Financial markets

Financial market setting

Financial markets driven by political developments and monetary policy

Against the backdrop of firmer global economic activity, developments in the international financial markets in the second quarter of this year were mainly shaped by political factors and changing expectations about the course of monetary policy on both sides of the Atlantic. Reduced political uncertainty in the euro area, where elections in France and Italy did not yield a positive outcome for Eurosceptic parties, stood in contrast to major doubts about the prospects of implementing further planned economic measures in the United States following the failure of the healthcare reform. The hike in the US policy rate by the Federal Reserve (Fed) in June had been broadly anticipated on the markets, but because the likelihood of further interest rate increases this year has fallen, yields on ten-year US government bonds have fallen by 20 basis points to 2.2% since the end of March. In the euro area, too, GDP-weighted yields on long-term government bonds have fallen on balance, although a speech by the ECB President at the end of June fuelled short-term market expectations that the Eurosystem's asset purchases might be phased out earlier than anticipated in response to the continued economic upturn. This led to a brief sharp increase in yields, particularly in Germany. On balance, yields on ten-year Bunds have gone up by 7 basis points to 0.4% since the end of March. Buoyed by rising earnings expectations, US equity indices climbed to new all-time highs at the beginning of August, while shares in the euro area were burdened by the strength of the euro as well as by the spread of the diesel emissions scandal and allegations that German car manufacturers were running a cartel. The euro recorded significant gains against the background of favourable economic data in the euro area. Measured against the currencies of 19 major trading partners, the euro appreciated by 5.2% compared with the end of the first quarter.

Exchange rates

Euro up markedly against the US dollar, …

The euro-dollar rate recorded slight gains between the end of March and mid-May 2017. This was attributable not only to the election result in France, but also to favourable economic data from the euro area and uncertainty among investors concerning the developments in US domestic politics. Starting in mid-May, the single currency then fluctuated within a narrow corridor of between US\$1.10 and US\$1.13. During this period, negative factors, such as the prospect of a less expansionary monetary policy in the United States, were broadly balanced out by positive factors, such as further surprisingly up-beat economic data from the euro area. The Fed's decision to raise its key policy rate in June had been largely anticipated, with the result that it did not place the euro under sustained pressure.

Remarks by the President of the ECB at the Forum on Central Banking in Sintra on economic and inflation developments in the euro area were interpreted as being quite confident, leading to the expectation among market participants of a forthcoming departure from the Eurosystem's highly accommodative monetary policy. The euro-dollar exchange rate rose in the next few days to US\$1.14, which at the time was the highest level since May 2015. Other voices from the ECB quickly dampened investors' expectations, tempering what would have been an even higher rise.

The euro-dollar rate was given further impetus by developments in the United States, including the renewed failure of the healthcare reform and statements before the US Congress by the chair of the Federal Open Market Committee (FOMC) of the Federal Reserve on the weak inflation trend in the United States. Investors interpreted these statements as a sign that expansionary monetary policy in the United States might continue for longer. The appreciation of the euro continued after the ECB Governing Council's meeting in July, despite no indications having been given of an early departure from the present monetary policy course. The euro received an additional boost when the FOMC kept the US policy rate stable at its meeting in July instead of once again increasing it. The single currency continued to make gains into August, at one point reaching US$1.19 – its highest level since January 2015. As this report went to press, the exchange rate stood at US$1.17. Overall, the euro-dollar exchange rate therefore appreciated by 9.4% over the reporting period.

… against the yen …

The single currency also appreciated considerably against the yen on balance. While it recorded significant losses before the first round of the French presidential elections amid geopolitical uncertainty, it quickly made good on these. In the period thereafter, the euro-yen exchange rate was strengthened, above all, by statements from Japan's central bank governor reaffirming the bank's commitment to yield curve control and by the Japanese central bank's interventions on the domestic bond market to ensure ten-year government bond yields remained on target. In addition, the Bank of Japan surprised market participants by again extending the timetable for achieving the inflation target. The prospect of a prolonged phase of expansionary monetary policy led to further appreciation of the euro against the yen. As this report went to press, the euro was trading at ¥128.8, and thus 7.7% above its level at the beginning of the reporting period.

… and against the pound sterling

On balance, the euro made substantial gains of just under 6.2% against the pound sterling. From the end of March to mid-May 2017, the euro-sterling exchange rate initially came under slight pressure, among other things due to the announcement by the British Prime Minister that she would work to achieve free trade agreements with the EU. Subsequently, however, it was buoyed by surprisingly weak economic data from the United Kingdom. In addition, the UK Prime Minister's Conservative Party lost its absolute majority in the snap parliamentary elections held at the beginning of June. The resulting uncertainty regarding the EU exit negotiations subsequently led to a lasting weakening of the pound against the euro. By contrast, voices from the Bank of England calling for an increase in interest rates in the near future on account of the positive inflationary developments in the United Kingdom only briefly dampened the euro's upward trajectory, especially as the Governor made clear he was against such a move. The euro made further gains when the Bank of England decided not to raise the policy rate at the beginning of August, showing that some market participants had

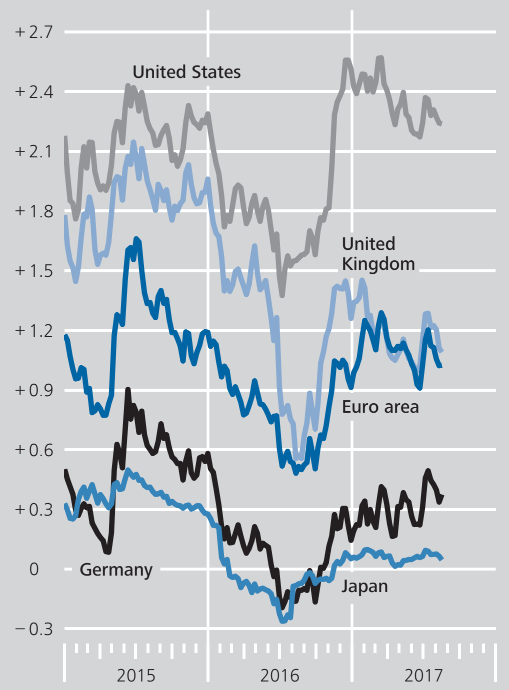
Exchange rate of the euro

Daily data, log scale

Source: ECB. **1** Exchange rate at the start of monetary union on 4 January 1999. **2** As calculated by the ECB against the currencies of 19 countries.
Deutsche Bundesbank

Yields* in the euro area and selected countries

% pa, weekly averages



Source: Thomson Reuters. * Government bonds with a residual maturity of ten years.
Deutsche Bundesbank

clearly still expected a policy rate hike. As this report went to press, the euro was trading at £0.91.

Euro has also appreciated significantly in effective terms

On the other hand, the single currency depreciated slightly against the Czech koruna, among others, after the Czech central bank discontinued the koruna's exchange rate floor to the euro. Measured against the currencies of 19 major trading partners, the euro appreciated by 5.2% on balance over the reporting period. When calculating the effective euro, recalculated trade weights were used for the first time (see the box on pages 41 to 43). The price competitiveness of euro area exporters deteriorated further due to the currency's appreciation. Since April 2015, when the real effective euro was at a multi-year low, a cumulative loss of competitiveness of around 10% has been calculated. However, in terms of the long-term average, the euro area's competitive position can continue to be regarded as neutral.

Securities markets and portfolio transactions

Monetary policy expectations impact yields on long-term government bonds

Bond market activity was determined, above all, by the changing expectations among some market participants concerning future monetary policy. Up to and into June, the yields on long-term government bonds initially fell in many countries, as market participants, for the most part, expected the Eurosystem's accommodative monetary policy to continue unchanged and somewhat lowered their expectations of a policy rate hike in the United States. However, comments at the Forum on Central Banking in Sintra, Portugal, at the end of June were – as mentioned above – interpreted by the markets as a sign of a forthcoming departure from the highly accommodative monetary policy in the euro area. This triggered a sharp rise in yields for a short time, though this partially receded by the end of the reporting period. On balance, the GDP-weighted yield on ten-year government bonds in the euro area fell by 15 basis points to 1.0% over the entire reporting period, which started at the end of March.

Increase in long-term Bund yields

Contrary to the European trend, the yield on ten-year Bunds since the end of March recorded a rise, on balance, of 7 basis points to 0.4%. It is possible that the mounting market expectation of a scaling back of bond purchases also led to a reduction in the scarcity premium on long-dated Bunds. The revised communication on the deposit rate after the meeting of the ECB Governing Council in June, the US policy rate hike and the speeches in Sintra had no direct impact at the short end of the yield curve. This maturity spectrum continued to be dominated by signals of scarcity. Since 2014, the yield on two-year Federal securities has fluctuated at a level close to the rate for overnight repo transactions for which Federal securities are used as collateral. The fact that the repo rate is significantly lower than the deposit rate is a sign that a special liquidity premium (scarcity premium) is applied

Recalculated weights for indicators of the German economy's price competitiveness

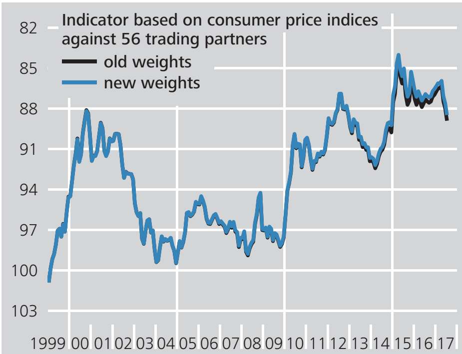
Indicators of price competitiveness are normally calculated as the weighted average of a country's relative price or cost development compared with major trading partners. The Bundesbank regularly calculates and publishes such indicators for Germany. Both conceptually and in the calculation procedure used, the indicators are in line with the real effective exchange rates published by the European Central Bank for the euro.[1] The individual trading partners are included in the indicators with time-variable trade weights, which are adjusted every three years to reflect changes in direct and indirect trade flows.[2] These regular adjustments aim to take account of current developments in foreign trade. The same applies to the most recent recalculation. Prior to the latest adjustment, the trade weights for all indicator series from 2010 onwards were based on the data from the years 2010 to 2012.[3] By contrast, the recalculated indicator values applying from 2013 use weights derived from trade links prevailing between 2013 and 2015.

The table on page 42 presents the recalculated weights that are used to calculate the indicator of the German economy's price competitiveness against a broad group of 56 trading partners. The weights for both the narrow and the medium-sized group of countries can be determined by rescaling the weights calculated for the broad group.[4]

The current weights deviate in some cases markedly from those of the previous period (basis 2010 to 2012), reflecting shifts in Germany's trading relations. For instance, the weight assigned to Germany's trade relations with China has increased further to currently 12%. In terms of the indicators of Germany's price competitiveness against the medium-sized and the broad group of countries, China therefore still has the highest trade weight of all of Germany's trading partners. The relative share of the United States, which was declining over an extended period of time, has gone up to just under 8½%. Thus, for the first time since the 2001-03 reference period, it is again greater than the relative share for France,

Price competitiveness of the German economy

1999 Q1 = 100, monthly, log scale[1]



1 Inverted scale: a rising curve (decline in values) indicates an increase in price competitiveness.
Deutsche Bundesbank

1 The calculation procedure is described in detail in M Schmitz, M de Clercq, M Fidora, B Lauro and C Pinheiro (2012), Revisiting the effective exchange rates of the euro, ECB Occasional Paper No 134. The most recent adjustments to the methodology may be found in Adjustments in the calculation of effective exchange rates and indicators of price competitiveness, Deutsche Bundesbank, Monthly Report, August 2013, pp 50-52.
2 Direct trade flows refer to direct bilateral trade between two given countries; in the case of indirect trade flows, two countries compete against one another not just in their respective markets but on a global level.
3 The most recent regular adjustments to the weights are collated in Deutsche Bundesbank, Monthly Report, August 2015, p 40.
4 Rescaling is achieved by proportionately distributing the weights of the countries which do not belong to the group of economies in question to the weights of the remaining countries.

Weighting scheme for the price competitiveness indicator of the German economy against a broad group of 56 trading partners

In thousandths

Group of countries/country	Up to 1997[1]	1998-2000	2001-2003	2004-2006	2007-2009	2010-2012	From 2013[2]
Narrow group of countries	778.5	770.5	744.9	709.9	677.7	634.7	624.3
Belgium	55.5	48.2	52.3	56.4	56.2	49.3	46.1
Estonia	0.5	0.7	0.9	1.0	1.0	1.0	1.1
Finland	10.7	11.3	11.2	11.1	10.6	8.0	8.0
France	113.1	107.8	100.8	93.6	89.3	83.7	80.6
Greece	4.7	4.5	4.5	4.5	4.5	3.1	2.6
Ireland	9.8	15.7	16.0	12.5	10.8	9.6	10.1
Italy	86.5	80.0	75.6	72.4	70.2	63.0	57.9
Latvia	0.5	0.7	0.9	0.8	0.9	0.9	1.0
Lithuania	1.0	1.1	1.5	1.6	1.9	1.9	2.1
Luxembourg	3.5	3.1	3.7	4.1	4.2	3.3	3.4
Malta	0.5	0.5	0.5	0.4	0.5	0.4	0.4
Netherlands	65.2	65.3	63.7	67.5	70.0	69.0	67.8
Austria	43.9	42.5	41.4	42.1	42.2	41.0	39.2
Portugal	10.7	10.6	9.7	7.9	7.1	6.5	6.7
Slovenia	5.1	4.8	4.5	4.5	5.1	5.0	5.2
Spain	35.9	37.3	38.1	39.5	38.1	32.7	32.2
Cyprus	0.3	0.3	0.3	0.5	0.5	0.3	0.2
Denmark	15.5	14.0	14.4	13.4	13.3	11.1	11.0
Sweden	22.8	21.3	19.6	20.9	20.1	19.1	17.9
United Kingdom	82.3	81.2	76.5	70.2	60.0	54.8	56.1
Norway	7.0	6.0	5.7	5.3	5.7	5.1	4.7
Switzerland	43.4	38.3	38.3	35.9	36.2	37.5	37.1
Slovakia	5.4	6.9	9.0	10.3	11.6	13.1	14.4
Japan	55.9	51.7	42.1	36.6	32.9	32.8	27.0
Canada	7.9	8.7	9.0	8.3	7.5	7.5	7.5
USA	90.9	108.0	104.7	88.6	77.3	75.0	84.0
Medium-sized group	121.6	134.8	161.0	190.3	217.7	250.4	265.6
Bulgaria	1.1	1.3	1.6	2.1	2.4	2.5	2.9
Croatia	2.5	2.1	2.1	2.2	2.1	1.6	1.7
Poland	18.5	21.8	25.0	27.0	33.4	35.5	39.6
Romania	4.0	4.3	5.4	7.0	8.7	9.8	11.4
Czech Republic	16.9	20.9	26.3	26.0	30.3	31.8	33.2
Hungary	10.9	16.6	18.9	19.4	18.6	17.4	19.6
China	26.6	31.7	45.3	65.2	84.9	110.8	117.4
Hong Kong SAR	11.5	10.3	10.1	10.4	9.3	10.4	10.9
Korea, Republic of	15.9	13.5	14.3	18.8	17.7	19.1	18.5
Singapore	9.6	8.7	8.4	8.5	6.5	7.2	6.6
Australia	4.1	3.6	3.6	3.7	3.8	4.3	3.8
Countries additionally included in broad group	99.9	94.7	94.1	99.8	104.6	114.9	110.1
Iceland	0.3	0.5	0.5	0.6	0.6	0.5	0.3
Israel	4.2	4.3	3.9	3.2	3.1	3.3	3.2
Russia	12.4	9.8	11.9	16.0	19.5	20.4	16.7
Turkey	14.0	13.4	13.3	16.1	16.1	17.7	18.8
Algeria	0.4	0.3	0.5	0.5	0.6	0.6	0.8
Morocco	1.4	1.4	1.4	1.2	1.3	1.4	1.6
South Africa	5.7	5.7	6.1	6.6	6.0	6.5	5.7
Argentina	2.1	1.9	1.2	1.2	1.5	2.1	1.8
Brazil	8.1	7.3	6.4	7.1	8.1	8.7	7.2
Chile	1.4	1.3	1.2	1.9	2.0	2.2	1.7
Mexico	4.9	7.5	7.9	7.5	7.9	8.5	9.2
Venezuela	0.9	0.8	0.7	0.6	0.6	0.5	0.3
India	7.6	6.3	6.8	8.6	11.1	13.3	12.7
Indonesia	5.6	4.3	4.1	3.4	3.4	4.0	3.9
Malaysia	7.3	6.7	6.6	6.2	5.8	6.7	6.7
Philippines	2.6	3.2	3.5	2.9	2.1	2.1	2.6
Taiwan	13.7	14.1	12.0	10.3	8.7	9.5	9.5
Thailand	6.6	5.3	5.4	5.2	5.6	6.3	6.7
New Zealand	0.7	0.6	0.7	0.7	0.6	0.6	0.7
Total	1,000.0	1,000.0	1,000.0	1,000.0	1,000.0	1,000.0	1,000.0

1 Basis 1995 to 1997. **2** Basis 2013 to 2015.
Deutsche Bundesbank

whose trade weight when calculating the indicators was down slightly on the previous three-year period. The relative share for Italy has shown a somewhat stronger decline; for the first time, its trade weight in the broad group of countries now stands at below 6%. By contrast, the trade weights of the central and eastern European countries have increased slightly, with Poland's relative share seeing the strongest growth. The relative share of Japan has contracted again, having also decreased compared with the previous baseline periods. It is now only around 2½%. There were no major changes in the weights assigned to the other Asian countries.

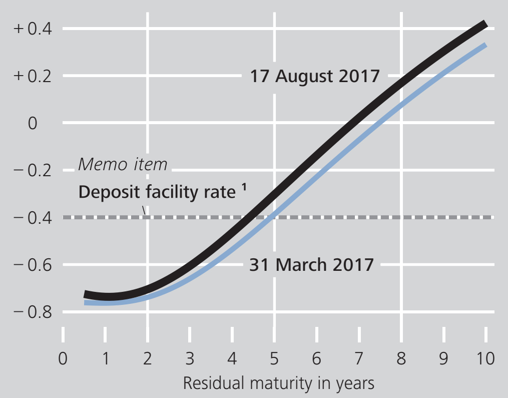
To summarise, in the underlying three years, the weight of Germany's relative trade flows shifted away from the large EU partner countries and Japan to the central and eastern European EU countries as well as, in particular, to the United States and China.

The recalculated indicators based on the consumer price indices show the German economy as having a somewhat stronger price competitiveness than on the basis of the old weighting (see the chart on page 41). This was partly due to the higher weight of both the United States and China, whose currencies have appreciated against the euro on balance – in nominal and in real terms – since the end of 2012. On the other hand, Japan's somewhat smaller relative share meant that the depreciation of the yen against the euro since the end of 2012 has had a less detrimental effect on Germany's price competitiveness than would have been the case using the old weighting.

The recalculated indicator of price competitiveness against 56 countries based on the consumer price indices now shows a virtually unchanged price competitiveness on balance for the period from December 2012 to July 2017. By contrast, using the old weights as a basis would have produced a marginal deterioration of ½%. For the medium-sized and the narrow group of countries, too, the recalculated indicator shows that Germany's price competitiveness has developed somewhat more favourably since the end of 2012 than on the basis of the old indicator (on balance, by around ½ percentage point in each case).

Yield curve on the German bond market*

%



* Interest rates for (hypothetical) zero-coupon bonds (Svensson method), based on listed Federal securities. **1** Current interest rate on the deposit facility in place since 15 March 2016.

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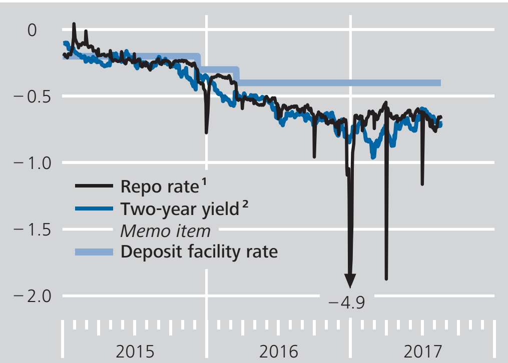
Repo rate and yield on short-dated Federal securities

% pa, daily data



1 Money market rate for overnight credit secured by German government bonds. Source: repofundsrate.com. **2** Yield on a two-year zero-coupon bond from the German yield curve.

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to Federal securities, which is reflected in the yields on short-term maturities.[1]

Political risks in euro area have not materialised; yield spreads have narrowed significantly

Spreads between long-term Bunds and government bonds from the rest of the euro area have narrowed significantly. In the GDP-weighted average, the difference has fallen by 36 basis points to 84 basis points since the end of March. This was partially attributable to the increase in yields in Germany – as well as in Austria and Slovakia – and a decline in yields in all the other countries of the euro area. The main reason for this was that the political risks in the euro area which had weighed on the markets in the first quarter did not materialise. In Italy, Eurosceptic parties performed worse than predicted in municipal elections, and in France, the outcome of the parliamentary election gives the newly elected President the possibility to implement a reform agenda. For Greece, a new tranche of rescue funds was approved in June, and in July the country successfully issued its first government bond in three years.

Rise in market-based inflation expectations, risk of deflation at lowest level for many years

The average market-based inflation expectations for the coming years in the euro area has risen across all maturities, particularly for short horizons. However, the flattening of the inflation curve accompanying this increase has led to a rise in the five-year forward inflation rates in five years derived from inflation swaps of only 4 basis points, on balance, to 1.6%. The probability of deflation over the next five years based on options data stood at a multi-year low in August.

US bond yields impacted by monetary and economic policy

Yields on ten-year US Treasuries have fallen by 20 basis points to 2.2% since the end of March, amid considerable fluctuations. The increase in the interest rate corridor by 25 basis points to between 1% and 1.25% in June had been broadly expected and therefore had no direct impact on the yield development following the FOMC meeting. Nevertheless, the future path of the policy interest rates expected by the market shifted downwards, placing pressure on yields. In addition, the Federal Reserve outlined the start of a gradual shrinking of its balance sheet. The exact form that this will take is still unclear, however. Yield fluctuations on the US government bond market were additionally caused by differing statements by FOMC members and persisting uncertainty about the im-

1 In contrast to the short-term yield on Federal securities, over the past year the yield on bonds of the same maturity issued by the Kreditanstalt für Wiederaufbau (KfW) has hovered, with minor fluctuations, close to the deposit facility rate at its current level of -40 basis points. KfW has an explicit guarantee of the Federal Republic of Germany. Its bonds are therefore regarded as comparably default-free as Federal securities. The spread between KfW bonds and Bunds reflects the special advantages Bunds have in terms of tradability and on the derivatives market and is therefore a widely used liquidity measure.

plementation of major projects of US economic policy.

Monetary policy also dominates bond market activity in the United Kingdom and Japan

Given the possibility of a tightening of monetary policy in response to the strong pattern of inflation, the yield on ten-year UK government bonds rose at the end of June, in some cases significantly. In August, however, this trend was reversed when the Bank of England revised its economic projection downwards. By contrast, the outcome of the parliamentary election had no direct impact on yields. By the end of the reporting period, at 1.1%, the yield on ten-year government bonds stood 5 basis points below its level at the end of March. In Japan, the central bank's adherence to yield curve control ensured that yields on ten-year government bonds remained virtually unchanged at 0.1%.

Decline in yields on bonds issued by financial corporations

Yields on BBB-rated European corporate bonds with a maturity of seven to ten years have continued to decrease since the end of March. Bonds issued by non-financial corporations recorded a decline of 10 basis points, delivering a yield of 1.4% as this report went to press, while yields on bonds issued by financial corporations fell by more than ½ a percentage point to 2.1%. This downward trend was only briefly interrupted following the speech by the President of the ECB in Sintra, when yields in both corporate sectors temporarily rose by almost 20 basis points within a matter of days. Overall, yield spreads in both the financial and non-financial corporate sector over German government bonds nonetheless fell by 71 and 20 basis points respectively in the course of the reporting period. Compared with their five-year average, financing conditions for enterprises therefore remain highly favourable.

Net issuance in the German bond market

Gross issuance in the German bond market amounted to €265 billion in the second quarter of 2017 and was therefore well below its previous-quarter level (€333 billion). After deducting redemptions and taking account of changes in issuers' holdings of their own bonds, net sales of debt securities came to €12 billion. In addition, foreign borrowers placed debt securities worth €18½ billion in the German market. On balance, the total outstanding volume of bonds in Germany thus climbed by €30½ billion in the quarter under review.

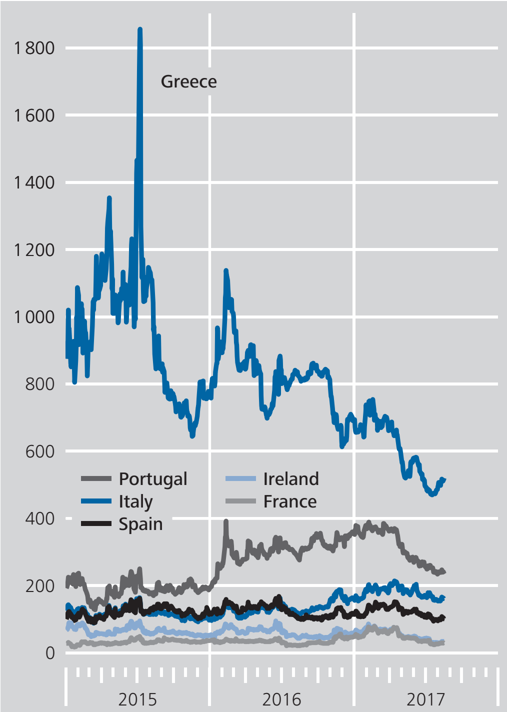
The public sector issued bonds in the amount of €9½ billion net in the second quarter, com-

Forward inflation rates and expectations in the euro area

Sources: Thomson Reuters, Consensus Economics and Bundesbank calculations. **1** Derived from the fixed cash flow arising from inflation swaps which is swapped for the actual annual inflation rates (HICP excluding tobacco) realised over the next five or ten years. Weekly averages.
Deutsche Bundesbank

Spreads of ten-year government bonds over German Federal bonds

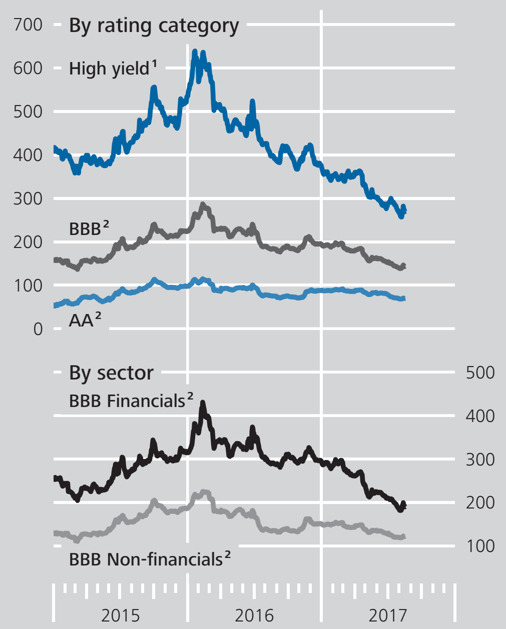
Basis points, daily data



Sources: Thomson Reuters and Bundesbank calculations.
Deutsche Bundesbank

Yield spreads of corporate bonds in the euro area*

Basis points, daily data



Sources: Thomson Reuters and Bundesbank calculations. * Compared with Federal securities with a residual maturity of seven to ten years. **1** Merrill Lynch index across all maturities. **2** In each case, iBoxx indices with a residual maturity of seven to ten years.

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Investment activity in the German securities markets

€ billion

Item	2016 Q2	2017 Q1	2017 Q2
Debt securities			
Residents	66.2	60.0	32.1
Credit institutions	− 19.7	− 20.8	− 13.6
of which			
Foreign debt securities	− 4.2	− 8.1	0.9
Deutsche Bundesbank	50.8	52.6	38.4
Other sectors	35.1	28.2	7.2
of which			
Domestic debt securities	8.1	13.7	− 10.9
Non-residents	− 26.6	− 22.4	− 1.4
Shares			
Residents	10.0	15.9	0.9
Credit institutions	1.9	2.1	3.1
of which			
Domestic shares	0.8	0.5	6.7
Non-banks	8.2	13.8	− 2.2
of which			
Domestic shares	5.1	8.0	− 3.2
Non-residents	− 5.2	2.7	− 2.4
Mutual fund shares			
Investment in specialised funds	19.8	21.4	9.3
Investment in open-end funds	5.8	7.9	7.6
of which			
Equity funds	0.8	1.4	1.1

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Increase in public sector capital market debt

pared to net redemptions totalling €3 billion one quarter earlier. These figures include issues by resolution agencies set up for German banks, which are ascribed to the public sector for statistical purposes. For its part, the Federal government mainly issued ten-year and 30-year bonds (for €13½ billion and €4½ billion respectively). This contrasted with net redemptions of Federal notes (Bobls) totalling €7 billion. In the quarter under review, state and local governments redeemed their own bonds to the tune of €½ billion net.

Net issuance by credit institutions

Domestic credit institutions continued the trend of the previous quarter by increasing their capital market borrowing by €8 billion (compared to €25½ billion in the first quarter). On balance, only debt securities of specialised credit institutions were placed in the market (€17 billion). This contrasted with net redemptions of other bank debt securities which can be structured flexibly (€5½ billion), public Pfandbriefe (€3 billion) and mortgage Pfandbriefe (€½ billion).

Fall in enterprises' capital market debt

In the second quarter, domestic enterprises redeemed debt securities worth €5 billion net, compared with net issuance totalling €6½ in the previous quarter. These redemptions were predominantly attributable to other financial intermediaries (€3 billion) and insurers (€1½ billion), while non-financial corporations only redeemed a very small volume of debt securities. All in all, the overwhelming majority of redemptions made over this period consisted of bonds with an original maturity of more than one year.

Purchases of debt securities

The Bundesbank was the predominant buyer in the German bond market in the second quarter of 2017, adding a net €38½ billion worth of paper to its portfolio, mainly under the Eurosystem's asset purchase programmes, and with a strong emphasis on domestic securities issued by the public sector (€32 billion). Domestic non-banks purchased debt securities (€7 billion), focusing primarily on foreign securities (€18 billion), and disposed of domestic instruments (€11 billion). By contrast, domestic credit institutions and foreign investors offloaded bonds worth €13½ billion and €1½ billion net respectively.

Global equity markets post gains overall

For the most part, the international equity markets developed positively during the period under review. In particular, following price gains at the beginning of the year, US and Japanese share prices continued to rise. Bolstered by favourable quarterly results and increased earnings expectations, the US S&P 500 index was up by a total of 2.8% on its end-of-March level, chalking up one all-time high after another in the interim period. Notwithstanding this increase, valuations, as measured by the price/earnings ratio, remained almost unchanged, but they are still high when viewed in a multi-year comparison. At 4.2%, price gains on the Japanese Nikkei 225 were even higher, although the index initially posted significant losses in the period up to mid-April. The British flagship FTSE 100 likewise recorded losses at the beginning of the second quarter, but it quickly recovered from this setback, going up by 0.9% overall in the reporting period. Developments in the euro area were even more subdued. The broad Euro Stoxx index was not quite able to maintain the distinct price gains seen for a while and was up by 0.8% as this report went to press. The price/earnings ratio has declined slightly, but remains above its average level of the past five years. The German CDAX index was down by 1.1%, with sector-specific factors and probably also the strong euro playing a key role.

Sector-specific factors: automotive industry under pressure …

The negative share price movements in Germany were chiefly attributable to the automotive sector which, in international terms, constitutes a relatively large share of the market as a whole. In addition to the diesel emissions scandal, which has weighed on the entire sector, German enterprises have recently faced allegations of running a cartel. Given the threat of fines and compensation claims, share prices of German car manufacturers have dropped, in some cases substantially.

Equity market

Weekly averages

Sources: Thomson Reuters and Bundesbank calculations. **1** Implied equity risk premiums determined using dividend discount models on the basis of earnings and dividend expectations (I/B/E/S).

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… whereas bank shares buoyant

By contrast, the prospect of higher dividend payments and improved profitability in the medium term meant that bank shares recorded broad gains on a global level. The increase in the price of bank shares on this side of the Atlantic even exceeded the 1.2% gain seen in the United States. The UK banking sector recorded a 4.8% increase, while bank shares in the euro area were up by a total of 5.4%. Among the euro area countries, the prices of Portuguese, Italian and French bank shares went up by double-digit percentages. The main reason for this above-average performance is likely to be that, with the takeover and reso-

Major items of the balance of payments

€ billion

Item	2016 Q2	2017 Q1	2017 Q2p
I Current account	+ 70.0	+ 65.8	+ 54.6
1 Goods[1]	+ 77.9	+ 67.2	+ 67.2
2 Services[2]	− 4.0	− 3.3	− 4.1
3 Primary income	+ 0.6	+ 15.9	+ 4.2
4 Secondary income	− 4.4	− 14.0	− 12.8
II Capital account	+ 1.1	+ 0.5	+ 0.0
III Financial account (increase: +)	+ 62.6	+ 64.4	+ 61.5
1 Direct investment	− 21.2	+ 20.3	+ 12.6
Domestic investment abroad	+ 6.1	+ 49.0	+ 22.6
Foreign investment in the reporting country	+ 27.3	+ 28.7	+ 10.0
2 Portfolio investment	+ 67.5	+ 51.7	+ 25.6
Domestic investment in foreign securities	+ 33.6	+ 31.0	+ 20.4
Shares[3]	+ 4.8	+ 5.5	− 2.4
Investment fund shares[4]	+ 8.0	+ 16.9	+ 4.4
of which Money market fund shares	− 1.3	+ 6.3	− 4.4
Long-term debt securities[5]	+ 25.6	+ 5.3	+ 19.1
of which Denominated in euro[6]	+ 17.2	+ 6.0	+ 13.1
Short-term debt securities[7]	− 4.7	+ 3.2	− 0.6
Foreign investment in domestic securities	− 33.9	− 20.8	− 5.2
Shares[3]	− 5.6	+ 1.5	− 2.4
Investment fund shares	− 1.7	+ 0.1	− 1.4
Long-term debt securities[5]	− 34.2	− 12.5	+ 0.2
of which Issued by the public sector[8]	− 39.5	− 21.2	− 2.2
Short-term debt securities[7]	+ 7.6	− 9.9	− 1.6
3 Financial derivatives[9]	+ 4.2	+ 0.0	+ 2.6
4 Other investment[10]	+ 11.5	− 7.3	+ 20.3
Monetary financial institutions[11]	− 30.1	− 35.0	− 7.7
Enterprises and households[12]	+ 2.6	− 13.0	+ 4.3
General government	− 6.9	− 1.7	− 1.8
Bundesbank	+ 45.8	+ 42.5	+ 25.6
5 Reserve assets[13]	+ 0.8	− 0.4	+ 0.4
IV Errors and omissions[14]	− 8.5	− 1.9	+ 6.9

1 Excluding freight and insurance costs of foreign trade. **2** Including freight and insurance costs of foreign trade. **3** Including participation certificates. **4** Including reinvested earnings. **5** Long-term: original maturity of more than one year or unlimited. **6** Including outstanding foreign D-Mark bonds. **7** Short-term: original maturity up to one year. **8** Including bonds issued by the former Federal Railways, the former Federal Post Office and the former Treuhand agency. **9** Balance of transactions arising from options and financial futures contracts as well as employee stock options. **10** Includes in particular financial and trade credits as well as currency and deposits. **11** Excluding the Bundesbank. **12** Includes the following sectors: financial corporations (excluding monetary financial institutions) as well as non-financial corporations, households and non-profit institutions serving households. **13** Excluding allocation of special drawing rights and excluding changes due to value adjustments. **14** Statistical errors and omissions, resulting from the difference between the balance on the financial account and the balances on the current account and the capital account.

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lution of three banks in Spain and Italy, uncertainty in the market was reduced.

Stock market funding and stock purchases

Issuing activity in the German equity market was muted in the second quarter. Domestic enterprises issued €1 billion worth of new shares. The outstanding volume of foreign equities in the German market dropped by €2½ billion in the same period. Equities were purchased by domestic credit institutions (€3 billion) which shifted their focus from foreign to domestic shares on balance. By contrast, both domestic non-banks (€2 billion) and foreign investors (€2½ billion) sold domestic equity instruments.[2]

Sales and purchases of mutual fund shares

During the quarter under review, domestic investment companies recorded inflows of €17 billion, after raising funds totalling €29½ billion in the previous three-month period. Specialised funds reserved for institutional investors (€9½ billion) as well as retail funds (€7½ billion) saw fresh inflows of funds. Among the asset classes, mixed securities-based funds attracted the most inflows (€6½ billion), though equity funds and open-end real estate funds (€3 billion in each case) and funds of funds (€2½ billion) also sold new fund shares. Foreign funds traded in the German market attracted inflows totalling €4½ billion net in the second quarter of 2017. Domestic non-banks were the main buyers, adding mutual fund shares worth €21½ billion to their portfolios. German credit institutions purchased investment fund shares for €1½ billion, while foreign investors sold mutual fund shares worth €1½ billion.

Direct investment

Direct investment sees capital exports

As with cross-border portfolio investment, which saw net outflows totalling €25½ billion in the second quarter of 2017, net capital exports were likewise recorded in the field of direct investment; these amounted to €12½ billion.

2 For further details, see Direct investment on pp 48-49.

German direct investment abroad

Direct investment abroad by German enterprises came to €22½ billion net in the period from April to June 2017, with domestic investors augmenting their equity capital by a total of €16 billion. This was achieved, in equal shares, by means of equity capital in the narrower sense and reinvested earnings (€8 billion in each case). German enterprises also stepped up their intra-group lending by €6½ billion. In this context, an increase in financial credits by €7½ billion contrasted with a decrease in trade credits in the amount of €1 billion. Countries receiving substantial direct investment from Germany in the second quarter of 2017 included the Netherlands (€6½ billion), the United States (€3½ billion) and Luxembourg (€3 billion). By contrast, domestic enterprises disinvested in China to the tune of €2½ billion.

Foreign direct investment in Germany

Non-resident enterprises boosted their investment in Germany in the months April to June 2017 by €10 billion, relying exclusively on intra-group lending to do so. This mainly occurred on the back of loans from foreign subsidiaries to their German parent companies. In regional terms, German firms saw large-scale inflows from the Netherlands (€5½ billion) and the United Kingdom (€2 billion). By contrast, Italian investors withdrew capital from Germany (€2 billion).