.6	– 6.0
II Capital transfers 1,4	– 1.5	+ 0.1	+ 0.2
III Financial account 1 (Net capital exports: –)	– 22.6	– 37.3	– 43.6
1 Direct investment	– 13.2	+ 20.5	– 17.2
German investment abroad	– 16.1	+ 4.0	– 17.1
Foreign investment in Germany	+ 2.9	+ 16.5	– 0.1
2 Portfolio investment	– 8.5	– 44.9	– 0.1
German investment abroad	– 65.4	– 59.9	– 60.9
Equity	+ 0.7	– 20.6	– 0.7
Mutual fund shares	– 13.9	– 5.3	– 18.2
Debt securities	– 52.2	– 34.1	– 42.0
Bonds and notes 5	– 55.4	– 32.6	– 41.6
of which: Euro-denominated bonds and notes	– 46.8	– 25.3	– 32.8
Money market instruments	+ 3.2	– 1.5	– 0.4
Foreign investment in Germany	+ 56.9	+ 15.0	+ 60.8
Equity	+ 5.3	+ 0.1	+ 0.6
Mutual fund shares	+ 0.2	– 1.9	+ 5.0
Debt securities	+ 51.4	+ 16.8	+ 55.3
Bonds and notes 5	+ 42.6	+ 24.7	+ 45.4
of which: Public bonds and notes	+ 13.6	+ 14.3	+ 21.5
Money market instruments	+ 8.8	– 7.9	+ 9.8
3 Financial derivatives 6	– 3.9	– 3.2	– 5.6
4 Other investment 7	+ 3.1	– 11.7	– 21.8
Monetary financial institutions 8	+ 6.8	+ 10.6	– 48.3
of which: short-term	+ 20.2	+ 38.4	– 30.0
Enterprises and individuals	– 10.7	+ 8.4	– 6.0
of which: short-term	– 14.7	+ 13.8	– 2.5
General government	+ 13.6	– 6.2	+ 5.1
of which: short-term	+ 8.6	– 6.0	+ 5.6
Bundesbank	– 6.6	– 24.5	+ 27.4
5 Change in reserve assets at transaction values (increase: –) 9	– 0.2	+ 1.9	+ 1.1
IV Errors and omissions	– 5.1	+ 16.7	+ 17.2

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** Includes financial and trade credits, bank deposits and other assets. — **8** Excluding the Bundesbank. — **9** Excluding allocation of SDRs and excluding changes due to value adjustments.

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