The economic scene in Germany in spring 2000

The international and European setting

Developments in the world economy

World economy remains on a path of expansion

The cyclical recovery of the world economy has continued at a brisk pace since the turn of 1999-2000. An especially strong growth of output was recorded once more in the east Asian emerging economies, which, after having overcome their serious economic crisis, are again the region with the highest growth rates worldwide. In addition, the upswing which had started during the course of 1999 in the Latin American region seems to have stabilised further. The central and eastern European countries in transition are likewise on a growth path. The same applies – with qualifications – to Russia, which recorded an increase in output amounting to over 3 % in 1999 and, according to official figures, an even higher growth rate in the first quarter of 2000.

In the industrialised countries, too, a sharp increase in aggregate output was recorded in the winter months of this year. In this group of countries, the United States continues to be the pace-setter; its economic growth actually accelerated again in the winter half of 1999-2000. In the euro area, the cyclical recovery which had got under way in 1999 continued at a brisk pace. By contrast, the upswing in other western European countries, particularly the United Kingdom, slackened somewhat. Although, in this context, Japan still brings up the rear, after its economy had suffered another cyclical setback in the second half of 1999, the expansionary forces seem to have regained the upper hand.

Altogether, therefore, the upswing in the industrial countries was curbed only slightly by the sharp rise in oil prices in the course of last year – unlike the situation following the surges in oil prices during the seventies and early eighties. The main reason for this was probably that the industrial countries' dependence on petroleum was reduced significantly by economies and substitutions and by the continued structural change in favour of the services sector. Moreover, the general price situation was far more favourable than it had been in the two comparative periods. Even so, the rise in oil prices influenced the movement of inflation rates both in the United States and in western Europe during the winter months.

Outlook for 2000 and 2001

In the light of the very buoyant global economic conditions and the favourable overall outlook, the International Monetary Fund (IMF) revised its autumn 1999 estimate of global output growth in 1999 and its forecast for 2000 markedly upwards, viz. by ½ percentage point and ¾ percentage point, respectively, to 3¼% and 4¼%. In 2001, global GDP growth is expected to slow down marginally to 4%, mainly reflecting expectations of a downturn in economic activity in the United States. The estimates for the growth of world trade this year were revised upwards by no less than 1 percentage point, to 8%, owing, in particular, to a reassessment of the emerging economies. Next year, the IMF expects that, in keeping with the slight decline in global output growth, the increase in cross-border trade in goods and services will slow down, too. With regard to price movements at the consumer level, the inflation rate in the "advanced economies" is forecast to rise by 1½% in 1999, to 2% in both 2000 and 2001, mainly as a result of the higher oil prices. In the developing countries and emerging economies, by contrast, the continued strong upward pressure on prices might slacken further. The central and eastern European countries in transition are likewise expected to record a decline in the average rate of inflation, largely reflecting the predicted stabilisation successes in Russia.

IMF forecasts for 2000 and 2001

Item	1998	1999	2000	2001
Real gross domestic product	Change from previous year in %			
Advanced economies [1]	+ 2.4	+ 3.1	+ 3.6	+ 3.0
of which				
United States	+ 4.3	+ 4.2	+ 4.4	+ 3.0
Japan	– 2.5	+ 0.3	+ 0.9	+ 1.8
EMU	+ 2.8	+ 2.3	+ 3.2	+ 3.2
Consumer prices [2]				
Advanced economies [1]	+ 1.5	+ 1.4	+ 1.9	+ 2.0
of which				
United States	+ 1.6	+ 2.2	+ 2.5	+ 2.5
Japan	+ 0.6	– 0.3	+ 0.1	+ 0.9
EMU	+ 1.2	+ 1.2	+ 1.7	+ 1.6
Unemployment	Number of unemployed as % of the labour force			
Advanced economies [1]	6.7	6.4	6.0	5.8
of which				
United States	4.5	4.2	4.2	4.2
Japan	4.1	4.7	4.7	4.6
EMU	10.9	10.1	9.4	8.9

Source: IMF, World Economic Outlook, May 2000. — **1** Industrial countries plus Israel, China (Taiwan), Hong Kong (Special Administrative Region), Republic of Korea and Singapore. — **2** Consumer price index.

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The risk of a "hard landing"

The recent IMF forecast is based, in essence, on the assumption of a "soft landing" of the US economy, a sustained recovery in Japan and a steady upswing in Europe and the emerging economies. In an alternative scenario, it is assumed – in order to facilitate the assessment of possible risks – that this year the global expansion will accelerate even more strongly than is currently being expected. That would enlarge the existing imbalances, particularly in the United States, where they are reflected in a current account deficit which is probably unsustainable over the long term, and in continued, exceptionally high stock market prices. That would increase the probability of a "hard landing" of the US economy not later than next year, involving substantial growth losses in 2001 which, according to IMF calculations, might amount to 2 percentage points for the United States, ¾ percentage point for the euro area, and 1 percentage point for the entire world economy. Admittedly, it is impossible to judge how realistic such an alternative scenario is; most forecasting institutions currently consider it unlikely, and are counting on a "soft landing" of the US economy.

United States

To date, there are no indications of a perceptible slowdown in the pace of growth in the United States. Provisional calculations suggest that, in the winter months, real GDP rose by a seasonally and working-day-adjusted 1¼ %, compared with the last quarter of 1999, and was 5 % up on the year. Hence US economic growth is running well above the potential growth path, which the IMF puts at just over 3 %. In the first quarter of 2000, growth was again stimulated most by private consumption, which increased by 2 %, after seasonal adjustment, and was 6 % higher than a year before. Similar effects were generated by the very buoyant investment activity, particularly in the private non-residential sector. Overall economic growth was significantly curtailed by the normalisation of stockbuilding, which had previously been stepped up particularly sharply owing to fears of computer problems. In addition, with real exports stagnating after seasonal adjustment and imports rising substantially, real net exports slid further into deficit, latterly amounting to just over 4 % of GDP.

The steep year-on-year rise in inflation at the consumer level, from 3.2 % in February to 3.7 % in March, has been interpreted by the US public as a further sign of imminent cyclical overheating. In this context, the higher rate of core inflation, in particular – which rose to 2.4 % (against 2.1 % in February), and which is calculated excluding energy and food and therefore reflects "home-grown" inflationary pressures better than the overall consumer-price index – triggered major price adjustments on the stock market. In April, the rate of price increases slowed down again, owing, in particular, to a decline in oil prices. However, the core inflation rate, at 2.2 %, was still markedly higher than at the beginning of the year. Fears of a further clouding of the price situation are fuelled, in particular, by the sharper rise in labour costs during the winter months and the persistent tightness of the labour market.

Japan

After the turn of 1999-2000, Japan seems to have overcome the renewed bout of economic weakness which affected the country in the second half of 1999, mainly on account of flagging fiscal stimuli. The business situation of enterprises, for example, was generally assessed more optimistically in the first quarter of this year than it had been before. Moreover, significant increases in profits are now expected. In addition, after capacities had been considerably reduced during the past few years, enterprises' propensity to invest now appears to be on the rise again. Foreign demand has likewise increased perceptibly of late. Industrial output grew by just over 2 ½ %, after seasonal adjustment, in the first quarter, thus being 6 ½ % up on the year. However, in the last few years there has often been a remarkable divergence between the course of real GDP and industrial output growth. This has cast doubts on the informative value of the national accounts "at the end of a series". The upswing is being curbed, in particular, by the consistently weak consumer demand of households. According to the IMF forecast, economic growth might average around 1 % in the year 2000.

United Kingdom

The British economy perceptibly lost momentum after the turn of 1999-2000. Initial estimates suggest that real GDP rose by "only" ½ % after adjustment for seasonal and working-day variations, compared with the level reached in autumn 1999, when it had increased by ¾ %; the year-on-year rate of growth of real GDP was 3 %. The main reason for the slower pace of growth was that the manufacturing sector had to curtail its output over time. That owed a great deal, in turn, to the high exchange rate of the pound sterling against the euro. The expansionary forces in the services sector, by contrast, barely slackened; the real value added in that sector was a seasonally adjusted ¾ % higher than in the previous quarter. However, the fact that price increases at the consumer level (excluding mortgage rates) continued to slow down perceptibly last year and, at 1.9 % of late, remained well below the official inflation target, should be rated a welcome side-effect of the high exchange rate of the pound sterling.

Macroeconomic trends in the euro area

Strong upswing in the autumn of 1999 ...

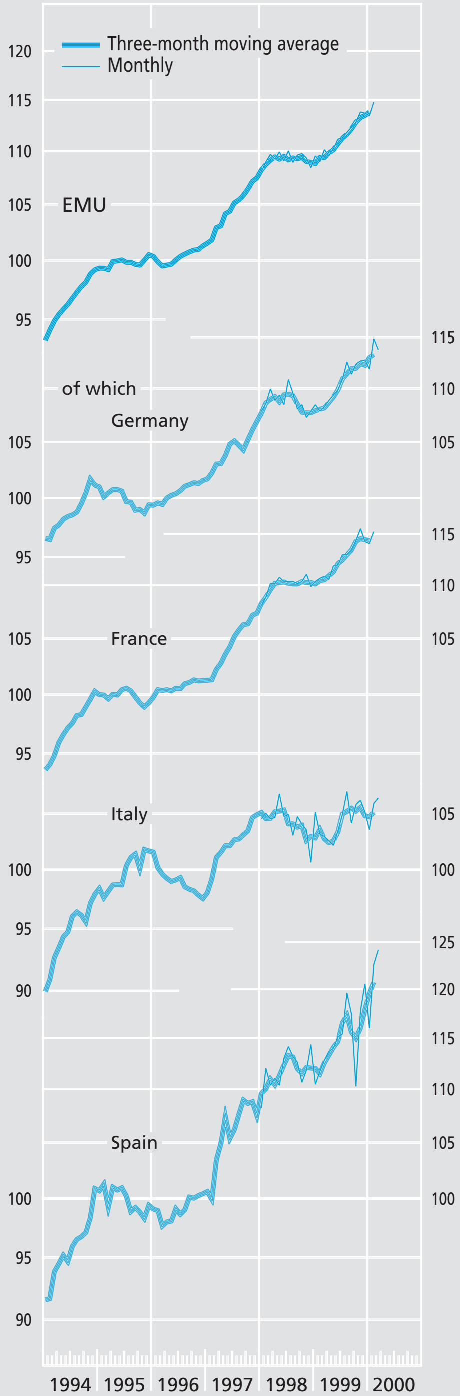
Altogether, the euro-area economies have progressed further along the growth path on to which they had moved during the summer months. In the final quarter of 1999, real GDP grew by a seasonally adjusted ¾ %, and was thus 3 % higher than a year before. The strongest contributions to growth came from private consumption and stockbuilding, which (possibly owing to fears of computer problems) had been sharply increased around the turn of the year. Real net exports likewise increased over time, albeit only moderately; in this context, exports and imports mutually boosted each other – a dynamic element which is not reflected in the balance.

... and the winter of 2000

According to the information currently available, the favourable economic trend, which was embedded in a buoyant international setting, persisted after the turn of 1999-2000. In April, the industrial confidence indicator reached its highest level since the beginning of 1995, which was very close to the peak recorded during the upswing of 1987-91. The survey data suggest that consumer confidence has remained at a very high level of late. Industrial capacity utilisation has likewise increased sharply since the beginning of the year; in April, it was almost 2 ½ % above the level recorded in mid-1999, when the euro area had been in a short-lived trough. The

Industrial output * in the euro area

1995 = 100, seasonally adjusted; log. scale



* Including mining and energy, excluding construction. — Sources: Eurostat, national statistics.

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average degree of utilisation in the nineties was exceeded by the same amount. At first glance, the movement of industrial output in January-February – more recent data are not yet available – is not quite consistent with this picture, since such output was only a seasonally adjusted ¼ % above the figure for the previous two-month period. The slight decline in industrial output in January, which is the reason for this development, might, however, result from the fact that production was cut down in many firms around the turn of the year and at the beginning of January owing to fears of computer problems. The existence of such a special factor is also suggested by the renewed sharp rise in industrial output in February. Another indication of the entrenched buoyancy of economic trends in the euro area is the sustained improvement in the labour-market situation. In March, the standardised unemployment rate stood at 9.4 %, compared with 9.6 % in December and an average of 10.0 % during 1999.

Favourable growth forecasts

According to the most recent forecasts by the IMF and the European Commission, real GDP will increase by 3 ¼ % to 3 ½ % this year, implying the sharpest rise since 1991. In 2001, growth is expected to slow down only slightly. Accordingly, the unemployment rate might decline to below 9 % of the labour force by 2001. In this connection, the cyclical gap between the euro-area countries is likely to narrow further.

Prices

Current price movements in the euro area diminished somewhat in April despite the increasing weakness of the euro. After consumer-price increases – measured in terms of the year-on-year rate of change in the Harmonised Index of Consumer Prices – had reached 2.1% in March, and had thus slightly exceeded the ceiling of the margin set by the ECB Governing Council for price stability (defined as a year-on-year increase of less than 2%), the rise moderated again, to 1.9% of late. Prices on the international oil markets were the main reason for both the previous increase and the recent slowdown in inflation. For the rest, price movements remained comparatively limited until the end of the period under review. The sharpest price rises were recorded in the services sector, where the previous year's level was exceeded by around 1¾% in April. By contrast, the prices of industrial goods included in the consumer price index were no more than ½% up on the year, and seasonal food prices continued to be only marginally higher than in the same period of 1999. The sharpest price increase in April was once again recorded in Ireland (5.0%), whereas prices in France and Germany rose only moderately (by around 1½%). According to the most recent forecasts of the IMF and the European Commission, the rate of inflation in the euro area will average around 1¾% in 2000. However, this forecast was made on the assumption of a stabilisation of exchange rates.

Trends in unemployment in the euro area

Standardised unemployment rate in %, seasonally adjusted

Item	1999		2000	
	Year	4th qtr	1st qtr	March
Euro area	10.0	9.7	9.5	9.4
of which				
Austria	3.7	3.6	3.5	3.4
Belgium	9.0	8.8	8.6	8.5
Finland	10.2	10.1	10.4	10.6
France	11.3	10.8	10.4	10.2
Germany	8.7	8.7	8.4	8.4
Ireland	5.8	5.3	5.0	5.0
Italy	11.3	11.1	11.1	.
Luxembourg	2.3	2.2	2.2	2.2
Netherlands	3.3	2.7	.	.
Portugal	4.5	4.2	4.2	4.1
Spain	15.9	15.2	15.0	14.9
Memo item				
EU	9.2	8.9	8.8	8.7

Source: Eurostat.

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Current account and exchange-rate developments in the euro area

Euro-area exports to third countries

In the first few months of this year, economic activity in the euro-area countries continued to be strongly stimulated by foreign trade. In January-February 2000, for example, (more recent data are not yet available) euro-area exports to third countries exceeded their 1999 level by no less than 22%. Thus, exporters in the euro-area countries benefited particularly significantly from the all-round recovery of the world economy.

Imports

At the same time, there was a substantial increase in imports, with the result that the stimulating effects imparted by euro-area foreign trade mutually reinforced each other in both directions. Owing to the sharp price increases recorded until March this year on the crude oil markets, the associated nominal income transfers from the euro area to the oil-producing countries actually distinctly exceeded the concurrent growth of European exporters' turnover. On balance, import payments to non-euro-area suppliers rose by

29 ½ %. Estimates suggest that about 20 percentage points of that ratio are attributable to price increases, with the weakness of the euro playing a role, in addition to the higher prices for petroleum and other commodities. Hence in the first two months of this year, the euro-area trade surplus vis-à-vis third countries – at slightly more than € 7 billion – was lower than in the same period of last year (€ 11½ billion).

Current account

On the other hand, the deficits in the area of "invisible" current account transactions declined somewhat in January-February 2000, compared with the previous year. This was mainly attributable to the development of current transfers, where the deficit was distinctly lower, mainly as a result of refunds from the EU budget. Overall, the current account of the euro area showed a deficit of just over € 4 billion in January-February 2000, compared with a largely balanced result in the corresponding period of last year.

Exchange-rate movements

In the spring months, the euro continued to come under selling pressure despite the favourable conditions, in terms of stabilisation policy, within the euro area and the fact that the outlook for growth had improved all round in the meantime. This applies vis-à-vis virtually all major currencies. However, attention was focused especially on the rate of the euro against the US dollar, which, underpinned by market participants' confidence in the strength and flexibility of the US economy, reached ever-new record highs vis-à-vis the euro, even though the prospects for economic growth seem to have shifted in favour of the euro area. Even the sharp price adjustment on the US technology market, which, until then, had been considered a magnet for capital seeking investment, was unable to reverse that trend. Finally, in the light of investors' apparently strong preference for US dollar investments, the interest-rate increases in the euro area had no discernible impact either, particularly since they failed to narrow the interest-rate advantage of the US dollar because of the concurrent rises in interest rates on dollar markets. Even the steadily growing US current account deficits and the resultant uncertainties failed to affect the positive underlying sentiment in favour of the US dollar. Altogether, the euro has lost 12 % of its value since the beginning of the year and was quoted in April almost 25 % weaker than in January 1999, when it had been launched. Given the fixed conversion rates between the euro and the Deutsche Mark, the US dollar, at DM 2.20, has latterly been more expensive than at any time since June 1986.

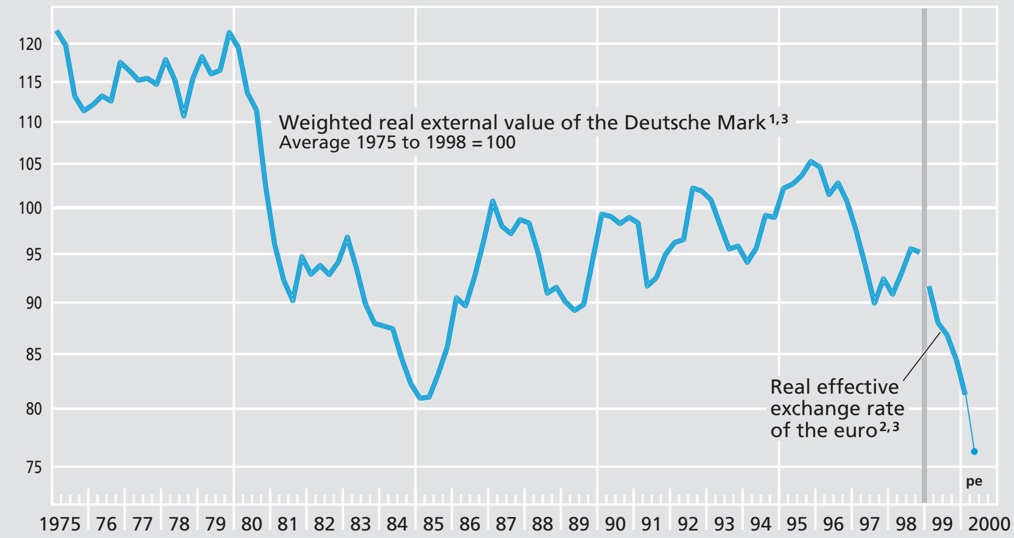
US dollar

Yen and pound sterling

Similar losses were recorded by the European single currency vis-à-vis the yen and the pound sterling (28 ½ % and 16 %, respectively, compared with the beginning of 1999). In particular, in the wake of the US dollar surge, the rates of the euro against the British currency reached a new low, at £ 0.57 per euro, during the period under review. Recently, however, the euro has been quoted somewhat higher again, at £ 0.60. After a temporary firming at the beginning of the year, when the euro had been quoted at more than 110 yen, the euro's rate against the yen fell below the 100 yen mark at the end of March and subsequently depreciated mark-

Weighted real external value of the Deutsche Mark and real effective exchange rate of the euro

Quarterly



1 Weighted against nine non-euro-area industrial countries. — **2** Against 13 industrial and developing countries. Values of the real effective exchange rate of the euro and the weighted real external value of the Deutsche Mark linked through the real effective exchange rate of the "theoretical" euro in the 4th quarter of 1998. — **3** Nominal external values and nominal effective exchange rates, respectively, adjusted for differences in price movements, measured in terms of consumer prices. — ● = Latest position: May 17, 2000.

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edly below that rate. This implies that the euro has lost more than one-quarter of its value against the Japanese currency since the beginning of 1999. In addition to return flows of foreign capital, which are not unusual towards the end of the fiscal year, Japan's persistently large current account surplus and the improved profitability of Japanese enterprises have presumably buttressed the yen. Moreover, after the weaker-than-expected economic growth at the end of last year, a somewhat more optimistic assessment of the further outlook for growth now seems to be gaining ground in the markets. By contrast, the well-known structural problems of the Japanese economy appear to have been relegated somewhat into the background in the eyes of market participants. However, those structural problems account for the relatively high degree of uncertainty underlying market players' assessments of the yen's exchange-rate movements in currency-options trading since the spring.

Effective exchange rate of the euro

On balance, since the beginning of the year the euro has lost more than 7 % of its value as a weighted average against the 13 principal trading partners of the euro-area countries, after having already depreciated by almost 14 % in the course of last year. Obviously, the euro's internal strength is not being duly appreciated on the foreign exchange markets. Temporary distortions of this kind are nothing new on those markets. Examples of such overshooting of exchange rates can also be found in the history of the Deutsche Mark. However, such false valuations are harmful to the reputation of the young currency. Moreover, the short-term competitive advantages which exporters from euro-area countries are currently deriving from the depreciation of the euro must not be overrated. The ratio of merchandise exports to total euro-area GDP has latterly come to 13 %. The stimuli to growth emanating from the export side have very largely been attributable to stabilisation in the regions in crisis and to the subsequent revival of global economic growth. Compared with that, the effects resulting from exchange-rate movements have played a minor role. At all events, the temporary competitive advantages deriving from the depreciation cannot offset the potential damage done to confidence.

Valuation of the exchange rate

In the period under review, the foreign exchange markets appear to have been driven by an intrinsic momentum which increasingly lost touch with the fundamentals. While the euro's depreciation in the course of 1999 – and particularly in the first half of the year – could be explained and substantiated quite consistently in terms of the outlook for growth and for interest rates (which had shifted to the disadvantage of the euro area at the time), all the relevant yardsticks for assessing exchange-rate relationships are now pointing to an overreaction. This conclusion is suggested not only by internal analyses of the Deutsche Bundesbank, but also by corresponding analyses carried out by international organisations, such as the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD). Despite all the uncertainties surrounding the underlying estimates of the undervaluation, the qualitative judgement of a faulty valuation of the euro on the part of market participants appears to be rather well founded in the light of the sheer magnitudes of 20 % to 30 % which are under debate.

Improved fundamentals

Obviously, the fact that the economic outlook for the euro area has meanwhile radically improved was not given adequate consideration. This applies to both the economic situation and the badly-needed structural improvements. At all events, some progress has been made and some measures have been initiated which would warrant a more optimistic assessment of the prospects for the euro area's future. Some examples of this are the progress towards the consolidation of public sector budgets and the manifest political will to continue that policy, the tax reform plans in major member states, the opening-up and liberalisation of the goods and services markets, and – not least – the increased flexibility of working hours and the indications of a wage policy which fosters employment. This does not alter the fact that many of these reforms are still to be implemented, and that other urgent tasks in other areas, such as the reform and modernisation of the social security systems and a greater differentiation of wage structures, have still not been tackled. Even so, at least a large number of European countries have already made significant headway along the reform path.

Monetary policy and the financial markets in the euro area

In March and April, the ECB Governing Council raised central bank rates anew. As in Feb-

Interest-rate increases in March and April

ruary this year, the Governing Council increased the key interest rates in the money market uniformly by one-quarter of a percentage point each. Accordingly, since April 28, the interest rates on the marginal lending facility and the deposit facility have been standing at 4.75 % and 2.75 %, respectively. Since then, main refinancing operations have been offered in the form of fixed-rate tenders at a fixed interest rate of 3.75 %. Hence, central bank rates are now 1¼ percentage points higher than in the autumn of last year, when the Governing Council started gradually to tighten its monetary policy stance. By raising its interest rates, the Governing Council countered the increasing risks to price stability. Against the backdrop of an accelerating upswing, such risks arose, in particular, from the sharp expansion of the monetary and credit aggregates, and from the euro's depreciation on the foreign exchange markets. By adopting a forward-looking strategy, monetary policy makers are contributing not only to the safeguarding of monetary stability but also to sustained economic growth.

Rise in money-market rates

The interest-rate measures taken in March and April had largely been expected by market participants. Correspondingly, time-deposit rates had already risen in all maturity categories well beforehand. Even after the recent increase in interest rates, the upward movement of time-deposit rates persisted unabated. Altogether, in mid-May time-deposit rates were around 80 basis points above their level of mid-February.

In the period under review, the movement of overnight interest rates was materially affected by market expectations of rising interest rates.

EONIA markedly above the refinancing rate

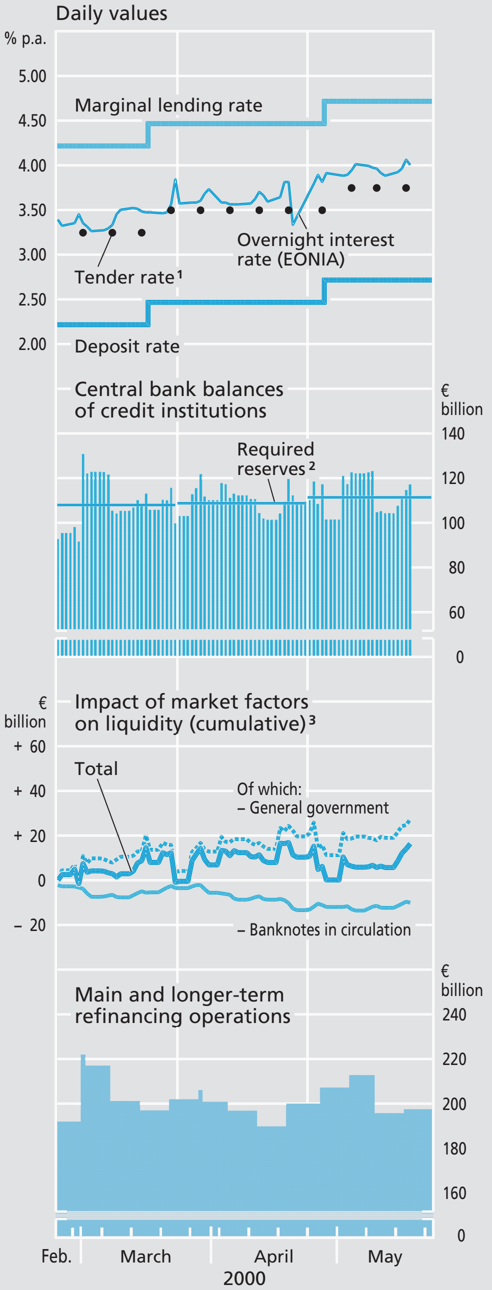
Despite the adequate provision of funds by the Eurosystem in March and April, which tended to curb the fluctuations in credit institutions' central bank balances, and enabled credit institutions to comply quite steadily with their reserve requirements, EONIA usually stood noticeably above the main refinancing rate. This interest-rate pattern encouraged competition among the bidders for the main refinancing operations, which were all offered in the form of fixed-rate tenders. The result was that allotment rates reached new all-time lows of below 2 %.

Liquidity management via main refinancing operations

When gauging the main refinancing operations, the Eurosystem had to take particular account of the high volatility of public sector deposits and of the faster growth of currency demand over the Easter holidays. In addition, the inflow of liquidity arising from the transfer to the Federal Government, on April 6, of the Bundesbank's profit for 1999 had to be offset, and the decision to reduce the outstanding volume of longer-term refinancing operations taken by the ECB Governing Council in January had to be taken into account. At the beginning and the end of March, main refinancing operations "left over" from the previous year, which amounted to € 25 billion each, and which compared with concurrent new contracts totalling only € 20 billion each, reached maturity. Overall, between February and April, credit institutions received liquidity amounting to € 5.9 billion by virtue of autonomous factors determining liquidity. At the same time, required minimum reserves increased by € 1.2 billion, in line with the con-

Interest-rate movements and liquidity management in the Eurosystem

Daily values



1 Interest rate for main refinancing operations. — 2 Maintenance periods: February 24 to March 23, March 24 to April 23, and April 24 to May 23, 2000. — 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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tinued strong monetary expansion. These changes were accompanied by a reduction of € 3.7 billion net in the Eurosystem's open market operations, and increased recourse to the deposit facility (see the table on page 17). Particularly towards the ends of the reserve maintenance periods, credit institutions resorted to the deposit facility. Recourse to the marginal lending facility remained limited to frictional amounts.

Renewed increase in monetary growth

In the first quarter of this year, the seasonally adjusted growth of the money stock M3, which had slowed down slightly towards the end of last year, accelerated again. Particularly in February and March, a sharp rise in the monetary aggregates was recorded. At the end of March, M3 in the entire euro area surpassed last year's level by 6.5 %, compared with 6.2 % at the end of December 1999. The three-month moving average of year-on-year growth rates between January and March was 6.0 %; thus monetary growth remained some 1½ percentage points above the reference value of 4½ %. Although the interpretation of monetary expansion continues to be complicated by statistical uncertainties, rather divergent developments in the individual euro-area countries and, more recently, by widespread expectations of a rise in interest rates, the provision of liquidity to the economy definitely remains abundant. Past experience has shown that this situation involves higher risks to future price stability. By the interest-rate decisions it has taken since the autumn of last year, the ECB Governing Council has demonstrated its determination to counteract such risks.

Components of the money stock M3

Among the individual components of M3, overnight deposits rose sharply in the first quarter of 2000; at the end of March, their year-on-year growth rate was 11.0 %, compared with 14.1% a year before, when the transition to the euro had led to an abrupt rise in sight deposits. By contrast, currency holdings were reduced, as expected, in the first quarter of this year, after they had been significantly increased towards the end of 1999 on account of the uncertainties prevailing at the time in connection with the "millennium change". At the end of March, the money stock M1 was 9.9 % higher than a year before. Investors' strong preference for liquid funds is likely to have been fostered recently both by the improved economic situation in the euro area and by pronounced expectations of an increase in interest rates in the financial markets. In the period under review, the other shorter-term deposits remained largely unchanged in the aggregate, and after seasonal adjustment. By contrast, heavy sums were invested in marketable financial instruments – above all, money-market-fund certificates, money-market paper and repo transactions. They benefited from the rise in money-market rates and the flattening-out of the yield curve.

Balance-sheet counterparts

In terms of the balance-sheet counterparts, monetary growth in the first quarter of 2000 was fuelled, in particular, by persistently strong lending to the private sector. At the end of March, lending by MFIs to households and enterprises was 10.9 % up on the year, compared with 10.5 % at the end of December 1999. In this context, not only securitised lending but also loans were markedly in-

Factors determining bank liquidity *

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

Item	2000 Feb. 24 to Mar. 23	Mar. 24 to Apr. 23	Feb. 24 to Apr. 23
I. Provision (+) or absorption (–) of central bank balances by			
1. Change in banknotes in circulation (increase: –)	– 0.0	– 2.1	– 2.1
2. Change in general government deposits with the Eurosystem	– 2.5	+ 6.1	+ 3.6
3. Change in net foreign exchange reserves 1	+ 1.4	+ 7.9	+ 9.3
4. Other factors 2	+ 0.7	– 5.6	– 4.9
Total	– 0.4	+ 6.3	+ 5.9
II. Monetary policy operations of the Eurosystem			
1. Open market operations			
a) Main refinancing operations	+ 5.2	+ 0.6	+ 5.8
b) Longer-term refinancing operations	– 4.3	– 5.2	– 9.5
c) Other operations	–	–	–
2. Standing facilities			
a) Marginal lending facility	+ 0.1	+ 0.0	+ 0.1
b) Deposit facility (increase: –)	– 0.1	– 0.6	– 0.7
Total	+ 0.9	– 5.2	– 4.3
III. Change in credit institutions' current accounts (I. + II.)	+ 0.5	+ 1.1	+ 1.6
IV. Change in the minimum reserve requirement (increase: –)	– 0.5	– 0.7	– 1.2
Memo items 3			
Main refinancing operations	136.1	136.7	136.7
Longer-term refinancing operations	66.2	61.0	61.0
Other operations	–	–	–
Marginal lending facility	0.2	0.2	0.2
Deposit facility	0.3	0.9	0.9

* 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 conducted in Stage Two and still outstanding at the beginning of Stage Three (outright transactions and the issuance of debt securities). — 3 Levels as an average of the maintenance period under review or the last maintenance period.

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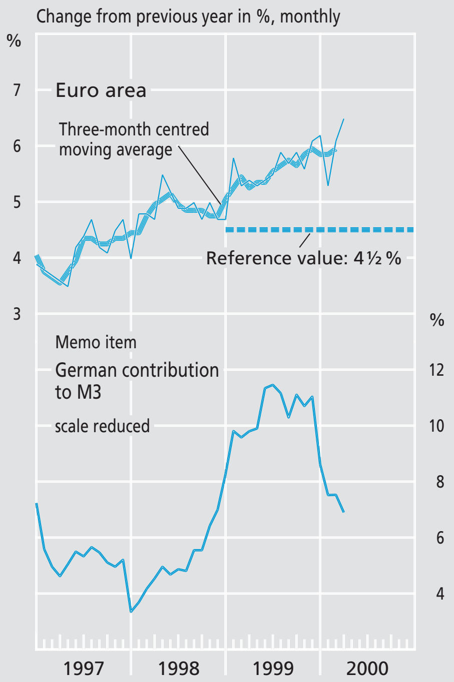
Growth of the money stock M3 in the euro area



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creased; between January and March, they rose at a seasonally adjusted annual rate of just under 13 %, compared with 7 ½ % in the final quarter of 1999. The economic recovery, the rise in real property prices in some euro-area countries and the continued merger and acquisition activity presumably contributed to this dynamic growth. Expectations of rising interest rates may have played a role, too. By contrast, lending to the public sector was cut back; this affected both loans and securitised lending. Monetary capital formation, which had accelerated comparatively continuously throughout 1999, lost some of its momentum in the first quarter of 2000 owing to the relatively strong expectations of a rise in interest rates. By contrast, the payment transactions of resident non-MFIs with non-euro-area residents, where a considerable outflow of funds was recorded in the first quarter, had a dampening effect on monetary growth.

Germany's contribution

In the first quarter of 2000, the seasonally adjusted German contribution to euro-area M3 grew somewhat more strongly than in the previous quarter. Even so, in the period under review monetary expansion in Germany was slower than that in the euro area as a whole. However, owing to the steep rise in the first half of 1999, the year-on-year change in the German contribution to M3 at the end of March, at 6.9 %, was slightly higher than the corresponding rate for the euro area. In fact, though, the expansion of liquidity in Germany probably continues to be statistically overstated; according to the balance-of-payments statistics, investors outside the euro area once again bought a rather large amount of German money-market paper in the first quarter of this year.[1]

Capital-market rates moving sideways

In the spring, capital-market rates in the euro area remained virtually unchanged, on balance, despite some marked fluctuations. At the beginning of the year, the yield on ten-year government bonds of euro-area countries initially went up to 5 ¾ %. Between mid-February and mid-April, it declined by ½ percentage point to an average of just over 5 ¼ %. Thereafter, the yield increased somewhat again, having reached slightly more than 5 ½ % by the time this Report went to press. This means that capital-market rates in

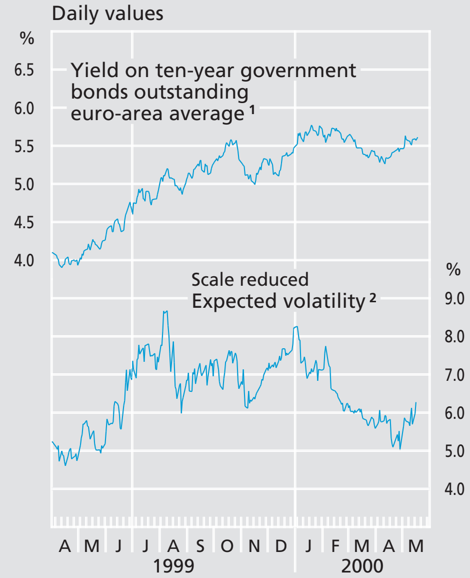
1 Since the outstanding amount of such paper is reported exclusive of the holdings of domestic MFIs and – owing to statistical difficulties – up to now no distinction has been made between purchasers from the euro area and those from non-euro-area countries, such liabilities of MFIs to investors residing outside the euro area go into the monetary aggregate M3.

Europe are still decidedly low. This is not least the upshot of the Eurosystem's policy, which is geared consistently towards the objective of price stability. By the tightening of its monetary policy, initiated in November 1999 and intensified by the interest-rate moves of February, March and April 2000, the ECB Governing Council has apparently been able to keep long-term inflation expectations in check, despite the markedly improved outlook for the economy and growth. Accordingly, the gap between capital-market rates and money-market rates has narrowed substantially since the beginning of the year, namely by approximately 100 basis points, to 1¼ percentage points in mid-May. The higher money-market rates also spread to shorter-term bonds, with the result that the yield curve in the bond market flattened out as well (see also pages 21 and 23). Moreover, the prospects of stronger growth in the euro area, with prices remaining largely stable, are likely to have contributed to the decline in uncertainty on the capital market. The implicit volatility of Bund futures, for example, which is indicative of the price fluctuations expected by market participants in the futures market in the short run, has dropped significantly since December 1999.

Strong temporary interest-rate impact from the United States

In the spring, interest-rate trends on the European capital market were repeatedly eclipsed by pronounced shorter-term movements. Such fluctuations primarily reflect the traditionally strong impact of interest-rate stimuli from the United States. The yield on ten-year US government bonds outstanding fell – at its peak – by more than 1 percentage point between the beginning of this year and mid-April. This striking decline was fostered, in part, by the decrease in oil prices and further interest-rate increases by the Fed, which, at least temporarily, exerted a dampening effect on the long-term inflation expectations reflected in capital-market rates. Downward pressure on interest rates was likewise exerted by the significant price adjustment on the US stock market at the end of March, which triggered increased demand by investors for bonds and notes. Finally, another important factor lowering interest rates is the reduction of the supply of US government bonds, which is expected by market participants on account of sustained US Federal budget surpluses. Against this background, the interest-rate advantage of ten-year US Treasuries over comparable bonds of euro-area countries had narrowed from over 1 percentage point at

Interest rate movements in the bond market



1 Weighted average yield on ten-year government bonds of the euro-area countries; GDP-weighted. — 2 Implicit volatility of EUREX Bund futures.

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the end of 1999 to no more than ⅔ percentage point by mid-April. By the middle of May, the interest-rate differential had widened again to 1 percentage point as US interest rates went up anew.

Moderate rise in equity prices, accompanied by increasing volatility

So far this year, equity prices in the euro area have risen only slightly on balance. Between January and mid-May, the prices of European shares – measured in terms of the Dow Jones Euro STOXX – went up by 4 %, after having increased by more than 30 % in the final quarter of 1999. This bull market, which owed much in Europe, too, to high-tech companies, initially persisted at the beginning of this year – albeit with markedly increasing price fluctuations. At the beginning of March, however, it culminated in an adjustment phase lasting until mid-April, during which equity prices in the euro area lost over one-tenth of their value. It was particularly striking that, during these periods, European prices diverged noticeably from price trends in the United States. The usual parallel movement of equity prices did not resume until the beginning of May, when a phase of recovery set in on the stock exchanges in Europe and overseas. At present, the price levels of European equities are being buttressed by the strong revival of growth and the continued comparatively low interest-rate level in the euro area. Another factor tending to push up share prices is the persistently brisk merger and acquisition activity, which likewise reflects the structural change in the euro area and the global increase in competitive pressures.