Securities markets

Bond market

Interest rate movements

Persistently low capital market rates

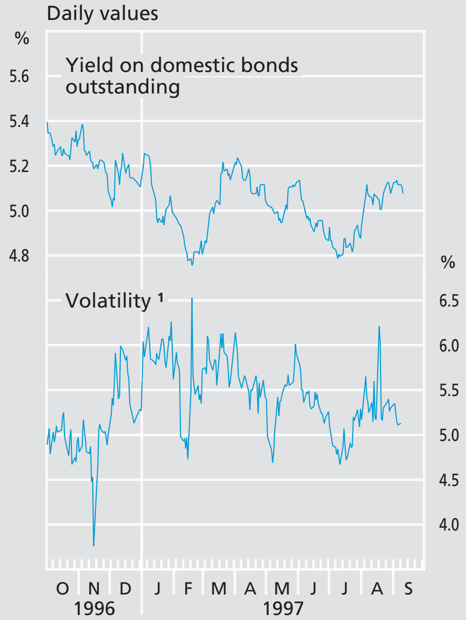
In the summer months interest rates in the German capital market continued to run at a very low level. The yield on domestic bonds outstanding, which had risen to 5 ¼ % in March, declined to just over 4 ¾ % by mid-July and thus almost reached its all-time low of February. Since that time it has again risen slightly; in mid-September it came to just over 5 %. At the same time interest rate uncertainty increased (measured in terms of the implied volatility). Only the yields at the short end of the capital market increased, however, whereas at the same time the rates in the long maturity categories fell slightly. The yield structure in the bond market thus flattened out slightly. The observable yield differential between ten-year and one-year bonds came to only two percentage points of late, compared with 2 ½ percentage points at the end of April.

Determinants of interest rate movements

Interest rate movements in the summer are a mirror image of contrasting external and internal economic influences on the different maturity categories of the bond market. Besides the slackening of the monetary expansion in Germany, the decline in yields in the US bond market also had a dampening effect on interest rates up to the end of July. After the Federal Reserve Board raised the interest rates at the end of March, confidence in the continuation of a largely tension-free economic growth had risen again there. Since the beginning of August, however, US yields – and in their wake, German capital market

Interest rate movements in the bond market

Daily values



1 Implicit volatility of at-the-money options on the bund future.

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rates – rose again slightly. On balance, the yield advantage of ten-year US Treasury paper over comparable Federal bonds decreased from about 1 percentage point to about ¾ of a percentage point of late. The movements at the long end indicate that market participants continue to take a positive view of the longer-term outlook for interest rates and prices. By contrast, consumer prices, which of late picked up, and the rapid strengthening of the US dollar affected the current price climate and contributed to rising interest rates in the shorter maturity categories and to the flattening-out of the yield curve.

Monetary policy implications

The monetary conditions for the economic recovery in Germany continue to be favourable. But it is important to avoid an increase in the inflation premiums and risk premiums in the yields and to secure favourable capital market conditions over the long term. The central bank therefore has to counteract discernible dangers to monetary stability at a very early stage. It is precisely in phases in which the range of monetary policy indicators appears unsteady and uncertain – owing, for example, to rapidly changing conditions on the foreign exchange markets – that monetary policy makers are particularly called upon to be alert.

Sales of bonds

Amount raised

Gross sales of domestic bonds were slightly lower between May and July, at DM 202.7 billion (market value), than in the previous three months, when domestic borrowers issued bonds worth DM 224.3 billion, yet were significantly higher than a year before (DM 147.0 billion). Net sales, which were obtained after deducting redemptions and after taking due account of the changes in issuers' holdings of own bonds, came to DM 65.3 billion in the period under review, compared with DM 79.7 billion between February and April and DM 52.4 billion a year before. Net sales of foreign bonds in Germany reached a record volume of DM 38.9 billion between May and July; between February and April bonds of foreign issuers were sold in Germany to the tune of only DM 14.8 billion. In particular, domestic investors' demand for foreign currency bonds, which accounted for DM 32.2 billion, was very brisk. Investments in Italian lire (DM 15.9 billion) and US dollars (DM 7.6 billion) met with particularly great interest. Bonds denominated in Deutsche Mark issued by non-residents were, on balance, sold in the domestic market to the tune of DM 6.7 billion. Net sales of domestic and foreign bonds came to DM 104.2 billion between May and July 1997, compared with DM 94.5 billion in the previous three months and DM 58.5 billion in the corresponding period of 1996.

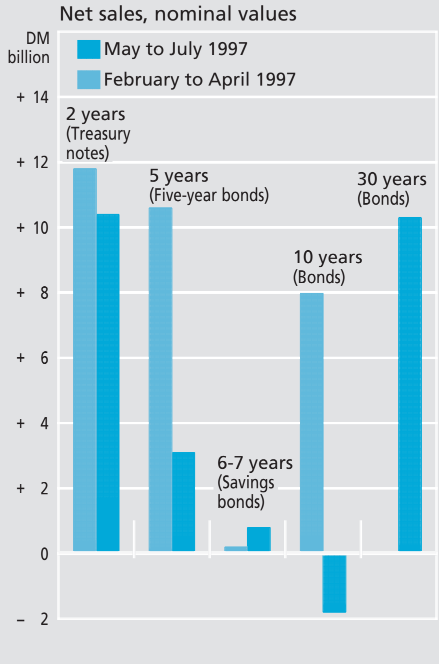
Bank bonds

Credit institutions received more than three-quarters of the amount raised from sales of domestic bonds between May and July (DM 53.4 billion net). Communal bonds *(Öffentliche Pfandbriefe)* continued to be well to the fore (DM 37.8 billion). Other bank bonds were sold to the tune of DM 7.4 billion net. In the period under review, DM 5.0 billion (net) were generated by sales of mortgage bonds *(Hypothekenpfandbriefe)*. The outstanding amount of bonds of specialised credit institutions rose by DM 3.1 billion.

Public bonds

Between May and July the public sector drew on the bond market to a much lesser extent than in the previous three months; its indebtedness in the bond market rose by DM 10.9 billion during this period, compared with DM 17.7 billion between February and April. Bonds issued by the Federal Government, which had improved its cash situation slightly by mid-year, came to DM 17.2 billion (net), compared with DM 27.6 billion (net) in the previous three months. The Federal Government's issuing activity was focused on the short end and on the very long end of the maturity range. The outstanding amount of two-year Treasury paper rose by DM 10.4 billion (nominal value). In July the Federal Government, for the first time since the beginning of 1994, again launched a thirty-year

Securities issued by the Federal Government, by maturity



bond issue (coupon: 6.5 %, volume: DM 10 billion); sales of this issue, which was built up by DM 2 billion at the end of July, yielded DM 10.3 billion (nominal value). Since the beginning of July stripping is possible in the case of this paper – as in the case of some other Federal bonds. In particular, in the case of the new thirty-year bond issue investors apparently had made use of this opportunity to a relatively large degree; according to information provided by the German securities depository, more than one-quarter of the bond volume has been stripped as of the end of July.

Five-year special Federal bonds and Federal savings bonds were sold to the net amount of DM 3.0 billion and DM 0.8 billion, respectively. The outstanding amount of ten-year bonds

Sales and purchases of bonds

DM billion

Item	1997 Feb. to April	1997 May to July	May to July 1996
Sales			
Domestic bonds 1	79.7	65.3	52.4
of which			
Bank bonds	61.7	53.4	35.6
Foreign bonds 2	14.8	38.9	6.1
of which			
Foreign currency bonds	12.8	32.2	2.7
Purchases			
Residents	81.0	72.9	36.0
Credit institutions 3	60.2	54.8	17.2
Non-banks 4	20.8	18.1	18.8
of which			
Foreign bonds	0.7	23.9	– 1.1
Non-residents 2	13.5	31.3	22.5
Total sales or purchases	94.5	104.2	58.5

1 Net sales at market values plus/less changes in issuers' holdings of own bonds. — **2** Transaction values. — **3** Book values, statistically adjusted. — **4** Residual.

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fell by DM 1.8 billion. The Länder Governments reduced their indebtedness in the bond market by DM 2.2 billion. Bonds of the post office and the Currency Conversion Equalisation Fund were redeemed to the tune of DM 3.0 billion and DM 1.4 billion, respectively. Bonded debt of the other public issuers changed only marginally.

Foreign Deutsche Mark bonds

Between May and July foreign borrowers issued bonds denominated in Deutsche Mark to the extent of DM 32.0 billion (nominal value). Barely one-quarter of this sum accrued to local authorities, with a number of countries in transition and newly industrialising countries making their debut as issuers in the Deutsche Mark segment of the international capital market. German enterprises' foreign financing subsidiaries issued bonds denominated in Deutsche Mark to the extent of about DM 4 billion. Net sales of foreign Deutsche Mark bonds came to DM 23.0 billion in the period under review, compared with DM 16.5 billion between February and April, and DM 15.5 billion in the corresponding period of 1996. The major part of the paper was sold abroad (DM 16.3 billion).

Short-dated bonds issued by domestic non-banks

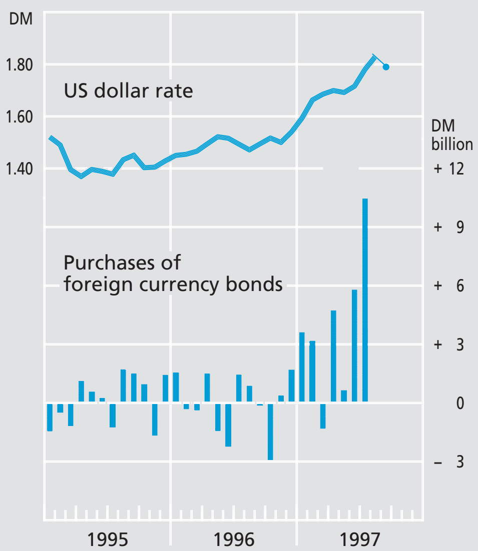
The outstanding amount of short-dated bonds issued by domestic non-banks (with an original maturity of one year or less), which, in principle, are not included in the figures analysed here, declined slightly between May and July; at the end of July it came to DM 33.6 billion, compared with DM 34.8 billion at the end of April. While domestic enterprises used Deutsche Mark commercial paper for short-term financing from external sources to about the same extent as in the previous period (outstanding volume at the end of July: DM 11.5 billion), the outstanding amount of public sector bonds running for less than one year declined by DM 1.1 billion. At the end of July it came to DM 21.9 billion.

Purchases of bonds

Brisk foreign demand

Non-residents' purchases in the German bond market increased sharply between May and July. Foreign investors' bond purchases added up to DM 31.3 billion (net) during this period, compared with DM 13.5 billion between February and April. Especially in June and July, non-residents sharply increased their holdings of domestic bonds (by DM 14.5 billion and DM 15.3 billion, respectively). Non-residents' purchases focused on public bonds (DM 23.1 billion). Non-residents purchased

Dollar rate and purchases of foreign currency bonds by non-banks *



* Net purchases of foreign currency bonds by non-banks. — • = Latest position: September 11, 1997.

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bank bonds to the tune of DM 8.2 billion, on balance consisting entirely of foreign currency bonds issued by domestic credit institutions.

Credit institutions' bond portfolios continued to rise sharply

Between May and July domestic credit institutions' bond portfolios rose by DM 54.8 billion, and thus only slightly less than in the previous three months (DM 60.2 billion). DM 39.8 billion accrued to bonds of domestic issuers, bank bonds being to the fore (DM 33.4 billion). Credit institutions increased their portfolios of public bonds by DM 6.3 billion. They thus continued to perform maturity transformation through the domestic bond market on a relatively large scale. Banks' holdings of foreign currency bonds issued by non-residents also increased sharply (+ DM 15.4 billion); credit institutions sold foreign Deutsche Mark bonds to the tune of DM 0.4 billion (net).

Non-banks' extensive purchases in foreign bond markets

Between May and July domestic non-banks purchased foreign bonds to the tune of DM 23.9 billion; this is more than ever before in a three-month period. Almost three-quarters of this sum (DM 16.9 billion) consisted of foreign currency bonds. Non-banks' extraordinarily extensive purchases of foreign currency paper must probably be seen against the background of the weakening of the Deutsche Mark against the US dollar. In July alone, when the US dollar rate increased rapidly, non-banks purchased foreign currency bonds to the record amount of DM 10.4 billion (net). It also seems apparent that many investors now expect the European monetary union to start with a large number of participating countries. Non-banks purchased Deutsche Mark bonds issued by non-residents to the tune of DM 7.0 billion net. Yet, on balance, they refrained from buying in the domestic bond market; their holdings of domestic bonds decreased by DM 5.8 billion. On the one hand, they purchased bank bonds to the tune of DM 11.8 billion, but on the other, they sold public bonds to a relatively large extent (– DM 18.5 billion net).

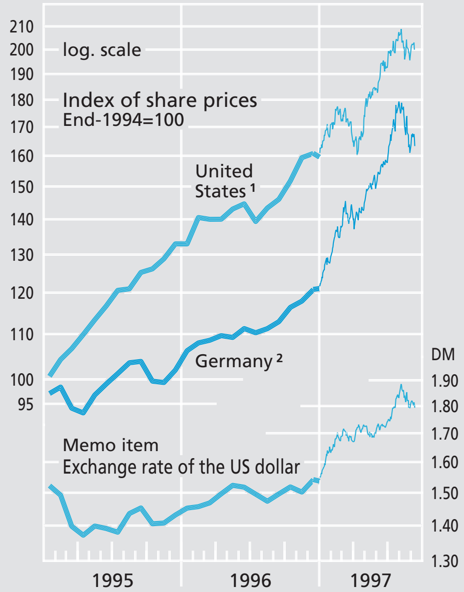
Equity market

Share price trend

Until the end of July the German share market experienced the largest bullish period since the end of the eighties. With average share price gains of almost 14 % (measured in terms of the market-wide CDAX share price index) the sharpest monthly increase

Price movements in the equity market

Monthly values; 1997: daily values



1 Standard & Poors 500 index. — **2** CDAX share price index of Deutsche Börse AG.

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could be reported in July since the spring of 1988; at the end of July the CDAX had outpaced its level of the beginning of the year by 46 %. In the case of the particularly liquid standard values, which are included in the DAX, the increase, which was by about 17 % in July and 52 % in the first seven months of the year, was even higher. A major driving force behind this bullish period was the persisting price movement in major foreign stock exchanges, in particular the US market. The rapid strengthening of the US dollar, which went hand in hand with the further improvement of the profit outlook for German exporters, lent additional support to the market. After the announced merger of two major regional banks, there was additional "merger fantasy" in the financial sector; in July alone prices for bank shares increased by 30 %. In the light of heavy setbacks in the US equity market and the weakening of the US dollar, there were several sharp price falls starting at the beginning of August. In mid-September share prices – with extreme volatility – were, on average, about 11% lower than at their peak at the end of July.

Share sales

Issuing activity in the German equity market slackened between May and July. Domestic enterprises issued new shares to the market value of DM 4.0 billion, compared with DM 4.6 billion between February and April. Foreign equities were sold in the domestic market to the tune of DM 11.4 billion (net) between May and July, after residents had purchased foreign shares to the tune of DM 22.9 billion in the previous three months. The total amount generated by sales of domestic and foreign equities came to DM 15.4 billion between May and July, compared with DM 27.5 billion in the previous period.

Share purchases

In the period under review, the buyers' side of the German equity market was marked by extensive purchasing on the part of foreign investors; they purchased equities to the tune of DM 30.6 billion net. Foreign purchases reached their peak in June and July (each DM 13.9 billion net). Domestic credit institutions' share portfolios decreased by DM 11.9 billion, with banks first and foremost selling domestic paper (– DM 10.7 billion). Domestic non-banks, on balance, sold equities totalling DM 3.3 billion.

Sales and purchases of shares

DM billion

Item	1997 Feb. to April	1997 May to July	May to July 1996
Sales			
Domestic shares 1	4.6	4.0	3.9
Listed	3.6	3.2	2.3
Unlisted	1.0	0.8	1.5
Foreign shares 2	22.9	11.4	3.7
Portfolio purchases	21.1	7.5	– 1.5
Direct investment	1.8	3.9	5.2
Purchases			
Residents			
Credit institutions 3	21.9	– 11.9	– 17.6
Non-banks 4	10.2	– 3.3	9.7
Non-residents 2	– 4.5	30.6	15.5
Total sales or purchases	27.5	15.4	7.6

1 Market values. — **2** Transaction values. — **3** Book values, statistically adjusted. — **4** Residual.

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Investment funds

Amount raised

Between May and July the amount generated by sales of domestic investment fund certificates, at DM 32.2 billion, ran at much the same extent as in the previous three months, when German funds had sold certificates worth DM 35.6 billion (net). In the period under review, residents purchased foreign investment fund certificates to the tune of DM 4.1 billion. On balance, sales of domestic and foreign investment fund certificates came to DM 36.3 billion between May and July, compared with DM 38.2 billion between February and April and DM 13.1 billion a year before.

Specialised funds

Between May and July the amount raised by specialised funds stabilised at a high level; they sold shares to the tune of DM 23.8 billion (net), compared with DM 23.5 billion in the previous period. The specialised funds launched for credit institutions were built up sharply; they received DM 9.7 billion on balance. The number of such specialised funds has increased considerably again (by 62 between May and July); in particular, savings banks and people's banks had intensive recourse to the fund management offered by associated institutions for their securities holdings. Among specialised funds, it was again the mixed funds which recorded the largest inflows (DM 14.8 billion). In the case of bond-based funds and share-based funds DM 6.0 billion and DM 2.8 billion, respectively, were generated. DM 0.2 billion were invested in open-end real estate funds.

Funds open to the general public

Overall, the demand for certificates of funds open to the general public declined between May and July. The funds open to the general public sold certificates to the tune of DM 8.4 billion, compared with DM 12.1 billion in the previous three months. Share-based funds benefited from the bullish period in the case of equities; they received DM 6.3 billion. Net sales of certificates of open-end real estate funds (DM 1.3 billion) and bond-based funds (DM 0.9 billion) were significantly lower. Money market funds had to redeem certificates totalling DM 0.8 billion, after return flows of DM 1.3 billion in the previous period. In July, however, for the first time since February, they were in a position to sell certificates again to a minor extent (DM 0.6 billion).

Purchases of investment fund certificates

It was mainly domestic non-banks that purchased investment fund certificates. Between May and July they purchased fund certificates to the value of DM 24.9 billion, compared with DM 30.5 billion in the previous three months. The certificates in question were predominantly certificates of domestic funds (DM 21.0 billion). Non-banks sold certificates of domestic and foreign money market funds to the extent of DM 1.1 billion. Credit institutions' holdings of investment fund certificates rose by DM 10.7 billion. Non-residents invested DM 0.7 billion (net) in certificates of German funds.