

## Financial markets

### Financial market environment

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In the first months of 2011, developments on the international financial markets were largely characterised by the further improvement in the economic outlook and by growing inflation worries; in some cases, both resulted in rising capital market rates. The political unrest in a number of North African countries as well as the devastating earthquake in Japan led to heightened uncertainty in the markets, but only temporarily. By contrast, the worsening debt crisis in individual euro-area peripheral countries drove their bond yields to record levels. For instance, Portugal applied for international financial assistance at the beginning of April 2011, which the euro-area finance ministers approved on 16 May. Moreover, investors once again focused on doubts about Greece's consolidation path. The international equity markets were largely unaffected by these negative factors; with the exception of Japan, they have rallied since the beginning of the year, mainly because corporate earnings exceeded expectations due to cyclical factors. The different interest rate expectations, in particular, resulted in a shifting exchange rate landscape. Whilst the US dollar eased, the euro recorded gains on balance.

*Financial  
market trends*

### Exchange rates

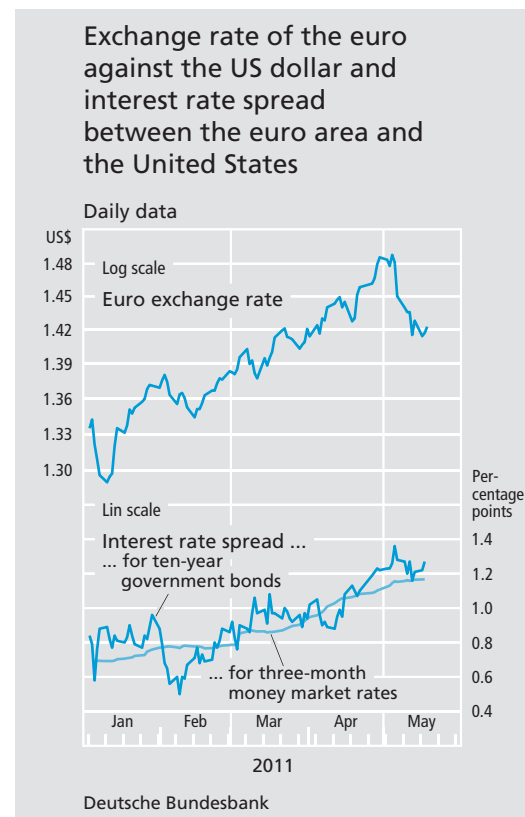
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On the foreign exchange markets, the global economic recovery and the increasing upward trend in prices have been in the spotlight since the beginning of the year. Market players have increasingly been raising the

*Euro exchange  
rate develop-  
ments against  
the US  
dollar, ...*

question whether the strongly expansionary monetary policy in the industrial countries should be tightened somewhat. The Governing Council of the ECB also voiced concern about inflation risks during its meeting at the beginning of March. Rising inflation was also reported from the USA at that time, but the Federal Reserve placed more emphasis on the continuing risks for the economic upturn and problems on the labour market. The impression taking hold on the market that the tightening of monetary policy will materialise earlier on this side of the Atlantic than in the USA resulted in an increasingly positive yield spread for the euro area and in an appreciation of the euro against the US dollar.

This monetary policy constellation gave rise to continued appreciation pressure for the euro in the spring, too. However, tensions in the sovereign bond markets of some euro-area peripheral countries interrupted the appreciation of the euro temporarily, for example when a rating agency downgraded the credit rating of Greek bonds markedly in March. The Governing Council of the ECB did then indeed raise the main policy rate at the beginning of April, which reinforced the interest rate spread vis-à-vis the USA. Investors' attention subsequently turned to the precarious budgetary position of the USA, additionally burdening the US dollar. Both controversy about the increase in the US borrowing limit and the downgrading of the outlook for US bonds played a part in this. The appreciation of the euro came to an end, however, after the ECB Governing Council meeting at the beginning of May, when some market players' expectations of rising



interest rates in the euro area were deferred to the future somewhat. In addition, renewed discussions about the fiscal situation in Greece and a further downgrading of its bonds' credit rating weighed on the euro. As this report went to press, the euro stood at US\$1.42, which represents an appreciation of 6½% since the beginning of the year.

Anticipation of an upcoming rise in lending rates in the single currency area helped the euro to gains against the yen, too, in the first two months of the year. In March, the euro-yen rate was largely influenced by the tragic events in Japan. At first, the yen appreciated substantially, owing to speculation on a surge in capital inflows to Japan, which – it was conjectured – would be fed by payments from reinsurers and the repatriation of funds

*against the yen ...*

by Japanese households and enterprises. Owing to concerns about market developments becoming difficult to control, the central banks of the G7 countries decided on concerted yen sales, which led to an abrupt depreciation of the yen. Given the likely budgetary burdens arising from reconstruction, the Bank of Japan's additional supply of liquidity and the significant correction in the outlook for the Japanese economy, the euro appreciated further against the yen in the weeks that followed. In addition, the expectation of a sustained expansionary Japanese monetary policy together with speculation on further foreign exchange intervention in the event of a marked yen appreciation raised the attractiveness of the yen as a financing currency for carry trades. Recently, however, a correction movement commenced against the yen similar to that against the US dollar, putting the euro at 115 yen at the end of the reporting period, 6½% stronger than at the beginning of the year.

*... and against  
the pound  
sterling*

In view of the especially high inflation in the United Kingdom and the corresponding expectation of upcoming monetary tightening, the euro came under pressure against the pound sterling at the beginning of the year. This changed, however, after the Bank of England indicated in mid-February that the surge of inflation was caused by the general increase in commodity prices along with the increase in British value added tax and the pound's depreciation during the crisis. After having contradicted market expectations in this connection that it was preparing the ground for a rise in lending rates, the euro began to appreciate. News of the compara-

tively sluggish economic recovery in the UK brought the pound sterling under additional pressure. In spite of the persistently high inflation rates, the Bank of England confirmed it would continue the exceptionally relaxed monetary policy during its meetings in March and April which supported a further appreciation of the euro. In May, market players' relative interest rate expectations for the euro and pound sterling shifted once again, causing the euro to weaken. As this report went to press, it was trading at 0.88 pound sterling, 2½% stronger than at the beginning of 2011.

Since the beginning of 2011, the euro's average value vis-à-vis the currencies of 20 major trading partners has appreciated by 3%. While the single currency gained ground against the above-mentioned currencies, it depreciated against the currencies of central European EU member states Poland, Romania, the Czech Republic and Hungary. The price competitiveness of euro-area suppliers compared with important trading partners has deteriorated further as a result of the euro appreciation and continues to stand at an unfavourable level.

*Effective euro  
exchange rate*

## Securities markets and portfolio investment

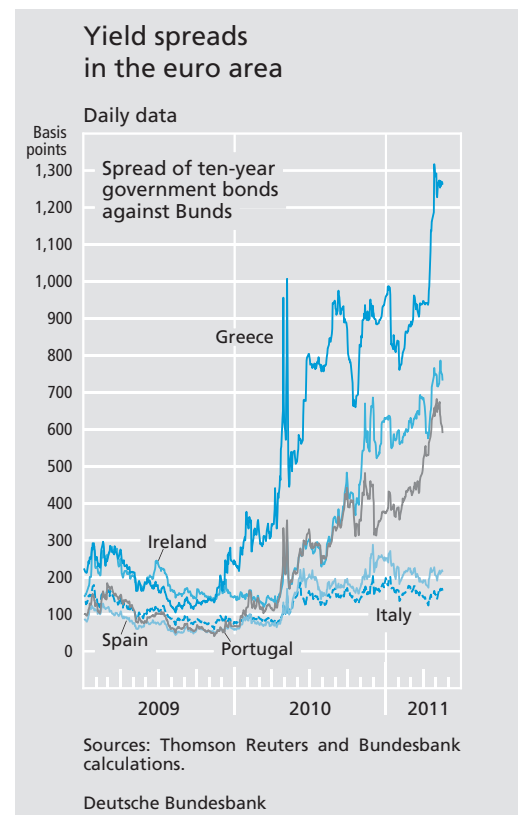
The positive global economic development also shaped events on the bond markets of major industrial countries in early 2011. In addition, growing inflation worries against the backdrop of sharp price increases for commodities and food influenced the nomin-

*International  
bond markets*

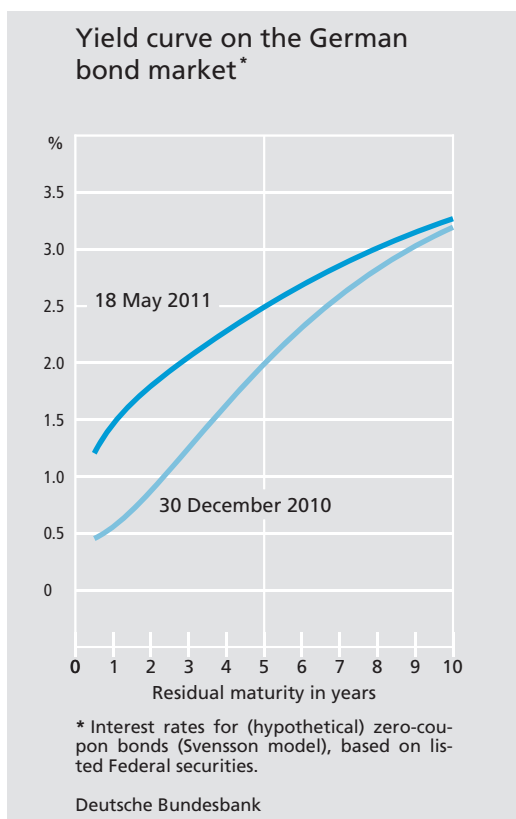
al yields. Recently the markets again focused more strongly on the European debt crisis, which led to shifts in Federal bonds (Bunds), with a yield-reducing effect. Thus, since the end of December 2010, yields on Bunds with a residual maturity of ten years have increased only marginally by ten basis points to just over 3%. By contrast, in spite of some fluctuations in the reporting period, yields on US government bonds with the same maturity have dropped somewhat on balance to just under 3¼%. Sentiment indicators that fell short of market expectations, safe-haven flows as well as the Fed's announcement to continue to keep central bank interest rates low recently had a yield-lowering effect. On the other hand, a major US rating agency's announcement that it would give a negative outlook for the USA's credit rating in view of the high level of sovereign debt only had a temporary yield-increasing effect on the bond market.

*Further intensification of European debt crisis*

After Ireland had already requested international support to resolve its budgetary problems at the end of November 2010, Portugal requested international financial assistance at the beginning of April. Negotiations about a new austerity package had previously failed in the Portuguese parliament, the minority government had announced it was stepping down and the major rating agencies had downgraded Portugal's credit rating. Until this time, the yield spreads of ten-year Portuguese government bonds to Bunds of the same maturity had increased by almost 180 basis points compared with the beginning of the year. Since then, the yield spread has expanded again, albeit in extraordinarily



thin markets, by just under 50 basis points to 599 basis points. Greek government bond yields have also increased significantly since the beginning of the year. Thus yields on ten-year government bonds climbed to almost 16% for a time. The corresponding two-year bonds yielded just under 25% for a short time. The huge increase in yields is probably attributable to doubt about Greece's ability to consolidate and the associated debate on a possible debt restructuring. Through the increase in risk premiums, the GDP-weighted yield dispersion expanded again in the euro area and recently hovered just below a new all-time high, after declining somewhat in January. The GDP-weighted average yield spread of long-term euro-area government bonds over Bunds recently stood at the high level of 184 basis points.



*Upward shift in yield curve*

Increased inflation expectations manifested themselves in the shift of the German yield curve at the beginning of the year, rising for shorter maturities in particular. The emphasis on medium-term inflation risks following the ECB Governing Council's monetary policy meeting in March was also reflected in the upward revisions of interest rate expectations in the market. Overall, the yield curve shifted upwards across all maturities. In the shorter-term maturity spectrum the increase was stronger, which caused the yield curve to flatten. The difference between ten and two-year yields declined by 85 basis points to 147 basis points, moving closer to the even smaller five-year average.

The financing conditions for European enterprises with the lowest investment-grade

category, BBB, in the bond markets improved slightly, in line with robust economic developments and waning stock price uncertainty. All in all, at the end of the reporting period, yields on euro-denominated corporate bonds – as measured by the iBoxx bond index, which comprises bonds issued by banks and non-banks – were, at just shy of 5½%, slightly more than one-quarter percentage point below the figure at the end of December. In view of the slight increase in Bund yields, the corresponding interest rate spreads narrowed by just below 50 basis points. The lower premium for corporate bonds reflects investors' increasing appetite for risk as well as the market's assessment of a lower credit risk for those enterprises able to tap the capital markets; this is also reflected in the markets for corporate credit default swaps. Here the credit derivatives index iTraxx Europe, which is composed of credit default swaps referencing investment grade credits with a maturity of five years, has fallen by seven basis points since the end of December and the comparable index for lower-rated enterprises (iTraxx Europe Crossover) by 79 basis points.

*Financing conditions for enterprises*

The favourable financial market setting was only partly reflected in buying and selling figures in the German bond market. In the first quarter of 2011, total gross issue volume was €371½ billion, so that it was down on the previous quarter's €425 billion. After deducting the likewise lower redemptions and taking account of changes in issuers' holdings of their own bonds, domestic debt securities totalling €44 billion net were sold. In addition, foreign borrowers sold debt securities for €22 billion on the German market. These were

*Net sales in the bond market down*

almost solely euro-denominated paper on balance. Funds totalling €66 billion were thus raised in the German bond market in the reporting period.

*Issues by  
non-banks*

Domestic enterprises used the improving financing conditions in the capital market to issue debt securities worth €20½ billion net in the first quarter of 2011. These were mainly bonds with a maturity of more than one year. Here it should be noted that since January 2011, issues of financial products launched in Germany, which are generally sold *en bloc* to group companies domiciled abroad, are additionally recorded as sales of other financial intermediaries. These mainly comprise certificates. Total sales of this kind of paper reached €16 billion.

*Borrowing  
by German  
government*

In the first quarter of 2011, the public sector raised €19 billion in the bond market, compared with net redemptions of €85½ billion in the previous quarter. Here central government issued mainly Federal notes (€16 billion), to a lesser extent two-year Federal Treasury notes (Schätze) and 30-year Federal bonds (€3 billion and €2 billion respectively). By contrast, the German Federal government redeemed Federal Treasury discount paper (Bubills) and ten-year bonds totalling €3 billion and €½ billion respectively. The German Länder did not tap the capital market on balance.

*Sales of bank  
debt securities*

By contrast, domestic credit institutions expanded their capital market debt slightly between January and March, by €4½ billion. Here they issued mainly other bank debt securities (€9 billion), which allow flexible

### Investment activity in the German securities markets

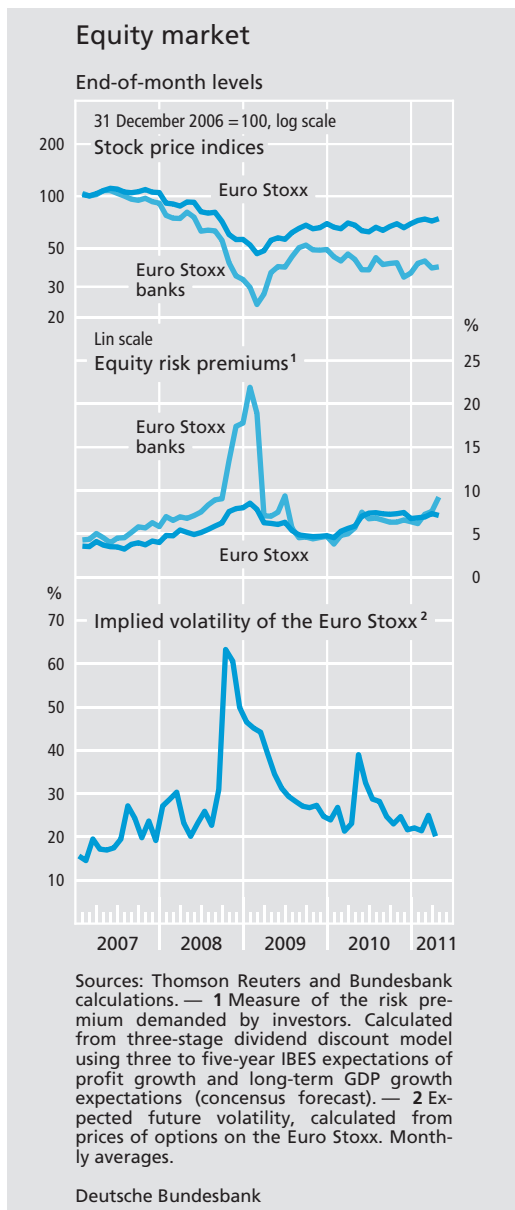
€ billion			
Item	2010		2011
	Q1	Q4	Q1
<b>Debt securities</b>			
Residents	32.4	106.3	16.0
Credit institutions	2.1	-28.9	-11.4
of which			
Foreign debt securities	1.5	-21.4	0.5
Non-banks	30.3	135.2	27.4
of which			
Domestic debt securities	11.9	3.5	5.9
Non-residents	7.6	8.9	49.8
<b>Shares</b>			
Residents	7.7	25.9	8.9
Credit institutions	3.0	9.0	5.8
of which			
Domestic shares	3.8	7.7	7.6
Non-banks	4.7	16.8	3.1
of which			
Domestic shares	3.3	6.4	2.6
Non-residents	-0.4	-2.6	-8.9
<b>Mutual fund shares</b>			
Investment in specialised funds	13.9	23.4	14.2
Investment in funds open to the general public	7.0	2.7	0.6
of which: Share-based funds	-0.4	4.0	0.2

structuring, as well as mortgage Pfandbriefe (€5½ billion) and specialised credit institutions' debt securities (€2½ billion). These contrasted with redemptions of public Pfandbriefe (€12½ billion).

In the first quarter of 2011, foreign investors were the main buyers; including the above-mentioned certificates, they added bonds worth €50 billion to their portfolios. Domestic non-banks purchased debt securities for €27½ billion, primarily adding foreign securities. By contrast, German credit institutions disposed of interest-bearing paper in the amount of €11½ billion; in net terms they sold exclusively domestic paper.

*Purchase of  
debt securities*

International stock markets were initially bolstered by the continued improvement in



International stock prices up despite short-term setbacks

economic prospects at the beginning of the year, which was reflected in the better-than-expected corporate results. Political unrest in several North African countries and related concerns about rising commodity prices then led to an interruption in the upturn, however, and (temporarily) to increased uncertainty in the markets. In addition, the rise in the Euro-system's key interest rates, indicated at the beginning of March and implemented in

April, initially dampened investors' risk appetite, as it heralded the end of the phase of exceptionally low euro-area interest rates, which the markets had originally not expected until the middle of the year. Equity markets suffered a setback in mid-March after the devastating earthquake and nuclear power plant catastrophe in Japan, which prompted stock prices to plummet worldwide. However, with the exception of the Japanese equity market, all major international indices were able to recoup their losses within a short period of time; this underscores investors' confidence in the economic upturn, which was supported further by positive corporate data at the start of the reporting season. Recently, uncertainty rose on the stock market, however, leading to slight price decreases. Measured against the broad-based CDAX and Euro Stoxx indices, German and European equities rose by 2% and 2½% respectively on balance from the end of December; US stocks (S&P 500) showed a somewhat stronger rise (+ 5½%), whereas Japanese shares were 6½% lower.

The excess return investors demand for an investment in European shares (Euro Stoxx) as compared to a safe investment, which can be calculated using a dividend discount model, has risen since the end of last year – in spite of price gains – by just over one-quarter percentage point to around 7%. It therefore remains considerably above the five-year average (5½%). This indicates that the price level is well-founded and that investors are still relatively cautious. This is also suggested by the fact that the implied risk premium for exposure to European banking stocks recent-

*Equity risk premium*



ly showed a further marked increase (to 9¼%). Investors are therefore demanding significantly higher risk compensation for bank shares in comparison with other equities for the first time since mid-2009.

*Stock market  
funding and  
stock purchases*

Despite – on the whole – favourable price development, issuance activity in the German stock market was still relatively subdued in the first quarter of 2011. Domestic enterprises issued €1½ billion worth of new shares, the majority of which were unlisted equities. The outstanding amount of foreign equities in the German market sank by €1½ billion. Equities were purchased primarily by German credit institutions (€6 billion), which bought only domestic shares on balance (€7½ billion). Resident non-banks bought shares for €3 billion, with domestic paper again accounting for the lion's share. By contrast, foreign investors sold German shares (€9 billion in total) – as was often the case in previous years in the run-up to the dividend payment dates.

*Sales and  
purchases of  
mutual fund  
shares*

During the reporting period, domestic investment companies recorded inflows of €15 billion, after raising funds totalling €26 billion in the previous three months. The fresh funds benefited mainly specialised funds reserved for institutional investors (€14 billion). Of the mutual funds open to the general public, in particular mixed securities-based funds were able to place mutual fund units (€1 billion), as were, albeit to a lesser extent, mixed funds and open-end real estate funds (€½ billion each). By contrast, bond-based funds redeemed their own shares (€1½ billion). Foreign funds traded in the German market

### Major items of the balance of payments

€ billion			
Item	2010		2011
	Q1	Q4	Q1
<b>I Current account 1, 2</b>	+ 34.6	+ 46.3	+ 35.3
Foreign trade 1, 3	+ 37.8	+ 39.5	+ 41.0
Services 1	- 0.9	+ 2.2	- 0.3
Income 1	+ 14.3	+ 14.2	+ 13.2
Current transfers 1	- 14.1	- 6.5	- 14.1
<b>II Capital transfers 1, 4</b>	+ 0.3	- 0.5	+ 0.9
<b>III Financial account 1</b>			
(Net capital exports: -)	- 32.8	- 42.5	- 57.1
<b>1 Direct investment</b>	- 36.2	- 1.0	- 30.0
German investment abroad	- 43.3	- 11.3	- 28.3
Foreign investment in Germany	+ 7.1	+ 10.3	- 1.8
<b>2 Portfolio investment</b>	- 15.2	- 107.7	+ 26.8
German investment abroad	- 24.3	- 115.7	- 20.3
Shares	+ 3.4	- 2.3	+ 4.6
Mutual fund shares	- 7.8	- 3.2	- 2.8
Debt securities	- 19.9	- 110.3	- 22.1
Bonds and notes 5	- 20.2	- 115.9	- 19.3
of which Euro-denominated bonds and notes	- 28.1	- 60.7	- 18.2
Money market instruments	+ 0.3	+ 5.6	- 2.7
Foreign investment in Germany	+ 9.2	+ 8.0	+ 47.1
Shares	- 0.2	- 2.1	- 5.1
Mutual fund shares	+ 1.7	+ 1.2	+ 2.4
Debt securities	+ 7.6	+ 8.9	+ 49.8
Bonds and notes 5	+ 13.2	- 7.3	+ 31.4
of which Public bonds and notes	+ 16.5	+ 8.4	+ 22.7
Money market instruments	- 5.6	+ 16.3	+ 18.4
<b>3 Financial derivatives 6</b>	- 3.6	+ 0.3	- 8.7
<b>4 Other investment 7</b>	+ 22.9	+ 66.4	- 43.8
Monetary financial institutions 8	+ 75.4	+ 47.0	- 4.8
of which: short-term	+ 65.3	+ 21.1	- 6.3
Enterprises and households	- 22.6	- 2.4	- 30.8
of which: short-term	- 13.4	+ 7.5	- 15.3
General government	- 1.0	+ 34.1	- 9.5
of which: short-term	+ 0.9	+ 75.2	- 11.4
Bundesbank	- 28.9	- 12.3	+ 1.3
<b>5 Change in reserve assets at transaction values (increase: -) 9</b>	- 0.7	- 0.5	- 1.4
<b>IV Errors and omissions</b>	- 2.0	- 3.3	+ 20.8

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.

Deutsche Bundesbank



acquired new resources totalling €3 billion net in the first quarter of 2011. Domestic non-banks were the main buyers, adding mutual fund shares worth €15 billion to their portfolios. This was domestic paper for the most part. Foreign investors invested €2½ billion in domestic funds. Domestic credit institutions acquired mutual fund units worth €½ billion.

### Direct investment

*German direct investment abroad*

In the first quarter of 2011, there were net outflows in direct investment from Germany (€30 billion), after the flows were close to balance in the last quarter of 2010. The main reason for this was that domestic companies increased their capital transfer to foreign countries from €11½ billion to €28½ billion. Intra-group financial and trade credits accounted for €10½ billion of this sum. Reinvested earnings and equity capital in-

creases constituted a further €9½ billion and €8½ billion respectively. Direct investment last year was mainly focused on the Netherlands (€14½ billion), Austria (€5½ billion), the United Kingdom (€2½ billion) as well as outside Europe, the USA (€3 billion). Holding companies and manufacture of transport equipment played a prominent role, with net capital exports of €6½ billion and €4½ billion respectively.

Transactions by foreign proprietors with their German affiliates also led to capital exports (€2 billion). Here they reduced their equity capital in Germany by €4½ billion, primarily as a result of the withdrawal of a French company's involvement in a German energy supply company. Money also flowed out of Germany under intra-group loans (€1½ billion). By contrast, €4 billion reached affiliates of foreign enterprises in Germany through reinvested earnings.

*Foreign direct investment in Germany*