Financial markets

Financial market trends

Financial market setting

The financial market crisis has worsened considerably since the second quarter of 2008. The problems besetting the financial sector include not only the continued weakness of the US real estate market but, above all, the gloomier economic outlook in the industrial nations and the emerging and developing world alike. The insolvency of a large US investment bank additionally heightened market participants' risk aversion. Plummeting share prices, a further decline in prices for risky assets and pronounced tensions on the money markets put financial institutions under increased pressure. The difficulties in the financial system resulted in numerous countries launching government rescue packages for individual institutions as well as broad-based aid measures for the financial sector as a whole. These generally include guarantees for non-banks' bank deposits as well as conditional support measures for financial institutions (see explanatory notes on pages 34-36). In addition, in early October, major central banks lowered their lending rates in a concerted effort, which was followed by further rate cuts. These actions restored a measure of stability to the markets. However, the international financial system is now having to contend increasingly with the repercussions of the weakened macroeconomic environment.

Exchange rates

In the past few months, the foreign exchange markets have been characterised by pro-

International financial market stabilisation measures

After the major economies had initially granted government assistance to distressed banks and financial institutions only as a case-by-case measure and in a discretionary manner, there were growing signs following the crash of the US investment bank Lehman Brothers that only broad-based packages of measures would be able to avert systemic crises in particularly hard-hit countries. In view of the feared burden for taxpayers and the possibility of distorting competition, such recommendations immediately met with considerable misgivings in terms of regulatory and distribution policy. However, these reservations were addressed by attaching specific conditions to government assistance and by a more concerted international approach.

On 3 October, the US House of Representatives adopted the "Emergency Economic Stabilization Act 2008" following defeat of a previous version. The centrepiece of this legislation is the "Troubled Asset Relief Program" (TARP). Originally designed as a vehicle for purchasing and guaranteeing financial assets, the programme provides US$700 billion which all US savings associations and banks are eligible to tap. This was followed by an additional infusion of government capital – in emulation of the UK model. Criticism of such comprehensive government assistance was addressed by the attachment of stringent conditions concerning, for example, participating banks' dividend policies, expanded regulation or the ban on "golden handshakes". In the light of recent experience, plans have been made to broadly replace the asset purchase programme with further recapitalisation programmes.

These rescue measures heralded the start of a series of additional economic relief programmes. The conclusions of the Council of EU economic and finance ministers (ECOFIN) of 7 October contain a commitment to pursue a coordinated approach designed to restore confidence in the financial sector. At the same time, they specified guidelines for national rescue measures which are mainly aimed at containing the risk of distortion in the level playing field and of abuse. Just one day later, Italy and the United Kingdom were the first EU countries to adopt rescue packages to protect their financial sectors. Since then, the comprehensive UK package of measures has played an instrumental role as a model for all subsequently adopted stabilisation programmes. It encompasses not only the provision of short-term liquidity but also government guarantees and a strategy to recapitalise the banking system through the purchase of preference shares by the government.

At the international level, the joint action plan announced by the G7 countries on 10 October represents a coordinated basis for future action by the leading industrial nations. The support measures contained in this plan are to be designed to protect taxpayer interests and avoid any harmful effects for other countries. With this objective in mind, the G7 countries have committed to strengthen their cooperation.

On the basis of the EU guidelines and the G7 action plan, the heads of state or government of the euro area issued a declaration on 12 October in Paris calling for coordinated action by the European Union, euro-area governments, central banks and supervisors. The final document puts forward concrete measures to be implemented by the individual nations. These stabilisation packages should be designed in such a way that they do not distort competition. For this reason, the provision of government assistance must be priced at least in line with market conditions and accompanied by restructuring measures while also protecting the interests of taxpayers. These principles were endorsed by the Brussels European Council on 16 October and apply to all European Union countries.

Just one month later, on 15 November, the heads of state or government of the G20 countries, along with representatives of international organisations, met in Washington for a global financial summit. This culminated in the adoption of a five-part declaration outlining the root causes of the current crisis and listing actions to be taken immediately, reforms to avoid future crisis and a reaffirmation of the group's commitment to an open global economy. An appended action plan defines concrete actions for implementing these agreements, some of which are scheduled for completion by 31 March 2009.

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International action plans and declarations

Institution	Date	Principles
ECOFIN	7 October	– Interventions should be timely and the support should in principle be temporary – Taxpayers' interests must be safeguarded – Existing shareholders should bear the due consequences of the interventions – Governments should be in a position to bring about a change of management – Management should not retain undue benefits – Legitimate interests of competitors must be protected – Negative spillover effects should be avoided
G7	10 October	– Support systemically important financial institutions – Unfreeze credit and money markets, and ensure that financial institutions have broad access to liquidity – Promote recapitalisation from public and private sources – Ensure that guarantee programmes are robust and consistent in order to maintain confidence in the banking system – Restart the secondary markets for mortgages and other securitised assets – Implement high quality accounting standards
Summit of the euro-area countries	12 October	– Ensure appropriate liquidity conditions for financial institutions – Facilitate the funding of banks – Allow for an efficient recapitalisation of distressed banks – Ensure sufficient flexibility in the implementation of accounting rules – Enhance the cooperation procedures among European countries
G8	15 October	– Reaffirmation of the G7 plan of action – Mitigation of the adverse impacts of the crisis on emerging market economies and developing countries – Strong support of the IMF's critical role in assisting affected countries – Commitment to open economies and well-regulated markets – Commitment to necessary reforms of the global financial markets
European Council	16 October	– Reaffirmation of the need to implement ECOFIN's EU roadmap – Establishment of an informal warning, information-exchange and evaluation mechanism for financial crisis situations ("financial crisis cell") – Increase in the transparency of existing commitments and risks – Strengthening of the supervision of the European financial sector, particularly cross-border groups
G20 (Summit on financial markets and the world economy)	15 November	– Unsound risk management practices, opaque financial products and macroeconomic imbalances are root causes of the current crisis – Stabilisation of financial markets and economic growth through national measures as well as IMF and World Bank emergency loans – Enhanced transparency and accountability; expansion of international bodies – including the Financial Stability Forum (FSF) – to a broader membership of emerging market economies – Request that Finance Ministers initiate processes to implement the action plan and formulate additional recommendations by 31 March 2009 – Commitment to an open global economy with a regulatory policy framework

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Government measures aimed at restoring financial market stability in the USA and the European Union (excluding central bank instruments)

Country or group of countries	Measures adopted on	Measures
USA	3 October	**Recapitalisation** Directed at: – US savings associations and banks Implementation: – US$125 billion in exchange for preference shares for eight big banks – US$125 billion for smaller banks – Possible buyback of preference shares after three years **Guarantees** Directed at: – Deposits: members of the US Federal Deposit Insurance Corporation (FDIC) – Others: see recapitalisation – Standard participation – Entities may explicitly opt out after 30 days Implementation: – Non-bank deposits up to US$250,000 – Senior unsecured debt instruments **Asset purchases** Directed at: – See recapitalisation Implementation: – Purchase of troubled assets – US$450 billion (US$700 billion from the Troubled Asset Relief Program (TARP) less US$250 billion for recapitalisation measures) – Cutbacks in favour of additional recapitalisation measures are under consideration
United Kingdom	8 October	**Recapitalisation** Directed at: – Systemically important banks subject to UK company law – Only one bank per banking group Implementation: – Tier 1 capital ratio of at least 9% – Decision to draw on government funds is voluntary – Individual arrangements – Eight major banks have committed to increase their tier 1 capital by an aggregate of £25 billion – Government injection totalling £37 billion in the form of ordinary shares and preference shares in three of these banks – Further £25 billion earmarked for smaller banks **Guarantees** Directed at: – Participants in the recapitalisation programme Implementation: – Non-bank deposits – Senior unsecured debt instruments denominated in pound sterling, US dollars or euro – Case-by-case decisions on the approval of individual products – Up to £250 billion
European Union (general guidelines)	National packages of measures since 8 October	**Recapitalisation** Directed at: – Entities determined by the individual member states – No discrimination against other member states' financial institutions Implementation: – Determined by the individual member states – Restricted to fundamentally healthy financial institutions **Guarantees** Directed at: – See recapitalisation Implementation: – Retail deposits – Newly issued, short to medium-term senior debt instruments – No guarantees for interbank deposits **Asset purchases** Directed at: – See recapitalisation Implementation: – Purchase or swap of high quality assets in exchange for government paper

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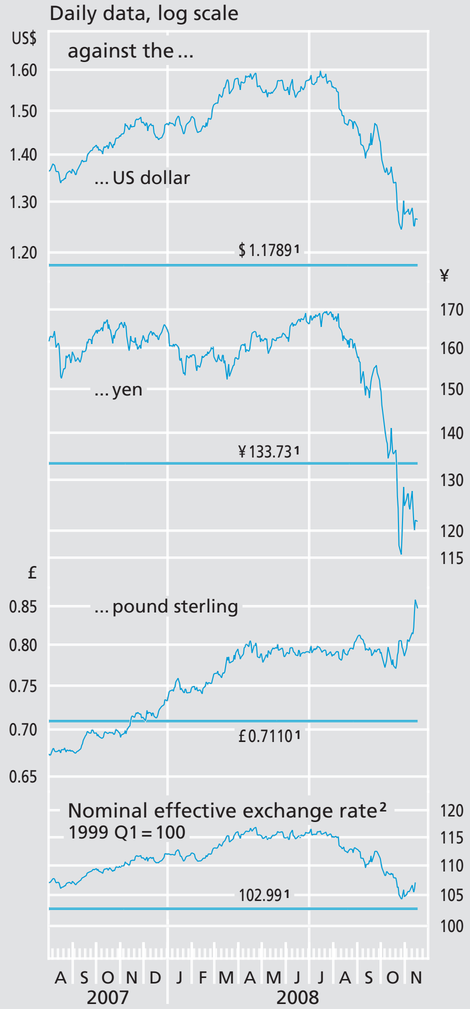
Euro exchange rate development against the US dollar ...

nounced exchange rate volatility and a broad-based recovery of the US dollar. In this environment, the euro slipped visibly against the US dollar, after peaking at just under US\$1.60 in mid-July. A number of negative news reports about the economy increasingly darkened the euro-area growth outlook. This was reflected most notably in the contrast between the negative euro-area growth rates in the second quarter and the surprisingly robust growth in the USA. This led the markets to expect a narrowing of the interest rate differential between the two currency zones, thereby putting the euro under pressure. The visible fall in crude oil prices also contributed to the depreciation of the euro against the US dollar, since this tends to reduce the US need for capital imports to finance the stubbornly large US current account deficit, which is caused *inter alia* by considerable imports of oil. All in all, the euro briefly dipped below the US\$1.40 mark up until mid-September.

Subsequently, however, the financial market turmoil in the United States worsened when the US government had to pass a rescue package for its two major mortgage finance companies, a major investment bank became insolvent and a systemically relevant insurance firm needed to be rescued. These measures, and the attendant fears regarding the burdens these government measures would place on the budget, caused the euro to recover 6% in less than two weeks. At the turn of the month, however, tensions in the financial markets spilled over to this side of the Atlantic as several European banks ran into difficulties. Government aid measures were necessary in various euro-area and EU countries.

Exchange rate of the euro

Daily data, log scale



1 Rate as at the beginning of monetary union on 4 January 1999. — 2 As calculated by the ECB against the currencies of 22 countries.

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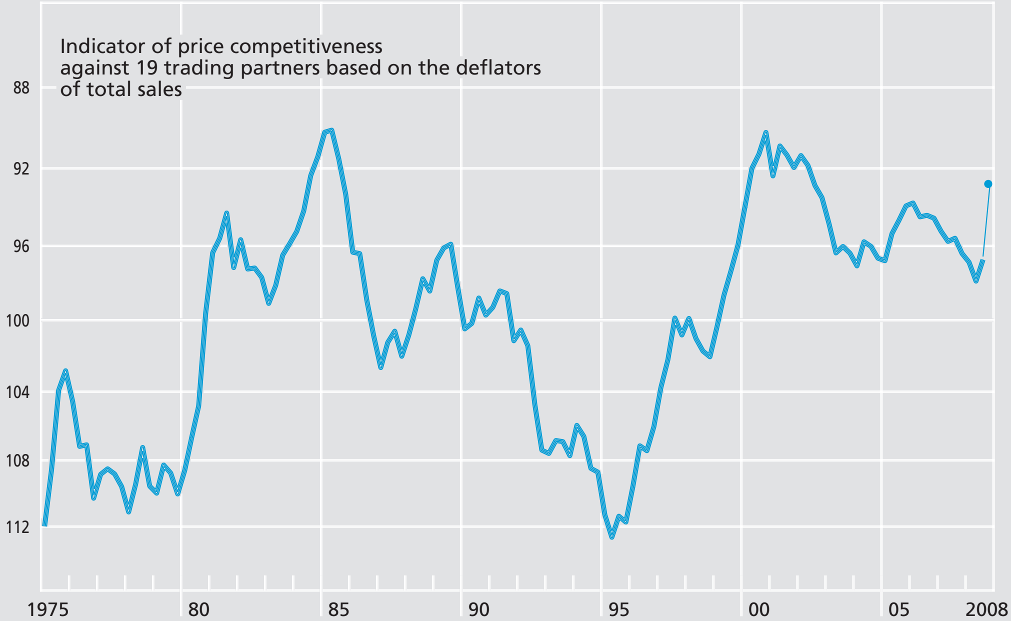
Against this backdrop, the euro came under renewed pressure against the US dollar in October. Despite having appreciated in the first half of the year, the euro was, at US\$1.27, trading 14% below its level at the beginning of the year as this report went to press.

... against the yen ...

In similar fashion, the euro fell almost continuously against the Japanese yen during the reporting period, after peaking at ¥170 in

The German economy's price competitiveness

Average since 1975 = 100, quarterly, log scale[1]



1 Inverted scale: a rising curve (falling values) denotes an increase in competitiveness. — ● = Latest reading estimated for 17 November 2008.

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July. The economic outlook was growing visibly gloomier in Japan, too. However, as interest rates there were already low, this initially did not lead to rate cut expectations as it had in the other key currency areas. This assessment was confirmed in early October when the major central banks – with the exception of Japan – cut their interest rates by ½ percentage point in a concerted move. Market expectations that interest rate differentials would continue to narrow, as well as investors' heightened risk aversion, put pressure on the euro's rate against the yen. The exceptionally high exchange rate volatility and the change in exchange rate trends caused foreign currency investments financed in yen (such as carry trades) to appear increasingly risky. Moreover, the yen benefited from the fact that Japanese banks are less affected by the US mortgage crisis than other institutions. After a comment on the yen by the G7 finance ministers and central bank governors and the subsequent unexpected interest rate cut by the Bank of Japan, the euro temporarily recovered some ground against the Japanese currency at the end of October. At last report, it was trading at ¥122, ie 26% lower than at the beginning of the year.

... and against the pound sterling

In the past few months, despite fluctuations, the euro posted net gains against the pound sterling. In the UK, too, there have been mounting signs of an economic downturn since August. In addition, the United Kingdom has been particularly hard hit by the crisis in the financial sector owing to the problems in the real estate markets and the relatively large size of its financial sector. This enabled the euro to rise against the pound sterling up until early September. However, high UK inflation subsequently prevented expectations of interest rate cuts from emerging. This development, along with the onset of problems afflicting financial institutions in the euro area, then put pressure on the euro. It was only when, in October, the market came to believe that the Bank of England and the UK government were giving the problem of combating slumping growth top priority, that expectations of interest rate cuts became entrenched in the UK, which resulted in the euro posting renewed gains. Following the sharp reduction in interest rates and the publication of the inflation report by the Bank of England in early November, the euro hit a new peak of £0.86 and ended the reporting period at £0.84, 15% higher than at the beginning of the year.

The effective exchange rate of the euro and the German economy's price competitiveness

The euro's average rate against the currencies of 22 key trading partners has thus fallen 4½% since the beginning of the year and 8½% from its second-quarter peak. The weaker euro is helping improve the German economy's price competitiveness, as is the comparatively moderate cost development in Germany, and is thus *per se* having a stabilising effect on German economic activity.

Securities markets and portfolio transactions

International bond markets

Since the middle of the year, bond markets have likewise been feeling the effects of the worsening financial market crisis and the perceptibly gloomier economic outlook. In a highly jittery environment, uncertainty about subsequent yield trends on either side of the Atlantic temporarily reached new highs.[1] Yields on ten-year European government bonds have fallen by a total of ¾ percentage point to just over 4% since the end of June, while similar US instruments were, on balance, trading slightly lower, at around 3¾%, as this report went to press. The effects on government bond yields of financial market turbulence and the various government rescue packages are apparently going in opposite directions. On the one hand, investors in search of a safe haven bought heavily into government bonds, especially in the light of considerable share price losses; this tended to reduce bond yields. On the other hand, the potential budgetary pressure imposed by the rescue measures and the attendant fears concerning future recourse to the capital market may well have pushed up yields. In the short-term segment, in particular, slightly more favourable inflation expectations, not least because of the considerable drop in oil prices, and the latest interest rate cuts by the major central banks caused a drop in yields.

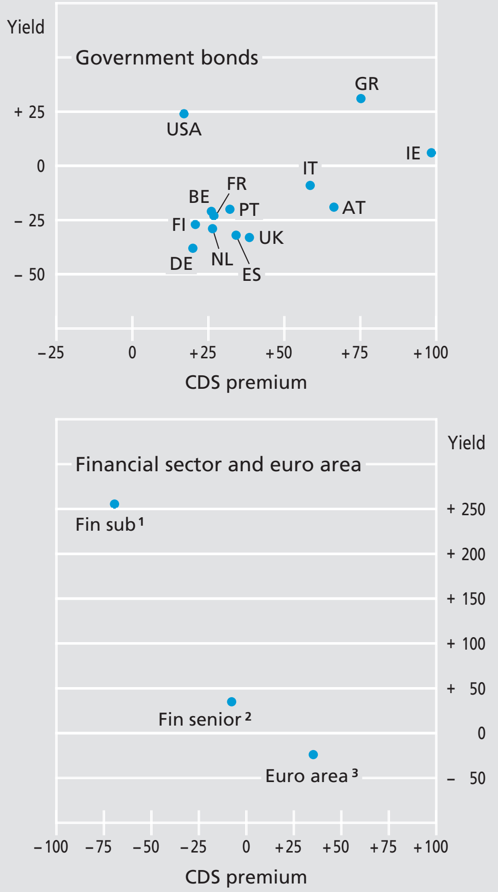
Uneven yield movements in the euro area

Federal bonds (Bunds), which have seen their yields in the ten-year segment fall by just under 1 percentage point since the second quarter, were the main beneficiaries of portfolio shifts to liquid and safe assets. The brisk demand for German government instruments was also reflected in the yield development relative to bonds issued by other euro-area countries. The GDP-weighted yield advantage

1 As measured by the implied volatility of options on the Bund future and T-note future with a constant maturity of three months.

Yields and credit risk *

Changes in the period 15 September to 17 November 2008 in basis points



* Yields on ten-year government bonds and on debt securities issued by euro-area financials and CDS premiums. Sources: Bloomberg, Reuters and Thomson Financial Datastream. — **1** Subordinated debt (iBoxx Index, iTraxx Index). — **2** Senior debt (iBoxx Index, iTraxx Index). — **3** GDP-weighted average of government bonds.

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of German bonds over other euro-area bonds temporarily reached around ¾ percentage point, a new all-time high since the launch of monetary union. Since the second quarter, Greece and Ireland in particular have seen spreads widen more than other euro-area nations. For one, this reflects differences in the liquidity of various euro-area countries' bonds, as is also mirrored in the bid-ask spreads on bonds. At least for the most recently issued government bonds, these are usually very narrow. During the reporting period, Bunds had the highest liquidity throughout the euro area. For another, the heterogeneous development of risk premiums – measured in terms of credit default swaps (CDSs) – also plays a role.[2] Whereas the premiums on five-year contracts for German government bonds have risen by 20 basis points since mid-September, other euro-area countries have seen theirs rise much more sharply, by up to 84 basis points (see adjacent chart). Unlike the rise in CDS premiums on government bonds, the premiums on bank debt securities – especially subordinated debt – have fallen owing to the guarantees given by the government. This demonstrates that the government rescue packages have transferred a considerable volume of risk from the financial sector to the government sector.

Yield curve

The term structure of Federal bonds reflects the various influences in the bond market more broadly than the yields on long-term bonds. Growing concerns about the economy over the course of the third quarter led to a temporary inversion in the medium-term maturity segment. At last report, investors' flight to safe government-issued instruments as well as falling short-term inflation expectations, the Eurosystem's latest interest-rate cuts and changes in market participants' expectations regarding the future monetary policy stance have put downward pressure on yields, especially those at the short end of the interest rate spectrum. All things considered, two-year yields have fallen by just over 2¼

2 In general terms, CDS premiums can be understood as the cost of insuring a bond.

percentage points to 2½% since the end of June. This means that the slope of the yield curve, expressed as the difference between two-year and ten-year yields, has risen to just under 1¾ percentage points.

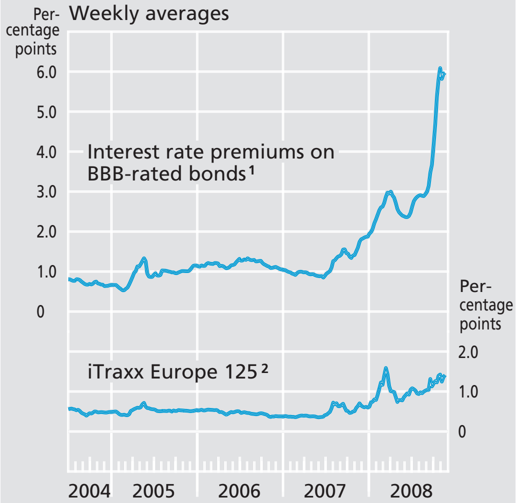
Financing conditions worsened

Despite falling government bond yields, firms' financing conditions in the capital market have worsened dramatically since mid-2008, not least owing to the collapse in share prices. In the euro-area bond markets, moreover, the yield gap between bonds still rated investment grade (BBB) and government bonds reached a new high of over 600 basis points, in line with trends in the United States. This rise probably reflects the gloomier economic outlook and fears that banks will implement tighter lending standards. In addition, financial market players are currently fairly risk averse, which must also be seen against the backdrop of the failure of a major investment bank and the problems encountered by a notable insurance company. In addition, the liquidity of corporate bonds has apparently diminished, which is likewise causing yields to rise. This is indicated by the comparatively small rise in the iTraxx indices, which reflect default risk. Still, the index for CDS premiums of various European investment-grade issuers (iTraxx Europe) almost hit its historic high, whereas the index for lower-grade issuers (iTraxx Europe Crossover) significantly surpassed its previous all-time high.

Issuing activity in bond market remains lively

Only in some areas of the German bond market was issuing activity marked by the increased uncertainty in the financial markets. Gross sales of debt securities issued by residents rose to a record high of €417½ billion in the third quarter of 2008 after having already peaked in each of the two preceding quarters. After taking into account the slight period-on-period decline in redemptions and changes in holdings of issuers' own bonds and notes, domestic issuers tapped the capital market for €37 billion net. By contrast, German investors reduced their holdings of debt securities issued by non-residents by the record amount of €18 billion. In the first half of 2008, non-residents were still able to sell €57 billion worth of bonds. The total amount of funds raised from sales of domestic and foreign debt securities in the third quarter was €19 billion, compared with €25½ billion in the preceding quarter.

Financing conditions in the European capital market



Sources: Bloomberg, Merrill Lynch and Thomson Financial Datastream. — **1** Yield spread of seven to ten-year euro-denominated BBB-rated corporate bonds over euro-area government bonds of similar maturity. — **2** Credit default risk premiums for 125 "investment-grade" European companies.

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Low issuance by the public sector ...

The public sector increased its borrowing in the bond market by €4½ billion from July to September and thus by about the same magnitude as in the first two quarters of 2008. Whereas the state governments' recourse to the capital market, at €5½ billion, was up on the preceding three-month period, the Federal Government reduced its market debt slightly by €1 billion net after having issued a net €½ billion worth of debt securities in the preceding period. The Federal Government redeemed, in particular, ten-year Bunds (€14 billion) but also, to a lesser extent, two-year Federal Treasury notes (Schätze) and Federal savings notes for a combined total of €1 billion. By contrast, it issued €3½ billion worth of 30-year bonds, €7 billion worth of medium-term Bobls and €3 billion worth of short-term Bubills. Also, it generated €½ billion from the first-time sale of "day-bonds" for private investors.

... and by credit institutions

German credit institutions sold €1 billion net of their own bonds and money market paper in the July to September period. Since July 2007, however, they have reduced their outstanding capital market debt by a total of €16 billion. During the quarter under review, they redeemed public Pfandbriefe amounting to €13½ billion net and thus confirmed a trend that has been in evidence for years and is attributable largely to a drop in financing requirements and the public sector's growing propensity to go straight to the bond market for funds. In the current year alone, the volume of public Pfandbriefe outstanding thus fell by €38½ billion. Net funds from the issuance of mortgage Pfandbriefe, by contrast, were positive in the third quarter (€3 billion). Other bank debt securities,[3] which can be structured flexibly, were issued to a total amount of €11 billion, the highest quarterly figure since the outbreak of the crisis. Sales of specialised credit institutions' debt securities, by contrast, were down distinctly on the quarter (€½ billion following €14 billion).

Net issuance of corporate bonds

Domestic enterprises tapped the bond market for a net €31½ billion during the quarter under review, almost all of which involved the issuance of longer-term instruments. The main reason why this figure is exceptionally high lies in a substantial securitisation transaction effected with the help of a domestic special-purpose vehicle. By contrast, the amount of short-term instruments outstanding did not rise noticeably.

Purchase of debt securities

In the third quarter of 2008, non-resident investors were the main buyers of debt securities, as they have been virtually without interruption since July 2007, adding a total of €35½ billion worth of debt instruments to their portfolios. Debt securities issued by the private sector accounted for around one-fifth of this figure. However, some of these cross-border transactions represent certificates and warrants created in Germany which were sold *en bloc* to affiliated companies abroad and held there, in most cases, until maturity. Ultimately, only a fraction of documented purchases by private investors are transacted outside the banking sector, the real target

3 These "other bank debt securities" include, for instance, the "uncovered" debt securities issued by mortgage banks, bearer debt securities and commercial paper issued by credit institutions, and certificates.

group for these products.[4] German investors, by contrast, were net sellers of interest-bearing securities. As in the preceding quarters, sales were attributable exclusively to domestic non-banks, who sold €21 billion worth net of debt securities.[5] Domestic credit institutions, by contrast, increased their bond market exposure by €4½ billion. They sold €12 billion worth of public-sector debt securities and purchased €25½ billion worth of corporate bonds, attributable mostly to the aforementioned substantial securitisation transaction.

Plummeting stock prices in September and October

In July and August, stock price movements on both sides of the Atlantic started out relatively moderate. Despite worries about the stability of the financial sector and growing scepticism about the state of the economy, market participants greeted the announcement by the US government of aid measures for the two largest US real estate finance companies with a certain feeling of confidence, especially given falling oil prices and the positive quarterly figures presented by some US banks. However, in September, in the light of the insolvency of a major US investment bank and the danger of a collapse of other financial institutions, this confidence gave way to growing global concerns about the overall state of the financial sector. European financial stock prices have subsequently dropped by more than 30% again after having already lost more than a quarter of their value between May and mid-July of this year. At the same time, stock price uncertainty – as measured by the implied volatility of stock options – peaked anew in major markets, surpassing the previous all-time high it reached in 2002.

Investment activity in the German securities markets

€ billion

Item	2007 Q3	2008 Q2	2008 Q3
Debt securities			
Residents	– 85.4	– 32.8	– 16.8
Credit institutions	– 0.2	33.3	4.4
of which			
Foreign debt securities	13.8	20.5	– 8.4
Non-banks	– 85.2	– 66.2	– 21.1
of which			
Domestic debt securities	– 75.8	– 69.9	– 11.5
Non-residents	52.1	58.1	35.6
Shares			
Residents	– 18.3	39.8	18.4
Credit institutions	– 4.0	– 14.3	2.6
of which			
Domestic shares	– 2.8	– 3.3	1.9
Non-banks	– 14.3	54.1	15.8
of which			
Domestic shares	0.8	51.4	15.6
Non-residents	3.0	– 46.7	– 12.0
Mutual fund shares			
Investment in specialised funds	– 1.2	2.8	7.3
Investment in funds open to the general public	– 6.9	1.2	– 2.9
of which: Share-based funds	– 2.5	1.1	– 1.2

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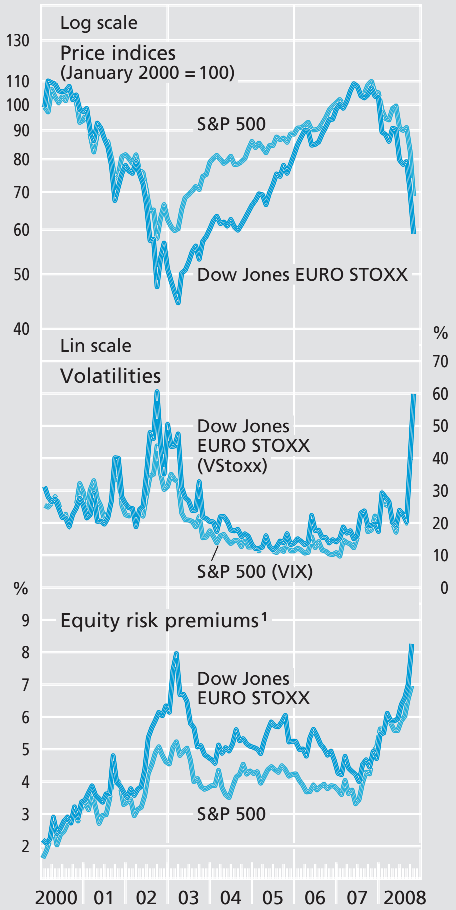
The growing jitteriness was accompanied by a further decline in risk appetite, which ultimately spread to the entire stock market.

Rescue measures created tentative calm in stock markets

The adopted government rescue packages for the financial sector were very slow to take hold in the stock markets, as their implementation is a time-consuming process and the overall outlook continued to cloud over. According to Consensus Economics surveys, growth expectations for the key economies have been revised downwards by 1½ to 2 percentage points between July and November. Since the beginning of the year, prices – as

4 For more details, see Deutsche Bundesbank, German balance of payments in 2007, Monthly Report, March 2008, pp 26-27.
5 The purchase of securities by German non-banks is a statistical residual and therefore subject to a high degree of uncertainty.

European and US equity markets



Sources: Thomson Financial Datastream and Bundesbank calculations. — **1** Measure of the risk compensation demanded by investors. Calculated using a three-step dividend discount model; see Monthly Report, March 2003, p 35.

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Stock market valuations down worldwide

measured by the broad stock price indices – have fallen by 42% and 47% respectively in the USA and the euro area, with Japanese shares trading, at last report, around 44% lower than at the beginning of the year. However, twelve-months-ahead earnings expectations were scaled back much less drastically than stock prices collapsed.[6] As a result, the price-earnings ratio based on expected earnings for European and US shares fell sharply to 7.4 and 9.8 respectively in October. These lows reflect the fact that the equity risk premium has now reached a record high.

Stock market funding and stock purchases

Issuing activity in the domestic stock market picked up somewhat in the third quarter compared with the two preceding quarters. Domestic enterprises issued €5½ billion worth of new shares, the vast majority of which were listed equities (€4 billion). Sales of foreign stocks on the German market were somewhat lower (€1 billion). Net purchasers of stocks in the third quarter included resident non-banks (€16 billion) as well as, to a lesser extent, domestic credit institutions (€2½ billion). Both groups purchased domestic instruments to the virtual exclusion of foreign stocks. By contrast, non-resident investors reduced their holdings of German stocks by a total of €12 billion.[7]

Sales and purchases of mutual fund shares

In the third quarter, domestic investment companies recorded inflows of funds amounting to €4½ billion, following €4 billion in the preceding three-month period. The inflows were channelled solely into specialised funds reserved for institutional investors (€7½ billion); by contrast, funds open to the general public were confronted with outflows amounting to €3 billion. In the case of mutual funds, fund units were redeemed in particular by bond-based funds (€3½ billion), followed by money market funds (€1½ billion) and equity-based funds (€1 billion). By contrast,

6 Even in previous downturn periods – most recently after the bursting of the New Economy bubble – analysts were slow to revise their estimates for corporate earnings downwards. However, earnings expectations for financial sector companies, in particular, have fallen disproportionately since the beginning of the year.
7 For more details on foreign direct investment, see p 45.

open-ended real estate funds (€1½ billion), funds of funds, mixed funds and mixed securities-based funds (each €½ billion) recorded inflows. Foreign investment funds also registered inflows from German investors, albeit modest in volume (€1½ billion). In the third quarter, mutual fund shares were purchased exclusively by domestic non-banks (€9½ billion), which chiefly added mutual fund shares issued by domestic investment companies to their portfolios (€8 billion). Domestic credit institutions and foreign investors, by contrast, disposed of, on balance, €1½ billion and €2 billion worth of mutual fund shares respectively.

Foreign direct investment

In the third quarter, foreign direct investment resulted in net capital exports amounting to just under €10½ billion. Capital outflows thus stood well below their second-quarter level (€30½ billion).

Germany's outward foreign direct investment

German proprietors provided €11½ billion worth of additional funds to their affiliated enterprises abroad during the period under review, as against €36½ billion in the preceding three-month period. They thereby increased their direct capital stakes in their foreign branches by just under €8 billion. This also included a significant boost to a stake in a Swedish motor vehicle manufacturer. In addition, foreign affiliates' reinvested earnings (€11 billion) played a significant role. By contrast, intragroup loans led to net capital imports (€7 billion).

Major items of the balance of payments

€ billion

Item	2007 Q3	2008 Q2	2008 Q3
I Current account 1,2	+ 41.8	+ 42.0	+ 34.5
Foreign trade 1,3	r + 50.2	+ 53.0	+ 39.3
Services 1	– 9.7	– 3.7	– 7.8
Income 1	+ 13.0	– 0.3	+ 13.0
Current transfers 1	– 9.0	– 4.3	– 7.9
II Capital transfers 1,4	+ 0.3	+ 0.3	– 0.3
III Financial account 1 (Net capital exports: –)	– 22.2	– 81.4	– 16.4
1 Foreign direct investment	– 16.9	– 30.4	– 10.3
German investment abroad	– 35.6	– 36.3	– 11.7
Foreign investment in Germany	+ 18.7	+ 5.9	+ 1.4
2 Portfolio investment	+ 47.8	– 4.5	+ 39.0
German investment abroad	– 2.0	– 17.0	+ 17.8
Shares	+ 5.1	+ 12.4	+ 1.2
Mutual fund shares	– 2.6	– 5.2	– 1.5
Debt securities	– 4.5	– 24.2	+ 18.1
Bonds and notes 5	+ 1.6	– 21.9	+ 12.3
of which Euro-denominated bonds and notes	+ 8.6	– 23.1	+ 11.5
Money market instruments	– 6.1	– 2.4	+ 5.8
Foreign investment in Germany	+ 49.8	+ 12.5	+ 21.2
Shares	– 3.1	– 46.1	– 12.4
Mutual fund shares	+ 0.8	+ 0.5	– 2.0
Debt securities	+ 52.1	+ 58.1	+ 35.6
Bonds and notes 5	+ 32.7	+ 47.5	+ 22.7
of which Public bonds and notes	+ 3.6	+ 25.2	+ 24.4
Money market instruments	+ 19.3	+ 10.6	+ 12.9
3 Financial derivatives 6	– 27.0	– 15.1	+ 3.0
4 Other investment 7	– 25.8	– 30.5	– 49.7
Monetary financial institutions 8	– 24.7	– 27.8	– 36.3
of which: short-term	+ 10.3	+ 20.0	+ 7.0
Enterprises and households	– 1.7	+ 8.7	– 25.1
of which: short-term	+ 1.0	+ 12.9	– 17.2
General government	+ 28.5	– 1.5	+ 13.2
of which: short-term	+ 29.1	– 1.1	+ 13.4
Bundesbank	– 27.9	– 9.9	– 1.4
5 Change in reserve assets at transaction values (increase: –) 9	– 0.3	– 0.9	+ 1.6
IV Errors and omissions	– 19.9	+ 39.1	– 17.8

1 Balance. — **2** Including supplementary trade items. — **3** Special trade according to the official foreign trade statistics (source: Federal Statistical Office). From January 2007, excluding supplies of goods for/after repair/maintenance, which, up to December 2006, were deducted via the supplementary foreign trade items. — **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.

Deutsche Bundesbank

Inward foreign direct investment in Germany

The funding of foreign enterprises' German affiliates was up by €1½ billion in the third quarter. This was mostly accomplished via reinvested earnings, whereas equity capital was increased only marginally. Parent companies had expanded their activity in Germany by as much as €6 billion during the previous period.