Financial markets

Financial market setting

Financial market trends

In the summer of 2011, financial market players have increasingly been monitoring the large sovereign debt burden facing developed countries. The consolidation pressure on government budgets was also highlighted in the domestic policy disputes in those countries, which stirred up fears among investors. Furthermore, global driving forces in the second quarter weakened noticeably and global economic prospects also diminished somewhat. The loss of purchasing power owing to increased oil prices and higher inflation rates likewise had a dampening effect. Turning to Europe, the markets enjoyed only a brief respite after the heads of state and government decided in mid-July to grant Greece another rescue package, staving off a default. At the beginning of August, the situation on the financial markets deteriorated further. Against the backdrop of a fierce parliamentary debate on whether to raise the statutory debt ceiling, the United States suffered its – first ever – credit downgrade by a rating agency. In the euro area, meanwhile, Spanish bond yields rose perceptibly, as did yields on bonds issued by heavily indebted Italy. In this environment, share prices around the world tumbled, and yields on the government bonds of the major industrial nations weakened noticeably as a result of safe haven inflows. Market participants' uncertainty regarding economic developments on both sides of the Atlantic caused noticeable fluctuations of the euro-dollar exchange rate, and both currencies depreciated against the yen and, in particular, the Swiss franc.

Exchange rates

Euro-dollar rate virtually unchanged on balance

In the foreign exchange market, the spotlight was on the euro-dollar rate, which was caught between opposing influencing factors from Europe and the USA. Thus there were phases when the euro depreciated noticeably, with the debt problems of the euro-area peripheral countries determining the euro's exchange rate performance. These contrasted with phases of a stronger euro when the focus was on US economic figures that were below expectations and, for a time, on disputes over the US debt ceiling.

The euro initially appreciated by nearly 5% from the end of March to the beginning of May 2011, and at US$1.49 it reached its highest level since December 2009. This was due to economic reports which tended to be more favourable for the euro area than the USA, and the resulting positive yield spread for the euro area. After the indication of a further key interest rate increase in the euro area in June, which was expected by some market participants, failed to materialise at the start of May, the euro devalued noticeably, however. In addition, a renewed credit downgrade of Greek government bonds and rumours of an imminent restructuring of Greek debt put pressure on the euro. Only at the start of June, when signs grew that the next tranche of the agreed aid programme would be disbursed to Greece, and disappointing US economic figures were published at the same time, did the focus swing back again towards the USA – in conjunction with a marked appreciation of the euro.

The euro has depreciated again since then, however. This was connected with the renewed escalation of the debt crisis in various euro-area countries. Examples of this were concerns that the Greek parliament would not approve the austerity package, the credit downgrade of Portugal and, finally, the rise in risk premiums on Italian and Spanish government bonds. However, the parliamentary debate on whether to raise the US debt ceiling served to prevent a larger depreciation of the euro. At US$1.44 as this report went to press, the euro is about 1% stronger than at the end of the first quarter of 2011.

Depreciation against the yen

The yen profited from investors' uncertainty over developments in the euro area and the USA, which has led to a depreciation of the euro against the Japanese currency by around 6½% since the end of March. The yen was also bolstered by signs of a rapid recovery of the Japanese economy from the slump after the natural and nuclear power plant disaster. Industrial output in Japan rose again clearly, as did retail sales and real exports of goods. The Japanese central bank reacted to the appreciation of the national currency with foreign exchange market interventions at the beginning of August, which were successful in the short term but could not prevent a further appreciation of the yen thereafter. As this report went to press, the euro was trading at ¥110.

Little change in euro against pound sterling on balance

The euro barely changed on balance against pound sterling during the reporting period. Reports regarding the UK's stalling economy led to a temporary appreciation of the euro during the course of June. Despite the inflation rate being above the Bank of England's target, the likelihood of a key interest rate increase fell, in the opinion of market participants. Since the beginning of July, the euro has been dogged by the debt crisis in the euro area again, however. At the end of the period under review, €1 was worth £0.87, down around 1½% compared with the end of March.

Noticeable exchange rate losses for euro against Swiss franc

The euro registered marked losses against the Swiss franc. Compared with the end of the first quarter, the euro of late stood at CHF1.14 – down 12½% – shortly after it had reached its lowest historical value of CHF1.05. The Swiss currency profited as a safe haven from great investor uncertainty over developments in the euro area and the USA, as well as from the sound state of the Swiss economy. The euro recovered somewhat of late again after a loosening of Swiss monetary policy as well as reports of a possible pegging of the Swiss franc to the euro.

Effective euro exchange rate

The euro lost about 1% in value compared with the beginning of the second quarter vis-à-vis the currencies of the 20 most important trading partners. However, it was still 2% above its level at the launch of monetary union. Thus, the price competitiveness of euro-area suppliers vis-à-vis important trade partners is still relatively unfavourable.

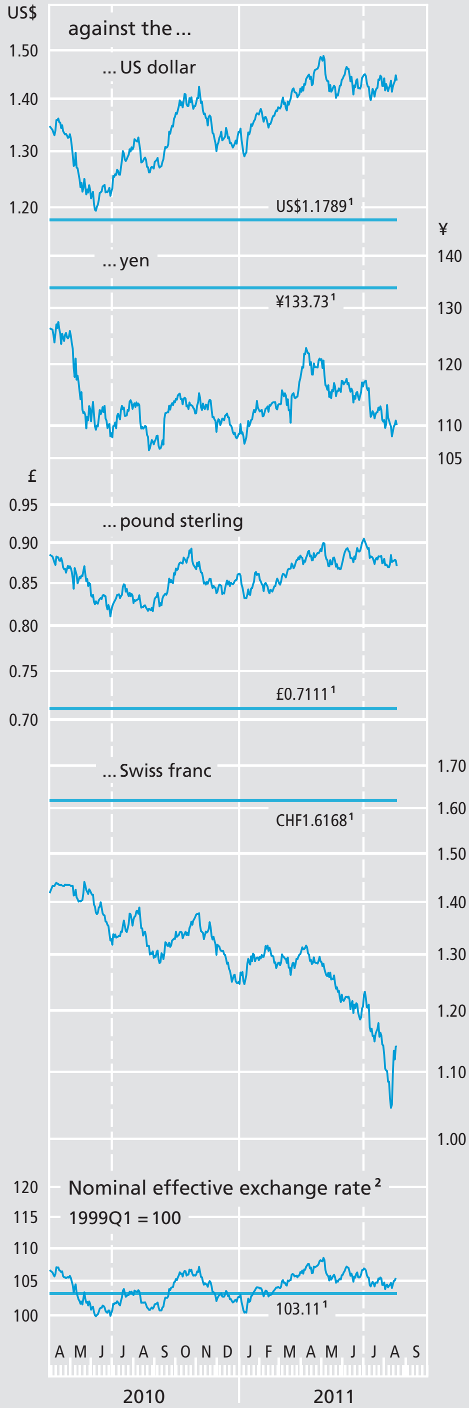
Securities markets and portfolio transactions

International bond markets affected by safe haven flows

Yields on US, Japanese and German government bonds decreased steadily during the spring and summer, and by mid-August were trading close to their historical lows. Thus, the

Exchange rate of the euro

Daily data; log scale



1 Exchange rate at the start of monetary union on 4 January 1999. — 2 As calculated by the ECB against the currencies of 20 countries.

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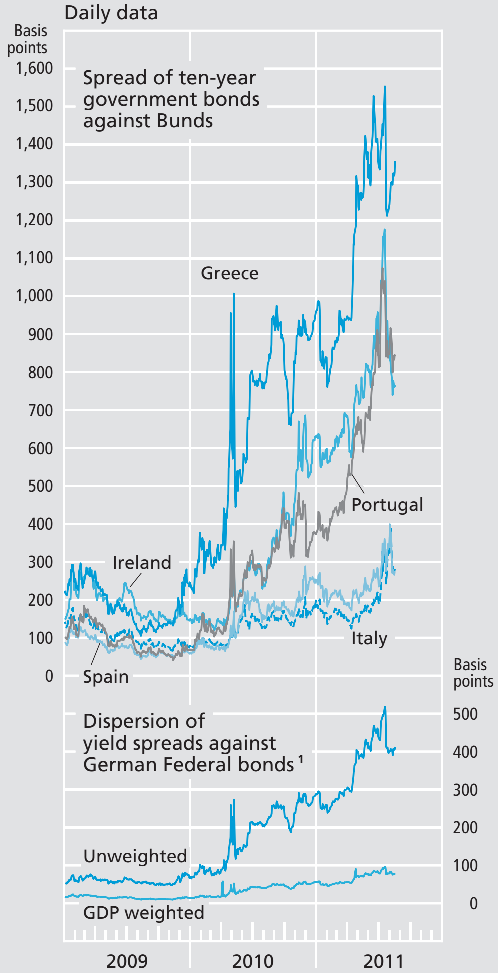
Yield spreads in the euro area

Daily data



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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yield on ten-year German government bonds (Bunds) has fallen by more than 120 basis points to 2.1% since the end of March 2011, while US Treasuries with the same maturity also dropped to 2.1% virtually in lockstep. The corresponding yield on Japanese government bonds fell from a lower level by 20 points to just over 1%. In an environment of high uncertainty – as gauged by the implied volatility of options on interest rate futures, which was above the five-year average – investors' search for safe and liquid investments was reflected in declining yields. They also expressed the more unfavourable global economic outlook. The indicators pointed to a slowdown in the upward growth tendency in the USA and then also for the euro area. The markets were affected of late by the credit downgrade of the USA, which triggered a paradoxical response from yields. Although the revaluation negatively affected investors' propensity to invest in US Treasuries, given the fragile market situation the increased uncertainty offset a possible substitution effect and ultimately led to an intensified demand for US Treasuries, which were still regarded as a safe haven. Due to Japan's rapid recovery following the devastating earthquake, Japanese government bonds recorded more stable prices than sovereign bonds on both sides of the Atlantic.

Yield spreads in the EMU at record level

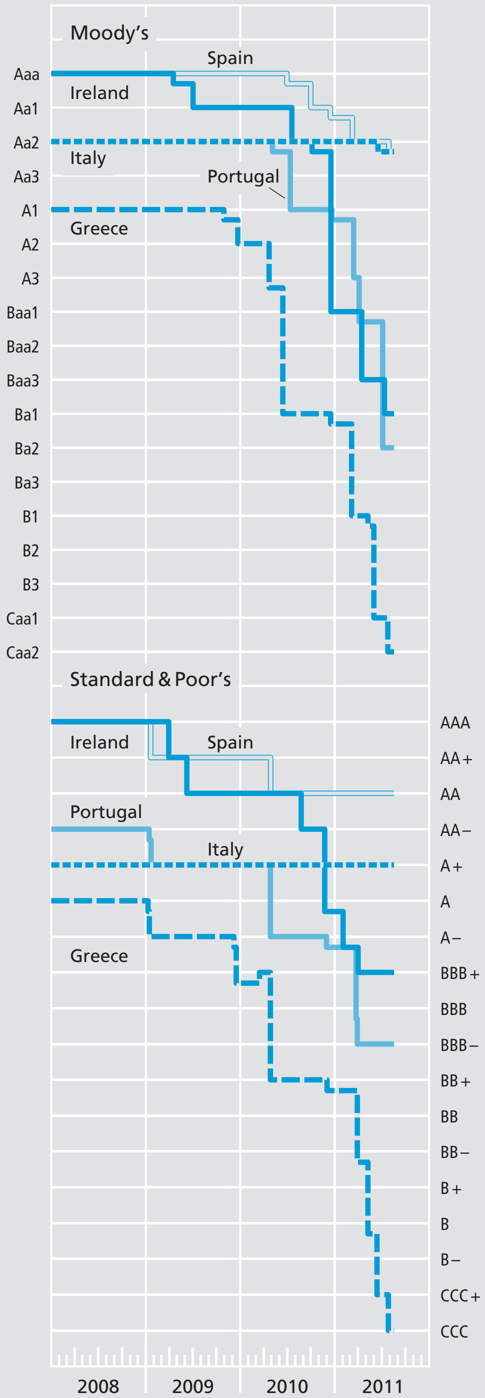
Throughout the review period, euro-area yield spreads were dominated by market participants' uncertainty regarding the solvency of highly indebted countries. Initial concerns centred on a possible credit event involving Greek bonds. The markets were also put under pressure by the facts that this jeopardised an IMF credit tranche that is tied to strict conditionality, that Greece was not meeting the objectives of its consolidation efforts and that the Greek parliament only adopted an urgently required austerity package, which had been agreed upon with the European Commission, ECB and the IMF, at the last possible moment. In addition, during the course of the quarter, the political dispute about whether the public sector should completely cover the risks entered into by the private sector with its exposure to

Greece came to the fore. At the European Union summit on 21 July 2011, a new rescue programme for Greece was finally resolved, and a plan for a maturity extension on capital market-financed public debt, with private sector involvement, was presented. Sovereign yields of highly indebted euro-area countries fell only briefly in response, however. When, in rapid succession, the rating agencies lowered their credit ratings for the already crisis-stricken countries as well as for Spain and Italy, the yield spreads on euro-area countries' long-term government bonds rose to new record highs against Bunds in August. Market participants' main concern was whether Italy's fiscal policy would drive the budgetary consolidation forward decisively enough. In light of the Eurosystem's secondary market purchases and additional consolidation efforts in Italy, the spread narrowed again, however; as this report went to press, it stood at over 240 basis points and thus still 130 basis points above its level at the end of March 2011.

Yield curve shifted downwards

The German yield curve has shifted downwards markedly since March, with interest rates in the short-term capital market segment falling less strongly than long-term yields. This reflects the key interest rate increases in the euro area, which led to rising money market rates and had a knock-on effect on short-term maturities on the capital market. However, in market participants' view, the time for further monetary policy steps had been put back compared with the end of March. The implied forward break-even inflation rate between five and ten years has increased appreciably since mid-June. For all the uncertainty involved in interpreting financial market data given the

Ratings of Greece, Ireland, Italy, Portugal and Spain *



* Long-term foreign currency rating. In this chart, a negative or positive outlook corresponds to one-third of a notch.

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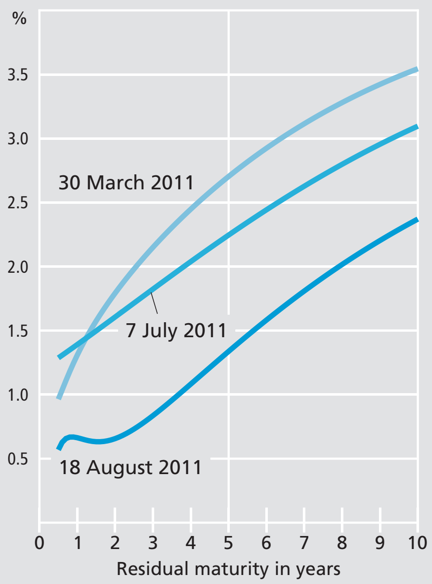
Yield curve on the German bond market*



* Interest rates for (hypothetical) zero-coupon bonds (Svensson model), based on listed Federal securities.

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high volume of safe haven flows, it cannot be ruled out that market participants envisage greater inflation risks in the long term. At the very least, the observed trend of this indicator for longer-term inflation expectations has continued upwards since autumn 2010.

Financing conditions for enterprises not unfavourable

Yields on BBB-rated European corporate bonds initially fell in the reporting period and only rose again slightly as the debt crisis intensified in August.[1] As interest on Bunds fell sharply at the same time, the gap to this benchmark widened to 380 basis points, which was clearly above the five-year average. This, and the increases in credit default derivative indices (iTraxx) show that market participants evaluate the credit risks of enterprises somewhat more critically than they did at the beginning of the second quarter. Besides – as with government bonds – the yield dispersion between the countries increased, with banks in some peripheral countries registering a particularly strong rise in debt financing costs. In absolute terms, bonds issued by enterprises to borrow on the capital market yielded just over 5.9% of late, and thus slightly below the average of the last five years. All in all, enterprises' financing conditions on the capital market cannot therefore be considered as unfavourable.

High issuance in the bond market

Issuance activity on the German bond market in the months April to June was, at €349 billion, below the volume recorded in the previous quarter (€371½ billion). However, after deducting redemptions, which also decreased, and taking account of changes in issuers' holdings of their own bonds, the volume of outstanding domestic bonds rose by €2 billion on balance. Foreign debtors sold debt securities totalling only €4 billion on the German market. Compared with the two-digit billion amounts which were seen before the crisis, this is a comparatively small amount. Before the outbreak of the debt crisis, even weaker partner countries – from a fiscal policy perspective – could regularly place large amounts in Germany. The smaller sales volume shows that some euro-area countries have lost the ability to procure capital market funds from private investors. A total of €6 billion flowed into the German bond market on balance.

High level of public sector borrowing

The public sector increased its capital market debt by €35½ billion in the second quarter. Of this amount, central government (including

1 Yields on BBB-rated corporate bonds in the iBoxx bond index are used as a basis. This index covers bonds issued by banks and non-banks.

FMS Wertmanagement) accounted for €22 billion. The German Federal government itself borrowed just under €9½ billion. It was striking that it continued with its issues to extend the maturity of its debt and in doing so secured the favourable interest rate level for longer. It primarily issued ten-year Bunds (€13 billion), and, to a smaller extent, two-year Federal Treasury notes (Schätze) and 30-year Federal bonds (€2 billion each). Conversely, the German Federal government redeemed five-year Federal notes (Bobls) and Federal Treasury discount paper (Bubils) totalling €4 billion and €3½ billion respectively. The Federal states borrowed €13½ billion from the capital market.

Bank issuance activity low

Non-bank domestic enterprises issued debt securities during the reporting period worth €3 billion, which on balance were solely bonds with a maturity of more than one year.

Net redemptions by credit institutions

By comparison, domestic credit institutions reduced their capital market debt – following the trend of the past years – by €36½ billion net (previous quarter: +€4½ billion). Above all, flexibly structured other bank debt securities (€31½ billion) and public Pfandbriefe (€10½ billion) were redeemed. By contrast, specialised credit institutions, which also include public promotional banks, issued bonds worth €5½ billion net.

Purchases of debt securities by foreign investors

The sole purchasers of German debt securities in spring 2011 were foreign investors, increasing their portfolios of domestic fixed-income securities by €60 billion. Throughout the entire quarter, they mainly invested in paper issued by the public sector. The figures once again reflect global financial market participants' trust in the soundness of the German Federal government as a debtor in times of crisis. This meant that on several occasions the euro-area debt problem triggered sharp inflows into Federal securities. By contrast, residents sold bonds on the German bond market (€54 billion), the majority of which was interest-bearing paper from domestic non-banks (€36½ billion). Domestic credit institutions sold debt securities worth €17½ billion, (primarily German paper). Demand for euro-denominated government bonds from highly indebted euro-area countries was virtually zero.

Investment activity in the German securities markets

€ billion

Item	2010	2011	
	Q2	Q1	Q2
Debt securities			
Residents	– 4.2	16.0	– 54.0
Credit institutions	– 44.5	– 11.4	– 17.5
of which			
Foreign debt securities	– 40.3	0.5	– 2.6
Non-banks	40.3	27.4	– 36.5
of which			
Domestic debt securities	0.4	5.4	– 43.1
Non-residents	1.0	50.3	60.1
Shares			
Residents	13.4	7.4	15.9
Credit institutions	– 1.6	5.8	– 0.3
of which			
Domestic shares	– 4.6	7.6	– 5.1
Non-banks	15.0	1.7	16.2
of which			
Domestic shares	6.8	2.4	10.5
Non-residents	– 1.5	– 8.7	12.4
Mutual fund shares			
Investment in specialised funds	14.0	14.2	4.2
Investment in funds open to the general public	0.6	0.6	0.5
of which Share-based funds	– 1.4	0.2	1.4

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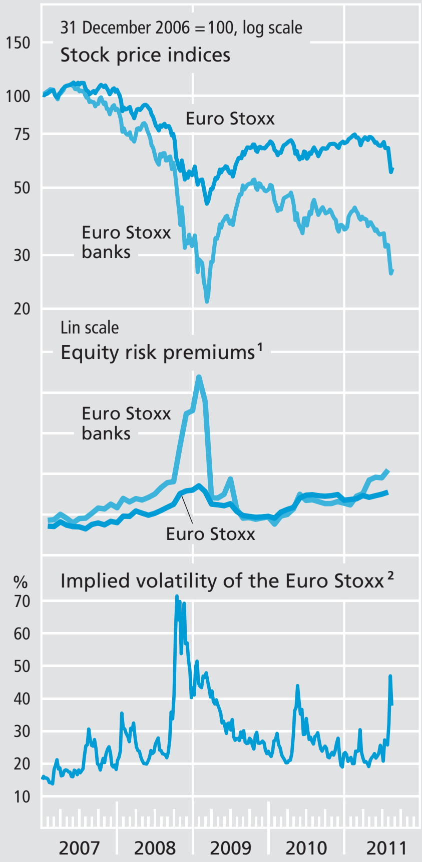
Heavy losses on international stock markets

The sovereign debt crisis in Europe and the discussions surrounding the debt ceiling in the USA led to greater uncertainty and significant price losses on the stock markets during the summer. The agreement on a new rescue pack-

Equity market

Weekly averages



Sources: Thomson Reuters and Bundesbank calculations. — 1 End-of-month levels; 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 (consensus forecast). — 2 Expected future volatility, calculated from prices of options on the Euro Stoxx.

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age for Greece and the publication of the bank stress tests results by the European Banking Authority did lead to temporary market rallies. With the altogether rather disappointing economic reports, first from the USA then later also from the euro area, as well as the concerns surrounding the budgetary situation in large countries, stock market prices fell in some cases by over 20% within a few days, however, and reached the levels last seen during the recession in 2009.

Listed US enterprises were also affected by share price losses, although the prospect of a continued low-interest-rate policy is producing negative expected real interest rates there. In Europe, equities performed very divergently. While equities from peripheral countries in particular had already registered clear declines in prices in the period from April to the end of July, the core countries' indices initially stabilised around the level seen at the end of March. Concerns about the stability of public finances and less favourable economic data also affected stock prices of late. On balance, the overall European Euro Stoxx index has fallen by 23½% since the end of March, with CDAX losses only marginally smaller. In view of these high share price decreases, the fact that profit growth expectations deteriorated only slightly was somewhat overshadowed. When considered as a whole, the P/E ratio of European shares is, at 8.9, clearly below its long-term average. Japanese shares lost 8½% in value based on the Nikkei 225 index despite Japan's brisker than expected recovery from the earthquake.

Equity risk premium quite high

The risk compensation investors demand for an investment in European shares (Euro Stoxx) as compared to a safer investment, which can be calculated using a dividend discount model, rose by just less than ½ percentage point to around 7¾%, mirroring the fallen P/E ratio. It therefore remains considerably above the five-year average (around 5½%). The implied risk premium for exposure to European banking stocks rose markedly of late to 10½%. This was because their prices were down even more sharply than earnings expectations for banks. The equity risk premium for bank equities is therefore at a level last seen during the banking crisis at the beginning of 2009.

Stock market funding and stock purchases not affected

The – on the whole – harsh stock exchange climate did not negatively affect issuance activity in Germany. In the second quarter of 2011, domestic enterprises issued new shares worth €18 billion, compared with €1½ billion in the months January to March. Capital increases in particular played a major role in this. The largest new issue was brought by a real estate enterprise that sees good investment possibilities in Germany. The outstanding amount of foreign shares in Germany rose by €10½ billion. Equities were acquired particularly by resident non-banks (€16 billion), which predominantly invested in domestic shares (€10½ billion). Credit institutions sold domestic shares (-€5 billion) in favour of foreign shares (+€5 billion). Non-resident investors expanded their exposure to the German stock market by €12½ billion, the vast majority of which was portfolio investment.

Sales and purchases of mutual fund shares declining

Domestic investment companies recorded inflows of €4½ billion in the months April to June, after €15 billion in the previous quarter. Almost all of the fresh funds benefited specialised funds reserved for institutional investors (€4 billion). Of the mutual funds open to the general public, equity-based funds attracted inflows of €1½ billion and open-end real estate funds €½ billion. By contrast, bond-based funds and money market funds suffered outflows of €1 billion and €½ billion respectively.

Major items of the balance of payments

€ billion

Item	2010 Q2	2011 Q1	2011 Q2
I Current account [1, 2]	+ 28.5	+ 35.3	+ 27.6
Foreign trade [1, 3]	+ 37.4	r + 40.8	+ 38.3
Services [1]	− 2.6	− 0.2	− 2.3
Income [1]	+ 3.1	+ 13.3	+ 0.7
Current transfers [1]	− 6.6	− 14.1	− 5.6
II Capital transfers [1, 4]	− 0.4	+ 0.9	− 0.3
III Financial account [1] (Net capital exports: –)	− 31.7	− 53.8	− 22.4
1 Direct investment	− 24.2	− 24.5	+ 4.5
German investment abroad	− 33.7	− 26.4	+ 1.7
Foreign investment in Germany	+ 9.5	+ 1.8	+ 2.9
2 Portfolio investment	− 9.1	+ 27.1	+ 58.8
German investment abroad	− 6.3	− 20.7	− 13.8
Shares	− 3.7	+ 4.8	− 8.4
Mutual fund shares	− 3.1	− 2.9	− 1.4
Debt securities	+ 0.4	− 22.6	− 4.0
Bonds and notes [5]	− 2.8	− 20.0	+ 3.7
of which Euro-denominated bonds and notes	− 2.4	− 18.7	+ 6.4
Money market instruments	+ 3.2	− 2.6	− 7.7
Foreign investment in Germany	− 2.8	+ 47.8	+ 72.5
Shares	− 3.8	− 4.9	+ 11.6
Mutual fund shares	+ 0.1	+ 2.4	+ 0.9
Debt securities	+ 1.0	+ 50.3	+ 60.1
Bonds and notes [5]	+ 20.9	+ 32.4	+ 38.3
of which Public bonds and notes	+ 22.4	+ 24.1	+ 31.3
Money market instruments	− 19.9	+ 17.9	+ 21.7
3 Financial derivatives [6]	− 6.3	− 11.5	− 5.5
4 Other investment [7]	+ 8.7	− 43.5	− 79.8
Monetary financial institutions [8]	+ 49.9	− 4.8	− 52.4
of which short-term	+ 41.0	− 6.3	− 47.6
Enterprises and households	+ 3.0	− 30.6	− 3.1
of which short-term	+ 13.1	− 15.3	+ 2.8
General government	− 3.9	− 9.3	− 8.1
of which short-term	+ 6.9	− 11.4	− 8.6
Bundesbank	− 40.2	+ 1.3	− 16.2
5 Change in reserve assets at transaction values (increase: –) [9]	− 0.8	− 1.4	− 0.4
IV Errors and omissions	+ 3.6	+ 17.5	− 4.9

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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Sales of foreign mutual fund units in Germany totalled €1½ billion.

As in the first quarter, mutual fund shares were mainly bought by domestic non-banks, which added €7½ billion worth of fund shares to their portfolios. This predominantly involved shares in domestic mutual funds (€7 billion). Non-resident investors increased their holdings of domestic fund units by €1 billion. By contrast, domestic credit institutions sold mutual fund shares worth €2½ billion, selling only domestic shares (€3 billion) on balance.

Direct investment

Net inflows in direct investment

As in cross-border portfolio transactions, which registered high net inflows in the second quarter of 2011 (€59 billion), Germany also recorded inflows in direct investment during the reporting period (€4½ billion). In the previous three months, net capital exports totalled €24½ billion. The main reason for the turnaround was that domestic enterprises withdrew funds from abroad (€1½ billion), while in the previous quarter they had distributed capital to their foreign subsidiaries to the tune of €26½ billion. This was mainly in the form of intra-group loans, which on balance provided funds to the resident parent enterprises during the second quarter of the year (€15½ billion). Furthermore, reinvested earnings decreased to €6½ billion. By contrast, the supply of additional equity capital was, at €7½ billion, slightly above the previous quarter's level. The geographical focus of German direct investment during the reporting period was on emerging market and developing countries (€3½ billion), while on balance funds were withdrawn from industrialised countries (€5½ billion).

Transactions by foreign proprietors with their German affiliates also led to net capital inflows (€3 billion) between April and June 2011. These were generally conducted via inter-group loans. Manufacturing enterprises in particular profited from this inflow. The funds predominantly came from affiliated enterprises in Luxembourg, the Netherlands and Switzerland.