Financial markets

Financial market trends

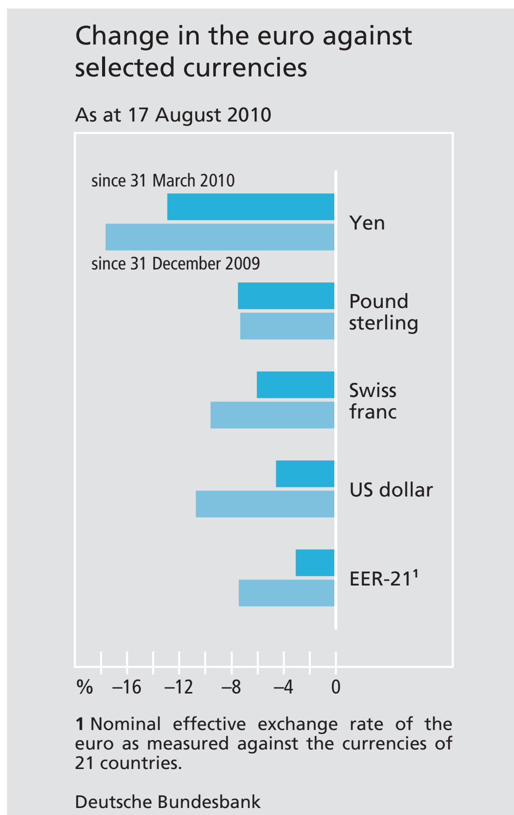
Financial market setting

International financial markets remained in the thrall of the dramatic escalation of the Greek debt crisis, which threatened to develop into a confidence crisis for the entire euro area and led to the implementation of extensive stabilisation measures by the EU, the IMF and the Eurosystem at the beginning of May. Euro-area government bond spreads remained high – despite narrowing temporarily in the immediate aftermath of the initiatives taken. Overall, however, the situation on the European sovereign bond markets has eased somewhat as a result, among other things, of the fiscal consolidation measures adopted by several euro-area countries, by steadier real economic developments and by the bank stress test, which showed the European and the German banking system to be robust, for the most part, under adverse scenarios. Buoyed by benign economic indicators and upbeat company reports, the European stock markets have rallied since the end of May. The euro, too, rebounded after having fallen to its lowest level in several years in the wake of the Greek debt crisis.

Exchange rates

Euro exchange rate developments against the US dollar, ...

The exchange rate movements of the euro against the US dollar were especially pronounced. After the euro countries had agreed in the first half of April to provide an aid package for Greece, and subsequently specified the details, the euro-dollar exchange rate strengthened to US$1.37. However, the single currency subsequently depreciated sharp-



ly again. Around this time, negative headlines on the financial situation in Greece and fears that the debt crisis might spread to other euro-area countries placed the single currency under a lot of pressure. The comprehensive rescue package agreed on at the beginning of May by Ecofin and the IMF for euro-area countries as well as the announcement of additional consolidation efforts only temporarily halted the euro's decline. In June, the euro-dollar exchange rate briefly touched US$1.19, its lowest level in four years.

A recovery got underway in mid-June after several euro-area countries were able to place government bonds with relative ease – albeit with high yield spreads over the corresponding German bonds. Moreover, various euro countries introduced savings measures with the result that, on the whole, concerns over the European debt crisis have receded somewhat into the background. Meanwhile, foreign exchange market players turned their attention more to differences in the perception of economic developments in the United States and in the euro area. Whereas weak figures from the US housing and labour markets dampened the outlook for the US economy, confidence in the economy of the euro area was bolstered in the second half of July by the announcement of a number of surprisingly positive economic data. Furthermore, the publication of the stress test results for European banks helped ease pressure on the financial markets and tended to support the euro. In August, the euro-dollar exchange rate pared some of its gains after the US Federal Reserve signalled that it would step in again to support the US economy in view of the more modest than anticipated recovery. This is likely to have raised risk aversion on the markets and increased demand for the US dollar given its traditional role as a "safe haven" currency. As this report went to press, the euro-dollar exchange rate stood at just under US$1.29. On balance, the single currency has lost 4½% against the US dollar since end-March. This left the euro-dollar exchange rate more than 10½% below its level at the turn of the year.

... against the yen ...

After range-trading around the ¥125 mark in April, the euro-yen exchange rate fell to ¥109 into the first half of June. During this time, the yen additionally benefited from rising risk aversion, which is likely to have led to an unwinding of risky carry trades. In the light of the announcement of surprisingly positive

euro-area economic data and the gradual calming of the financial markets, the euro had meanwhile also regained some lost ground against the japanese currency. However, as this report went to press, the euro stood back at almost ¥110, 17½% below its level at the beginning of 2010.

... and against the pound sterling

The euro also depreciated considerably against the pound sterling in spring and summer, falling from £0.91 at the beginning of the second quarter to an exchange rate of £0.81 in the first half of July. At first, the tensions in the euro area put downward pressure on the euro against the pound sterling. Moreover, greater inflationary pressures in the United Kingdom triggered speculation in June that the Bank of England could raise interest rates, which further bolstered the British pound on a broad front. In addition, the new British government's austerity programme restored some confidence in Britain's public finances and contributed to the strength of the pound. As this report went to press, the euro stood at £0.82, which is 7½% down on the start of the year.

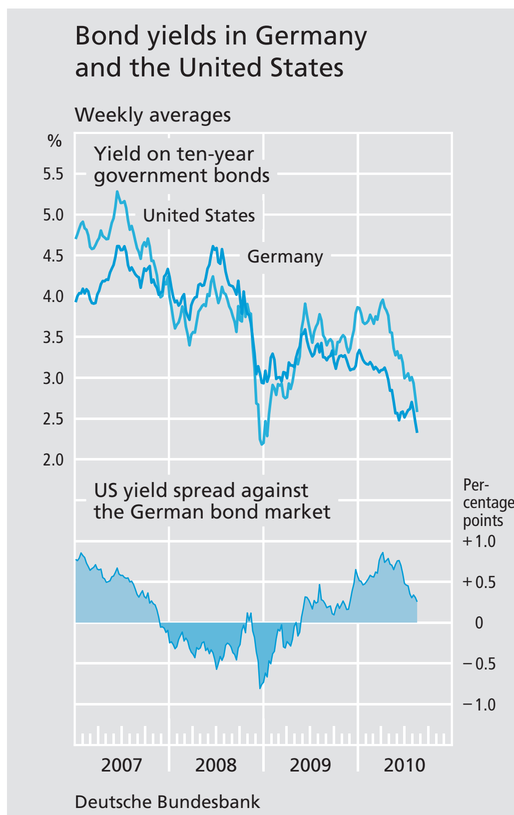
Effective euro exchange rate

The euro also depreciated against the Swiss franc in the reporting period, hitting a new all-time low after the Swiss National Bank indicated it would be discontinuing its foreign exchange intervention. By contrast, the single currency appreciated against a number of central and eastern European currencies. These changes were reflected in the euro's average value vis-à-vis the 21 major currencies in the exchange rate index falling roughly 5% since the end of March. At last count, the euro's effective exchange rate was 9% below its level at the beginning of the year and roughly 1% lower than at the launch of the monetary union.

Securities markets and portfolio transactions

Spotlight on the European debt crisis

From the beginning of April onwards, the European bond markets' focus swung between the crisis of confidence in the sustainability of the public finances of a number of euro-currency countries and attempts to stem the shock waves emanating from Greece by implementing numerous monetary policy and fiscal measures. Market players' rapidly changing views are very clearly reflected in the GDP-weighted yield spread of the other euro-area government bonds against corresponding German debt. Whereas this spread had stood at an already fairly high 71 basis points at the end of March, it widened to as much as 153 basis points when the crisis was at its worst, before narrowing to 131 basis points by mid-August amid some volatity. The widening was driven primarily by Greece, which quickly lost the markets' confidence when, at the end of April, it again revised upwards its budget deficit for 2009 and public protest mounted against the announced austerity measures. Negative sentiment grew when rating agencies downgraded, first, the sovereign rating of Greece and Portugal and then that of Spain and Ireland. Whereas prices for the bonds issued by these countries fell sharply, safe haven paper – notably the German benchmark bond – appreciated perceptibly. Even after the euro rescue package had been set up, European government bond



markets remained very heterogeneous and volatile. The situation eased somewhat when several euro-area countries implemented additional austerity measures and several bond auctions were successful. This positive development was underpinned by improving real economic conditions in the euro area and the positive reaction to the results of the stress test among European banks. German government bonds were in demand throughout the reporting period. As this report went to press, the yield on Bunds with ten years left to maturity stood at an historic low of 2.3%.

German yield curve flattening

As long-dated German bonds rallied, the German yield curve flattened significantly over the quarter. Thus the interest-rate differential between ten-year and two-year yields is, at 200 basis points, up to 40 basis points lower than at the end of March. The flattening of the curve mainly reflects safe haven buying by market players. Another factor is that the Eurosystem's monetary policy is expected to remain accommodating.

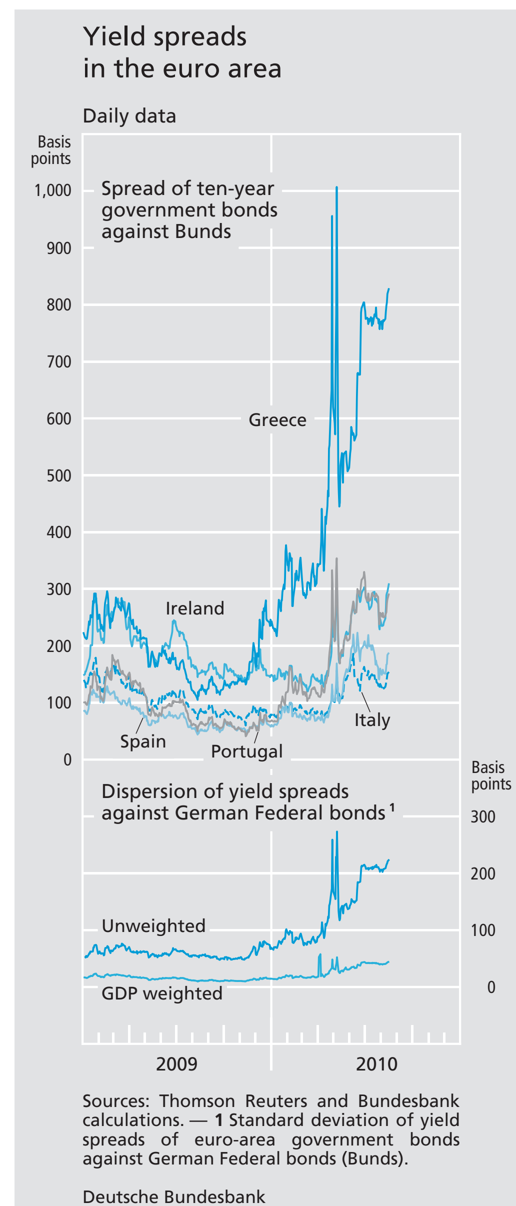
International bond markets

The debt crisis in several euro-area countries had a knock-on effect on the prices for securitised government bonds outside of the euro area. As market players shifted out of euro-area bond exposures they considered to be risky, some moved into secure investments outside of the euro area, triggering significant downward yield movements in the major currency areas. The yield on Japanese government bonds fell by 44 basis points, while UK and US government paper saw yields decline by 88 basis points and 129 basis points respectively. In the United States, the fact that a number of indicators have, since early June, been pointing to a slightly weaker economic recovery than initially assumed by market participants may also have been a factor. Moreover, the Fed has decided to use the proceeds of maturing securities to buy US Treasuries. On balance, 10-year paper were yielding 2.6% in mid-August.

Financing conditions for enterprises

European enterprises' financing conditions on the bond markets worsened initially in May as investors' risk aversion increased perceptibly. However, with brighter economic prospects and declining uncertainty on the stock markets, investors took a more optimistic view of credit risk again. As this article went to press, the spreads on BBB-rated corporate bonds denominated in euro against government bonds – as measured by the Merrill Lynch bond indices – were, at 215 basis points,

roughly 10 basis points higher than at the end of March.[1] While euro-area government bond yields edged lower, BBB-rated corporate bond yields fell by 35 basis points overall. The markets for corporate credit default swaps (CDS), which had come under considerable pressure with the debt crisis, were normalising as this report went to press and partially reversed the preceding rise in premiums. As measured by the credit derivatives index iTraxx Europe, which is composed of credit default swaps referencing investment grade credits, CDS premiums were, at the end of the reporting period, some 35 basis points higher than at the end of March, at 115 basis points.



Sources: Thomson Reuters and Bundesbank calculations. — 1 Standard deviation of yield spreads of euro-area government bonds against German Federal bonds (Bunds).

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Net redemptions in the bond market

The second quarter saw issuance on the German bond market pick up for the first time since end-2008 (€379 billion). However, as redemptions also rose, to €375½ billion, the outstanding volume of domestic bonds fell slightly by €3 billion on balance, taking account of changes in issuers' holdings of their own bonds. However, looking through the quarterly figures reveals, in some cases sharp, movements in the individual months, reflecting the tensions on the markets for European government bonds. For instance, domestic issuers were in some cases noticeably reticent with new placements at the height of the crisis in May (€87 billion). In June, however, gross sales figures picked up perceptibly (€173½ billion). This pattern was observed for private issuers not only in Germany, but throughout Europe. Foreign debtors repaid €3 billion to investors in the reporting period, meaning net redemptions on the domestic bond market totalled €6 billion.

Borrowing by German government

The public sector raised its capital market debt by €21½ billion in the second quarter. The Federal states were especially active issuers (€13 billion), while the Federal government tapped the market for a much smaller €8½ billion. The high issuance by the Federal states can, overall, be attributed exclusively to the funding requirements of the First

1 The increase is probably due, in part, to a change in index composition.

Winding-up Agency (*Erste Abwicklungsanstalt* or EAA), which has assumed WestLB's exposures and non-strategic businesses. It is striking that the Federal government in its issuance continued to extend the maturity of its debt, thereby securing the favourable financing conditions for longer. As in the previous quarter, it issued 30-year and, in particular, 10-year Bunds (€7½ billion and €12½ billion respectively) to replace maturing Federal Treasury discount paper (Bubills: €11½ billion), whose maturity spectrum had last year been extended to up to 12 months. Issuance of the short-dated bonds was stepped up a year ago in order to provide funds for the Special Fund for the Stabilisation of the Financial Market (Financial Market Stabilisation Agency or SoFFin). In addition, the Federal government also sold five-year Federal notes (Bobls) and two-year Federal Treasury notes (Schätze) for a total of €4 billion and redeemed a US-dollar-denominated issue (€4 billion), which it had placed five years ago.

Issues by non-banks

Non-bank domestic corporations issued €2½ billion worth of debt securities in the reporting quarter. Short-dated commercial paper, a financing instrument which has hardly been used since the collapse of the Lehman Brothers bank, accounted for more than half of this total (€1½ billion). The majority of the placements took place in April. With the loss of confidence on the markets for government bonds, this financing channel for non-banks, too, temporarily dried up, with non-financial corporations particularly hard hit.

Net redemptions by credit institutions

Domestic credit institutions lowered their capital market debt by another €26½ billion in the reporting period, about the magnitude observed since the fourth quarter of 2008 (quarterly average since then: €31 billion). They mainly redeemed other bank debt securities which allow flexible structuring (€19½ billion), the instruments that have suffered the most pronounced turnaround since the onset of the financial crisis, as well as public Pfandbriefe (€15 billion). On balance, mortgage Pfandbriefe, where the Eurosystem covered bonds purchase programme expired on 30 June, were redeemed on a quarterly basis (€2 billion) despite more lively issuance towards the end of the programme. By contrast, specialised credit institutions, which include the public promotional banks, issued bonds worth €9½ billion (net).

Purchase of debt securities

The debt crisis is also leaving its mark in purchase figures. Overall, residents were net sellers of German bonds (€10 billion). However, there was major shifting among the sectors, although these were mainly related to the above-mentioned transfer of risk exposures out of the banking sector. Where debt securities were affected, this was treated as a sale by the bank transferring the paper. Moreover, domestic credit institutions sold paper issued by euro-area debtors that have been particularly hard hit by the crisis, and have invested some of the sales proceeds in Federal government issues, which are, in times of crisis, a liquid and safe investment vehicle of preference. They sold €44½ billion worth of fixed income securities on balance. By contrast, other groups of domestic buyers – including the EAA, which is classed as the gov-

ernment sector, and the Bundesbank, which acquired securities through its monetary policy operations – added debt securities worth a total of €34½ billion to their portfolios. Although foreign investors' trading volumes on the German market reached the double-digit billion euro mark during the quarter, on balance their cross-border exposure did not change much (€4 billion).

International equity markets between debt crisis ...

In the second quarter, the international stock markets were initially also affected by the loss of confidence in the sustainability of public debt in some euro-area countries and concerns about the consequences the debt crisis might have on financial institutions and the real economy. Fears that the crisis on some euro-area government bond markets could spill over to other countries and require high write-downs fuelled market players' uncertainty about the general state of the financial sector. Market participants were also worried that the required consolidation measures could place a damper on the economic outlook. Meanwhile, the rescue package passed for ailing euro-area countries had no long-term impact on the equity markets. In this environment, financials suffered particularly large losses. By the end of May, the broad market equity indices in Europe (Euro Stoxx) and the United States (S&P 500) had also fallen by around 14% and 8% respectively from their levels of end-March. Market participants' strong uncertainty was a major contributory factor in sending prices on the international equity markets lower. As measured by the implied volatility of equity options, share price uncertainty reached peak values of close to 40% on both sides of the Atlantic; this was well above its five-year average. It was, however, still well below the record levels of the fourth quarter of 2008, when implied volatility in Europe and the United States had spiked to some 80%.

Investment activity in the German securities markets

€ billion

Item	2009	2010	
	Q2	Q1	Q2
Debt securities			
Residents	42.5	29.9	– 10.1
Credit institutions	27.4	2.1	– 44.4
of which			
Foreign debt securities	– 5.4	1.5	– 40.3
Non-banks	15.1	27.8	34.3
of which			
Domestic debt securities	– 14.9	11.5	– 2.8
Non-residents	27.5	8.1	4.1
Shares			
Residents	10.5	7.5	7.7
Credit institutions	– 2.4	3.0	– 1.6
of which			
Domestic shares	– 2.0	3.8	– 4.6
Non-banks	12.8	4.5	9.4
of which			
Domestic shares	9.3	3.1	6.9
Non-residents	1.2	– 0.2	– 1.6
Mutual fund shares			
Investment in specialised funds	– 4.7	13.9	14.0
Investment in funds open to the general public	5.1	7.0	0.6
of which: Share-based funds	2.3	– 0.4	– 1.3

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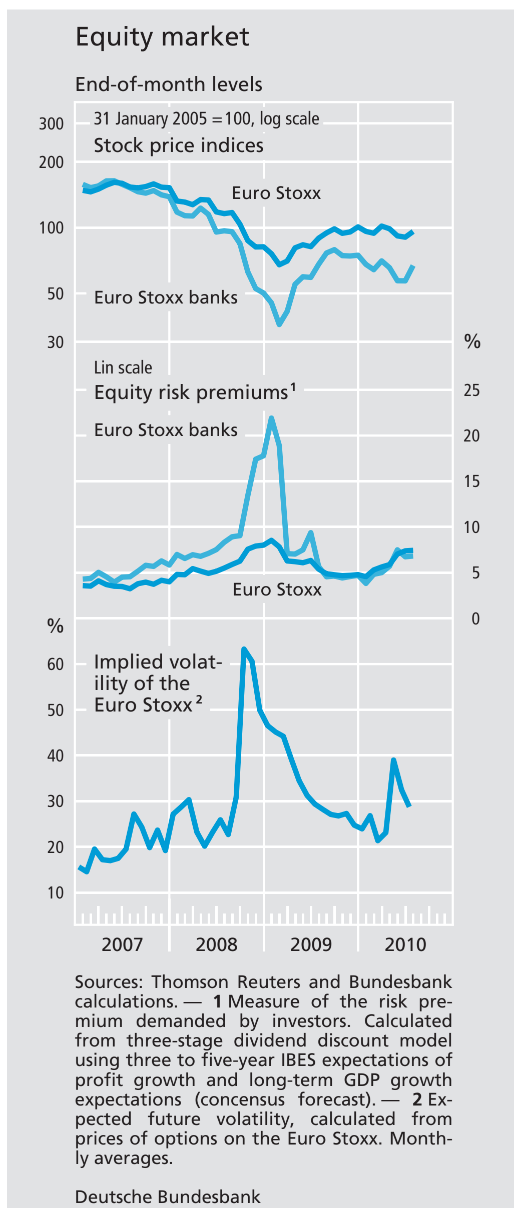
... and economic recovery

Buoyed by brighter economic prospects for the euro area, share price uncertainty eased from June onwards and stock markets recovered. Moreover, analysts raised their earnings estimates worldwide, further driving up prices. Optimism with regard to profit developments was additionally underpinned by unexpectedly positive quarterly results for US and European enterprises towards the end of the reporting period. Moreover, market players' confidence in the solidity of the financial sector was strengthened by the publication of the results of the bank stress test in the EU,



Sources: Thomson Reuters and Bundesbank calculations. — 1 Measure of the risk premium demanded by investors. Calculated from three-stage dividend discount model using three to five-year IBES expectations of profit growth and long-term GDP growth expectations (concensus forecast). — 2 Expected future volatility, calculated from prices of options on the Euro Stoxx. Monthly averages.

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which investors largely rated positively. Nonetheless, the preceding share price losses meant German and European shares, as measured by the CDAX and the Euro Stoxx, were still trading 3% and 7% respectively below their levels at the beginning of the second quarter as this report went to press, while US equities (S&P 500) were down 7½%.

Higher equity risk premium

The excess return investors demand for an investment in European shares (Euro Stoxx) as compared to a secure investment, which can be calculated using a dividend discount model, was well above its five-year average (around 5%), at roughly 7½%, as this report went to press and thus signals that investors are taking a relatively cautious stance. The implied risk premium of an exposure to European banking stocks rose to just under 7% at the end of the period under review, not far off its five-year average.

Stock market funding and stock purchases

Given the debt crisis and market players' at times heightened risk aversion, issuance on the domestic stock market weakened significantly in the second quarter. Domestic enterprises issued just €½ billion in new shares, compared with €6½ billion in the months January to March. By contrast, the volume of outstanding foreign equities in Germany increased by €5½ billion. Domestic non-banks were the only net buyers of equities (€9½ billion), mainly focusing on German shares (€7 billion). Credit institutions sold domestic shares (-€4½ billion) in favour of foreign shares (€3 billion). Non-resident investors reduced their exposure to the German equity market by €1½ billion, all of which was portfolio investment.[2]

Sales and purchases of mutual fund shares

Domestic investment companies recorded inflows of €14½ billion in the months April to June, after €21 billion in the previous quarter. Almost all of the fresh funds flowed into specialised funds reserved for institutional investors (€14 billion). Among funds open to the

2 For more details on direct investment, see p 47.

general public, mixed securities-based funds, bond-based funds and mixed funds attracted inflows (€1½ billion, €1 billion and €1 billion respectively). By contrast, share-based funds, open-end real estate funds and money market funds suffered outflows (€1½ billion, €1 billion and €½ billion respectively). Sales of foreign mutual fund units in Germany reached €3 billion.

As in the first quarter, mutual fund shares were mainly bought by domestic non-banks, which added €16 billion worth of fund shares to their portfolios. The majority of these were domestic fund shares (€14½ billion). Credit institutions acquired €1 billion worth of mutual fund shares, buying only foreign fund shares on balance (€2 billion). Non-resident investors increased their holdings of domestic fund units by €½ billion.

Direct investment

German direct investment abroad

Like portfolio investment (€½ billion), direct investment suffered net capital outflows in the second quarter of 2010 (€22½ billion after €27½ billion from January to March). The main reason for these capital exports was German firms' renewed investment abroad (€27 billion). German firms primarily supplied their foreign branches with funds in the form of intra-group loans (€19 billion), but also by increasing their equity stakes and by reinvesting earnings.

Foreign direct investment in Germany

Direct investment by foreign enterprises in Germany amounted to €4 billion for the April to June period, after €6½ billion in the previ-

Major items of the balance of payments

€ billion

Item	2009	2010	
	Q2	Q1	Q2
I Current account [1, 2]	+ 23.8	+ 31.7	+ 26.1
Foreign trade [1, 3]	+ 31.7	+ 37.6	+ 37.0
Services [1]	– 2.3	– 1.5	– 2.5
Income [1]	– 0.1	+ 11.5	+ 0.7
Current transfers [1]	– 3.5	– 13.4	– 6.0
II Capital transfers [1, 4]	+ 0.3	+ 0.3	– 0.4
III Financial account [1] (Net capital exports: –)	– 45.2	– 15.4	– 16.4
1 Direct investment	– 6.7	– 27.5	– 22.6
German investment abroad	– 16.1	– 34.1	– 26.9
Foreign investment in Germany	+ 9.4	+ 6.6	+ 4.2
2 Portfolio investment	+ 1.5	– 11.4	– 0.5
German investment abroad	– 27.1	– 22.1	– 3.6
Shares	– 1.4	+ 3.6	– 3.7
Mutual fund shares	– 1.0	– 7.8	– 3.1
Debt securities	– 24.6	– 17.9	+ 3.2
Bonds and notes [5]	– 27.4	– 18.9	– 0.2
of which Euro-denominated bonds and notes	– 25.0	– 26.8	+ 0.4
Money market instruments	+ 2.8	+ 1.0	+ 3.4
Foreign investment in Germany	+ 28.7	+ 10.6	+ 3.1
Shares	+ 1.1	+ 0.8	– 1.7
Mutual fund shares	– 0.0	+ 1.7	+ 0.7
Debt securities	+ 27.5	+ 8.1	+ 4.1
Bonds and notes [5]	– 1.3	+ 13.4	+ 19.9
of which Public bonds and notes	+ 21.0	+ 16.5	+ 21.9
Money market instruments	+ 28.8	– 5.3	– 15.8
3 Financial derivatives [6]	+ 4.1	– 4.1	– 6.4
4 Other investment [7]	– 44.2	+ 28.3	+ 14.0
Monetary financial institutions [8]	– 10.1	+ 75.3	+ 49.9
of which: short-term	+ 9.7	+ 65.3	+ 41.0
Enterprises and households	+ 2.2	– 17.9	– 3.2
of which: short-term	– 2.8	– 9.9	+ 5.3
General government	– 19.5	– 0.2	+ 7.5
of which: short-term	– 18.1	+ 0.9	+ 7.3
Bundesbank	– 16.8	– 28.9	– 40.2
5 Change in reserve assets at transaction values (increase: –) [9]	+ 0.0	– 0.7	– 0.8
IV Errors and omissions	+ 21.1	– 16.6	– 9.3

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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ous three-month period. Foreign firms provided their branches in Germany with funds (€5½ billion) particularly through intra-group loans. By contrast, dividend payouts to the parent companies caused fund outflows from German branches.