The economic scene in Germany in summer 1999

The international and European environment

Developments in the global economy

Global economy once again on a path of expansion

In the first half of 1999, the situation of the global economy appeared much more favourable than at the turn of 1998-9. In a number of countries the economy has regained its footing; in some other economies, signs of an upswing have become more pronounced; and for a third group of countries, important conditions for economic recovery have at least improved. The strong growth process in the United States has continued; and in Japan, which is trying to extricate itself from a dogged recession, there was an unexpectedly sharp expansion in overall economic output following the turn of 1998-9 owing above all to massive fiscal stimuli. In addition, the East Asian emerging market economies have continued to stabilise. In some cases, they have entered onto a rather steep path of growth. However, there is still a considerable unwelcome heritage from the past which needs to be overcome. In particular, the vulnerability of the financial sector and the high level of corporate debt in those countries harbour serious risks of a relapse.

More favourable outlook for Latin America and in central and eastern Europe

In some Latin American countries which had been profoundly affected by the financial crisis at the beginning of the year and the decline in commodity prices lasting until the end of the first quarter of 1999, the situation has eased over the past few months. This is especially true of Brazil. Now that the economic policy framework conditions have improved, and commodity prices are once again edging upward, it may be possible to overcome the economic slump more quickly than was generally expected this spring. The rise in crude oil and commodity prices benefits the Russian economy, in particular. Owing to the major structural imbalances which continue to exist, however, a rapid, sustainable recovery does not seem likely. In most central and east European reform countries (including the Baltic states), the growth rate continued to decline in the first half of the year, yet as of late the growth prospects seem to have brightened following the revival of the economy in the industrialised countries, especially those in western Europe. The economic losses in the countries neighbouring Yugoslavia caused by the Kosovo conflict are estimated by the IMF at an (unweighted) average of 3 % to 4 % of real GDP, with great differences among the individual countries. However, the economic significance of those countries is quite minor in the overall European context.

United States

In the spring, the exceptionally rapid rate at which the American economy had grown during the winter half of 1998-9, which over the long term would likely have led to distinct signs of overheating, declined noticeably; however, it remained quite high. According to preliminary information, the seasonally adjusted real GDP was just over ½ % higher than in the preceding period (where it had increased by 1%); hence, real GDP was 4 % higher than a year before. One factor which made an important contribution to the "normalisation" of growth was that households' demand for consumer goods, at a seasonally adjusted + 1%, did not rise quite as steeply in the spring as during the winter months. This growth could only be achieved by increased recourse to savings; the private saving ratio fell in the second quarter, at a rate of – 1.1%, to a new all-time low. In addition, the upswing in housebuilding has slowed down somewhat. As in the case of the demand for consumer durables, this may have been the result of the rise in interest rates.

Domestic demand, which is not quite as buoyant as it once was, contrasted with a marked recovery on the part of exports, which had still declined perceptibly in the previous quarter in seasonally adjusted terms. At the same time, import growth slowed down somewhat, which meant that real net exports declined less sharply than at the beginning of the year. Consumer price inflation picked up, particularly owing to the visible rise in crude oil and commodity prices; this year-on-year increase ranged from 1.5 % in the autumn of 1998 to 2.1% between April and June 1999. In the spring, given a labour market that was as tight as before, wages and salaries rose noticeably, which might lead to growing, homemade price pressure.

Japan

Following the turn of the year 1998-9, the decline in output in Japan which had started in the autumn of 1997 has been halted at least for the time being with the help of massive government demand stimuli. In the first quarter, seasonally adjusted real GDP rose by 2 %, thus returning to the level of a year before. However, it is not clear whether it was possible to maintain this level in the spring; at all events, industrial output, after elimination of seasonal variations, was 1% lower in the period between April and June than in the winter months. Other up-to-date indicators, for the most part, do not seem to point towards a lasting recovery, either. Real exports showed a downward trend in the spring; the manufacturing sector curbed its investment once again owing to the weak utilisation of manufacturing capacity; and retail purchases were only slightly higher in the second quarter than at the beginning of the year. Households' consumption behaviour is likely to have suffered owing to, amongst others, the increasing deterioration of the situation on the labour market, reflected in the sharp rise in unemployment from a seasonally adjusted 4.4 % in January to 4.9 % in June, and to generally lower job security. This contrasts in a sense with recent public opinion polls which signal a noticeable improvement in the mood of Japanese enterprises. This could well be due to the advancing economic recovery in East Asia and the growing confidence that the government will continue to prop up the economy.

United Kingdom

In the spring, the British economy apparently overcame the slowdown in growth of the winter half of 1998-9. According to preliminary estimates, real GDP rose by a seasonally adjusted ½ % compared with the first quarter of the year and by just over 1% compared with the same period of the previous year. For the first time since the summer of last year, industry contributed positively to overall economic growth. The driving force on the demand side was private consumption, which benefited from lower interest rates and a labour market situation that was largely robust. Foreign trade is likely to have once again exerted a negative impact on the UK economy, but the decline in exports seems to have slowed down. Notably under the influence of the preceding cyclical downturn, inflation continued to weaken in the spring. Not including mortgage rates, consumer price inflation between May and July, at 2.2 %, was at its lowest level since autumn 1994.

General economic trends in the euro area

Growth accelerated following the turn of 1998-9

The growth rate in the euro area, which had declined distinctly over the course of the past year, picked up slightly following the turn of 1998-9. According to calculations based for the first time on the European System of Accounts 1995 (ESA 95), total economic output rose by a seasonally adjusted ½ % in the first quarter of 1999 compared with the previous period, and was thus just under 2 % higher than a year before. This growth in the euro area was supported by final domestic demand, whereas the adjustment of inventories and foreign trade had contractionary effects on the economy. In the spring, according to as yet rather incomplete data, the upward trend seems to have continued. Industrial confidence has improved noticeably since the last trough in March; this is attributable to a more positive assessment of the outlook for exports and to a concomitant brightening of production expectations. The more favourable business climate, though, has not been reflected in industrial manufacturing yet; in April/May it remained slightly below the level of the first quarter of the year, after seasonal adjustment. Towards the middle of the year, capacity utilisation was slightly lower than at the beginning of spring. This is confirmed by the fact that the reduction of unemployment in the euro area has recently come to a halt;

since March the unemployment rate has remained unchanged at 10.3 %.

Disparate growth patterns in the euro area

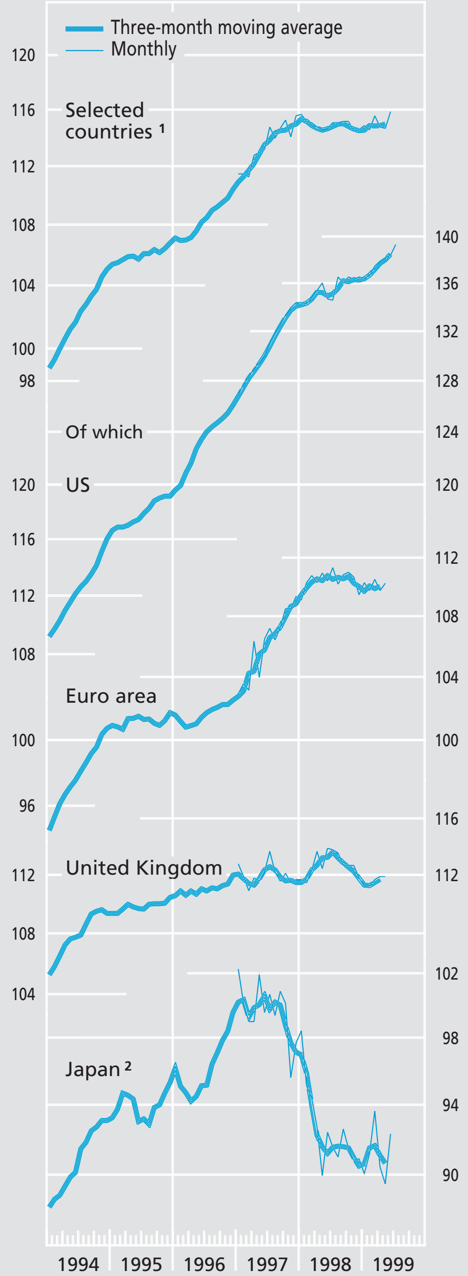
The growth patterns of the individual euro area countries continue to diverge considerably. Particularly the smaller member states (with the exception of Belgium), despite a certain cyclical weakness over the past year, have recorded distinctly faster growth rates than the major countries, particularly Italy and Germany. In those cases where differences can be attributed to Italy's and Germany's exports being affected relatively strongly by the crises in East Asia, Latin America and Russia, or to the euro area countries benefiting in diverse fashion from the preceding interest rate convergence process, the cyclically induced divergence in growth is likely to decrease over time. In part, the growth differential reflects deviations from the potential growth path; these deviations are generally long-term in nature. Such differences constitute a necessary precondition for economic recovery for those economies where the level of prosperity is still well below the euro area average.

Smaller member states with high growth rates

The leading country in terms of economic growth continues to be Ireland. Industrial output in that country – statistics from the national accounts within the past 12 months are not available – was 10 % higher in the spring than it was a year before. Even so, this indicates a slowdown compared with 1997 and 1998, in each of which industrial output had gone up by over 15 %. In Spain, real GDP rose in the first quarter, seasonally adjusted, by 1% over the previous period, and by 3 ½ % over the same time in the preceding

Industrial output *
in selected countries

1991=100, seasonally adjusted, log. scale



* Including mining and energy, excluding construction. — 1 In addition to the euro area and the countries above: Denmark, Greece, Norway, Sweden, Switzerland and Canada; weighted with that country's industry's respective share of gross value added in 1991. — 2 Excluding public utilities. — Sources: national statistics, Eurostat and Bundesbank calculations.

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year. The Spanish economy has been buoyed as of late by the sharp decline in interest rates in the run-up to monetary union, which has since then led to a pronounced boom in the real-estate market. In addition, the propensity of households to incur debt has increased noticeably owing to the relatively low interest rates, which has provided additional impetus to consumer demand. In most of the remaining relatively small member states, the economy has also been running at a healthy clip.

France

Of the three major participating countries, which account for nearly three-quarters of overall economic output in the euro area, the French economy was able to maintain its growth lead in the first half of 1999. However, seasonally adjusted real GDP growth weakened at the beginning of the year to just under ½ %, making it no stronger than in Germany. Owing to the relatively large overhang from autumn 1998, the corresponding result from the previous year was exceeded by 2 ½ %, compared with a growth rate of less than 1% for Germany and Italy each. Expansionary stimuli were provided in particular by fixed capital formation, with real investment of the sector "households" (as defined by ESA 95), focused on new housing construction, growing by a seasonally adjusted 3 ½ % compared with the previous quarter, especially thanks to government promotional measures. By contrast, households' consumption expenditure increased by only a small margin, after adjustment for seasonal and price variations. Given a simultaneous decline in exports and imports, real net exports stagnated at the previous period's level.

According to official estimates – there is no exact information yet – growth of real GDP may have become somewhat stronger in the spring. In addition, there are growing signs of a revival in industry. The index for the business climate in the manufacturing sector rose sharply in July, which is attributable especially to a more favourable assessment of foreign business. For the year 1999 as a whole, the French statistical office expects an economic growth rate of 2 ¼ %.

Italy

Italy's economic growth is relatively sluggish at present. In the first quarter of the year, a rise in overall economic output by a seasonally adjusted ¼ % was barely enough to offset the downturn of autumn 1998 and to exceed the level of a year before by only just under 1%. Real domestic demand increased by slightly less than 1% from the previous quarter's level. In particular, gross fixed capital formation was expanded considerably. For the first time since autumn 1997, exports contributed positively to growth, yet this was more than offset by a very sharp expansion of imports. Hopes for a thorough economic revival which rose after the turn of 1998-9 did not yet come to fruition this spring. Industrial output fell by a seasonally adjusted ¾ %, compared with the already low level of the first quarter of the year, and was thus 3 % lower than a year earlier. Capacity utilisation in the manufacturing sector also declined. Even so, an improvement in the economic situation is in sight for the second half of the year: In June/July, the business climate brightened noticeably, due to more favourable production expectations. These expectations are also confirmed by surveys, according to which the incoming orders were as strong around the middle of the year as they had last been at the beginning of spring 1998.

Labour market

The labour market situation in the euro area has hardly improved any further in the last few months. The standardised unemployment rate has remained unchanged at 10.3 % since March, yet this represents a significant improvement compared with the previous year, when this figure was close to 11%. In Spain, in particular, it was possible to reduce unemployment in the course of the year, yet the unemployment rate as of late, at over 16 % of the labour force, is still far above the euro area average. France, too, had a relatively high unemployment rate, at just over 11%, and progress in eradicating this unemployment is only moving slowly. The same goes for Germany, where unemployment is slightly lower than the euro area average. The situation has been much more promising in some smaller countries, i.e. the Netherlands, Austria and Portugal, where the unemployment rate has, in some cases, remained clearly below the 5 % mark.

Consumer prices

Up to now, price movements in the euro area have on the whole been calm. In July, consumer price inflation, measured in terms of the Harmonised Index of Consumer Prices, was, at 1.1%, a little higher than at the beginning of the year. This is primarily due to the fact that crude oil prices have risen decidedly since March. This rise was so sharp that it more than offset reductions in the annual rate of price increases for other goods. The spread of the national inflation rates remained relatively large in the spring months; two groups of countries with differing inflation trends have crystallised. In the cyclically more advanced economies of Ireland, the Netherlands, Portugal and Spain, the year-on-year rate of consumer price inflation in July averaged around + 2 %, as opposed to + 0.6 % in Germany, + 0.4 % in France and + 0.3 % in Austria.

Euro area current account and exchange rate developments

Foreign trade of the euro area with third countries

The onset of the recovery of world economic growth has given new impetus to trade relations between the euro area and third countries. From the exchange rate side, this was supported by the weakening of the euro during the period under review, which tended to improve the competitiveness of euro area-based suppliers. It is true that in April/May, exports did not yet return to the high level of the previous year. However, in those two months, exports were only 5 % lower than last year, whereas prior to that, in the first quarter of 1999, the value of goods delivered by the euro area to third countries had been more than 6 ½ % lower than in the previous year.

At the same time, the value of imports by the euro area went back up. Whereas in the first quarter imports were still 5 ½ % lower than a year earlier, the year-on-year gap was reduced in April/May to just under 1%. However, this was mainly attributable to the fact that prices for crude oil and petroleum products have again increased noticeably since the beginning of spring. During the last two months (April/May) the euro area, on balance, generated a nominal export surplus of € 15 billion, compared with ECU 20½ billion during the corresponding period of the previous year.

Current account

Since, at the same time, the deficit in the area of "invisible" current account transactions was distinctly lower than in the preceding year (€ 5½ billion, as opposed to nearly ECU 9 billion in April/May 1998), the result of the overall current account for the euro area, at a surplus of € 9½ billion, was only slightly lower than in the previous year (ECU 12 billion).

Exchange rate developments

On the foreign exchange markets, the euro initially lost some of its value at the beginning of the year. This was due especially to the major growth divide between the euro area and the US economy and the resulting interest rate expectations. In addition, some doubts as to the euro area countries' resolve to undertake the urgently needed structural reforms and with regard to their self-imposed fiscal consolidation goals also played a role. Recently, though, the single European currency has stabilised, recovering some of the ground it had previously lost.

The dollar

These developments have been characterised to a great extent by the markets' assessment of the US dollar. Given the robust state of the US economy and the concomitant interest rate expectations, the dollar, with only a few interruptions, continued to rise up to mid-July, when the euro hit its all-time low, at US$ 1.01; that was 14% lower than its value at the beginning of the year. For Germany, this meant the dollar was more expensive than at any time following the end of the eighties, when it cost over DM 1.90. In the second half of July, the euro was able to recover distinctly, in connection with the publication of favourable data on the state of the economy in Germany and France. After a temporary weakening in mid-August, the euro stood at US$ 1.07 as this Report went to press, i.e. it was around the level of May, but still 9½% below its rate at the beginning of the year.

The yen and ...

The brightening-up of the hitherto cloudy economic picture in Japan through surprisingly favourable growth figures for the first quarter, as well as a somewhat more optimistic view of the outlook for further growth, have also led to a stabilisation of the yen, especially against the dollar, but also to a lesser extent against the euro. Despite repeated interventions by the Japanese central bank to counteract what it considered to be an exaggerated appreciation tendency, the yen rose distinctly, recently reaching its highest level against the euro since the beginning of the year.

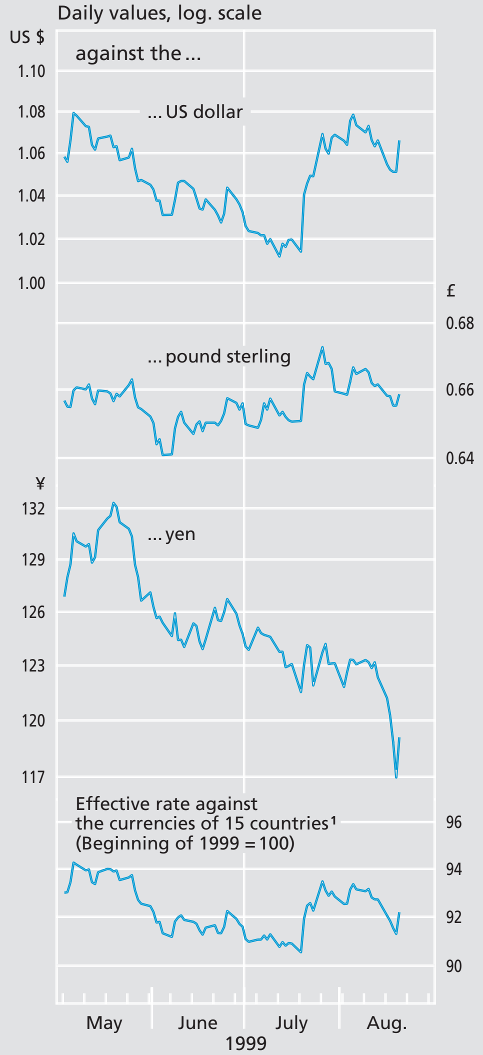
... the pound sterling

Against the pound sterling, though, the euro moved between mid-April and mid-July within a rather narrow corridor of between £ 0.64 and £ 0.66. Since then, the pound sterling temporarily lost some ground, however; as this Report went to press, the rate was £ 0.66 to the euro.

Effective rate of the euro

Nonetheless, as a weighted average the euro was recently still down by almost 8% from its level at the beginning of the year. Bearing in mind the relatively small inflation differential among the major industrial countries, the competitive conditions on the world markets remain favourable for the export sectors of the euro area countries despite the exchange rate adjustments that have occurred in the meantime. A continuation of the recovery of the world economy is thus likely to exert a positive influence on the industrial sector's foreign business in the euro area countries in the foreseeable future, too.

Exchange rate of the euro



1 BIS calculations based on weighted averages of the euro exchange rates.

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Monetary policy and financial markets in the euro area

Interest rates in the Eurosystem unchanged

After lowering interest rates on April 8, the ECB Governing Council left the interest rates in the Eurosystem unchanged. The Eurosystem's main refinancing operations have since then been carried out as fixed-rate tenders at a – pre-announced – fixed rate of 2.5 %; the interest rates on the marginal lending facility and the deposit facility are 3.5 % and 1.5 %, respectively. Both the monetary and the overall economic situations suggested a continuation of the present course of interest rate policy.

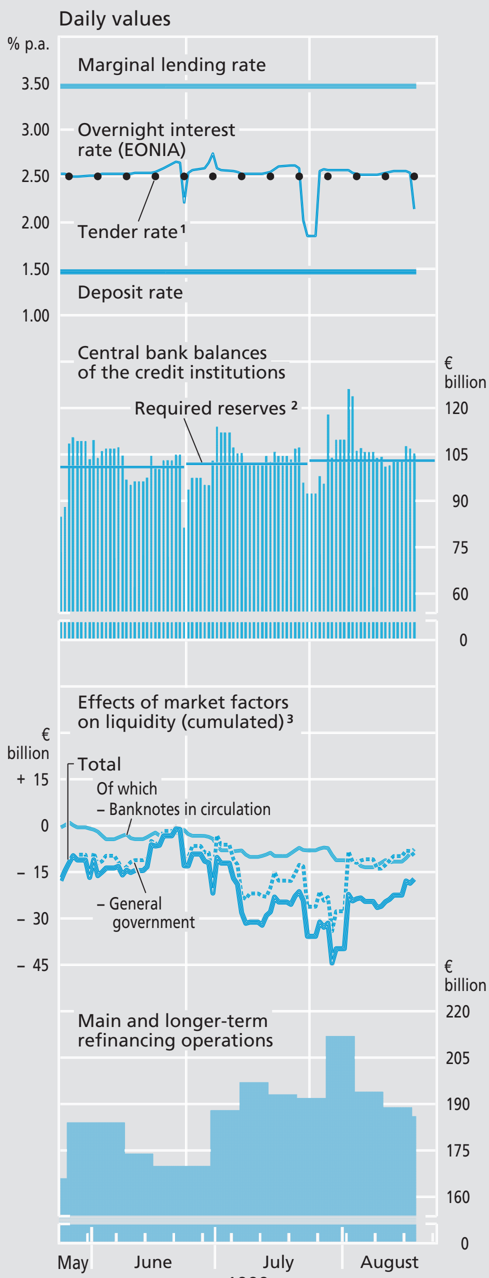
Fixed-term deposit rates higher

Whereas the overnight interest rate (measured in terms of the EONIA), on balance, remained somewhat above the main refinancing rate, fixed-term deposit rates have picked up since the end of May, particularly in the area of longer-term maturities. This is probably mainly attributable to the fact that market participants, in view of the economic recovery which is presently materialising, expect central bank interest rates to rise slightly over the medium term. Moreover, quotations in medium maturities now also contain an add-on for the millennium date change. Seen as a whole, the yield curve on the money market has steepened distinctly. The margin between the one-month interest rate and the 12-month interest rate, having only been ten basis points in May, rose up to slightly less than ¾ percentage points by mid-August.

Ample liquidity provision

In ongoing money market management, the Eurosystem continued to have to deal with extreme fluctuations in central bank deposits

Interest rate movements and liquidity management in the Eurosystem



1 Interest rate for main refinancing operations. — 2 Maintenance periods: May 24 to June 23, June 24 to July 23, and July 24 to August 23,1999. — 3 Banknotes in circulation, net general government position vis-à-vis the Eurosystem, net foreign currency reserves of the Eurosystem and other factors; provision (+) or absorption (–) of central bank balances.

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of central and regional authorities. It is true that the changes in the interest rate regulations for public deposits at the Banque de France, which came into force at the beginning of May, produced the intended distinct reduction in the volatility of this market factor. However, at the end and the beginning of the maintenance periods, the Italian tax payment date regularly led to a withdrawal of a major volume of liquidity from credit institutions which flowed only gradually back into the market afterwards. To offset this as yet unusual liquidity profile, the Eurosystem sharply replenished the main refinancing operations concluded at the beginning of the reserve maintenance periods. The latest tenders of the periods were calculated generously, which led to a temporary drop in overnight money market rates. Despite the ample provision of liquidity, competition among bidders in the main tenders picked up; the allotment rates continued to decline during the period under review.

Refinancing operations

The longer-term refinancing operations which reached maturity during the period under review have each been completely replaced, as decided in April by the ECB Governing Council. The bids in these multiple-rate tenders with a three-month maturity also reflected the more stable overnight rates; the allotment rates increased slightly. The overall volume of transactions amounted to a constant € 45 billion. On the whole, the Eurosystem's open market operations rose by € 21.5 billion to € 188.1 billion (see table on page 15). This offset market-related liquidity withdrawals of € 19.2 billion; the most important contributing factors were general government deposits with the Eurosystem and the increasing volume of currency in circulation. Moreover, required reserves rose sharply. The Eurosystem continued to refrain from short-term fine-tuning operations. The credit institutions generally took little recourse to the Eurosystem's standing facilities, with the exception of the last few days of the maintenance periods.

Money stock M3 still slightly exceeds the reference value

In June the money stock M3 in the euro area was 5.0 % higher than in the same period last year, compared with 5.2 % in May and 5.0 % in April. Of late, the three-month moving average of the annual rate of increase has been 5.1%, thus slightly exceeding the reference value of 4 ½ %. However, over the last few months the pace of monetary growth has slackened somewhat. In April and June, in particular, the money stock M3 increased only moderately.[1] But some caution is warranted when interpreting M3 growth at present. For one thing, the extremely heterogeneous developments in the individual countries make an assessment difficult. For instance, the robust increase in the German contribution to M3 (see page 17) contrasts with a slow rise in the French and Spanish contribution and a decrease in the Italian contribution. For another, either temporary special factors or structural influences seem to affect the money stock M3 in some countries. Nevertheless, the overall monetary situation suggests that there is a relatively high amount of liquidity in the euro area at present. If the

1 The ECB has recently started publishing seasonally adjusted data for the monetary aggregates and the component sub-groups M2 – M1 and M3 – M2 on the Internet and in its Monthly Bulletin.

Factors determining bank liquidity *

€ billion;
calculated on the basis of daily averages
of the maintenance periods

Item	1999 May 24 to June 23	1999 June 24 to July 23	1999 May 24 to July 23
I. Provision (+) or absorption (–) of central bank balances by			
1. Change in banknotes in circulation (increase: –)	– 3.2	– 5.1	– 8.3
2. Change in general government deposits with the Eurosystem	– 4.1	– 5.3	– 9.4
3. Change in net foreign exchange reserves 1	– 2.7	+ 2.6	– 0.1
4. Other factors	+ 0.9	– 2.3	– 1.4
Total	– 9.1	– 10.1	– 19.2
II. Monetary policy operations of the Eurosystem			
1. Open market operations			
a) Main refinancing operations	+ 10.4	+ 11.1	+ 21.5
b) Longer-term refinancing operations	– 0.0	+ 0.0	– 0.0
c) Other operations 2	–	–	–
2. Standing facilities			
a) Marginal lending facility	– 0.5	+ 0.1	– 0.4
b) Deposit facility (increase: –)	– 0.2	+ 0.0	– 0.2
Total	+ 9.7	+ 11.2	+ 20.9
III. Change in credit institutions' current accounts (I. + II.)	+ 0.6	+ 1.1	+ 1.7
IV. Change in the minimum reserve requirement (increase: –)	– 0.7	– 1.0	– 1.7
Memo items 3			
Main refinancing operations	132.0	143.1	143.1
Longer-term refinancing operations	45.0	45.0	45.0
Other operations 2	–	–	–
Marginal lending facility	0.3	0.4	0.4
Deposit facility	0.6	0.6	0.6

* For longer-term trends and the contribution of the Deutsche Bundesbank see pages 14* and 15* in the Statistical Section of this Report. — 1 Including end-of-quarter valuation adjustments with no impact on liquidity. — 2 Including monetary policy operations concluded in stage two and still outstanding at the beginning of stage three; excluding outright transactions and the issue of debt certificates (included in item I.4.). — 3 Levels on an average of the maintenance period under review or the last maintenance period.

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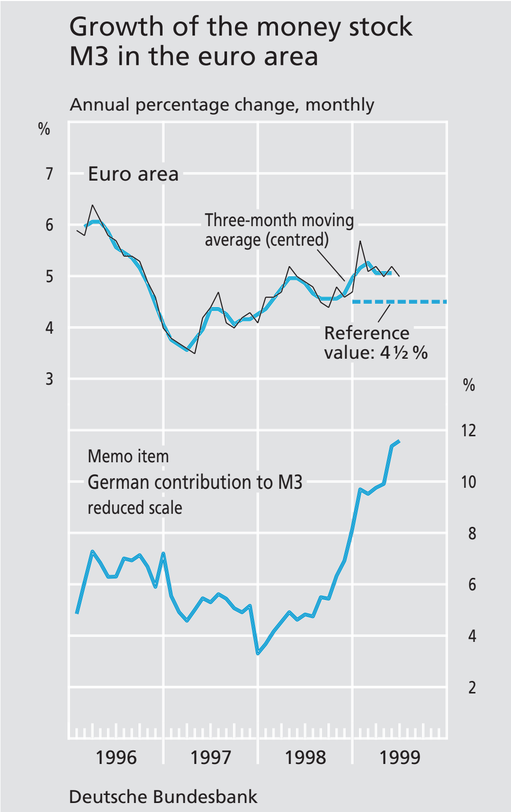


upturn in economic activity is expected to be of a lasting nature, it is particularly advisable to take into account the significance of M3 growth – but also of the development of the narrow money M1 and lending to the private sector – for monetary stability.

Components of the money stock

The individual components of the money stock continued to develop rather differently in the second quarter of 1999. Again, overnight deposits expanded at a particularly strong pace. In June they were 13.1% higher than in the same month last year. The increase in sight deposits during the period under review is probably also due to the relatively drastic decline in interest rates on shorter-run fixed-term deposits following the lowering of interest rates by the ECB Governing Council. In addition, the increased volatility of the financial markets gave further impetus to investors' liquidity preference. Of late, currency in circulation has also increased quite strongly. On the whole, the money stock M1, which includes the two most liquid components (currency in circulation and sight deposits), expanded at a seasonally adjusted annual rate of almost 10 ½ % between April and June. Among the other money stock components, money market funds, money market paper and deposits redeemable at a period of notice of up to three months continued to increase noticeably, while deposits with an agreed maturity of up to two years were reduced.

Counterparts of M3 in the balance sheet

Lending to the private sector, which constitutes one of the balance-sheet counterparts of M3, continued to expand strongly in the second quarter of this year. Credit granted by MFIs to the private sector rose by € 167.9 billion from April to June, compared with € 118.5 billion a year ago. Both holdings of shares and other equity and MFI loans to enterprises and households increased markedly. The continued dynamic growth of private sector lending probably mainly reflects the fact that interest rates on bank advances continue to be very low. Furthermore, the recent rise in longer-term interest rates is likely to have prompted quite a few borrowers to take up loans earlier than they had originally intended. In addition, the lending pattern could also reflect the great number of takeovers and the sizeable direct and portfolio investment outside the euro area. Hence, borrowing by the private sector is likely to have only a limited effect on demand in the euro area goods markets. By contrast, MFI lending to the public sector declined by € 14.0 billion in the second quarter. In addition, monetary capital formation again contributed to reducing the pace of monetary growth as of late. In the second quarter sizeable outflows of funds were once more registered in payments between resident non-MFIs and counterparties outside the euro area due to high levels of direct investment and portfolio transactions. The MFIs' net liabilities vis-à-vis non-euro area residents, whose decrease reflects this development, declined by € 61.5 billion, compared with a drop of € 70.2 billion in the first quarter.

German contribution

The German contribution to M3 growth in the euro area continues to increase at a clearly faster pace than the euro area aggregate. In June it exceeded last year's level by 11.6 %. However, this rate is likely to noticeably overstate the current liquidity situation in Germany. For one thing, this is evidenced by the tax-induced sharp expansion of lending and the money stock at the turn of the year which will only even out later this year. For another, there are persistent return flows of funds from the Euro-market (see page 25 f.) Finally, the German contribution could also have been bloated by the fact that a relatively large percentage of the money market paper and bank debt securities with a maturity of up to two years (which are included in M3) seems to have been purchased by investors from non-euro area countries. Since the outstanding volume of these instruments is shown less the holdings of the euro area MFIs and no additional distinction between euro area and non-euro area buyers has been introduced as yet owing to statistical problems, such liabilities of MFIs vis-à-vis non-euro area creditors are included in the money stock M3. The German share in MFI credit to the private sector is continuing to expand at a slower pace than in the euro area as a whole. As of late, loans were up by 8.1% over last year. The slower increase in lending is probably attributable to the sub-par economic activity in Germany.[2]

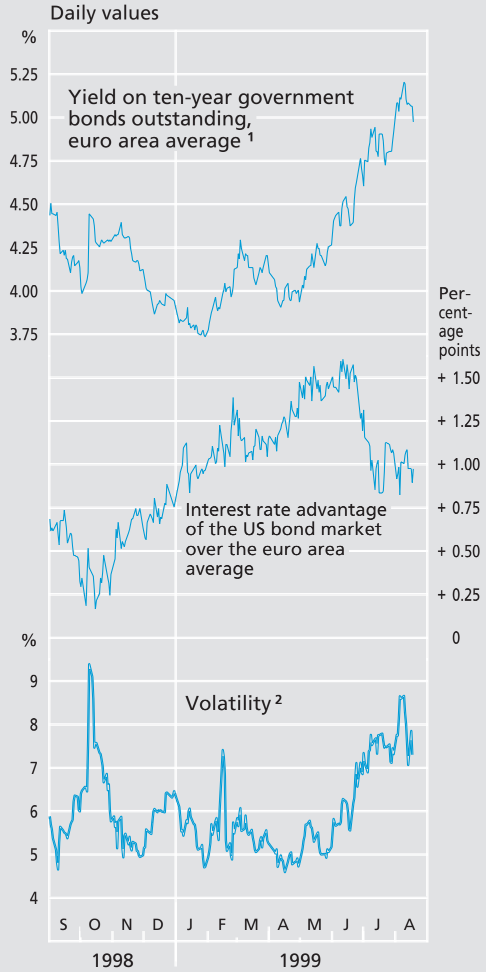
Sharp rise in long-term interest rates owing to international effects ...

Following an all-time low, the long-term interest rates in the euro area rose sharply this summer. The average yield of ten-year government bonds in the euro area countries increased by one percentage point to 5 % between end-March and the beginning of August. The driving force behind the rising interest rates was a reassessment of the situation of the world economy and – to an increasing extent – of the outlook for growth in Europe. When the crises in East Asia and other regions subsided and the international financial markets gradually calmed down, the bond markets of the industrial countries became less significant as "safe havens". This development led to a revision of the long-term interest rates in Europe and the United States, which had been exceedingly low owing to these crises. At the same time, the risk of inflationary pressures in the United States, which recorded sustained and strong growth, returned to the fore. In this context, the long-term interest rates in the US increased markedly. In June the yield on ten-year Treasury bills passed the 6 % threshold for the first time since end-1997. This trend also affected the long-term interest rates in the euro area;

2 For deposit and lending business in Germany, see page 25 ff.

Interest rate movements in the bond market

Daily values



1 Weighted average yield on ten-year government bonds of the euro area countries; GDP-weighted. — **2** Implied volatility of the Bund future.

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yet the respective European rates increased far less sharply by the end of June owing to the still moderate level of economic activity in the major participating countries. Therefore, the interest rate advantage of the US bond market for ten-year instruments expanded to 1½ percentage points by the middle of the year.

... and domestic factors

From the beginning of July further significant shifts occurred in the spread between the United States and the euro area. After the Federal Reserve Board had raised the interest rates at the end of June, the US yields initially remained at roughly 6 %, while European interest rates continued to rise. In the course of a few weeks the interest rate advantage of the United States dwindled to less than one percentage point. At the same time the interest rate gap between the money market and the capital market widened substantially. In mid-July the ten-year yields were around two percentage points higher than the three-month EURIBOR, compared with only 1¼ percentage points at the end of March. While uncertainties regarding the development of the euro exchange rate and regarding some euro area countries' will to carry out economic reforms appear to have contributed to the initial rise in interest rates, the more optimistic expectations regarding cyclical trends in Europe gradually became the driving force in the course of the summer. This is also evidenced by the clear stabilisation of the euro exchange rate at the end of July. In mid-August the ten-year yields in the euro area amounted to 5 % and were thus one percentage point lower than the yield of similar US paper. Up to now the volatility and hence the interest rate uncertainty in the European bond market has remained much higher than this spring. This is a sign that market participants believe expectations in the capital market are still subject to change.

Stock market drops after new record high

In July euro area equity prices reached a new all-time high but then lost ground thereafter. In the context of rising prices in key international stock market centres, European prices – measured in terms of the Dow Jones Euro Stoxx index – increased by 9 % up to mid-July. This development was enhanced by the stabilisation of the US dollar. Shares of the sector machinery and equipment for manufacturing (+ 21 %) and of the chemical industry (+ 16 %) recorded above-average price rises. From mid-July onwards the drastic price drops on Wall Street also exerted pressure on equity prices in the euro area. By the beginning of August the Dow Jones Euro Stoxx index had fallen by roughly 10 % below its last peak, causing price uncertainties to grow markedly. Afterwards prices recovered somewhat. As this Report went to press, they were 6 % lower than their record level of July and 2 % higher than at the end of March.